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CFA® Program Level I

Economics: 35 Free Practice Questions

2027 curriculum · 8 readings · answers and full explanations

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CredGuild · CFA® Program Level I · Economics: 35 Free Practice Questions
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If these questions help you, pass the file on to someone else who is studying.

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CFA® PROGRAM LEVEL I · FREE PRACTICE QUESTIONS

Economics

Questions 1–35 · 8 readings

12 Oligopoly

Question 1

Hartwell Joinery employs 35 carpenters and makes furniture in a factory it leases on a five-year contract, using machinery it owns. Over which inputs does the firm have a choice in the long run?

A The carpenters only.

B The factory and the machinery only.

C The carpenters, the factory and the machinery.

Question 2

Lindqvist Ferries operates in a market in which it faces a downward-sloping demand curve. For the coming year it forecasts total revenue of $2.10 million, total variable costs of $1.65 million and total fixed costs of $0.72 million. If these conditions are expected to persist, the firm should *most appropriately*:

A shut down in the short run, because total revenue is less than total cost.

B continue operating in the short run but exit the market in the long run.

C continue operating in both the short run and the long run, because total revenue exceeds total variable cost.

Question 3

An industry study reports the following:

- many sellers act independently of one another;
- product features differ from firm to firm;
- entry into the industry is easy;
- each firm's demand curve slopes downward but is quite elastic.

The industry is best characterized as:

A an oligopoly.

B monopolistic competition.

C a monopoly.

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Question 4

Norden Cement and Solvik Cement are the only two suppliers in a regional market. Each firm independently chooses a high or a low price, and the resulting annual profits are shown below.

Annual profits (in $ thousands) of Norden Cement and Solvik Cement under each pricing strategy

	Solvik: high price	Solvik: low price
Norden: high price	Norden 800, Solvik 700	Norden 300, Solvik 900
Norden: low price	Norden 950, Solvik 250	Norden 500, Solvik 450

Based on the concept of a Nash equilibrium, the *most likely* outcome is that:

A both firms charge a high price.

B both firms charge a low price.

C Norden charges a high price and Solvik charges a low price.

Question 5

An analyst has annual sales for the producers of industrial fasteners in a region:

Annual sales of industrial fastener producers (€ millions)

Firm	Sales (€ millions)
Arlo	240
Brisk	180
Calder	150
Dunmark	120
Eske	60
All other firms	50

The industry's three-firm concentration ratio and three-firm Herfindahl-Hirschman Index (HHI) are *closest* to:

A 71.25% and 0.1758.

B 71.25% and 0.1983.

C 76.00% and 0.2000.

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13 Business Cycle

Question 6

An economy that is in the contraction phase of the business cycle would *most typically* display:

A a falling unemployment rate.

B real GDP growth above its sustainable long-term rate.

C decreasing inflationary pressure.

Question 7

A bank economist makes three claims about the lending (credit) cycle and its link to the business cycle. Which claim is *least accurate*?

A Easy credit conditions during an expansion can contribute to asset price bubbles.

B Credit cycles tend to amplify business cycles.

C On average, credit cycles have been shorter than business cycles.

Question 8

Orders at Brightwater Castings, a maker of pump housings, have started to fall as the economy begins to contract. Management is not yet convinced the downturn will last and wants to keep its workforce and its productive capacity intact for now. Its *first* adjustment is *most likely* to be:

A laying off part of its workforce.

B postponing scheduled maintenance on its machinery.

C cutting back the overtime hours its employees work.

Question 9

An analyst wants a US data series that tends to change direction *before* the overall economy does. Which of the following should she choose?

A The index of consumer expectations.

B The average duration of unemployment.

C The index of industrial production.

14 Fiscal Policy

Question 10

To support a slowing economy, the finance ministry of Norvessa announces a cut in personal income tax rates together with a larger budget for road and rail projects. These measures are *best* described as:

A fiscal policy.

B monetary policy.

C a combination of fiscal and monetary policy.

Question 11

The governments of Tarsia and Morvenna both keep their tax rates unchanged and both run a balanced primary budget, meaning that tax revenue exactly covers all government spending other than interest on the debt. Tarsia's government debt equals 85% of GDP, the real interest rate on that debt is 3.1%, and Tarsia's real GDP grows by 1.3% a year. Morvenna's government debt equals 50% of GDP, the real interest rate on that debt is 0.9%, and Morvenna's real GDP grows by 2.7% a year. If these conditions persist, the ratio of government debt to GDP will *most likely*:

A rise in Tarsia and fall in Morvenna.

B rise in both Tarsia and Morvenna.

C fall in both Tarsia and Morvenna.

Question 12

Inflation in Brennholt is running well above target. Which of the following is an appropriate *discretionary fiscal policy* response?

A Scaling back government spending on large public construction projects.

B Raising the central bank's target for the overnight interbank rate.

C Reducing the money supply.

Question 13

The government of Kestrel Isles increases its spending by $60 million. Households have a marginal propensity to consume of 90%, and the tax rate is 30%. The potential increase in aggregate demand is *closest* to:

A $600 million.

B $162 million.

C $82 million.

Question 14

Over the past year, new tax and spending decisions (not the business cycle) have widened the budget deficit of Estavia's government and shrunk the budget surplus of Marquessa's government. How would the fiscal policies of the two countries *best* be described?

A Both are expansionary.

B Both are contractionary.

C One is expansionary and the other is contractionary.

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15 Quantitative Easing

Question 15

Rumors about loan losses lead depositors at several banks in Harwick to start withdrawing their money. Harwick's central bank announces that it will provide whatever funds are needed to any sound bank facing a cash shortage, and the withdrawals soon stop. This announcement reflects the central bank's role as:

A lender of last resort.

B holder of gold and foreign exchange reserves.

C sole supplier of currency.

Question 16

Suppose the Federal Reserve carries out open market sales of Treasury securities. What happens to bank reserves and to the federal funds rate?

A Reserves decrease, banks can lend less, and the federal funds rate rises.

B Reserves decrease, banks can lend less, and the federal funds rate falls.

C Reserves increase, banks can lend more, and the federal funds rate falls.

Question 17

In Taviston, unions and employers routinely write the central bank's announced inflation target into multi-year wage agreements, and lenders price loans on the assumption that inflation will stay close to that target. This behavior indicates that Taviston's central bank has:

A credibility.

B transparency.

C target independence.

Question 18

Quellan's central bank has set its policy rate at 4.0% and aims for inflation of 2.4%. Economists expect real GDP to expand at a trend pace of 1.6% a year. How is Quellan's monetary policy *most likely* classified?

A Neutral.

B Expansionary.

C Contractionary.

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Question 19

Growth in Tarnovia has stalled. Its government and central bank want both public-sector spending and private-sector consumption and investment to expand. Which policy mix fits this goal, and what is its *most likely* effect on interest rates?

A Expansionary fiscal and contractionary monetary policy; interest rates rise.

B Contractionary fiscal and expansionary monetary policy; interest rates fall.

C Expansionary fiscal and expansionary monetary policy; interest rates usually fall.

16 Introduction to Geopolitics

Question 20

During the same year, the government of Aldmere (1) signs an agreement with neighboring states to harmonize product standards and lower tariffs among them, and (2) bans all exports of rare-earth minerals mined within its borders. From a geopolitical perspective, which of the two actions counts as cooperative?

A Neither of the actions.

B Both of the actions.

C Only one of the actions.

Question 21

An analyst compares the goals listed in Article I of the International Monetary Fund's (IMF's) Articles of Agreement with the stated mission of the World Bank and the role of the World Trade Organization (WTO). Which of her conclusions is *most accurate*?

A Of the three, only the World Bank has fighting poverty as its explicit mission.

B Of the three, only the WTO works to expand international trade.

C Of the three, only the IMF lends financial resources to member countries.

Question 22

A portfolio manager is classifying the geopolitical risks that could affect her emerging market holdings. Which of the following is *best* described as an event risk?

A A gradual shift in migration patterns that is expected to play out over several decades.

B A rebellion that breaks out suddenly, with no warning signs identified in advance.

C A referendum on leaving a customs union, scheduled for a date set a year ahead.

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Question 23

Which of the following statements about the effect of geopolitical risk on investments is *most accurate*?

A Scenario analysis is generally not an appropriate technique for estimating how geopolitical risks could affect a portfolio.

B A given geopolitical risk may have a larger effect on investment values in a recession than in an expansion.

C Geopolitical risks affect entire countries or regions, rather than individual companies or industries.

17 Comparative Advantage

Question 24

Regarding the gains and losses that international trade creates, which of the following statements is *most accurate*?

A Every group in each of the trading countries is made better off by increased trade.

B The costs of trade fall mainly on firms and workers in domestic industries that compete with imports.

C With respect to domestic employment, the costs of trade outweigh its benefits.

Question 25

Which of the following statements correctly describes how a tariff differs from a quota?

A A tariff is set by international organizations, whereas a quota is set by an individual country.

B A tariff is imposed by one government, whereas a quota is an international agreement capping the total volume of world trade.

C A tariff is a tax on imported goods, whereas a quota is a limit on the amount of imports allowed over some period.

Question 26

Tessaly, a small country, is choosing among three measures that would each cut its imports of washing machines by the same quantity: a tariff, an import quota whose licenses the government auctions for their full value, or a voluntary export restraint agreed with the main exporting country. Which measure would cause the greatest loss of national welfare for Tessaly?

A The voluntary export restraint.

B The tariff.

C The import quota with auctioned licenses.

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Question 27

Which sequence ranks regional trading agreements correctly, starting with the lowest and ending with the highest level of economic integration?

A Common market, customs union, economic union.

B Free trade area, customs union, common market.

C Customs union, free trade area, monetary union.

18 Capital Flows and the FX Market

Question 28

Buy-side participants in the foreign exchange market include real money accounts and leveraged accounts. Compared with a real money account, an investment account classified as a leveraged account is *most likely* distinguished by its:

A active use of leverage, typically through derivatives.

B role as a dealer quoting two-way prices to other participants.

C restriction to long-term, unleveraged holdings of foreign-currency assets.

Question 29

Tomas Riedl, an economist in Lorvania, tracks the real exchange rate of the Lorvanian crown against its main trading partner's currency, quoted as the number of crowns needed to buy one unit of the partner's currency (domestic/foreign). Holding all other factors constant, which of the following would cause this real exchange rate to fall?

A A rise in the foreign price level.

B A rise in the nominal exchange rate (domestic/foreign).

C A rise in the domestic price level.

Question 30

Under Pelagia's monetary law, the monetary authority may issue Pelagian dinars only when each new dinar is fully matched by euro reserves, and it must exchange dinars for euros on demand at a fixed rate. The authority earns interest on the euro reserves it holds. The regime Pelagia operates is best classified as:

A a currency board arrangement.

B formal dollarization.

C a conventional fixed peg arrangement.

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Question 31

Which of the following is *least likely* to be cited by a government as an objective of restricting capital flows?

A Maintaining a fixed exchange rate.

B Protecting strategic industries from foreign ownership.

C Keeping domestic interest rates high.

19 Exchange Rate Calculations

Question 32

Using the quotes EUR/USD 0.9240 and NZD/EUR 1.7960, an analyst calculates the spot cross rate between the US dollar and the New Zealand dollar. Stated as USD/NZD, it is *closest* to:

A 0.51448.

B 0.60259.

C 1.65950.

Question 33

The spot exchange rate is 1.3450 CAD/USD. The 180-day money market rate is 4.20% for the Canadian dollar and 5.40% for the US dollar, both quoted as annualized rates on a 360-day basis. The 180-day no-arbitrage forward CAD/USD exchange rate is *closest* to:

A 1.3297.

B 1.3371.

C 1.3529.

Question 34

The central bank of Selvia unexpectedly raises its policy rate, and Selvian money market rates move well above euro-area rates. Two analysts comment on the outlook for the Selvian lev (SLV) against the euro:

- Ruiz: "The higher-yielding currency always trades at a forward discount, so the rate increase tells us the SLV will now weaken against the euro."
- Okoye: "Higher Selvian rates should draw in foreign capital, which tends to push the SLV up against the euro."

Which evaluation of the two comments is *most accurate*?

A Ruiz is right; the forward discount is a reliable forecast of the future spot rate.

B Neither is right; a change in the policy rate leaves the spot rate unaffected.

C Okoye is right; parity sets today's forward rate but does not forecast spot rates.

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Question 35

A dealer's SGD/AUD quotes are 0.8870 for spot settlement and 0.8795 for delivery in 12 months. Measured against spot, the forward quote is a:

A premium of 75 points, and the SGD is at a forward discount to the AUD.

B discount of 75 points, and the SGD is at a forward premium to the AUD.

C discount of 7.5 points, and the SGD is at a forward discount to the AUD.

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ECONOMICS

Answers and explanations

Answer key: 1. C · 2. B · 3. B · 4. B · 5. A · 6. C · 7. C · 8. C · 9. A · 10. A · 11. A · 12. A · 13. B · 14. A · 15. A · 16. A · 17. A · 18. A · 19. C · 20. C · 21. A · 22. C · 23. B · 24. B · 25. C · 26. A · 27. B · 28. A · 29. C · 30. A · 31. C · 32. B · 33. B · 34. C · 35. B

Question 1 **Answer: C**

The long run is the period over which every factor of production is variable. The firm can let the lease expire or sign a new one, sell or buy machinery and change its workforce, so all three inputs can be changed. In the short run the factory and machinery are fixed and only labor (and materials) can vary.

Why the other options are wrong

- **A.** Labor alone describes the short run, when the plant and equipment are fixed. In the long run the plant and equipment can be changed as well.
- **B.** This reverses the usual assumption: labor is variable even in the short run, so it is certainly variable in the long run.

Key takeaway In the long run all costs are variable; the short run is defined by at least one fixed input, usually capital.

Reading 12: The Firm and Market Structures. Notes: credguild.com/cfa/level-1/notes/economics/oligopoly/

Question 2 **Answer: B**

For a price searcher, breakeven and shutdown are judged with totals because price does not equal marginal revenue. Total revenue exceeds total variable cost, so operating covers all variable cost and part of fixed cost and loses less than shutting down; but total revenue is below total cost, so the firm cannot survive in the long run when all costs are avoidable.

Total cost: $TC = TVC + TFC = 1.65 + 0.72 = \$2.37$ million.

- Loss if it operates: $TR - TC = 2.10 - 2.37 = -\$0.27$ million.
- Loss if it shuts down (fixed costs still due): $-\$0.72$ million.

Since $TVC(1.65) < TR(2.10) < TC(2.37)$: operate in the short run (a loss of \$0.27 million instead of \$0.72 million), but exit in the long run because TR does not cover TC.

Why the other options are wrong

- **A.** Short-run shutdown is warranted only when $TR < TVC$. Here TR exceeds TVC by \$0.45 million, so closing now would raise the loss from \$0.27 million to the full \$0.72 million of fixed costs.
- **C.** Covering variable costs is enough only for the short run. In the long run the firm must cover total cost; with TR below TC by \$0.27 million it should exit if conditions persist.

Key takeaway If $TR < TVC$, shut down now; if $TVC < TR < TC$, operate now and exit later; if $TR \geq TC$, stay.

Reading 12: The Firm and Market Structures. Notes: credguild.com/cfa/level-1/notes/economics/oligopoly/

Question 3 **Answer: B**

Many independent sellers, differentiated products, low barriers to entry and downward-sloping, highly elastic firm demand are the conditions of monopolistic competition.

Why the other options are wrong

- **A.** An oligopoly has a small number of interdependent sellers and high barriers to entry.
- **C.** A monopoly has a single seller protected by high barriers to entry.

Key takeaway Checklist for monopolistic competition: many sellers, differentiation, easy entry, elastic downward-sloping demand.

Reading 12: The Firm and Market Structures. Notes: credguild.com/cfa/level-1/notes/economics/oligopoly/

Question 4 **Answer: B**

A Nash equilibrium is a combination of choices from which no firm can raise its profit by changing its own choice alone. Charging a low price is each firm's best response whatever the other does, so both choose a low price and neither wants to deviate, even though both would earn more if they could collude on high prices.

Norden's best response: if Solvik is high, low (950) beats high (800); if Solvik is low, low (500) beats high (300), so Norden prices low either way.

Solvik's best response: if Norden is high, low (900) beats high (700); if Norden is low, low (450) beats high (250), so Solvik prices low either way.

Nash equilibrium: (low, low) with profits 500 and 450. Joint profit there is 950 versus 1,500 at (high, high), the collusive outcome.

Why the other options are wrong

- **A.** Both charging high gives the largest joint profit (1,500), but it is not stable: either firm could raise its own profit by switching to a low price (Norden from 800 to 950, Solvik from 700 to 900). Only collusion could sustain it.
- **C.** If Solvik prices low, Norden earns only 300 with a high price versus 500 with a low price, so Norden would switch; this combination is not an equilibrium.

Key takeaway Check each cell: if either firm can gain by changing only its own choice, the cell is not a Nash equilibrium. The Nash equilibrium need not maximize joint profit.

Reading 12: The Firm and Market Structures. Notes: credguild.com/cfa/level-1/notes/economics/oligopoly/

Question 5 **Answer: A**

Both measures use market shares, so each firm's sales must first be divided by total industry sales, including the sales of all the smaller firms. The three-firm concentration ratio adds the shares of the three largest firms; the three-firm HHI adds the squares of those shares.

Total industry sales $= 240 + 180 + 150 + 120 + 60 + 50 = 800$.

Shares of the three largest firms: $240/800 = 30\%$, $180/800 = 22.5\%$, $150/800 = 18.75\%$.

$$\text{3-firm ratio} = 30 + 22.5 + 18.75 = 71.25\%$$

$$\text{HHI} = 0.30^2 + 0.225^2 + 0.1875^2 = 0.0900 + 0.0506 + 0.0352 = 0.1758$$

Why the other options are wrong

- **B.** 0.1983 also squares Dunmark's 15% share ($0.1758 + 0.0225$), which is a four-firm HHI. The question asks for the three largest firms only.
- **C.** These values leave the other firms' sales of 50 out of the total, so shares are computed on 750: $32\% + 24\% + 20\% = 76\%$ and $0.1024 + 0.0576 + 0.0400 = 0.2000$.

Key takeaway Convert sales to shares using total industry sales, then use the same N largest firms for both measures.

Reading 12: The Firm and Market Structures. Notes: credguild.com/cfa/level-1/notes/economics/oligopoly/

Question 6 **Answer: C**

A contraction (recession) is a period of declining real GDP. Weaker demand and rising unemployment reduce pressure on prices, so inflation pressure typically decreases, often with a lag.

Why the other options are wrong

- **A.** Unemployment usually rises in a contraction because hours are cut and, if the downturn persists, workers are laid off.
- **B.** In a contraction real GDP growth is low or negative. Growth above the sustainable rate is associated with an expansion, especially one nearing its peak.

Key takeaway Contraction: output falls, unemployment rises, inflation eases.

Reading 13: Understanding Business Cycles. Notes: credguild.com/cfa/level-1/notes/economics/business-cycle/

Question 7 **Answer: C**

Historical evidence suggests credit cycles have been *longer* on average than business cycles, so a claim that they are shorter is inaccurate. The other two statements are accurate: loose lending in good times can inflate asset prices beyond plausible levels, and expansions and contractions tend to be stronger and deeper when they coincide with credit cycles.

Why the other options are wrong

- **A.** Accurate. Loose credit can fuel bubbles, as happened with subprime mortgages before the 2007–2009 financial crisis.
- **B.** Accurate. Credit availability rises in expansions and shrinks in slowdowns, which reinforces the business cycle rather than dampening it.

Key takeaway Credit cycles amplify business cycles, can cause bubbles, and have tended to last longer than business cycles.

Reading 13: Understanding Business Cycles. Notes: credguild.com/cfa/level-1/notes/economics/business-cycle/

Question 8 **Answer: C**

Hiring and firing are costly and damage morale, so at the start of a slowdown firms reduce output by using existing labor and capital less intensively, for example by trimming overtime. Only when the contraction looks persistent do they reduce capacity by laying off workers and cutting physical capital, typically by deferring

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maintenance or not replacing worn equipment.

Why the other options are wrong

- **A.** Layoffs are a later step, taken once management believes the contraction is likely to persist. They are not the initial response while the outlook is uncertain.
- **B.** Deferring maintenance is how firms shrink physical capacity. It cuts the capacity management wants to keep, so it belongs to the stage when the downturn looks durable.

Key takeaway Sequence in a slowdown: first reduce intensity of use (overtime, hours), then reduce capacity (layoffs, deferred maintenance).

Reading 13: Understanding Business Cycles. Notes: credguild.com/cfa/level-1/notes/economics/business-cycle/

Question 9 **Answer: A**

Consumer expectations about business conditions are a leading indicator: sentiment tends to turn before actual spending and output do.

Why the other options are wrong

- **B.** The average duration of unemployment is a lagging indicator. Spells of joblessness lengthen only after a contraction has been under way for a while.
- **C.** Industrial production is a coincident indicator; it moves with the cycle rather than ahead of it.

Key takeaway Expectations and orders lead; production and sales are coincident; duration, inventories-to-sales and the prime rate lag.

Reading 13: Understanding Business Cycles. Notes: credguild.com/cfa/level-1/notes/economics/business-cycle/

Question 10 **Answer: A**

Fiscal policy is the government's use of taxation and spending to influence economic activity. Cutting tax rates and raising infrastructure spending are both fiscal tools, and they are chosen here to influence growth.

Why the other options are wrong

- **B.** Monetary policy is conducted by the central bank through the quantity of money and credit (and short-term interest rates). Neither tax rates nor government spending are monetary tools.
- **C.** No central bank action (money supply or policy rate change) is involved, so nothing in the package is monetary policy.

Key takeaway Taxes and government spending mean fiscal policy; money, credit and policy rates mean monetary policy.

Reading 14: Fiscal Policy. Notes: credguild.com/cfa/level-1/notes/economics/fiscal-policy/

Question 11 **Answer: A**

With tax rates held constant, tax revenue grows with real GDP, while the debt grows with the interest paid on it. A government whose debt carries a real interest rate above real GDP growth sees its debt ratio climb over time; one whose real borrowing rate is below real growth sees the ratio shrink. In Tarsia the real interest rate of 3.1% exceeds real growth of 1.3%, so the ratio rises. In Morvenna the real interest rate of 0.9% is below real growth of 2.7%, so the ratio falls.

With a balanced primary budget, the government borrows only to pay the interest on its debt, so in real terms the debt grows at r while real GDP grows at g. Next year's debt ratio is approximately

$$d_{t+1} \approx d_t \times \frac{1+r}{1+g}$$

Tarsia: $0.85 \times 1.031/1.013 = 0.8651$. The ratio rises from 85.0% to about 86.5% and keeps rising while $r > g$.

Morvenna: $0.50 \times 1.009/1.027 = 0.4912$. The ratio falls from 50.0% to about 49.1% and keeps falling while $r < g$.

Why the other options are wrong

- **B.** This looks only at the debt. A government with a balanced primary budget borrows to pay its interest, so debt grows in both countries. In Morvenna, however, real GDP grows at 2.7%, faster than the 0.9% real rate at which the debt grows, so debt shrinks relative to GDP.
- **C.** This treats a balanced primary budget as a balanced overall budget, as if the debt stayed constant while GDP grew. The primary balance leaves out interest, which is paid with new borrowing. In Tarsia the debt grows at a real 3.1% a year while real GDP grows only 1.3%, so the ratio rises.

Key takeaway With tax rates unchanged and a balanced primary budget, the debt-to-GDP ratio rises when the real interest rate on government debt exceeds real GDP growth and falls when it is below real growth. The comparison of r with g sets the direction; the starting level of the debt does not.

Reading 14: Fiscal Policy. Notes: credguild.com/cfa/level-1/notes/economics/fiscal-policy/

Question 12 **Answer: A**

Discretionary fiscal policy consists of the government's decisions about spending and taxes. Cutting spending on major public construction lowers aggregate demand and eases pressure on prices, which is the appropriate direction when inflation is high.

Why the other options are wrong

- **B.** Raising a policy interest rate target (like the federal funds target rate in the US) is a monetary policy action by the central bank. It fights inflation, but it is not fiscal policy.
- **C.** Reducing the money supply is also a monetary policy action.

Key takeaway Right direction is not enough; check the tool. Spending and taxes are fiscal, while interest rates and the money supply are monetary.

Reading 14: Fiscal Policy. Notes: credguild.com/cfa/level-1/notes/economics/fiscal-policy/

Question 13 **Answer: B**

Each round of extra spending becomes income. Part of it is taxed and the MPC share of what remains is spent again. The fiscal multiplier captures the total effect, and the potential increase in aggregate demand equals the change in spending times the multiplier.

$$\text{fiscal multiplier} = \frac{1}{1 - MPC(1-t)} = \frac{1}{1 - 0.90(1-0.30)} = \frac{1}{1-0.63} = \frac{1}{0.37} = 2.703$$

$$\Delta AD = \Delta G \times \text{multiplier} = 60 \times 2.703 = \$162.2 \text{ million}$$

First rounds: income $+60$; disposable income $60 \times 0.70 = 42$; new spending $42 \times 0.90 = 37.8$; then $37.8 \times 0.63 = 23.8$, and so on until the total converges to about 162.

Why the other options are wrong

- **A.** \$600 million uses $1/(1 - MPC) = 1/0.10 = 10$, ignoring the tax leakage. Taxes reduce the disposable income available for each round of spending.
- **C.** \$82 million puts the tax rate t in place of $(1 - t)$: $1/[1 - 0.90(0.30)] = 1/0.73 = 1.370$, and $60 \times 1.370 = 82.2$. The MPC applies to the after-tax share of income, $1 - t$.

Key takeaway Fiscal multiplier $= 1/[1 - MPC(1 - t)]$: it rises with the MPC and falls with the tax rate.

Reading 14: Fiscal Policy. Notes: credguild.com/cfa/level-1/notes/economics/fiscal-policy/

Question 14 **Answer: A**

When the change comes from policy decisions rather than from the business cycle, fiscal policy is judged expansionary if the deficit increases or the surplus decreases, and contractionary if the deficit decreases or the surplus increases. A widening deficit (Estavia) and a shrinking surplus (Marquessa) are both expansionary.

Why the other options are wrong

- **B.** Contractionary would require a shrinking deficit or a growing surplus, which is the opposite of both situations described.
- **C.** It is tempting to treat 'deficit' and 'surplus' as opposites. What matters is the *direction of change*, and both budgets moved toward more stimulus.

Key takeaway Look at the direction of change in the policy-driven (structural) budget balance. Whether the balance is a deficit or a surplus does not decide the stance.

Reading 14: Fiscal Policy. Notes: credguild.com/cfa/level-1/notes/economics/fiscal-policy/

Question 15 **Answer: A**

Because the central bank can create central bank money (reserves and currency) at will, it can lend to banks that run short of funds. Knowing this backstop exists assures depositors their money is safe and helps prevent bank runs. That is the lender-of-last-resort role.

Why the other options are wrong

- **B.** Holding the nation's gold and foreign currency reserves is a separate role. It concerns official reserves rather than emergency lending to domestic banks.
- **C.** Being the sole supplier of currency is what *enables* emergency lending, but the role being performed here is lending to banks in distress, i.e., lender of last resort.

Key takeaway Preventing bank runs by standing ready to lend to banks is the lender-of-last-resort role.

Reading 15: Monetary Policy. Notes: credguild.com/cfa/level-1/notes/economics/quantitative-easing/

Question 16 **Answer: A**

Buyers of the securities pay with funds that leave the banking system, so bank reserves fall. With fewer reserves to lend to one another, banks bid up the overnight rate, and the federal funds rate increases. This is how the Federal Reserve moves the rate toward a higher target.

Why the other options are wrong

- **B.** The reserve effect is right, but scarcer reserves push the federal funds rate up.
- **C.** This describes open market *purchases*, which add reserves and lower the federal funds rate.

Key takeaway Open market sale: reserves down, federal funds rate up.

Reading 15: Monetary Policy. Notes: credguild.com/cfa/level-1/notes/economics/quantitative-easing/

Question 17 **Answer: A**

A credible central bank is one whose stated targets people believe. They then base their decisions (wages, nominal contracts, loan pricing) on the target inflation rate, which helps make the target self-fulfilling.

Why the other options are wrong

- **B.** Transparency means periodically disclosing the state of the economy (e.g., inflation reports) and the indicators used. It supports credibility, but the behavior described is the definition of credibility itself.
- **C.** Target independence means the central bank determines how inflation is computed, sets the target level and the horizon. It says nothing about whether the public believes the target.

Key takeaway Decisions based on the announced target = credibility. Regular inflation reports = transparency. Deciding the policy rate or the target = independence.

Reading 15: Monetary Policy. Notes: credguild.com/cfa/level-1/notes/economics/quantitative-easing/

Question 18 **Answer: A**

The neutral rate of interest equals the real trend rate of growth plus the inflation target, 4.0%. The policy rate equals the neutral rate, so monetary policy is neither expansionary nor contractionary.

$$\text{neutral rate} = 1.6\% + 2.4\% = 4.0\%$$

Policy rate $= 4.0\% =$ neutral rate, so policy is neutral.

Why the other options are wrong

- **B.** Expansionary would require a policy rate below 4.0%.
- **C.** Contractionary would require a policy rate above 4.0%. This answer comes from comparing 4.0% with only the inflation target (2.4%) or the trend growth rate (1.6%).

Key takeaway When the policy rate equals trend real growth plus the inflation target, the stance is neutral.

Reading 15: Monetary Policy. Notes: credguild.com/cfa/level-1/notes/economics/quantitative-easing/

Question 19 **Answer: C**

When both policies are expansionary, government spending grows through fiscal policy while easier monetary policy keeps interest rates low, usually lower than before, which supports private consumption and investment. Both the public and the private sectors expand, and aggregate demand rises strongly. Expansionary fiscal policy also has a larger effect on output when monetary policy is expansionary at the same time.

Why the other options are wrong

- **A.** Tight monetary policy combined with fiscal expansion raises interest rates. Government spending grows as a share of GDP, but higher rates discourage private investment and consumption, so the private sector does not share in the expansion.

- **B.** Lower interest rates stimulate private spending, but contractionary fiscal policy reduces government spending as a share of GDP. The public sector shrinks, which conflicts with the goal.

Key takeaway Easy fiscal and easy monetary: rates usually lower, both sectors grow. Tight fiscal and tight monetary: rates higher, both sectors shrink. Easy fiscal and tight monetary: rates higher, the public sector's share rises. Tight fiscal and easy monetary: rates lower, the private sector's share rises.

Reading 15: Monetary Policy. Notes: credguild.com/cfa/level-1/notes/economics/quantitative-easing/

Question 20 Answer: C

In geopolitics, cooperation means interacting and engaging with other countries, for example by allowing goods to move freely across borders, harmonizing tariffs and standardizing rules. The regional agreement is therefore cooperative. Banning exports of a particular good restricts engagement with other countries, so it is noncooperative. Only one of the two actions is cooperative.

Why the other options are wrong

- **A.** The trade and standards agreement is a clear example of economic cooperation, so it is not true that neither action is cooperative.
- **B.** An export ban limits interaction with other countries and is noncooperative, so both actions cannot be cooperative. A country can be cooperative on some issues and noncooperative on others at the same time.

Key takeaway Cooperation is a spectrum and is judged issue by issue: trade agreements and harmonization are cooperative, while export bans and investment restrictions are noncooperative.

Reading 16: Introduction to Geopolitics. Notes: credguild.com/cfa/level-1/notes/economics/introduction-to-geopolitics/

Question 21 Answer: A

The World Bank describes its mission as fighting poverty, and it provides low-interest loans, interest-free credits and grants to developing countries for that purpose. The IMF's goals in Article I of its Articles of Agreement concern monetary cooperation, the growth of trade, exchange stability, the payments system and balance of payments support, and the WTO deals with the rules of trade. Neither Article I nor the WTO's role includes poverty reduction, so the World Bank is the only one of the three explicitly focused on it. The IMF's broader mission statement also mentions reducing poverty, which is why the comparison uses Article I.

Why the other options are wrong

- **B.** Expanding trade is not unique to the WTO. One of the IMF's main goals is facilitating the expansion and balanced growth of international trade.
- **C.** Providing funds is not unique to the IMF. The IMF makes resources available to members with balance of payments difficulties, but the World Bank also provides loans, credits and grants to developing countries for development.

Key takeaway Trade growth: IMF and WTO. Funding members: IMF and World Bank. Poverty: World Bank only.

Reading 16: Introduction to Geopolitics. Notes: credguild.com/cfa/level-1/notes/economics/introduction-to-geopolitics/

Question 22 Answer: C

Event risk arises from an event whose timing is known but whose outcome is uncertain. The referendum is scheduled a year ahead, while its result remains unknown.

Why the other options are wrong

- **A.** A known factor with effects that build over many years is thematic risk.
- **B.** A sudden rebellion with no advance warning is exogenous risk, not event risk.

Key takeaway Event risk: known timing, uncertain outcome. Exogenous risk: unanticipated events. Thematic risk: known factors whose effects develop over a long period.

Reading 16: Introduction to Geopolitics. Notes: credguild.com/cfa/level-1/notes/economics/introduction-to-geopolitics/

Question 23 **Answer: B**

The business cycle affects the impact of geopolitical risk. The same risk may have a greater effect on investment values during a recession than it would during an expansion.

Why the other options are wrong

- **A.** Scenario analysis, qualitative or quantitative, is a standard way to gauge the potential effects of geopolitical risks on a portfolio.
- **C.** Geopolitical risks can have discrete effects on a specific company or industry as well as broad effects on a country, a region or the world. Investors should judge which applies to each high-impact risk.

Key takeaway Focus analysis on high-impact risks, decide whether each is discrete or broad, allow for a larger impact in a recession, and use scenario analysis and signposts.

Reading 16: Introduction to Geopolitics. Notes: credguild.com/cfa/level-1/notes/economics/introduction-to-geopolitics/

Question 24 **Answer: B**

For the economy as a whole, the benefits of trade exceed the costs. The costs are concentrated among firms and workers in domestic industries that compete with imports, who may suffer lower profits or lost jobs.

Why the other options are wrong

- **A.** Not every group gains. Import-competing industries and their workers can lose, even though the gainers could in principle compensate them.
- **C.** Jobs lost in import-competing industries are offset by jobs created in export and growing industries, and over time retrained workers find new work. Economists do not conclude that trade's employment costs exceed its benefits.

Key takeaway Overall gains exceed losses, but the losses are concentrated in import-competing industries.

Reading 17: International Trade. Notes: credguild.com/cfa/level-1/notes/economics/comparative-advantage/

Question 25 **Answer: C**

A tariff is a tax on imported goods collected by the government; a quota caps the quantity that may be imported over a period. Both are trade restrictions imposed by individual countries.

Why the other options are wrong

- **A.** Tariffs are not set by international organizations. Individual countries impose both tariffs and quotas.
- **B.** A quota is not a worldwide agreement on total trade. It is a limit on imports set by the individual importing country, just as a tariff is.

Key takeaway Tariff = tax on imports; quota = quantity limit on imports; both are imposed by the importing

country.

Reading 17: International Trade. Notes: credguild.com/cfa/level-1/notes/economics/comparative-advantage/

Question 26 Answer: A

All three measures raise Tessaly's domestic price by the same amount and cut imports by the same quantity, so they cause the same loss of consumer surplus, the same gain in domestic producer surplus and the same deadweight losses. They differ in who receives the amount equal to the price increase times the remaining imports. Under a tariff the government collects it as tariff revenue, and under the auctioned quota the government captures it by selling the licenses. Under a voluntary export restraint the foreign exporters keep it as quota rents, so it is lost to Tessaly and the national welfare loss is the largest.

Illustration with assumed areas: consumer surplus falls by 50, domestic producer surplus rises by 20, the rectangle (price increase $\times$ remaining imports) is 18 and the two deadweight triangles total 12, so $50 = 20 + 18 + 12$.

Tariff: $-50 + 20 + 18 = -12$. Auctioned quota: $-50 + 20 + 18 = -12$. Voluntary export restraint: $-50 + 20 = -30$, because the rectangle goes to foreign exporters.

Why the other options are wrong

- **B.** A tariff causes the same price rise and deadweight losses, but the government collects tariff revenue equal to the price increase times the remaining imports. That revenue stays in Tessaly and offsets part of the consumers' loss.
- **C.** Auctioning the licenses for their full value lets the government capture the quota rents, so the national welfare effect matches the tariff. A quota would be as costly as the voluntary export restraint only if its licenses were given away to foreign exporters.

Key takeaway For an importing country, the national welfare loss from a tariff equals that from a quota whose licenses are sold at full value. A voluntary export restraint, like a quota whose rents go to foreign exporters, adds the quota rents to the loss.

Reading 17: International Trade. Notes: credguild.com/cfa/level-1/notes/economics/comparative-advantage/

Question 27 Answer: B

Integration increases in this order: free trade area, customs union, common market, economic union, monetary union. Each step adds a feature: common external trade restrictions (customs union), free movement of labor and capital (common market), common institutions and economic policy (economic union), and a single currency (monetary union). The sequence free trade area, customs union, common market follows that order.

Why the other options are wrong

- **A.** A customs union is less integrated than a common market, so it cannot come after it.
- **C.** A free trade area is the least integrated form, so it cannot come after a customs union.

Key takeaway Least to most integrated: free trade area, customs union, common market, economic union, monetary union.

Reading 17: International Trade. Notes: credguild.com/cfa/level-1/notes/economics/comparative-advantage/

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Question 28 **Answer: A**

Leveraged accounts are investment firms such as hedge funds, proprietary trading firms and other trading firms that make substantial use of leverage, typically through derivatives. Real money accounts, such as mutual funds, pension funds, insurance companies and similar institutional accounts, are restricted in their use of leverage. Both are buy-side participants.

Why the other options are wrong

- **B.** Quoting two-way prices is the role of the dealers on the sell side (large multinational banks). Leveraged accounts are buy-side clients of those dealers.
- **C.** Being restricted to long-term, unleveraged holdings describes a real money account, the opposite of a leveraged account.

Key takeaway Leveraged accounts (hedge funds, trading firms) use leverage extensively, typically via derivatives; real money accounts (mutual funds, pension funds, insurers) are restricted in their use of leverage.

Reading 18: Capital Flows and the FX Market. Notes: credguild.com/cfa/level-1/notes/economics/capital-flows-and-the-fx-market/

Question 29 **Answer: C**

The real domestic/foreign rate equals the nominal domestic/foreign rate multiplied by $CPI_{\text{foreign}}/CPI_{\text{domestic}}$. The domestic price level sits in the denominator, so an increase in it lowers the real exchange rate and raises the purchasing power of the domestic currency over foreign goods.

$$\text{real D/F} = \text{nominal D/F} \times \frac{CPI_F}{CPI_D}$$

Here D (the domestic currency) is the price currency and F is the base currency. Raising CPI_D shrinks the ratio, so the real rate falls; raising CPI_F or the nominal rate increases it.

Why the other options are wrong

- **A.** A higher foreign price level raises the real rate: foreign goods become more expensive relative to domestic goods, so the domestic currency loses purchasing power over foreign goods.
- **B.** The real rate equals the nominal rate times a price-level ratio, so a higher nominal domestic/foreign rate raises the real rate, other things equal.

Key takeaway In the real P/B formula the base-country CPI is on top and the price-country CPI is on the bottom. Other things equal, a higher price level in the price-currency country lowers the real rate, while a higher base-country price level or a higher nominal rate raises it.

Reading 18: Capital Flows and the FX Market. Notes: credguild.com/cfa/level-1/notes/economics/capital-flows-and-the-fx-market/

Question 30 **Answer: A**

Under a currency board arrangement the monetary authority commits to convert its own currency into one named foreign currency on demand at a fixed rate, and it may issue domestic currency only when every unit is backed by reserves of that foreign currency. The country keeps its own currency and earns interest on its

reserves, but it gives up independent monetary policy and in effect imports the inflation rate of the anchor currency.

Why the other options are wrong

- **B.** Under formal dollarization a country has no currency of its own; it uses another country's currency, and the interest earned on the assets backing that currency goes to the issuing central bank. Pelagia issues its own dinars and earns interest on its reserves.
- **C.** A conventional fixed peg keeps the currency within a narrow band, about 1% either side of the target rate, through intervention and policy, without a rule that every unit of domestic currency be backed by foreign reserves. The monetary authority keeps more policy flexibility than under a currency board.

Key takeaway Currency board: the country has its own currency, fully backed by an anchor currency at a fixed rate; its reserves earn interest, and it has no independent monetary policy.

Reading 18: Capital Flows and the FX Market. Notes: credguild.com/cfa/level-1/notes/economics/capital-flows-and-the-fx-market/

Question 31 **Answer: C**

A commonly cited objective of capital restrictions is to keep domestic interest rates low, not high. When residents cannot move funds abroad to chase higher yields, the central bank can keep rates low and run a more independent monetary policy. Maintaining fixed exchange rates and protecting strategic industries are also standard objectives.

Why the other options are wrong

- **A.** Limiting capital flows makes an exchange rate target easier to defend, so this is a standard objective.
- **B.** Governments often bar foreign investment in sectors such as defense and telecommunications, so this is a standard objective.

Key takeaway Capital controls let a country keep domestic rates low while defending its exchange rate.

Reading 18: Capital Flows and the FX Market. Notes: credguild.com/cfa/level-1/notes/economics/capital-flows-and-the-fx-market/

Question 32 **Answer: B**

Convert EUR/USD into USD/EUR by inverting, then divide by NZD/EUR (equivalently, multiply by EUR/NZD) so the euro cancels and USD/NZD remains.

$$\text{USD/EUR} = \frac{1}{0.9240} = 1.08225$$

$$\frac{\text{USD}}{\text{NZD}} = \frac{\text{USD/EUR}}{\text{NZD/EUR}} = \frac{1.08225}{1.7960} = 0.60259$$

Why the other options are wrong

- **A.** This divides EUR/USD by NZD/EUR without first inverting EUR/USD, so the units do not cancel to USD/NZD.
- **C.** This multiplies the two quotes: $0.9240 \times 1.7960 = 1.6595$. The units (EUR/USD $\times$ NZD/EUR) give NZD/USD, which is the inverse of the USD/NZD rate asked for ($1/1.6595 = 0.60259$).

Key takeaway Invert first, then chain the quotes so the common currency cancels.

Reading 19: Exchange Rate Calculations. Notes: credguild.com/cfa/level-1/notes/economics/exchange-rate-calculations/

Question 33 **Answer: B**

The no-arbitrage forward rate equals spot times (1 + price-currency rate for the period) / (1 + base-currency rate for the period). Money market rates are de-annualized using days/360. Because the US dollar (base currency) has the higher rate, it trades at a forward discount, so the forward rate is below spot.

$$F_{CAD/USD} = 1.3450 \times \frac{1 + 0.0420\,(180/360)}{1 + 0.0540\,(180/360)} = 1.3450 \times \frac{1.0210}{1.0270} = 1.3450 \times 0.99416 = 1.3371$$

Why the other options are wrong

- **A.** This uses the full annual rates ($1.3450 \times 1.042/1.054$) instead of the 180-day rates.
- **C.** This puts the USD (base-currency) rate in the numerator; the price-currency (CAD) rate belongs on top.

Key takeaway For forwards shorter than one year, scale each money market rate by days/360 before applying the parity formula.

Reading 19: Exchange Rate Calculations. Notes: credguild.com/cfa/level-1/notes/economics/exchange-rate-calculations/

Question 34 **Answer: C**

Interest rate parity is a no-arbitrage condition: at a point in time, the higher-yielding currency trades at a forward discount so that borrowing in one currency and investing in the other with a forward cover earns no riskless profit. It does not say how the spot rate responds when interest rates change, and interest rate differentials have historically been poor predictors of future spot rates. Capital-market analysis points the other way: a higher domestic interest rate attracts foreign investment, which raises demand for the currency and tends to make it appreciate. Okoye's comment follows this reasoning, while Ruiz treats the forward rate as a forecast.

Why the other options are wrong

- **A.** Ruiz treats the no-arbitrage forward rate as the expected future spot rate. Parity only sets the forward rate that rules out arbitrage today; it does not describe how the spot rate moves after a rate change, and rate differentials have forecast future spot rates poorly.
- **B.** A change in the policy rate does affect the exchange rate. The exchange rate is one channel of the monetary transmission mechanism: higher domestic rates attract capital and tend to strengthen the domestic currency.

Key takeaway Treat the no-arbitrage forward rate as the rate that prevents arbitrage today; it is not a forecast of the future spot rate. A higher domestic interest rate tends to attract capital and strengthen the currency.

Reading 19: Exchange Rate Calculations. Notes: credguild.com/cfa/level-1/notes/economics/exchange-rate-calculations/

Question 35 **Answer: B**

The forward SGD/AUD rate is below spot, so the forward quote is a discount. With four-decimal quotes the difference of 0.0075 equals 75 points. The AUD (base currency) is at a forward discount, which means the SGD (price currency) is at a forward premium to the AUD.

$$F - S = 0.8795 - 0.8870 = -0.0075 = -75 \text{ points}$$

AUD: $0.8795/0.8870 - 1 = -0.85\%$ (discount); SGD: $0.8870/0.8795 - 1 = +0.85\%$ (premium).

Why the other options are wrong

- **A.** The forward rate is below spot, so the quote is a discount of 75 points. The SGD, as the price currency, is at a premium.
- **C.** Each point is 0.0001, so a 0.0075 difference is 75 points. The SGD is also at a premium, because the AUD buys fewer SGD forward than spot.

Key takeaway The sign of the points describes the base currency; the price currency moves the other way.

Reading 19: Exchange Rate Calculations. Notes: credguild.com/cfa/level-1/notes/economics/exchange-rate-calculations/

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