<u>Quiz 9 – Answers</u>

<u>Question 1</u>
What policies could the government and the central bank use to achieve the goal of slowing down the economic expansion?

A. The government could impose wage and price controls, while the central bank could raise interest rates.
B. The government could lower taxes and/or raise expenditures, while the central bank could lower interest rates.
C. **The government could raise taxes and/or reduce expenditures, while the central bank could raise interest rates.**
D. The government could reduce the value of the dollar and the central bank could retire currency from circulation.

Discuss fiscal and monetary policies and their differences, with examples of monetary policies that can be used

<u>Question 2</u>

Is minimum guaranteed income an automatic countercyclical component of fiscal policy?
A. No, because it needs a vote to be passed
B. No, because its amount can be changed by Congress
C. No, because its effectiveness depends on inflation
D. **Yes, because it encourages consumption when income goes down**

Discus the difference between automatic and discretionary components of fiscal policy.

<u>Question 3</u>

What could explain why a decrease in taxes could lead to a less than proportionate increase in output?

A. As a result of diminishing returns to current consumption, consumers may choose to spread the extra spending over the long term rather than consuming the proceeds of a tax cut all at once.
B. Consumers may choose to save much of the tax cut in anticipation of having to pay higher taxes in the future.
C. A decrease in taxes might induce lower government outlays, thus largely offsetting the higher consumption expenditures of households.

D. **All of the above**

Use the accounting identity to discuss what could happen to other expenditure aggregates when taxes are lowered by $1. Perhaps consumers are not going to spend that $1 entirely because they will spread the saving over time, especially if they perceive the tax change as temporary, and perhaps consumers expect this tax change to be reversed in the future (to keep the government budget balanced), thus saving in anticipation of higher taxes.

Question 4

In his book The Optimum Quantity of Money, Milton Friedman talks about a helicopter dropping $2,000 over a community. The cash dropped by the helicopter gives the people in this community more money to spend. A tax cut also has the same effect: it increases disposable income. Suppose tax cuts, analogous to the helicopter drop, were proposed as a method to shift the labor demand curve to the right following a recession.
How effective do you think this policy would be?

A. Very effective, since tax cuts are concentrated among wealthy individuals who usually spend all or most of the extra income.
B. Not effective, since the tax cuts go to consumers rather than to the employers (demanders) of labor.
C. **Somewhat effective, but only to the extent that most of the tax cut is concurrently spent on domestic output, that multiplier effects occur, and crowding out is small.**
D. Not effective, since the majority of the tax cut is saved and any portion spent leads to complete crowding out.

Discuss crowding out hypothesis and effect of government expenditure on consumption and investment.
Discuss also the role of imports in undoing expansionary fiscal policy.

Question 5

Which of the following aspects does the 2008 Troubles Assets Relief Program (TARP) share with fiscal, as opposed to monetary policy programs?

A. It raised the marginal income tax on the highest tax brackets.
B. It was transferring capital to banks, as opposed to reserves.

C. **It was establishing transfers to non-financial companies.**
D. All of the above

B is an aspect of monetary policy because it affects the balance sheets of financial institutions; C is a transfer to the private sector and is more generally a fiscal policy element; A is simply not an aspect of TARP.

Question 6

Tire production in the United States has been on the decline, in both absolute and relative terms. Imported tires are replacing most of the domestically manufactured tires in the market. Trade unions in the United States have claimed that over 7,000 jobs have been lost due to Chinese tire imports. You read a blog post that uses this example to say that this is exactly why countries should not engage in free trade; cheaper imports will flood the domestic market and unemployment in the country will increase.
Do you think the blogger's conclusions are entirely correct?

A. No, because the efficiencies gained from exploiting comparative advantage generate more winners than losers.
B. No, as long as the winners from free trade could possibly compensate the losers.
C. Yes, because the country loses jobs and workers are made worse off.
D. Yes, because the losers from free trade are likely to outnumber the winners, making the country worse off overall.
E. A and C.
F. **A and B.**

Discuss efficiency of specialisation, and how this efficiency means there might be transfers from winners to compensate losers. May want to discuss practical feasibility and political support for such transfers.

Question 7

A country has a trade deficit when

A. the value of exports equals the value of imports
B. **the value of exports is less than the value of imports**
C. the value of imports and exports is less than the value of GDP
D. the value of imports is less than the value of exports

Discuss trade balance, deficit and surplus.

Question 8

Which of the following are sources of factor payments that domestic US residents make to foreigners?

A. **Apple corporation pays a stock dividend to a resident of India.**
B. A person renting an apartment in Berlin, Germany, pays rent to the owner, who is a U.S. resident.
C. A resident of Morocco sends money to their sister in Detroit, Michigan.
D. A Canadian citizen working in Seattle, Washington, sends money to their parents in Calgary.

Define factor payments to-from foreigners. Remind of residency principle. Classify each of the above payments: B = factor payment to the US; C= transfer to the US. D = transfer to foreign residents.
Discuss definition of current account.

Question 9

The net flows in the financial account

A. are equal to the net changes in factor payments and transfers from abroad.
B. are equal to the net change in trade.
C. are larger in absolute value than the net flows in the current account.
D. are smaller in absolute value than the net flows in the current account.
E. **exactly offset the net flows in the current account.**

Discuss definition of financial account and why it exactly offsets current account (handout 17, slides 22-24).