Name:________________________

ECO 200 820 Principles of Macroeconomics **Exam 2** **November 9, 2000** **Form A**

Part I: Multiple Choice (3.5 points each)

Read each question carefully and select the most appropriate response. Circle the appropriate letter of the response and fill in the corresponding circle on your answer sheet.

1. If wages and prices are flexible, recessions can best be eliminated when
   a) prices and wages both rise.
   b) prices and wages both fall
   c) prices rise and wages drop.
   d) prices drop and wages rise.

2. The U.S. national debt is approximately
   a) $5.6 trillion.
   b) $3 trillion.
   c) $1.2 trillion.
   d) $300 billion.

3. Suppose the consumption function = 1000 + .8Y. If investment falls by 100 then aggregate demand will shift ____ by ____.
   a) right; 500
   b) left; 500
   c) right; 800
   d) left; 100

4. The Federal Reserve governors
   a) take their orders about monetary policy directly from the President.
   b) take their orders about monetary policy directly from Congress.
   c) take their orders about monetary policy directly from the Treasury Department.
   d) are given independence in setting monetary policy.

5. Today the United States dollar is
   a) a poor store of value
   b) only counted in M1.
   c) commodity money
   d) fiat money

6. When aggregate demand increases the resulting change in equilibrium output
   a) will be smaller than the increase in aggregate demand due to higher prices.
   b) will be larger than the increase in aggregate demand due to higher prices.
   c) will be larger than the increase in aggregate demand due to lower prices.
   d) will be identical to the increase in aggregate demand.
   (hint: DRAW THE GRAPH!)

7. Which of the following would theoretically INCREASE the money supply?
   a) An open market sale of Treasury bonds
   b) An increase in the required reserve ratio
   c) A decrease in the discount rate
   d) both a and b.
   e) both a and c.

8. Aggregate demand shifts to the left when:
   a) Government taxes are increased.
   b) Government transfers are decreased.
   c) Government purchases are decreased.
   d) All of the above.

9. Under the Keynesian view of monetary policy, which of the following occur(s) when the Fed buys Treasury bonds?
   a) interest rates fall
   b) investment increases
   c) money supply decreases
   d) both a and b.
   e) all of the above

10. A tax cut is less powerful than an increase in government purchases of the same size because
   a) a portion of the tax cut is spent on exports.
   b) a portion of the tax cut is saved.
   c) tax cuts do not increase disposable income.
   d) the tax-cut multiplier is equal to 1.

11. Suppose $100 is deposited in M&T Bank. The required reserve ratio is 8%. What is the amount of potential deposit creation?
   a) $500.
   b) $1000.
   c) $1150.
   d) $800.

12. An automatic stabilizer is designed to
   a) stabilize interest rates.
   b) be a part of discretionary fiscal policy.
   c) respond automatically to counteract changes in real GDP.
   d) increase government revenues during recessions.

13. During the business cycle, a recession is measured as
   a) the period from a peak to a trough.
   b) the period from a trough to a peak
   c) the period from a peak to the next peak.
   d) the period from a trough to the next trough.

14. The aggregate demand curve is downward-sloping in part because
   a) people buy fewer goods and services at lower interest rates.
   b) people buy more goods and services at lower average prices.
   c) a higher average price level will induce producers to offer more output than otherwise.
   d) people buy more goods and services at higher average prices.

15. Open market operations are voted on by the ______ and implemented by the ______.
   a) Federal Reserve Board of Governors; Federal Open Market Committee (FOMC)
   b) FOMC; Federal Reserve Bank of New York
   c) Federal Reserve Bank of New York; Federal Reserve Board of Governors
   d) FOMC; Federal Reserve Bank of Washington D.C.

16. The marginal propensity to consume is
   a) total consumption divided by total income.
   b) the part of consumption that does not depend on disposable income.
   c) the fraction of each additional (marginal) dollar of disposable income spent on consumption.
   d) all of the above.

17. When fighting inflation both the Keynesians and Monetarists
    a) advocate decreasing the money supply, but for different reasons.
    b) differ over whether monetary policy would even be effective.
    c) advocate decreasing the money supply due to its effects on investment and consumption.
    d) believe only fiscal policy will be effective.

18. The deficit differs from the national debt in that
    a) the deficit covers a calendar year with the debt covers a fiscal year.
    b) the deficit is the revenue shortfall within a year, while the debt is a cumulative measure of borrowing.
    c) the deficit is adjusted for inflation while the national debt is in nominal terms.
    d) the deficit only results from discretionary spending while the debt is caused by all types of spending.

19. In our model of aggregate expenditure, which of the following does NOT affect investment?
    a) changes in interest rates.
    b) changes in expected profits.
    c) changes in the marginal propensity to consume.
    d) changes in technology.

20. M1 will decline but M2 will remain unchanged if
    a) I withdraw $100 of spending money from my checking account.
    b) My cat eats a $10 bill.
    c) I deposit $500 cash into a savings account.

Part II: Short Answer (55 points)
Answer each question in the space provided.

1. (10 points) Contrast the views of the Keynes and the classical economists on the business cycle. Be sure to address the issues of the inherent stability of the economy, the seriousness of business cycles, and possible remedies for the business cycle.

2. (15 points) Use the model below to answer the following questions. **<u>You must show all of your work for proper credit</u>**.

   C = 400 + .75Y
   I = 12 0
   G = 150
   T = 110

   a) Calculate the equilibrium income for this economy.

b) Suppose the government wishes to increase equilibrium income by 600. (1) By how much would they have to increase G to do this? (2) by how much would they have to decrease T to do this?

3. (15 points) Consider the effects of the national debt on the U.S. economy:

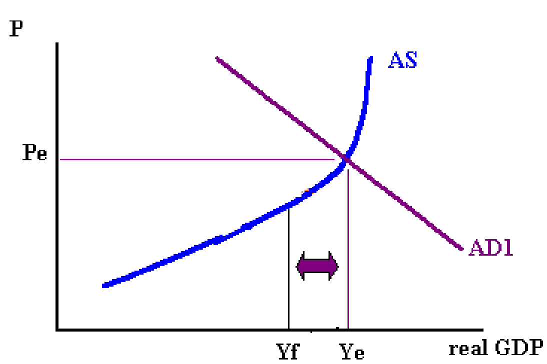
a) Is the national debt out of control? Explain your answer.

b) Are interest payments on the debt a burden to future generations? Explain your answer.

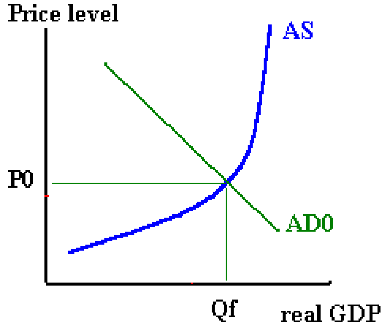
c) What is the crowding out effect?

4. (15 points) For each case below, show how the changes on the graph provided. Explain how the state of the economy changes in the space provided, and whether or not the new equilibrium is desirable.

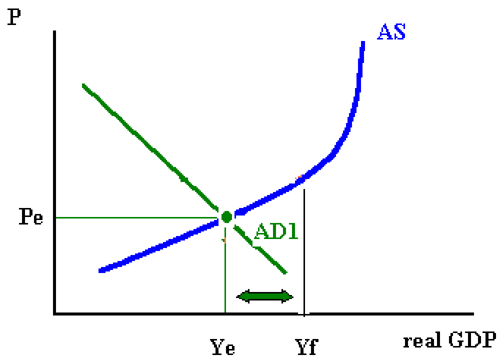
a) The Fed sells Treasury bonds on the open market (and you are a Keynesian).



b) President Bush is successful in implementing his tax cut plan.



c) Concerns about bank failures causes the Fed to increase the reserve requirement on banks.



BONUS (2 points)

Who won the U.S. Presidential election?

Who won the NY Senate election?

Eco 200 820 Principles of Macroeconomics exam 2 answer key form A

1. B 2. A 3. B 4. D	5. D 6. A 7. C 8. D	9. D 10. B 11. C 12. C	13. A 14. B 15. B 16. C	17. A 18. B 19. C 20. C

1. (10 points) The classicals believed that the economy was inherently stable and that business cycles would be mild and temporary. Flexible wages and prices would fall in a recession, allowing the economy to self correct. Keynes believed that the economy was inherently unstable and that business cycles were serious. He argued that the economy would not self-correction quickly because wages and prices were not flexible, so government intervention was necessary.
2. (15 points)
   (a) AE = C + I + G = 400 + .75Y + 150 + 120 = 670 + .75Y.
   in equilibrium, Y = AE = 670 + .75Y
   so Y-.75Y = 670 or .25Y = 670, so Y = 2680
   (b) the gov't spending multiplier is 1 / (1-MPC) = 1 / (1-.75) = 4; the tax multiplier is MPC / (1-MPC) = .75 / (1-.75) = 3
   So to increase Y by 600, you must increase G by 600 / 4 = 150; or you must decrease T by 600 / 3 = 200
3. (15 points)
   (a) No. The debt / GDP ratio is the best way to measure the size of the debt. And this ratio for the U.S. is smaller than other countries and well below historical highs for the U.S.
   (b) No. Most of the debt is owned by U.S. citizens and corporations so we just pay interest to ourselves.
   (c) The crowding out effect occurs when the government borrows, pushing interest rates up, which discourages borrowing in the private sectors (decreasing both C and I)
4. (15 points)
   (a) The Fed sells Tbonds, decreasing MS and shifting AD left. The new equilibrium is at full-employment, which is good.
   (b) The tax cut increases disposable income, shifting AD right. The new equilibirum is above full-employent, or an inflationary gap, which is not good.
   (c) Increasing the reserve requirement will decrease the MS, shifting AD left. This worsens the recessionary gap, which is not good.