## Question #1 of 41

Question ID: 1573013

Assume the U.S. economy is undergoing a recession. In its efforts to stimulate the economy by trying to influence short-term interest rates the Fed is *most likely* to take which two actions?

**A)** Buy Treasury securities and decrease bank reserve requirements. ✓

**B)** Sell Treasury securities and decrease bank reserve requirements. ✗

**C)** Sell Treasury securities and increase bank reserve requirements. ✗

**Explanation**

If the economy is in a recession, the Fed is likely to attempt to decrease short-term interest rates. Thus, the Fed will buy Treasury securities and decrease bank reserve requirements.

(Module 15.1, LOS 15.b)

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## Question #2 of 41

Question ID: 1573016

Which of the following policy tools is the *least likely* to be available to the U.S. Federal Reserve Board?

**A)** Setting the discount rate at which banks can borrow from the Federal Reserve. ✗

**B)** Requiring the banking system to tighten or loosen its credit policies. ✓

**C)** Buying and selling Treasury securities in the open market. ✗

**Explanation**

The U.S. Federal Reserve can encourage or persuade banks as a whole to tighten or loosen their credit policies, but it cannot compel them to do so.

(Module 15.1, LOS 15.b)

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## Question #3 of 41

Question ID: 1573012

Which of the following statements regarding U.S. Federal Reserve open market operations is *least accurate*?

**A)** If the Fed wants to stimulate the economy, it will sell Treasury securities to banks.

**B)** When the Fed buys Treasury securities, short-term interest rates will generally decrease.

**C)** When the Fed sells Treasury securities, excess reserves decrease.

**Explanation**

If the Fed intends to stimulate the economy, they will buy, not sell, Treasury securities. Buying Treasury securities injects reserves into the banking system.

(Module 15.1, LOS 15.b)

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## Question #4 of 41

Question ID: 1573034

A central bank follows an inflation targeting monetary policy. If the permissible band is plus-or-minus 2% around the target inflation rate, the central bank is *most likely* to choose a target inflation rate of:

**A)** 0%.

**B)** 1%.

**C)** 3%.

**Explanation**

Because they consider deflation to be disruptive to an economy, central banks typically choose inflation targets and bands that do not include a negative rate of inflation.

(Module 15.2, LOS 15.c)

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## Question #5 of 41

Question ID: 1573007

A country is experiencing a core inflation rate of 7% during a recessionary period of real GDP growth. If the central bank has a single mandate to achieve price stability and uses inflation targeting with an acceptable range of zero to 4%, its monetary policy response is *most likely* to decrease:

**A)** GDP growth in the short run.

**B)** short-term interest rates.

**C)** the foreign exchange value of the country's currency.

**Explanation**

If the central bank has a price stability mandate, it will most likely respond to the above-target inflation rate by decreasing the money supply, even though GDP growth is in a recessionary phase. Decreasing the money supply will result in higher short-term interest rates and appreciation of the currency, but will likely cause GDP growth to decrease further in the short run.

(Module 15.1, LOS 15.a)

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## Question #6 of 41

Question ID: 1573026

Silvano Jimenez, an analyst at Banco del Rey, is reviewing recent actions taken by the U.S. Federal Reserve (the Fed) in setting monetary policy. Recently, the Fed decided to increase the money supply, which has resulted in a decrease in real interest rates. At a staff meeting, Jimenez brings this matter to the attention of his colleagues and makes the following statements:

Statement 1: Although the money supply increase has led to a decrease in real interest rates, we should begin to see U.S. investors decrease their investments abroad and the U.S. dollar will appreciate in the foreign exchange market.

Statement 2: The Fed's increase in the money supply will increase the amount of imports into the U.S.

Are Statement 1 and Statement 2 as made by Jimenez CORRECT?

| | Statement 1 | Statement 2 |
|---|---|---|
| **A)** | Correct | Incorrect |
| **B)** | Incorrect | Correct |

**C)** Incorrect Incorrect

**Explanation**

If the Fed increases the money supply and real interest rates decline, U.S. investors will seek higher real rates of return abroad and the U.S. dollar will depreciate as the dollar will be exchanged for foreign currencies in order to buy the foreign investments. Likewise, the decrease in real interest rates will reduce the inflow of funds from abroad as foreign investors seek higher rates of return outside the U.S. With a dollar that has depreciated, U.S. exports should increase, as U.S. products will become cheaper for foreign buyers. As such, both statements are incorrect.

(Module 15.1, LOS 15.b)

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## Question #7 of 41

Question ID: 1573031

Central banks that are able to define how inflation is computed and determine its desired level are *best described* as having:

**A)** operational independence.

**B)** target independence.

**C)** transparency.

**Explanation**

Target independence means the central bank defines how inflation is computed, sets the target inflation level, and determines the horizon over which the target is to be achieved. Central banks that have operational independence are allowed to determine the policy rate. Transparency refers to the degree to which central banks report to the public on the state of the economic environment and is one of the three essential qualities of an effective central bank.

(Module 15.2, LOS 15.c)

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## Question #8 of 41

Question ID: 1573025

If a country's economy is growing at an unsustainably rapid rate and the central bank decreases its target overnight interest rate, the country's:

**A)** expected rate of inflation is likely to decline.

**B)** inflation rate is likely to increase.

**C)** long-term rate of economic growth will increase.

**Explanation**

The central bank should increase target interest rates when the economy is growing at an unsustainable (above-full-employment) level. Decreasing the target overnight rate is likely to further increase aggregate demand and cause inflation to accelerate, which will be detrimental to the long-term growth rate of the economy.

(Module 15.1, LOS 15.b)

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## Question #9 of 41

Question ID: 1573009

Central banks are *most likely* to pursue a target inflation rate:

**A)** between 0% and 2%.

**B)** equal to 0%.

**C)** between 2% and 3%.

**Explanation**

Central banks typically define price stability as a stable inflation rate of about 2% to 3%. A target of zero is not typically used because it would risk deflation.

(Module 15.1, LOS 15.a)

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## Question #10 of 41

Question ID: 1573010

Which of the following is *least likely* a function or objective of a central bank?

**A)** Issuing currency.

**B)** Keeping inflation within an acceptable range.

**C)** Lending money to government agencies.

**Explanation**

Lending money to government agencies is not typically a function of a central bank. Central bank functions include controlling the country's money supply to keep inflation within acceptable levels and promoting a sustainable rate of economic growth, as well as issuing currency and regulating banks.

(Module 15.1, LOS 15.a)

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## Question #11 of 41

Question ID: 1573017

Central banks pursuing expansionary policies may:

**A)** decrease the policy rate and make open market purchases of securities. ✓

**B)** decrease the policy rate and make open market sales of securities. ✗

**C)** increase the policy rate and make open market purchases of securities. ✗

**Explanation**

Decreasing the policy rate, decreasing reserve requirements, and purchasing securities in the open market are expansionary monetary policy actions.

(Module 15.1, LOS 15.b)

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## Question #12 of 41

Question ID: 1573045

Which of the following policy combinations would *most likely* lead to private sector growth and a decreasing government share of GDP?

**A)** Contractionary fiscal policy and expansionary monetary policy. ✓

**B)** Contractionary fiscal policy and contractionary monetary policy. ✗

**C)** Expansionary fiscal policy and contractionary monetary policy. ✗

**Explanation**

Contractionary fiscal policy combined with expansionary monetary policy is more likely to increase private sector growth and decrease the government share of GDP than the other policy combinations.

(Module 15.1, LOS 15.d)

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## Question #13 of 41

Question ID: 1573043

Which one of the following Federal Reserve monetary policies, when pursued in line with the U.S. government's fiscal policies, would help increase aggregate demand during a period of high unemployment?

**A)** An increase in the reserve requirements for financial institutions.

**B)** A decrease in the discount rate.

**C)** The sale of bonds by the Fed.

**Explanation**

A decrease in the Fed's lending rate is a monetary tool that the Fed can use to increase the money supply, thereby increasing aggregate demand during recessionary times when there is high unemployment. An increase in the reserve requirements and the sale of bonds by the Fed would all be restrictive monetary policies that would reduce the amount of money in the economy and reduce aggregate demand.

(Module 15.1, LOS 15.d)

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## Question #14 of 41

Question ID: 1573037

To determine whether monetary policy is expansionary or contractionary, an analyst should compare the central bank's policy rate to the:

**A)** neutral interest rate.

**B)** target inflation rate.

**C)** trend rate of real growth.

**Explanation**

The neutral interest rate is the sum of the trend rate of real economic growth and the target inflation rate. Monetary policy is expansionary if the policy rate is less than the neutral interest rate and contractionary if the policy rate is greater than the neutral interest rate.

(Module 15.2, LOS 15.c)

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## Question #15 of 41

Question ID: 1573014

When the Federal Reserve sells government securities on the open market, bank reserves are:

**A)** decreased, which reduces the amount of money banks are able to lend, causing a decrease in the federal funds rate.

**B)** decreased, which reduces the amount of money banks are able to lend, causing an increase in the federal funds rate.

**C)** increased, which increases the amount of money banks are able to lend, causing a decrease in the federal funds rate.

**Explanation**

When the Federal Reserve wants to increase the federal funds rate through open market operations, it sells government securities. Open-market sales reduce bank reserves and cause the federal funds rate to increase.

(Module 15.1, LOS 15.b)

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## Question #16 of 41

Question ID: 1573041

Which of the following conditions is difficult for monetary policy to address because a central bank cannot reduce its nominal policy rate much below zero?

**A)** Deflation.

**B)** Inflation.

**C)** Stagflation.

**Explanation**

Deflation is difficult for central banks to address when policy rates cannot be lowered any further. Inflation can be addressed by contractionary monetary policy. Stagflation is difficult to address because monetary policy cannot pursue higher growth and lower inflation at the same time.

(Module 15.2, LOS 15.c)

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## Question #17 of 41

Question ID: 1573029

A central bank has operational independence if it can independently determine:

**A)** the horizon over which to achieve its inflation target.

**B)** the policy rate.

**C)** how inflation is calculated.

**Explanation**

A central bank is said to have operational independence if it has the authority to determine the policy rate independently. Determining how inflation is calculated and the time horizon for achieving its target rate of inflation refer to a central bank that has target independence.

(Module 15.2, LOS 15.c)

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## Question #18 of 41

Question ID: 1573015

If the Federal Reserve wishes to lower market interest rates without changing the discount rate, it can:

**A)** buy Treasury securities.

**B)** increase bank reserve requirements.

**C)** raise the yield on Treasury securities.

**Explanation**

Buying Treasury securities pumps money into the economy, lowering interest rates. Higher reserve requirements will restrict the money supply, causing rates to rise. The Federal Reserve has no direct control over the yield on existing Treasury securities.

(Module 15.1, LOS 15.b)

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## Question #19 of 41

Question ID: 1573032

A central bank is said to have credibility if:

**A)** economic actors base decisions on the central bank's stated inflation targets.

**B)** it issues inflation reports monthly.

**C)** it determines both the policy rate and the method for computing the inflation rate.

**Explanation**

If a central bank has credibility, economic actors come to believe the inflation rate will be near the central bank's target and factor this inflation rate into their decisions. Periodic inflation reports enhance the transparency of a central bank. A central bank that determines both the policy rate and the method for computing the inflation rate is said to have independence. (Module 15.2, LOS 15.c)

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## Question #20 of 41

Question ID: 1573011

If a monetary policy is focused on combating inflation, which open market actions by the Federal Reserve will *most* effectively accomplish this?

**A)** Sell Treasury securities, causing aggregate demand to decrease.

**B)** Sell Treasury securities, causing aggregate demand to increase.

**C)** Purchase Treasury securities, causing aggregate demand to decrease.

**Explanation**

If the Federal Reserve wants to slow inflation, it needs to decrease aggregate demand (i.e., business investment, consumer purchases of durable goods, and exports). To accomplish this, the Federal Reserve could engage in open market sales of Treasury securities.

(Module 15.1, LOS 15.b)

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## Question #21 of 41

Question ID: 1573039

The *most likely* reason for deflation to persist despite expansionary monetary policy is:

**A)** a liquidity trap.

**B)** bond market vigilantes.

**C)** inelastic demand for money.

**Explanation**

Deflation is often associated with liquidity trap conditions. A liquidity trap is a situation in which demand for money becomes highly elastic. Expanding the money supply has little effect on economic activity under these conditions because individuals and firms choose to hold the additional money in cash. "Bond market vigilantes" is an expression referring to the fact that expansionary monetary policy may cause long-term interest rates to increase, instead of decreasing as intended, if bond market participants expect the expansionary policy to increase future inflation rates.

(Module 15.2, LOS 15.c)

## Question #22 of 41

Question ID: 1573027

Which of the following is the *most likely* result of a central bank's shift to an expansionary monetary policy?

**A)** Domestic currency appreciates.

**B)** Exports increase.

**C)** Interest rates increase.

**Explanation**

Expansionary monetary policy decreases interest rates. This should cause the domestic currency to depreciate, which should increase foreign demand for the country's exports.

(Module 15.1, LOS 15.b)

## Question #23 of 41

Question ID: 1573036

An analyst has determined the projected trend rate of real GDP growth is 2.5% and the central bank's inflation target is 2.5%. If the central bank policy rate is 5.0%, monetary policy is *most likely*:

**A)** neutral.

**B)** expansionary.

**C)** contractionary.

**Explanation**

The neutral rate of interest is real trend rate of economic growth plus the inflation target. In this example, the neutral rate = 2.5% + 2.5% = 5.0%. Because the policy rate is the same as the neutral rate of interest, monetary policy is neither contractionary nor expansionary.

(Module 15.2, LOS 15.c)

## Question #24 of 41

Question ID: 1573038

An economy's long-term trend rate of real GDP growth is 3% and the central bank's target inflation rate is 2%. If the policy rate is 6%, monetary policy is:

**A)** contractionary.

**B)** expansionary.

**C)** neutral.

**Explanation**

Monetary policy is contractionary when the policy rate is greater than the neutral rate, which is the sum of the real trend rate of economic growth and the target rate of inflation. Here, the neutral rate is 3% + 2% = 5% and the policy rate of 6% is greater than the neutral rate. Monetary policy is expansionary when the policy rate is less than the neutral interest rate.

(Module 15.2, LOS 15.c)

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## Question #25 of 41

Question ID: 1573024

The velocity of transactions in an economy has been increasing rapidly for the past seven years. Over the same time period, the economy has experienced minimal growth in real output. According to the equation of exchange, inflation over the last seven years has:

**A)** been minimal, consistent with the slow growth in real output.

**B)** increased at a rate similar to the growth rate in the money supply.

**C)** increased more than the growth in the money supply.

**Explanation**

The equation of exchange is MV = PY. If velocity (V) is increasing faster than real output (Y), inflation (P) would have to be increasing faster than the money supply (M) to keep the equation in balance. (Module 15.1, LOS 15.b)

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## Question #26 of 41

Question ID: 1573030

What are the three essential qualities an effective central bank should possess?

**A)** Transparency, independence, and consistency.

**B)** Independence, credibility, and transparency.

**C)** Credibility, relevance, and reliability.

**Explanation**

A central bank that is independent from political interference, possesses credibility, and exhibits transparency is more likely to achieve its monetary policy objectives than a central bank that lacks these qualities. The other characteristics listed in the answer choices relate to financial statements and financial reporting standards.

(Module 15.2, LOS 15.c)

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## Question #27 of 41

Question ID: 1573023

Contractionary monetary policy is *least likely* to decrease consumption spending by decreasing:

**A)** expectations for economic growth.

**B)** securities prices.

**C)** the foreign exchange value of the currency.

**Explanation**

Contractionary monetary policy is likely to increase the value of the domestic currency in the foreign exchange market, which decreases foreign demand for the country's exports. Contractionary monetary policy should cause both securities prices and expectations for economic growth to decrease, each of which is likely to cause consumers to decrease spending.

(Module 15.1, LOS 15.b)

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## Question #28 of 41

Question ID: 1573040

Which of the following statements regarding the monetary policy transmission mechanism is *most* accurate?

**A)** Central banks can control short-term interest rates directly, but long-term interest rates are beyond their control.

**B)** Central banks can control long-term interest rates directly because decisions by consumers and businesses are based on these rates.

**C)** Central banks can control short-term interest rates by increasing the money supply to increase interest rates or by decreasing the money supply to decrease interest rates.

**Explanation**

Central banks can control short-term interest rates directly. However, the decisions of consumers and businesses are based on long-term interest rates, which are beyond the control of central banks. Increasing the money supply will decrease interest rates and decreasing the money supply will increase interest rates.

(Module 15.2, LOS 15.c)

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## Question #29 of 41

Question ID: 1573044

The government is reducing its spending to balance the budget, while the central bank is lowering its official policy rate. What will *most likely* be the combined effect on the economy?

**A)** The private sector as a percentage of GDP will increase.

**B)** The public and private sectors as a percentage of GDP will neither decrease nor increase.

**C)** The public sector as a percentage of GDP will increase.

**Explanation**

The private sector will expand as a percentage of GDP because (1) the public sector will decrease as a percentage of GDP due to government spending cuts and (2) lower interest rates should cause the private sector to expand.

(Module 15.1, LOS 15.d)

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## Question #30 of 41

Question ID: 1573019

A central bank that wants to increase short-term interest rates is *most likely* to:

**A)** issue long-term bonds.

**B)** decrease bank reserve requirements.

**C)** sell government securities.

**Explanation**

Open market operations to sell securities will decrease the outstanding supply of cash balances and increase short-term interest rates. The central bank does not issue long-term bonds but may buy and sell bonds issued by the government. Decreasing reserve requirements or purchasing government securities would tend to decrease short-term interest rates.

(Module 15.1, LOS 15.b)

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## Question #31 of 41

Question ID: 1573035

Which of the following is currently the most-used target for central banks?

**A)** Interest rate targeting.

**B)** Money supply targeting.

**C)** Inflation targeting.

**Explanation**

Inflation targeting is the most-used tool of central banks for making monetary policy decisions.

(Module 15.2, LOS 15.c)

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## Question #32 of 41

Question ID: 1573006

If a bank needs to borrow funds from the Federal Reserve to fund a temporary shortage in reserves, it would borrow funds at the:

**A)** discount rate.

**B)** prime rate.

**C)** federal funds rate.

**Explanation**

Banks are able to borrow from the Fed at the discount rate. The federal funds rate is the interest rate banks charge other banks to borrow reserves from other banks. The prime rate is the rate that commercial banks charge their best customers.

(Module 15.1, LOS 15.a)

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## Question #33 of 41

Question ID: 1573008

Which of the following is *least likely* to be a function of the central bank?

**A)** Collect tax payments.

**B)** Issue currency.

**C)** Regulate the banking system.

**Explanation**

The three functions of a central bank are to issue a country's currency, regulate its banking system, and to manage the money supply. Tax collection is typically conducted by a government agency created specifically to carry out that function.

(Module 15.1, LOS 15.a)

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## Question #34 of 41

Question ID: 1573022

The open market sale of Treasury securities by the Federal Reserve is *least likely* to result in:

**A)** increased exports of U.S. goods.

**B)** increased longer-term interest rates.

**C)** a decreased rate of inflation.

**Explanation**

When the Fed sells Treasuries, it causes both short- and long-term interest rates to increase. This rate increase causes the dollar to appreciate, which reduces foreign demand for domestic goods, causing exports to decline. The interest rate increase also puts downward pressure on price levels, which causes inflation to slow.

(Module 15.1, LOS 15.b)

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## Question #35 of 41

Question ID: 1573028

Xanadu attempts to decrease its inflation rate by implementing contractionary monetary policy. Which of the following is *most likely* to be the long-run effect on Xanadu's trade balance as a result of the monetary policy change?

**A)** Worsen.

**B)** Remain the same.

**C)** Improve.

**Explanation**

Contractionary monetary policy likely will cause higher domestic interest rates and attract foreign capital. As foreign capital flows in, the currency will appreciate relative to other currencies. The higher cost of its currency will result in higher cost exports that become less attractive to other countries. Xanadu's trade balance will most likely worsen.

(Module 15.1, LOS 15.b)

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## Question #36 of 41

Question ID: 1573033

If a central bank implements an exchange rate targeting policy successfully, the country's inflation rate is *most likely* to be:

**A)** less than that of the target currency.

**B)** the same as that of the target currency.

**C)** greater than that of the target currency.

**Explanation**

Successful exchange rate targeting should result in the same inflation rate in the targeting country as in the country of the target currency.

(Module 15.2, LOS 15.c)

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## Question #37 of 41

Question ID: 1573005

The primary objective of a central bank is typically to:

**A)** control inflation.

**B)** stabilize exchange rates.

**C)** achieve full employment.

**Explanation**

Although some central banks have other stated goals including stabilizing exchange rates and achieving full employment, the primary objective for a central bank is to control inflation and promote price stability.

(Module 15.1, LOS 15.a)

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## Question #38 of 41

Question ID: 1573020

The Federal Reserve has decided to increase the federal funds rate (the interest rate that banks charge each other for overnight loans). To implement this policy, the Federal Reserve will *most likely*:

**A)** sell government securities in the open market. ✓

**B)** increase currency exchange rates (cause domestic currency to appreciate). ✗

**C)** set a lower price on Treasury bills and notes that it is auctioning. ✗

**Explanation**

Selling government securities on the open market reduces bank reserves and drives up the federal funds rate. The other two statements are incorrect because the Federal Reserve does not directly control exchange rates or the prices of government securities. (Module 15.1, LOS 15.b)

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## Question #39 of 41

Question ID: 1573018

If a central bank's targeted inflation rate is above the current rate, the central bank is *most likely* to:

**A)** increase the overnight lending rate. ✗

**B)** buy government securities. ✓

**C)** increase the reserve requirement. ✗

**Explanation**

Buying government securities is an expansionary policy that would increase the money supply and allow the inflation rate to increase to the targeted range. Increasing reserve requirements and overnight lending rates are contractionary and would have the opposite effects.

(Module 15.1, LOS 15.b)

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## Question #40 of 41

Question ID: 1573021

If the U.S. Federal Reserve decides to decrease the money supply, which of the following is *most likely* to occur in the short run?

**A)** An increase in the real rate of interest.

**B)** A decrease in the unemployment rate.

**C)** An increase in the velocity of money similar to decrease in the money supply.

**Explanation**

If the U.S. Federal Reserve decreases the money supply, an increase in nominal and real interest rates will occur. Higher real rates will cause businesses to invest less, which will cause the unemployment rate to increase. Furthermore, households will decrease purchases of durable goods, automobiles, and other items that are typically financed at short-term rates. This will decrease aggregate demand. The decrease in aggregate demand and expenditures will cause incomes to go down, which further decreases consumption and investment. Moreover, this decrease in aggregate demand will decrease real GDP and the price level in the short run and the long run.

(Module 15.1, LOS 15.b)

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## Question #41 of 41

Question ID: 1573042

Which of the following fiscal and monetary policy scenarios is *most likely* to increase the size of the public sector relative to the private sector?

**A)** Contractionary fiscal and monetary policy.

**B)** Expansionary fiscal policy and contractionary monetary policy.

**C)** Expansionary monetary policy and contractionary fiscal policy.

**Explanation**

Expansionary fiscal policy tends to expand the public sector. Contractionary monetary policy tends to contract the private sector.

(Module 15.1, LOS 15.d)