

Name: _____

Student id: _____



**College of Business Administration
Department of Economics
Aggregate Economic Conditions
ECO 3203
O. Mikhail
Fall 2001**

FINAL EXAM

- This closed book exam is worth 100 points.
The exam totals 44 multiple-choice questions and 2 short essay questions.
Only the first 35 correct multiple-choice questions will count for 70 points.
Each correct multiple-choice answer is worth 2 points.
The short-essay questions are worth 30 points. Each is worth 15 points.
Allocate your time accordingly.
- Answer all the short essay questions in the given space below each question.
- Including the cover page, the exam totals 11 pages.
- Answer the multiple-choice questions on the computer sheet.
- DO NOT forget to write your name and your student id on both: the computer sheet and the exam booklet.
- Non-Programmable calculators and language dictionaries are allowed.
- At the end of the exam, hand-in the exam booklet and the computer sheet to the examiner.

7:00 a.m. – 9:50 a.m.

BA 110

December 5, 2001

MULTIPLE-CHOICE: (70 points)

1. Suppose that an increase in oil prices is accompanied by a decline in the level of potential output. Which of the following is the most likely long-run effect?
 - a) real GDP will decrease but the price level will increase
 - b) real GDP and the price level will both decline
 - c) real GDP will remain the same but the price level will increase
 - d) the unemployment rate and the price level will both increase
 - e) both A) and D)

2. Assume a model of the expenditure sector. The marginal propensity to save is 0.2, the marginal propensity to import is 0.1 and the marginal tax rate is 0.25. What is the size of the multiplier?
 - a) 2
 - b) 2.5
 - c) 4
 - d) 5
 - e) 10

3. In a model with no government or foreign sector, if income = 800, autonomous consumption = 100, and the marginal propensity to consume (mpc) = 0.7, then total consumption is
 - a) 100
 - b) 560
 - c) 660
 - d) 870
 - e) 900

4. Autonomous spending
 - a) is always dependent on the level of income
 - b) is always determined by the form of the consumption function
 - c) is not part of aggregate demand
 - d) is independent of the level of income
 - e) increases when disposable income increases

5. Which of the following is NOT reflected in a shift of the AD-curve?
 - a) a change in real money balances due to a change in the price level
 - b) a change in real money balances due to a change in nominal money supply
 - c) a change in government transfer payments
 - d) a change in the confidence of consumers and businesses
 - e) all of the above will shift the AD-curve

6. Monetary policy becomes more effective as
- a) the marginal propensity to save increases
 - b) the interest sensitivity of investment increases
 - c) the interest sensitivity of money demand increases
 - d) the income tax increases
 - e) none of the above
7. The multiplier measures
- a) the number of steps it takes to move from one equilibrium to another
 - b) the rise in saving resulting from a rise in income
 - c) the change in investment resulting from a change in income
 - d) the change in induced consumption caused by a change in income
 - e) none of the above
8. The ill effects of unemployment are often more severe than is evident from the official data since
- a) the natural rate of unemployment is not accounted for
 - b) the incidence of unemployment, both in frequency and duration, is spread unevenly throughout the economy
 - c) the turnover rate is fairly high as many people move quickly into and out of the unemployment pool
 - d) much of the unemployment that is reported is structural
 - e) workers trying to enter the labor force for the first time are not counted as unemployed
9. What sort of event could lead to a simultaneous decrease in the rates of inflation and unemployment?
- a) a decrease in money supply
 - b) an increase in money supply
 - c) an adverse supply shock
 - d) a decrease in material prices
 - e) restrictive monetary policy following an adverse supply shock
10. In an adverse supply shock, wage indexation is likely to
- a) prevent any increase in inflation
 - b) limit inflation to 1 or 2 percent
 - c) almost immediately shift the AS-curve back to the right
 - d) lead to a wage-price spiral
 - e) none of the above
11. The size of the multiplier depends on
- a) the marginal propensity to consume
 - b) the marginal propensity to import
 - c) the marginal income tax rate
 - d) all of the above
 - e) only A) and B)
12. The consumption function has a positive vertical intercept indicating that
- a) some consumption is unaffected by income
 - b) the mpc is less than one
 - c) the apc will always increase as income increases
 - d) some consumption will occur no matter what the price level
 - e) a positive fraction of income is saved

13. Policy A is a tight-money/easy-fiscal policy mix and Policy B is an easy-money/tight-fiscal policy mix. Compared to Policy B, Policy A will cause a
- a) lower level of investment
 - b) higher level of investment
 - c) higher level of consumption
 - d) lower level of saving
 - e) surplus in the current account of the balance of payments
14. Okun's law states that one extra percentage point in unemployment causes
- a) a 2 percent fall in GDP
 - b) a 0.5 percent fall in GDP
 - c) a 2 percent fall in the rate of inflation
 - d) a 0.5 fall in the rate of inflation
 - e) a 2 percent increase in the sacrifice ratio
15. In a model with income taxes, if autonomous net exports decrease, which of the following is FALSE?
- a) the budget deficit will not be affected
 - b) the budget deficit will increase
 - c) disposable income will decrease
 - d) saving will decrease
 - e) income will decrease by more than net exports
16. The insider-outsider model refers to
- a) policy making in White House
 - b) the fact that the unemployed do not take part in collective bargaining
 - c) the fact that wages do not respond significantly to unemployment
 - d) slow price adjustments in an imperfectly competitive environment
 - e) both B) and C)
17. If there is a decrease in government expenditures
- a) the LM-curve will shift to the left
 - b) the IS-curve will shift to the left
 - c) the LM-curve will become flatter and shift to the left
 - d) the IS-curve will become steeper and shift to the left
 - e) the expenditure multiplier will become smaller and the IS-curve will shift to the left
18. If money demand becomes more income elastic, the LM-curve will
- a) shift to the right
 - b) shift to the left
 - c) become steeper
 - d) become flatter
 - e) remain unaffected
19. The IS-curve is
- a) positively sloped
 - b) negatively sloped
 - c) shifted by changes in money supply
 - d) shifted by changes in the transactions demand for money
 - e) both A) and C)

20. In 1992, the U.S. unemployment rate as was 7.4%. What was the dollar amount of output lost due to this unemployment rate?
- a) roughly \$500 billion
 - b) roughly \$250 billion
 - c) roughly \$125 billion
 - d) roughly \$60 billion
 - e) roughly \$30 billion
21. If factor markets were perfectly competitive, then full employment would be the normal condition, and
- a) inflation would always be zero
 - b) the AS-curve would be horizontal
 - c) there would never be any reason for prices to change
 - d) output would rise steadily with price increases
 - e) the AS-curve would be vertical
22. A movement along the AD-curve from left to right is equivalent to a shift of
- a) the LM-curve to the right due to an increase in real money balances
 - b) the IS-curve to the right due to a decrease in interest rates
 - c) the LM-curve to the right due to an increase in nominal money supply
 - d) the IS-curve to the right due to a lower interest rate
 - e) both the IS- and LM-curves to the right due to a lower price level
23. The two major determinants of the level of investment are
- a) the levels of consumption and saving
 - b) business expectations and the interest rate
 - c) the levels of income and saving
 - d) business expectations and the level of saving
 - e) corporate income taxes and the level of saving
24. In the IS-LM model, an increase in money supply will
- a) increase income, interest rates and prices
 - b) increase income and prices, but decrease interest rates
 - c) increase income, decrease interest rates, but leave prices unchanged
 - d) increase income and prices but leave interest rates unchanged
 - e) increase prices and interest rates but leave income unchanged
25. When the LM-curve is vertical, then
- a) the monetary policy multiplier is zero
 - b) monetary policy is at its weakest but fiscal policy has a maximal effect
 - c) monetary policy has a maximal effect, but fiscal policy has no effect on income
 - d) fiscal policy's impact on interest rates will not affect investment
 - e) monetary policy affects interest rates but this will not change investment spending

26. Assume a model with income taxes in which imports increase proportionally to income. Which of the following is FALSE?
- a) the expenditure multiplier increases with an increase in the marginal propensity to import
 - b) the expenditure multiplier decreases with an increase in the marginal propensity to import
 - c) the expenditure multiplier decreases with an increase in the marginal propensity to save
 - d) the expenditure multiplier decreases with an increase in the marginal income tax rate
 - e) the expenditure multiplier decreases with a decrease in the marginal propensity to consume
27. Which of these people could officially be counted as unemployed?
- a) a waitress who got fired from her old job two months ago but will start a new job in two weeks
 - b) a busboy who works only four hours a day, five days a week but would prefer to work full-time
 - c) an accountant who quit her job when she had a baby two months ago
 - d) a woman who joined the baby sitters' union several months ago and averages about five customers a week at her new \$9/hour rate
 - e) none of the above
28. Assume an economy with no foreign sector, a marginal propensity to save of $mps = 1/10$, and a marginal income tax rate of $t = 1/3$. What change in government purchases would lead to an increase in national income of 500?
- a) 50
 - b) 100
 - c) 200
 - d) 300
 - e) 500
29. Looking at the behavior of interest rates over time, we realize that
- a) they tend to fall shortly before a recession
 - b) they tend to be high before a recession and fall during a recession
 - c) they tend to rise in a recovery and fall in a recession
 - d) they tend to be high in a recession
 - e) both B) and C)
30. Which of the following is FALSE?
- a) the AS-curve is horizontal in the Keynesian case
 - b) the AS-curve is vertical in the classical case
 - c) the AS-curve is upward-sloping in the medium run
 - d) the AS-curve is more price elastic in the long run than in the short run
 - e) none of the above

31. If investment becomes more responsive to changes in the interest rate, then
- a) the size of the expenditure multiplier will increase
 - b) income will increase more with any increase in the interest rate
 - c) the IS-curve will become flatter
 - d) the IS-curve will become steeper
 - e) both A) and C)
32. As a result of a decrease in government purchases and an increase in nominal money supply we should expect in the medium run that
- a) aggregate demand decreases and aggregate supply will increase
 - b) aggregate demand, prices, and the interest rate will all increase
 - c) the interest rate will decrease, while aggregate demand and prices may increase, decrease or remain the same
 - d) aggregate demand and prices will decrease, while the interest rate will increase
 - e) none of the above
33. Most economists prior to Keynes thought
- a) unemployment could be eliminated by an active fiscal policy
 - b) full employment was the normal condition
 - c) the economy would always adjust to a natural rate of inflation
 - d) monetary policy could eliminate the business cycle
 - e) government intervention was needed to avoid persistent unemployment
34. In an IS-LM framework, a decrease in money supply will lead to
- a) an increase in the demand for money
 - b) a decrease in both income and the interest rate
 - c) an increase in the interest rate and a decrease in income
 - d) a decrease in the size of the monetary policy multiplier
 - e) both A) and C)
35. Assume the government implements spending cuts and the Fed responds by increasing money supply. Which of the following is the most likely result?
- a) lower interest rates and a lower budget deficit
 - b) lower interest rates and a higher trade deficit
 - c) a decrease in investment and net exports
 - d) a lower budget deficit and lower tax revenues
 - e) both A) and D)
36. Assume an economy with no foreign sector, a marginal propensity to save of $mps = 1/10$ and a marginal income tax rate of $t = 1/3$. Assume that government transfer payments decrease by 200. Which of the following is true?
- a) national income will decrease by 450
 - b) tax revenues will decrease by 150
 - c) the budget deficit will decrease by 50
 - d) consumption will decrease by 450
 - e) all of the above

37. If money supply were not fixed by the Fed but instead were interest sensitive (that is, an increase in the interest rate would lead to an increase in the supply of money), then
- a) the LM-curve would become flatter
 - b) the LM-curve would become steeper
 - c) monetary policy would be more effective
 - d) the LM-curve would shift to the left
 - e) the LM-curve would become horizontal
38. Assume you would like to stimulate investment but leave income roughly the same. What policy would you propose?
- a) an income tax cut combined with monetary expansion
 - b) an investment subsidy combined with monetary expansion
 - c) an investment subsidy
 - d) a tax decrease combined with monetary restriction
 - e) a government spending cut combined with monetary expansion
39. A policy mix designed to promote a higher economic growth rate through an increase in investment might involve
- a) money supply cuts and income tax reductions
 - b) a government spending increase financed by an income tax increase
 - c) cuts in government purchases and higher investment tax credits
 - d) money supply cuts combined with reductions in government purchases
 - e) reduced investment tax credits and increased transfers to households
40. When conducting monetary policy, the Fed should
- a) only be concerned with current economic conditions
 - b) be less concerned with current conditions than with future conditions
 - c) always try to keep interest rates low
 - d) always combine expansionary monetary policy with expansionary fiscal policy
 - e) none of the above
41. Which of the following is NOT a property of the upward-sloping short-run AS-curve
- a) if output is above the full-employment level, the AS-curve shifts to the right
 - b) the position of the AS-curve depends on the past level of prices
 - c) the AS-curve becomes steeper as the impact of changes in output and employment on wages becomes larger
 - d) if output is below the full-employment level, the AS-curve will shift to the right
 - e) if wages respond very little to changes in unemployment, the AS-curve is very flat
42. In a normal IS-LM model,
- a) expansionary fiscal policy will not be crowded out if the Fed undertakes open market sales at the same time
 - b) expansionary monetary policy will affect investment by affecting interest rates
 - c) increased government spending will not affect national income unless it is financed by an increase in money supply
 - d) tax rate cuts will increase the slope of the IS-curve and thus increase income and reduce interest rates
 - e) expansionary monetary policy will be neutral, since price increases will reduce real money holdings

43. Which of the following statements is FALSE?
- a) there is a high turnover rate in the labor market
 - b) a significant amount of the turnover rate in the labor market is cyclical
 - c) there are large variations in unemployment rates across groups defined by age, race and sex
 - d) most workers who become unemployed in any given month remain unemployed for a lengthy time period
 - e) many workers who are counted as unemployed will be (or have been) unemployed for quite some time
44. In the medium run the aggregate supply curve is upward sloping since
- a) workers immediately realize that nominal wage increases are only the result of price increases
 - b) firms encounter costs to resetting prices and they are willing to pay workers above market-clearing prices
 - c) wages and prices always immediately change in proportion to the money stock
 - d) there is always natural friction in the labor market that prevents unemployment from reaching zero
 - e) none of the above

SHORT ESSAY QUESTION: (30 points)
ANSWER IN THE GIVEN SPACE BELOW THE QUESTION
BE CLEAR, BRIEF and USE GRAPHS WHENEVER POSSIBLE

QUESTION I: (15 points)

What is a liquidity trap? If the economy were stuck in one, would you advise the use of monetary or fiscal policy? Explain your answer and use graphs.

QUESTION II: (15 points)

BE CLEAR, BRIEF and USE GRAPHS

Many analysts have concluded that the U.S. economy entered a recession in March 2001. The Federal Reserve reacted to the weakening economy with a lower target for the federal funds rate. In July 2001, a fiscal' stimuli took place in the form of a tax cut. Assume that the effect on income of the monetary policy is more powerful than the effect of the fiscal stimuli.

Using IS-LM, AD-AS and the Money Market:

- Show the behavior of the economy from March 2001 to July 2001 to the Long Run (3 equilibrium points). Using output, unemployment, real interest and the price level as criteria, compare between the equilibrium points.
- Each time a curve shifts, explain why and what are the consequences.
- What are the consequences on the next year debt-to-GDP ratio? Explain why.

Answer Key

1. a real GDP will decrease but the price level will increase
2. a 2
3. c 660
4. d is independent of the level of income
5. a a change in real money balances due to a change in the price level
6. b the interest sensitivity of investment increases
7. e none of the above
8. b the incidence of unemployment, both in frequency and duration, is spread unevenly throughout the economy
9. d a decrease in material prices
10. d lead to a wage-price spiral
11. d all of the above
12. a some consumption is unaffected by income
13. a lower level of investment
14. a a 2 percent fall in GDP
15. a the budget deficit will not be affected
16. e both B) and C)
17. b the IS-curve will shift to the left
18. c become steeper
19. b negatively sloped
20. b roughly \$250 billion
21. e the AS-curve would be vertical
22. a the LM-curve to the right due to an increase in real money balances

23. b business expectations and the interest rate
24. b increase income and prices, but decrease interest rates
25. c monetary policy has a maximal effect, but fiscal policy has no effect on income
26. a the expenditure multiplier increases with an increase in the marginal propensity to import
27. a a waitress who got fired from her old job two months ago but will start a new job in two weeks
28. c 200
29. e both B) and C)
30. d the AS-curve is more price elastic in the long run than in the short run
31. c the IS-curve will become flatter
32. c the interest rate will decrease, while aggregate demand and prices may increase, decrease or remain the same
33. b full employment was the normal condition
34. c an increase in the interest rate and a decrease in income
35. a lower interest rates and a lower budget deficit
36. d consumption will decrease by 450
37. a the LM-curve would become flatter
38. e a government spending cut combined with monetary expansion
39. c cuts in government purchases and higher investment tax credits
40. b be less concerned with current conditions than with future conditions
41. a if output is above the full-employment level, the AS-curve shifts to the right
42. b expansionary monetary policy will affect investment by affecting interest rates
43. d most workers who become unemployed in any given month remain unemployed for a lengthy time period

44. b firms encounter costs to resetting prices and they are willing to pay workers above market-clearing prices