The CFA Aficionado

www.cfa-aficionado.cjb.net
www.cfa-aficionado.biz14.com

1081 Questions + Answers

of the

CFA EXAM

Level 1

Study Session : Macroeconomics

(Part A)

Introduction by the Author :

Hi there, CFA fellows, here you are . You see , it doesn't need to be an expensive prep course to get first class preparation for the CFA exams.

The following questions are original CFA AIMR questions and not just composed by prep course providers. They all come with a clear answer.

In order to understand why the questions are commented by "answer is correct / incorrect" it is important to know that all questions have automatically been responded with the first (and only the first) answer.

Your CFA-Aficionado

cfa-aficionado@cfa-aficionado.cjb.net
cfa-aficionado@cfa-aficionado.biz14.com
cfa-aficionado@softhome.net

And now here we go :

The government currently has no debt. To alleviate an economic slow down, Congress proposes an increase in spending partially offset by an increase in the highest marginal tax rate. This will force the Treasury to issue new debt. According to which of the following economic theories would this stimulate the economy?

I. fiscal policy
II. supply-side
III. crowding out

* none of these answers is correct
* I only
* I, II, III
* II only
* II, III

That answer is incorrect.
Correct answer:
I only

Anytime the government runs a deficit, it can be considered a fiscal stimulus. However, since marginal tax rates were increased, the supply-side effect would be negative. The crowding out effect suggests that government borrowing will increase interest rates and partially offset the stimulate effects of the new spending.

If the quality of education in the U.S. improved, the direct effect would be a(n)

* reduction in prices.
* increase in both output and prices.
* increase in both long-run and short-run aggregate supply.

* increase in both short-run aggregate supply and aggregate demand.

That answer is incorrect.
Correct answer:
increase in both long-run and short-run aggregate supply.

Increases in education, training and skill-enhancing experience can improve the quality of the labor force and thereby expand the supply of human resources, This could cause the cost of resources to decline (permanently) and expand both short run output and long run sustainable output.

The crowding-out effect refers to the possibility that an

* increase in consumption spending will crowd out government spending.
* increase in private savings will crowd out the taxable income of households.
* increase in the money supply will result in a decline in taxes.
* increase in the federal deficit will result in higher interest rates, which will crowd out private investment and consumption.

That answer is incorrect.
Correct answer:
increase in the federal deficit will result in higher interest rates, which will crowd out private investment and consumption.

The crowding out theory implies that government borrowing drives up real interest rates and thus crowds out" private investment. Private investment falls under higher interest rates because the cost of investment (the real interest rate) rises if the government borrows heavily. Under the usual law of supply and demand, the government causes the interest rate to rise under deficit spending because there is a limited supply of loanable funds. The government competes with the private sector for these resources and thus drives up the price (i.e., the interest rate).

An acceleration in the growth rate of the money supply is known as ________.

* expansionary monetary policy
* restrictive monetary policy
* the quantity of money
* the velocity of money
* excess supply of money

That answer is correct!

The Fed generally pumps additional money into the economy via open market operations - the purchase of bonds in the open market. The consequence of this action is usually a rise in the real interest rate. The Fed can also implement expansionary monetary policy through manipulation of the discount rate. A higher discount rate will serve to contract the money supply; a lower rate will expand the money supply.

Which of the following would be counted in the calculation of GDP?

* the sale of cocaine in the black market
* the broker's fees from the sale of 100 shares of IBM stock
* damage to a house caused by a hurricane
* the sale of a rare coin to a coin collector

That answer is incorrect.
Correct answer:
the broker's fees from the sale of 100 shares of IBM stock

GDP is the total market value of all final goods and services produced domestically during a specific period. Non market activities are not counted; the sale of used goods are also not counted. A broker's fee is counted because it represents a service that was produced domestically.

Under a ________ income tax system, as income grows, the average personal income tax liability of individuals and families increases.

* corporate
* regressive
* discretionary
* automatic
* progressive

That answer is incorrect.
Correct answer:
progressive

With rising incomes, more people find themselves above the "no tax due" cutoff. Others are pushed into a higher tax bracket. Therefore, during an economic expansion, revenue from the personal income tax increases more rapidly than income.

The inflation rate in an economy currently in equilibrium jumps up unexpectedly. According to the Adaptive Expectations hypothesis, unemployment will in the short run.

* all of these answers can happen.
* decrease
* increase
* remain unaffected.

That answer is incorrect.
Correct answer:
decrease

According to the Adaptive Expectations hypothesis, people consider the recent past as the best predictor of the immediate future. Therefore, when the inflation rate jumps up unexpectedly, workers using adaptive expectations will lag behind in their estimates and underestimate the future inflation. Hence, they will get into wage contracts that will under-compensate for the higher inflation. Over a short run, this will lead to improved profit margins for businesses, who will expand the output by utilizing more resources. In the short run, unemployment rate will fall.
Over the long run, this mistake gets corrected, wages increase and unemployment rate falls back to the natural rate.

The Keynesian range (the horizontal range) of a short-run aggregate supply curve illustrates that changes in aggregate demand exert little impact on prices and a great deal of impact on output when

* resources in the economy are fully employed.
* aggregate demand exceeds aggregate supply.
* natural unemployment is present.
* substantial excess capacity is present.

That answer is incorrect.
Correct answer:
substantial excess capacity is present.

Below the full employment capacity of the economy, increases in aggregate supply have little effect on the price level. This is the result of the Keynesian assumption that at less than full employment output levels, prices and wages are fixed since they are inflexible in a downward direction.

Which of the following will most likely increase aggregate supply in the long run?

* advances in technology
* a low rate of capital formation
* higher real interest rates due to the federal government's large budget deficits
* unfavorable weather conditions in agricultural areas
* an increase in the expected inflation rate

That answer is correct!

Improvements in technology can cause the aggregate supply curve to permanently shift to the right. This is because such advances make it possible to produce and sustain a larger rate of output from a specific resource supply.

Cyclical unemployment is a result of

* inaccurate and/or costly information about job opportunities.
* an inadequate matching of qualified workers and available jobs.
* not enough employees to fill available jobs.
* insufficient employment in the building trades.
* a downturn in economic activity.

That answer is incorrect.
Correct answer:
a downturn in economic activity.

Cyclical unemployment occurs due to recessionary business conditions and inadequate aggregate demand for labor.

On a certain date, the banking system had $2 billion in excess reserves. The legally required reserve ratio was 12.5 percent. Potentially, the banking system as a whole could increase its loans a maximum of

* more than $25 billion.
* $2 billion.
* $12.5 billion.
* $16 billion.

That answer is incorrect.
Correct answer:
$16 billion.

The deposit expansion multiplier in this economy is 8 (found by taking the inverse of 12.5%=1/(.125)). Since banks hold an excess $2 billion in reserves they could extend loans in this amount and increase the money supply by 8 x $2 billion = $16 billion.

Structural unemployment is a result of

* not enough employees to fill available jobs.
* inaccurate and/or costly information about job opportunities.
* insufficient employment in the building trades.
* an inadequate matching of qualified workers and available jobs.

That answer is incorrect.
Correct answer:
an inadequate matching of qualified workers and available jobs.

Structural unemployment occurs because there are structural characteristics of the economy that make it difficult for job seekers to find employment and employers to hire workers. Basic structural characteristics of the economy make it difficult for employees and employers to "match up." Unemployment due to this structure of the economy, means that unemployed workers do not possess the skills necessary to fill available jobs.

Which of the following is a false statement?

* CPI is calculated using a market basket of consumer goods.
* CPI is a broad measure of prices throughout the economy.
* The GDP deflator is used to calculate real GDP from nominal GDP.
* Both CPI and the GDP deflator suffer from substitution bias.
* The CPI and the GDP deflator tend to move in the same direction.

That answer is incorrect.
Correct answer:
CPI is a broad measure of prices throughout the economy.

CPI is designed to measure the changes in the price level of consumer goods only. Since GDP includes productions in all sectors, not just the consumer sector, consumer price inflation is inadequate to calculate real GDP from nominal GDP.

Which of the following best describes the relationship between the velocity of money and the demand for money?

* When the demand for money increases, the velocity of money increases.
* The demand for money is not related to the velocity of money.
* The demand for money must be stable for the velocity of money to increase.
* When the demand for money declines, the velocity of money increases.

That answer is incorrect.
Correct answer:
When the demand for money declines, the velocity of money increases.

When decision makers conduct a specific amount of business with a smaller amount of money, their demand for money balances is reduced. Each dollar, though, is now being used more often. Therefore, the velocity of money is increasing. Thus, for a given income level, when the demand for money declines, the velocity of money increases.

Which of the following lend support to supply-side economics?

I. High marginal tax rates discourage additional work effort and reduce productivity.

II. High tax rates increase the costs of supplier resources, leading to inflation.

III. High tax rates affect adversely the efficient channeling of capital.

IV. High marginal tax rates skew the demand preferences of consumers geared toward non-productive activities.

* I, III & IV
* I & III
* I & IV
* I, II, III & IV

That answer is correct!

Marginal tax rates are central to the effects postulated by Supply-side economists. According to this theory, an increase in marginal tax rates decreases the incentive to work. People to shift away from productive work and toward more leisure. Non-productive activities explicitly directed toward avoiding taxes increase and projects are selected at least partly due to their tax benefits and not necessarily due to their intrinsic merits. This leads to inefficient channeling of capital resources.

Uncertainty may cause banks to hold larger excess reserves. Other things constant, this will

* tend to reduce the money supply during a period of inflation and increase it during a recession.
* tend to reduce the money supply.
* tend to increase the money supply.

* have no effect on the money supply.

That answer is incorrect.
Correct answer:
tend to reduce the money supply.

The money supply is reduced when banks hold larger excess reserves through the work of the deposit expansion multiplier. Since banks extend fewer loans when they hold larger excess reserves, the money supply falls.

Which of the following is a definition of inflation:

I. a pervasive increase in prices
II. too many dollars chasing too few goods
III. a general decline in the value of money
IV. a general increase in wages

* II, IV
* I, II, III, IV
* I, II, III
* II only
* I, III
* I, II

That answer is incorrect.
Correct answer:
I, II, III

Inflation is a pervasive increase in prices which is caused by too many dollars chasing too few goods. A price increase that has some other cause (such as an improvement in a product) is not inflationary. Therefore these two ideas are inseparable from the definition of inflation. Since prices are increasing, each unit of currency can buy fewer goods. Hence, a general decline in the value of money.

A new payroll tax on businesses results in an increase in cost for each unit of production. Assuming no change in income or in the production mix, would this cause inflation?

* Yes, because producers would pass new costs onto consumers.
* No, because firms would choose to use more capital and less labor.
* Yes, because government spending would increase aggregate demand.
* Yes, because higher costs result in less production and lead to higher prices.
* No, because firms are "price takers" and will be unable to increase prices.

That answer is incorrect.
Correct answer:
Yes, because higher costs result in less production and lead to higher prices.

When firms face generally higher unit costs they decrease production. Assuming no change in income, there would be too many dollars (i.e. income) chasing too few goods (i.e. production). Although it may be tempting to say that costs are being "passed on" to consumers, this explanation is not economically viable. If demand for the product would support a higher price, then firms would have been charging a higher price prior to the oil shock and reaping higher profits. Even if we assume firms are "price takers," the new tax will take the firm's zero economic profit and turn it into an economic loss. The result will be fewer firms in the industry and less production overall.

Which of the following determine(s) the demand curve for a good?

I. Disposable income.
II. Price of the good demanded.
III. Availability of substitutes.
IV. Consumer tastes and preferences.

 * I & III
 * I, III & IV
 * I, II & III
 * II only

That answer is incorrect.
Correct answer:
I, III & IV

You should be careful about distinguishing between a movement of the demand curve and a movement along the demand curve. When the demand curve moves, the price for every quantity that may be demanded changes. Such a move can come about when people's disposable income changes. An increase in income moves the demand curve to the right, since for every given price, the quantity demanded is higher at higher incomes. Similarly, an increase in the availability of substitutes moves the demand curve to the left, since for every given price, the quantity demanded is now lower. Further, as the consumers' tastes and preferences evolve over time, so will the demand curve for a good. However, a simple change in the price of the good demanded will only lead to an adjustment in the quantity demanded, without moving the demand curve. After all, that is the definition of a demand curve!

The actual rate of unemployment could fall below the natural rate of unemployment during which of the following?

I. An economic boom.

II. An economic expansion, where the economy is trying to extricate itself from a recession.

III. A war.

IV. Never. The natural rate of unemployment is a lower limit on unemployment rate in a given economy, depending on its structural features.

 * II & III
 * I & III
 * I, II & III
 * IV only

That answer is incorrect.
Correct answer:
I & III

If the economy is in a recession, that means the unemployment rate is quite high, far above the natural rate. Hence, II is incorrect. IV is also incorrect since the natural rate of unemployment prevails in a healthy economy operating at maximum sustainable efficiency. However, in times of high demand like economic booms or war, it is possible that the unemployment rate temporarily dips below the natural rate, causing the output to rise above the sustainable GDP.

Suppose the Fed sells $25 million worth of Treasury bonds in the open market. This action will serve to ________ the consumption of interest-rate sensitive goods like home mortgages. The U.S. dollar will ________ against the other currencies.

* increase; appreciate
* increase; depreciate
* decrease; appreciate
* decrease; depreciate

That answer is incorrect.
Correct answer:
decrease; appreciate

The sale of bonds implies that the Fed takes out money from the economy. This reduces the monetary base and the total money supply in the economy, causing the real interest rates to rise in the short run. This makes the opportunity cost of consuming interest rate sensitive goods like homes and cars more expensive, leading to a decrease in the consumption of these goods. The high real rates will attract foreign funds into the U.S., causing the demand for U.S. dollars to increase. The U.S. dollar will thus appreciate in the short run.

Which of the following statements is false?

* real GDP excludes earnings by domestic citizens abroad
* the change in real GDP plus the inflation rate equals growth in nominal GDP
* changes in nominal GDP include the impact of changes in the money supply
* real GDP measures strictly changes in national output
* change in nominal GDP is always greater than the change in real GDP

That answer is incorrect.
Correct answer:
change in nominal GDP is always greater than the change in real GDP

The change in nominal GDP usually exceeds that of real GDP because inflation is usually positive. However, in a flat or declining price environment real GDP would exceed nominal GDP change.

Which of the following is not an example of an inflationary change in prices?

I. A car dealer decides to charge more for a new model year of cars because of new features
II. A university decides to increase tuition to pay for a new athletic field
III. An electronics retailer charges more for new DVD players than for outdated VCRs

* I, II
* I, III

 * I only
 * II, III
 * II only
 * None of these answers is correct

That answer is incorrect.
Correct answer:
None of these answers is correct

Prices for goods can increase for reasons other than inflation. Inflationary price increases are the result of too many dollars chasing too few goods. These examples are price increases that are the result of improvements in the good being purchased.

During periods of rapid growth in output

 * there has been no consistent relationship between output growth and employment or unemployment.
 * both employment and unemployment generally rise.
 * employment generally decreases and unemployment increases.
 * employment generally increases, while unemployment decreases.
 * both employment and unemployment generally fall.

That answer is incorrect.
Correct answer:
employment generally increases, while unemployment decreases.

During a business expansion, business sales tend to rise, GDP grows rapidly and the rate of unemployment declines.

Which of the following would be considered an automatic stabilizer?

I. Federal Reserve policy
II. government payrolls
III. public works projects

 * I, III
 * none of these answers is correct
 * II, III
 * I, II, III
 * I, II
 * III only

That answer is incorrect.
Correct answer:
none of these answers is correct

An automatic stabilizer is anything that would decrease the government budget surplus during slow economies and increase the surplus during strong economic periods. Federal Reserve policy is not automatic, its directed. Government payrolls do not inherently increase or decrease during economic periods. Similarly, public works projects would not automatically increase due to an economic slowdown.

Which of the following would appear on the liability side of the balance sheet of a commercial bank?

 * loans outstanding
 * demand and other transaction deposits
 * vault cash
 * U.S. government securities

That answer is incorrect.
Correct answer:
demand and other transaction deposits

Demand and other transaction deposits constitute liabilities for commercial banks because they "owe" depositors the amount of their deposits. Outstanding loans represent assets for commercial banks because the borrower "owes" the bank the principal of the loan plus accrued interest.

A passive budget deficit is a deficit that

 * merely reflects a decline in tax revenue during an economic boom.
 * results from legislative action that reduces tax rates.
 * results from legislative action that increases government expenditures.
 * merely reflects a decline in tax revenue during a recession.

That answer is incorrect.
Correct answer:
merely reflects a decline in tax revenue during a recession.

A passive deficit is a good example of an automatic stabilizer. During a recession, government tax revenues fall and expenditures rise. Thus, the preferred and natural state for the government budget during a recession is to be in a deficit in order to stimulate aggregate demand.

Which one of the following will most likely reduce aggregate supply?

 * a technological advance that reduces the cost of energy
 * an increase in the nation's net investment rate
 * an increase in the labor force participation rate
 * regulatory action that generates more benefits than costs
 * a substantial increase in the minimum wage

That answer is incorrect.
Correct answer:
a substantial increase in the minimum wage

An increase in the minimum wage reflects and increase in the cost of a resource, labor. This implies that the SRAS will shift inward because the costs of production are now higher. If the change is permanent, then LRAS will also shift inward.

If the effects of an expansionary macroeconomic policy are accurately anticipated, then

 * wages will rise more rapidly than product prices.
 * market participants will quickly adjust to the expected inflation.
 * profit margins will improve.
 * resource prices will remain constant.

That answer is incorrect.
Correct answer:
market participants will quickly adjust to the expected inflation.

Anticipated macroeconomic policies are ineffective in stimulating aggregate output and employment because market participants create labor contracts which automatically account for rising prices. Thus, employment is not increased because the real wage is constant.

An economy is currently in a state of equilibrium, at full employment. If a sudden supply shock were to decrease aggregate supply, which of the following effects will occur in the short run?

I. Real interest rates will increase.
II. Prices will rise.
III. Aggregate demand will remain unaffected.
IV. The SRAS will shift to the left.

 * II & III
 * I & III
 * I, II & III
 * I, II & IV

That answer is incorrect.
Correct answer:
I, II & IV

The decrease in the aggregate supply curve will be represented by a movement of the short-run supply curve to the left. In the short run, this will cause an increase in prices since the demand curve does not move. Aggregate demand will fall, unemployment will rise above the natural rate and aggregate output will fall. The total disposable income in the economy will decrease and consumers will liquidate part of their savings to maintain stable consumption. This will decrease the supply of loanable funds, raising interest rates in the short run.

According to supply-side theory, an increase in marginal tax rates will

 * all of these answers.
 * encourage individuals to substitute less-desired, tax-deductible goods for more-desired, non-deductible goods.
 * decrease the supply of capital and reduce its productive efficiency.
 * decrease the supply of labor and reduce its productive efficiency.

That answer is correct!

Increasing marginal tax rates reduces the incentive to work since individuals keep a smaller percentage of their earnings. Additionally, increased marginal tax rates divert resources away from productive roles to roles designed to "shelter" capital owners from taxation. The final consequence is that efficiency is reduced since individuals choose deductible (and less desirable) goods over non-deductible goods. Efficiency is compromised because although the non-deductible goods are affordable and preferable to deductible goods, they are not consumed.

Which of the following statements about expected inflation are true?

* Interest rate volatility will increase
* Price increases will typically outpace increases in wages
* All of these answers are correct
* Lenders are not compensated for the loss of purchasing power when funds are repaid
* None of these answers is correct

That answer is incorrect.
Correct answer:
None of these answers is correct

Market participants will compensate for expected inflation. For example, when lenders make loans, they will price a certain inflation rate into the interest rate. If inflation is as expected, then the rate will adequately compensate the lender for lost purchasing power. Inflation is generally assumed to impact all prices, including wages, equally, therefore workers will demand wage increases in line with inflation.

Which of the following is an integral part of the Keynesian view of the business cycle?

* Equilibrium is a state of full employment without inflation.
* Multiplier effects magnify the impact of changes in aggregate demand (especially in investment) and thereby promote economic instability.
* Changes in private consumption are the major source of economic instability.
* Supply creates its own demand.
* Falling wage rates eventually lead the economy back to full employment.

That answer is incorrect.
Correct answer:
Multiplier effects magnify the impact of changes in aggregate demand (especially in investment) and thereby promote economic instability.

The multiplier effect causes small changes in aggregate expenditures to result in much larger changes in income, leading to economic instability. This effect applies to all components of the aggregate expenditure model, and therefore none of the four components can be called "the major source of economic stability."

The period between the trough of the business cycle and the next peak is called the

* cyclic phase.
* expansionary phase.
* contractionary phase.
* recessionary phase.

That answer is incorrect.
Correct answer:
expansionary phase.

After a downturn reaches bottom and economic conditions begin to improve, the economy enters the expansion phase of the cycle. Here business sales rise, GDP grows rapidly and the rate of unemployment declines. The expansion eventually blossoms into another business peak.

An unanticipated decrease in short-run aggregate supply will lead to a

* higher price level and a lower real interest rate.
* lower price level and a lower real interest rate.
* lower price level and a higher real interest rate.
* higher price level and a higher real interest rate.

That answer is incorrect.
Correct answer:
higher price level and a higher real interest rate.

An unanticipated reduction in short run aggregate supply will cause the price level to rise as the short run aggregate supply curve shifts left. Since people will believe that their lower incomes are temporary, households will reduce their current saving level to maintain current consumption at a level more consistent with their longer term perceived opportunities. This reduction in the supply of loanable funds causes the interest rate to increase.

If decision makers fail to anticipate the inflationary effects of demand stimulus policies, in the short run the stimulus will

* increase both inflation and the nominal interest rate but exert little impact on real output and employment.
* increase the real interest rate.
* reduce the real interest rate.
* lead primarily to larger output and high employment.
* both lead primarily to larger output and high employment and reduce the real interest rate.

That answer is incorrect.
Correct answer:
both lead primarily to larger output and high employment and reduce the real interest rate.

Unanticipated inflation, as the result of demand stimulus policies, increases output and employment since the real wage is eroded and the cost of labor declines.

The primary cause of frictional unemployment is

* fluctuations in aggregate demand.
* the lack of training and marketable qualifications in job seekers.
* inaccurate and costly information about job opportunities.
* high unemployment benefits that reduce the incentive of unemployed workers to seek work.

That answer is incorrect.
Correct answer:
inaccurate and costly information about job opportunities.

Frictional unemployment is the result of a scarcity of information and the search activities of both employers and employees for information that will help them make better employment choices.

What incentives does inflation create in consumers and producers?

* Consumers will save less and producers will invest more.
* Consumers will spend more and producers will produce more.
* Consumers will save more and producers will produce more.
* Consumers will spend more and producers will sell off inventories.
* Consumers will spend less and producers will lay off workers.

That answer is incorrect.
Correct answer:
Consumers will spend more and producers will produce more.

Inflation causes consumers to spend now, because goods will be more expensive in the future. Conversely, producers will produce goods now, because wages and raw materials prices are expected to rise. Producers will also build up inventories in anticipation of higher future prices.

"Rapid growth in the money supply is the primary cause of inflation. The time period between acceleration in the growth rate of the money supply and an acceleration in inflation is often lengthy (for example, from 12 to 36 months) and difficult to predict." These two statements are

* basic tenets of the Keynesian doctrine.
* normative economic statements.
* basic tenets of the Monetarist doctrine.
* internally inconsistent.

That answer is incorrect.
Correct answer:
basic tenets of the Monetarist doctrine.

Monetarists believe that monetary instability is the major cause of fluctuations in real GDP and rapid growth of the money supply is the major cause of inflation.
Monetarists cite lengthy and unpredictable time lags between the implementation of a monetary policy change and the observation of its primary effects as a justification for not using discretionary monetary policy as a stabilization tool.

The Central Bank increases the money supply by 5%. This was not anticipated by economic participants. The economy is operating below potential. In the long-run, this will cause the aggregate supply curve to ________, the aggregate demand curve to ________, and the price level to ________.

 * shift left, shift right, increase
 * not change, shift right, increase
 * not change, shift left, increase
 * not shift, not shift, not change
 * shift right, shift left, increase
 * shift right, shift right, not change

That answer is correct!

In order to determine how each curve changes, think of the effects independently. First the demand curve. The new money supply is effectively new income for consumers, it is irrelevant for this exercise whether this is real or nominal income. An increase in income shifts the demand curve to the right.

Next the supply curve. If producers anticipate inflation, this is effectively an increase in their costs. Again, whether this is a nominal or real cost increase is irrelevant. Higher costs cause the supply curve to shift to the left.

The directional shift in both curves indicates a higher price level. Note that the quantity demanded/produced is the same. This is because while the increase in income shifts the demand curve, the increase in prices offsets the effect. Similarly, the increase in revenues (due to higher prices) offsets the higher costs for suppliers.

According to the Keynesian model, if the marginal propensity to consume were 0.80, an independent increase in investment expenditures of $20 billion would cause the equilibrium aggregate nominal income to rise

 * $80 billion.
 * $16 billion.
 * $100 billion.
 * $20 billion.
 * $50 billion.

That answer is incorrect.
Correct answer:
$100 billion.

The expenditure multiplier is found by M = 1/(1-MPC). Thus, here M = 1/(1-.8) = 5. Therefore the $20 billion increase in aggregate expenditures is magnified five times to $100 billion.

First National Bank currently does not have the legally required cash reserves on hand. The bank expects this situation will only last a day or two. In order to rectify the reserve problem, the bank treasurer borrows cash on the intra-bank loan market. The loan was actually granted by the Central Bank. This is the only action by the Central Bank that day. How has the Central Bank's actions impacted the demand curve for the purchase of intra-bank loans and the interest rate paid on those loans?

* Demand curve shifts upward, interest rate falls
* Demand curve shifts upward, interest rate increases
* Quantity demanded increases, interest rate falls
* Demand curve does not change, interest rate increases
* Quantity demanded decreases, interest rates rise

That answer is correct!

When a bank lacks reserves it has essentially loaned too much money, i.e. it has put too much money into circulation. If the Central Bank lends money to the bank to cover the shortfall, then the cash from the excess loans can stay in circulation.

If the reserve loan had come from another bank, then this would have simply transferred excess reserves from one bank to another. Since the Central Bank stepped in, banks with excess reserves will now choose to make more traditional loans and further expand the money supply.

Remember that the borrower has sold a loan and the lender has bought a loan. Therefore, the Central Bank's actions have increased demand for intra-bank loans. This would cause the interest rate paid to fall.

According to the New Classical View, ________ is unaffected by deficits since people will save more money in order to pay the higher future taxes.

* the real interest rate
* the marginal tax rate
* price equalization
* the supply-side
* fiscal policy

That answer is correct!

New classical economies stress that debt financing merely affects the timing of taxes, not their magnitude. Debt financing substitutes higher future taxes for lower current taxes. As a result, households reduce their current consumption in response to additional government debt as surely as would be the case if an equivalent amount of current taxes were levied.

If the Central Bank wishes to diminish unemployment, it would attempt to ________ the money supply by ________ short-term interest rates.

* decrease, increasing
* stabilize, decreasing
* stabilize, increasing
* increase, decreasing
* increase, increasing
* stabilize, stabilizing
* decrease, decreasing

That answer is incorrect.
Correct answer:
increase, decreasing

The central bank would increase the money supply in an attempt to decrease unemployment. This can be accomplished by decreasing short-term rates.

An individual who is employed part time but who is looking for a full-time job is classified as

 * frictionally unemployed.
 * employed.
 * structurally unemployed.
 * cyclically unemployed.

That answer is incorrect.
Correct answer:
employed.

Since the individual is currently employed he or she is considered employed, technically. Such a person is underemployed but not technically unemployed.

When the output of an economy exceeds the economy's full-employment capacity, then

 * aggregate supply will increase until the economy can produce the output at the existing price level.
 * aggregate demand will decline until full-employment equilibrium is restored at a lower price level.
 * unemployment will exceed the economy's natural unemployment.
 * wages and prices will rise until full employment is restored at a higher price level.

That answer is incorrect.
Correct answer:
wages and prices will rise until full employment is restored at a higher price level.

Higher than full employment output will cause resource prices to rise (i.e. the price of labor and other prices in the economy) which will result in decreased demand for labor and a contraction of aggregate supply. The economy will toward its long run equilibrium output.

Under adaptive expectations, a shift to a more expansionary macroeconomic policy will

 * reduce unemployment in both the short and long run.
 * fail to systematically reduce unemployment in either the short run or long run.
 * reduce unemployment in the short run but not in the long run.
 * reduce unemployment in the long run but not in the short run.

That answer is incorrect.
Correct answer:
reduce unemployment in the short run but not in the long run.

The effects of a more expansionary macroeconomic policy under adaptive expectations are to reduce unemployment only in the short run. This is because the inflationary effects of the demand-stimulus policy will be underestimated and thus the real wage would be eroded. The consequence of this erosion is an increase in employment. However, in the long run, unemployment is unchanged since the higher rate of inflation is anticipated.

Which of the following is true?

 * During a recession, cyclical unemployment will be low.
 * Frictional unemployment implies a lack of available jobs.
 * When an economy is at full employment, actual unemployment will be less than the natural unemployment.
 * When actual GDP equals potential GDP, the actual unemployment will equal the economy's natural unemployment.

That answer is incorrect.
Correct answer:
When actual GDP equals potential GDP, the actual unemployment will equal the economy's natural unemployment.

Under full employment, the rate of unemployment will be equal to the natural rate of unemployment given the economy's frictional and structural characteristics. Potential GDP is defined as the amount of output that could be expected at full employment. Therefore, at potential GDP, the rate of unemployment is equal to the natural rate of unemployment.

The unemployment rate equals the number of persons

 * unemployed divided by the population age 16 and over.
 * unemployed divided by the number in the labor force.
 * not working divided by the population age 16 and over.
 * unemployed divided by the number employed.

That answer is incorrect.
Correct answer:
unemployed divided by the number in the labor force.

The rate of unemployment is the percent of persons in the labor force who are unemployed. It is calculated as: number of persons unemployed divided by the number of persons in the labor force.

Within the simple Keynesian model, when an economy operates below its long-run, full-employment output constraint, an increase in aggregate demand will lead to an increase in

 * real income.
 * unemployment.
 * prices.
 * employment, output and prices, but real income will remain constant.
 * interest rates and money income, but employment and real income will remain constant.

That answer is correct!

Keynes considered aggregate supply to be accommodative of aggregate demand. Thus, an increase in aggregate demand will stimulate aggregate output. The equivalence between output and income also suggests that real income will rise. Below the full employment capacity of the economy, increases in aggregate supply have little effect on the price level. This is the result of the Keynesian assumption that at less than full employment output levels, prices and wages are fixed since they are inflexible in a downward direction.

In the simple Keynesian model, if equilibrium output is less than the level required for full employment, what must happen for full employment to be achieved?

* Aggregate demand must fall.
* Interest rates must rise.
* Aggregate supply must increase.
* Prices must rise.
* Aggregate demand must increase.

That answer is incorrect.
Correct answer:
Aggregate demand must increase.

When equilibrium output is less than the economy's capacity, only an increase in expenditures will lead to full employment. This is because under the Keynesian model, aggregate expenditures are considered the catalyst the change in output; that is, aggregate output is accommodative of aggregate expenditures.

In the Keynesian model, if the marginal propensity to consume were 0.75, an independent decline in investment of $10 billion would cause equilibrium income to decline ________.

* $40 billion
* $75 billion
* $10 billion
* $50 billion

That answer is correct!

The expenditure multiplier is found by M = 1/(1-MPC). Thus, here M = 1/(1-3/4) = 4. Therefore the $10 billion decrease in aggregate expenditures is magnified four times to $40 billion.

In year 1, the nation of Economica has no government debt, production is at potential, the nominal interest rate is 8.6% and the real rate is 5.2%. In year 2, the nominal rate is 11.1% and the real rate is 6.7%. Which of the following would be most likely to cause such a situation?

* Federal budget deficit
* Monetary expansion
* Recession
* Trade surplus
* Increase in aggregate supply

That answer is correct!

In this case, the real rate has increased, as well as the rate of inflation. This is most likely to be caused by a budget deficit. Deficit spending causes the real rate to rise due to government demand for debt. Inflation would also increase because government spending amounts to an increase in aggregate demand, which would shift the price level higher.

If the money velocity is 5, the amount of money in circulation $200 million and real GDP $10 million, then prices are ________.

 * 4
 * 400
 * 42
 * 100

That answer is incorrect.
Correct answer:
100

According to the equation of exchange which is defined as MV = PY we must solve for P in the following way: ($200 million x 5) = ($10 million x P). This implies that P=100.

In the 1980s, the government cut back on the tax rates in an effort to spur the economy. This led to a significant decrease in real tax revenues. A breakdown of this decrease indicated that most of the decrease came from the lower tax brackets. Tax revenues from top tax bracket actually increased despite the cut. There was a modest growth in the GDP during this period, though amongst all the industrialized nations, only Japan matched this rate. This empirical evidence indicates that:

 * The supply side effects are not as potent as hypothesized by economists.
 * The supply-side response of tax payers can have a strong effect on a nation's growth.
 * The Rational Expectations model is a fair description of how people respond to fiscal policy.
 * The tax avoidance behavior governing the demand side has a significant impact on the economy.

That answer is incorrect.
Correct answer:
The supply-side response of tax payers can have a strong effect on a nation's growth.

The important part in this empirical observation is the effect of a change in marginal tax revenues. Marginal tax rates are central to the effects postulated by Supply-side economists. According to this theory, a reduction in marginal tax rates increases the incentive to work and save more by increasing the disposable income. This causes people to shift away from leisure and toward more productive work, enlarging the effective resource base and improving the efficiency with which it is utilized. The empirical evidence in the study indicate that supply-side effects can be quite important in directing the growth of an economy.

How does inflation impact interest rates, all else equal?

* increases the real rate; increases the nominal rate
* has no direct impact on interest rates
* has no effect on the real rate; increases the nominal rate
* increases the real rate; has no effect on the nominal rate
* impossible to determine

That answer is incorrect.
Correct answer:
has no effect on the real rate; increases the nominal rate

The real rate of interest is simply the nominal rate less inflation. Therefore, the real rate is not directly effected by inflation, while the nominal rate would rise as inflation rises.

If the economy is producing less than the full-employment output level, which of the following would most likely direct the economy back to long-run equilibrium?

* a decrease in resource prices
* an increase in the real rate of interest
* an increase in resource prices
* an increase in technology

That answer is correct!

To understand this question, note that the price of resources is simply a function of supply and demand. This question is implying that demand for resources (i.e. labor) is weak. Holding supply constant, if demand for a good falls, prices must fall as well. Eventually some equilibrium will be reached.

The goal of an ideal inflation policy would be

* focusing on unemployment first
* minimizing average inflation
* keeping inflation stable
* growing the money supply at a constant rate
* driving the price level higher

That answer is incorrect.
Correct answer:
keeping inflation stable

Anticipated inflation, even at relatively high levels, is generally not problematic. Therefore an ideal inflation policy would attempt to keep inflation as predictable and as stable as possible. Of course, the ideal inflation rate would be zero, but minimizing average inflation, with no attention paid to the variability, would not be helpful. In the U.S., for example, the Federal Reserve and the Treasury department are careful to broadcast the money supply, so that market participants can make as accurate an estimate of inflation as possible.

Recent data reveal that the ratio of inventories to sales has risen sharply, suggesting that businesses are experiencing an unplanned build-up in inventories. According to the Keynesian model, these findings indicate that

* the economy is operating at full-employment equilibrium, which will probably be sustained in the foreseeable future.
* aggregate expenditures exceed output and, as a result, inflation is likely to accelerate.
* aggregate expenditures exceed output and, as a result, national income will rise.
* aggregate expenditures are less than output and, as a result, national income will decline.

That answer is incorrect.
Correct answer:
aggregate expenditures are less than output and, as a result, national income will decline.

Actual inventories exceed planned inventories only when actual expenditures fall short of expected expenditures. Thus, producers anticipated a certain level of expenditure and produced output accordingly. Thus, output exceeded expenditure and national output (i.e., income) will decline.

The multiplier effect refers to the fact that an autonomous change in spending (aggregate demand) will

* cause prices to rise by some multiple of the initial increase in spending.
* reduce prices by some multiple of the increase in spending.
* increase the money supply.
* increase unemployment.
* cause nominal output to rise by some multiple of the initial increase in spending.

That answer is incorrect.
Correct answer:
cause nominal output to rise by some multiple of the initial increase in spending.

The multiplier explains why small changes in investment, government or consumption spending triggers much larger changes in output.

"Fractional Reserve Banking" refers to:

* The Federal Reserve System.
* All of these answers.
* The banking system where part of the reserves are derived in the form of loans from the Central Bank.
* The banking system where banks hold less than 100% reserves against deposits.

That answer is incorrect.
Correct answer:
The banking system where banks hold less than 100% reserves against deposits.

In a fractional reserve system, a bank can loan out almost all of the deposits it receives, maintaining only a small part as reserves to meet regular withdrawals and as a provision for loan defaults.

The phrase, "GDP equals what you eat plus what you invest plus what you export" characterizes which of the following methods?

 * Expenditure approach.
 * Income-cost approach.
 * Consumption-investment approach.
 * Resource cost-income approach.

That answer is correct!

The Expenditure approach has four components:

1. Personal consumption expenditure.
2. Gross private domestic investment (investments by people residing outside the country are ignored, even if they happen to be citizens of the country).
3. Government consumption & investment.
4. Net exports.

These can be summarized as "GDP equals what you eat plus what you invest plus what you export."

The current account trade balance + the capital account trade balance =

 * the currency balance at the World Bank
 * GDP
 * the foreign exchange rate
 * GNP
 * the trade deficit/surplus
 * zero

That answer is incorrect.
Correct answer:
zero

By accounting identity, the capital account and current account must balance to zero. If there is a deficit in one, there must be a surplus in the other. This is one reason why if a nation has a government budget deficit, which amounts to negative domestic investment, the shortfall could be made up by foreigners, causing a capital account surplus. Conversely there must be a current account deficit in such a situation. This is one reason why budget deficits and trade deficits are linked. Note that the term "trade balance" usually refers to the current account.

Mathematically, the marginal propensity to consume is

 * income divided by consumption.
 * additional consumption divided by additional income.
 * consumption divided by income.
 * additional income divided by additional consumption.

That answer is incorrect.
Correct answer:
additional consumption divided by additional income.

The marginal propensity to consume is found according to the following equation:

MPC = total change in consumption / total change in income

The rate of unemployment is equal to:

* the number of unemployed people as a fraction of the total labor force.
* the number of unemployed people as a fraction of the total population.
* none of these answers.
* the number of unemployed people as a fraction of the total population eligible to work.

That answer is correct!

The labor force of an economy consists of adults (defined as being of age 16 and above) who are either employed or actively seeking employment. The unemployment rate is then the fraction of the labor force that is not employed.

Mrs. Davis was in the habit of keeping $500 in currency in her jewelry chest in case she ever needed cash and the bank was closed. However, she recently got a combination debit/ATM card that gives her access to her checking account 24 hours a day. She deposits her $500 in cash into her checking account.

How does this immediately impact the monetary base and the effective amount money available for transactions?

* decrease, increase
* increase, decrease
* no change, decrease
* both increase
* no change for either
* decrease, no change
* both decrease

That answer is incorrect.
Correct answer:
decrease, no change

Effectively, there is no difference in how Mrs. Davis is using money, simply a different vehicle for spending it. Therefore the effective level of money in circulation has not changed. However, where the monetary base previously had including her $500 in currency, it would now only include the percentage of this money held in reserve by her bank. The monetary base equals currency plus bank reserves. Therefore the monetary base would decrease.

Innovations like debit cards have decreased the need to hold currency. Therefore certain measures of the money supply may decrease despite no real change in the money level in circulation.

The primary cause of frictional unemployment is

* the presence of legislated high minimum wages that price unskilled workers out of the market.
* discouraged workers who quit looking for a job after extended periods of unsuccessful job search.
* inaccurate and costly information about job opportunities.
* high unemployment benefits that reduce the incentive of unemployed workers to search for employment.

That answer is incorrect.
Correct answer:
inaccurate and costly information about job opportunities.

Frictional unemployment results from a scarcity of information and the search activities of both employers and employees for information that will help them make better employment choices.

The change in aggregate income/output for a given change in aggregate expenditure is known as the:

* demand multiplier.
* expenditure multiplier.
* marginal propensity to consume.
* income elasticity.

That answer is incorrect.
Correct answer:
expenditure multiplier.

The expenditure multiplier is directly linked to the "marginal propensity to consume" (MPC), which reflects the amount of each additional dollar in income that is spent on current consumption. In particular, the ideal expenditure multiplier equals 1/(1-MPC).

Assuming that an expansionary fiscal policy package could be enacted and implemented immediately, approximately how far in advance would be problem of a lagging economy need to be recognized?

* 1-2 years
* 6 months to 1 year
* impossible to determine
* if policy could be enacted immediately, timing would not be a problem
* 1 year

That answer is incorrect.
Correct answer:
impossible to determine

One of the primary problems with fiscal policy is one of timing. Any stimulus package would take time to work its way through the economy. For example, if unemployment were high and the government passed fiscal policy legislation involving many new hires, it would take time for the new employees to be hired, then they would go through training, and probably not begin productive work for many months. Furthermore, the new income the employees now receive would be spent on goods, which would become income for other individuals, etc. This creates a multiplier effect over time. How long this will take to be fully realized is impossible to determine.

When the number of discouraged workers increases during a severe recession,

 * the measured unemployment tends to overstate the severity of the unemployment problem.
 * the measured unemployment tends to understate the severity of the unemployment problem.
 * frictional unemployment will rise.
 * the natural unemployment will decline.

That answer is incorrect.
Correct answer:
the measured unemployment tends to understate the severity of the unemployment problem.

Persons who have given up searching for employment because they believe additional job search would be fruitless are termed discouraged workers. Because they are not current searching for work, they are not counted among the unemployed. As a result, the number of unemployed workers will be understated since unemployed individuals will drop out of the labor force and thus not be counted as unemployed.

The chairman of the House Ways and Means committee, who has major sway on spending programs, has been researching the economy and believes that the nation is heading for an inflationary spiral. Inflation is currently not considered a problem. He proposes a fiscal policy solution. Which of the following would not impede his proposition from alleviating the problem?

I. congressional opposition to spending cuts
II. difficulty determining the degree of spending cuts required
III. correctly choosing between tax hikes and spending cuts
IV. impact lag
V. recognition lag

 * III, IV
 * I, II, IV, V
 * II, IV, V
 * II, IV
 * I, II, III, IV, V
 * I, II, V

That answer is incorrect.
Correct answer:
I, II, IV, V

I, II, IV, and V are classic problems with fiscal policy. III is incorrect because in terms of fiscal policy tax or spending measures are interchangeable.

An economy is currently in equilibrium at full employment. If there is an unanticipated decrease in demand, the employment rate in the short run:

 * will increase.
 * will remain unaffected but wages will decrease.
 * will rise above the natural rate.
 * none of these answers.

That answer is incorrect.
Correct answer:
none of these answers.

If there is an unanticipated decrease in demand, the demand curve will move to the left. The supply curve will not move in the short run since the demand cut-back is unanticipated. This will lead to a decrease in the employment rate and a fall in real GDP. Prices will also fall as a result of decreased demand.

Seeing that the unemployment rate is reaching new highs each month, several Senators group together to propose major tax cuts and spending increases to stimulate the economy. Both the increased spending and tax cuts will be implemented in the following January, more than six months away. Due to major public outcry, these bills pass through legislature very quickly. During the six months in between passage and implementation, the unemployment rate begins to fall. Another year passes, now 18 months after the bill was first passed, and the economy is suffering from significant inflation. What problem(s) with fiscal policy does this illustrate?

I. recognition lag
II. impact lag
III. crowding out effect
IV. rational expectations

* I, II, III, IV
* I, II, III
* I only
* II only
* I, II
* III, IV

That answer is incorrect.
Correct answer:
I, II

In this case, tax cuts and spending increases took approximately six months to enact. However, illustrating the recognition lag, by the time six months had passed, the economy was recovering. One year later, the economy is suffering from inflation. This is due to the fact that fiscal policy takes time to have its full impact, or impact lag. By the time the full impact was realized, the economy had recovered, and the fiscal stimulus caused inflation.

Since World War II the labor force participation rate (LPR)

* of women has steadily decreased while the LPR for men has increased.
* of women has steadily increased while the LPR for men has declined.
* of both women and men has increased.
* of both women and men has decreased.

That answer is incorrect.
Correct answer:
of women has steadily increased while the LPR for men has declined.

Since 1948 the labor force participation rate for women has steadily increased while the rate for men has been declining. This suggests that the composition of work force participation within the family has changed substantially during the last five decades.

To the extent that people eventually adjust to demand stimulus policies, persistent expansionary macropolicy will lead to

* lower money interest rates.
* a reduction in the long-run unemployment.
* inflation with no permanent reduction in unemployment.
* more rapid economic growth but no change in prices.

That answer is incorrect.
Correct answer:
inflation with no permanent reduction in unemployment.

Correctly anticipated inflation will result in persistent, though consistent, inflation with no effect on unemployment since there will be no effect on the real wage.

Which of the following is true?

* GDP = GNP + (income of citizens received for factors of production supplied abroad) - (income paid to foreigners for their contribution to domestic output)
* The GDP is always larger than GNP since it includes the output produced by foreign nationals living in the country.
* The GNP is always larger than GDP since it includes the income by the country's citizens living abroad.
* GNP = GDP + (income of citizens received for factors of production supplied abroad) - (income paid to foreigners for their contribution to domestic output).

That answer is incorrect.
Correct answer:
GNP = GDP + (income of citizens received for factors of production supplied abroad) - (income paid to foreigners for their contribution to domestic output).

GNP measures the productive value generated by the labor and capital owned by the citizens of a country, regardless of whether those citizens and assets reside within the country or out of it. Hence, while calculating GNP, the income generated by foreign nationals residing in the country as well as by assets owned by foreign nationals is excluded. On the other hand, GDP measures the productive activity within the country, regardless of who produces it.

When the economy is in short-run equilibrium below potential output, then

* actual unemployment will be greater than the natural unemployment.
* the natural unemployment will decline.
* the economy will be unable to sustain output in the long run.
* actual unemployment will be less than the natural unemployment.
* a strong demand for resources will place upward pressure on resource prices.

That answer is correct!

An equilibrium below potential output implies that demand for labor and other resources is weak. This implies that the actual rate of unemployment will be greater than the natural rate since the natural rate prevails when the economy is operating at full employment.

Full employment means that which of the following is zero?

* frictional unemployment
* aggregate unemployment
* cyclical unemployment
* structural unemployment
* total unemployment

That answer is incorrect.
Correct answer:
cyclical unemployment

Full employment is the level of employment that results from the efficient use of the labor force after allowance is made for the normal rate of unemployment due to information cost, dynamic changes and the structural conditions of the economy. Cyclical unemployment is short run and therefore must be zero in order to attain full employment.

Keynesian analysis implies that

* flexible wages and prices will quickly direct a market economy to full employment.
* the federal budget should be balanced annually.
* fluctuations in aggregate demand are an important source of economic instability.
* fluctuations in the money supply are the major source of economic instability.

That answer is incorrect.
Correct answer:
fluctuations in aggregate demand are an important source of economic instability.

According to Keynes, the major source of business instability is fluctuations in aggregate demand. Thus, policies that effectively stabilize aggregate demand substantially reduce economic instability.

An economy is currently in equilibrium at full employment. If there is an anticipated governmental demand-stimulus policy and people correctly anticipate the effects, which of the following effects can be seen in the short run?

I. The demand curve moves to the right.
II. Real GDP increases.
III. Prices increase.
IV. The supply curve shifts to the left.

* I, II, III & IV
* I, III & IV
* I & III
* III & IV

That answer is incorrect.
Correct answer:
I, III & IV

If the buyers and sellers in the resource market completely anticipate the effects of an increase in demand, then they will correctly forecast the higher future inflation. This will prompt buyers to try and buy the goods today, at lower prices. On the other hand, suppliers would prefer to sell in the future, at higher prices. Thence, the demand curve will quickly move to the right and the supply curve will move to the left. An equilibrium will be reached at a higher price which leaves the real quantities unaffected, changing only the nominal variables.

Which of the following factors would reduce aggregate demand in the goods and services market?

* a decrease in the real interest rate
* an increase in the expected inflation rate
* increased pessimism concerning the expected strength of future business conditions
* an increase in stock prices

That answer is incorrect.
Correct answer:
increased pessimism concerning the expected strength of future business conditions

What people think will happen in the future influences current purchasing decisions. Pessimism about the future state of the economy causes consumers and investors to cut back on their current spending for fear of becoming over extended. This pessimism leads to a decline in aggregate demand.

According to Keynesians, which of the following is/are true?

I. Wages and prices are flexible and automatically direct an economy toward full employment.
II. Changes in output rather than changes in prices direct an economy toward equilibrium.
III. An economy can be in equilibrium even if there isn't full employment prevailing.

* I, II & III
* III only
* I & II
* II & III

That answer is incorrect.
Correct answer:
II & III

Keynesian economics maintains that businesses produce only the quantities consistent with anticipated demand. Thus, expected aggregate expenditures are crucial to determining the state of the economy. If the planned expenditures exceed the anticipated demand, then the economy will expand and vice versa. Equilibrium will be attained where output equals the spending level. Hence, in Keynesian economics, equilibrium can occur at any level of output and employment rate, even if that level is less than the potential GDP. Further, only changes in demand will fuel changes in output; changes in prices will not be capable of moving an economy toward equilibrium.

If the Fed starts following a contractionary monetary policy:

I. the U.S. trade deficit with other countries rises.
II. the unemployment rate increases.
III. real interest rates increase.

* I, II & III
* I & III
* II only
* II & III

That answer is correct!

When the Fed institutes a contractionary monetary policy, the real interest rates rise because money supply falls. This makes the opportunity cost of current consumption higher, reducing consumer demand and spending. This lower demand leads to lower production and higher unemployment. Further, the U.S. dollar tends to strengthen because foreign investments in U.S. increase due to higher real interest rates. The exports fall due to this. The effect on imports is more ambiguous since reduced consumer spending decreases imports but a stronger dollar increases them. The net effect is usually seen to be an increase in trade deficit due to a larger fall in exports.

In the aggregate demand/aggregate supply model, an increase in a country's sustainable potential output is represented by an increase in

* actual unemployment.
* prices.
* aggregate demand.
* long-run aggregate supply.

That answer is incorrect.
Correct answer:
long-run aggregate supply.

Changes in long run aggregate supply affect the economy's long run potential output. Changes in short run aggregate supply do not affect the long run potential of the economy.

An increase in the discount rate makes it more expensive for banking institutions to fall below the ________ ratio.

* none of these answers
* discount
* reserve
* federal funds
* required reserve

That answer is incorrect.
Correct answer:
required reserve

The required reserve ratio is the ratio of reserves to deposits that the Fed requires all banks to meet. If a bank fails to meet its required reserve ratio is must borrow funds from the Fed or from the federal funds market to meet the ratio. The bank can borrow funds from the Fed at the discount rate; thus if this rate increases, it becomes more expensive for banks to fail to meet the required reserve ratio.

An improvement in technology would shift which of the following curves?

* aggregate demand and long-run aggregate supply
* short-run and long-run aggregate supply
* only short-run aggregate supply
* aggregate demand and short-run aggregate supply
* only aggregate demand

That answer is incorrect.
Correct answer:
short-run and long-run aggregate supply

Improvements in technology permit the economy to squeeze a larger output from a specific resource supply. Thus, such improvements enhance productivity and thereby shift the LRAS curve to the right. Before such technology shifts the long run aggregate supply however, the short run aggregate supply is affected. Thus, both the SRAS and LRAS curves shift outward under a technology improvement.

Under rational expectations, a shift to a more expansionary macroeconomic policy will

* fail to systematically reduce unemployment in either the short run or long run.
* reduce unemployment in both the short run and long run.
* reduce unemployment in the short run but not in the long run.
* reduce unemployment in the long run but not in the short run.

That answer is correct!

Under rational expectations two scenarios are feasible when expansionary macroeconomic policy is employed: if the policy is anticipated, the inflation rate will rise while unemployment will be unchanged. If the policy is unanticipated and underestimated, unemployment will temporarily fall; if the policy is unanticipated and overestimated, unemployment will temporarily rise above the natural rate.

Which of the following determine(s) the supply curve?

I. Supply curves of factor resources.
II. Total money supply flowing in the economy.
III. Cost of running operating capacity at a given level.
IV. Prices of related goods.

* I & III
* III & IV
* I, II, III & IV
* I, II & III

That answer is incorrect.
Correct answer:
I, II & III

Note that the total money supply in the economy determines the values plotted on the price-axis of a supply curve.

Under a monetary expansion, aggregate demand can be expected to ________.

* stay the same
* rise
* fall, then rise
* fall
* rise, then fall

That answer is incorrect.
Correct answer:
rise

Under a monetary expansion, individuals posses more money balances. Since they invest/save more and consume more, aggregate demand increases due to increased consumption.

If you were asked to study the economy over the past five years, you would use the real GDP series rather than the nominal GDP series because

* the nominal GDP series reflects changes in both output and prices, whereas the real GDP series, roughly speaking, merely reflects changes in output.
* the nominal GDP series fails to account for transfer payments, whereas the real GDP series includes these payments.
* the real GDP series accounts for imports, making it more precise than the nominal GDP series.
* exports are excluded from the real GDP series, making it less complicated than the nominal GDP series.

That answer is correct!

It is almost always true that economists are interested in real changes rather than nominal changes because nominal changes look at both changes in the amount of goods and services produced and prices. Real changes focus only on changes in the amount of goods and services produced.

If the Fed wanted a more expansionary monetary policy, which of the following would be most appropriate?

* reduce taxes
* increase government expenditures
* buy government bonds from the public
* raise the discount rate

That answer is incorrect.
Correct answer:
buy government bonds from the public

To expand the money supply the Fed may buy government bonds from the public. This action injects money into the economy because individuals who formerly held U.S. security notes now hold money balances.

Country A's workforce consists in large part of seasoned workers, with an average age of around 45. Country B is relatively young, with an average workforce age of just 31. A is also a mature country, having implemented many modern advances in technology. B is a growing country with a dynamic leadership which is bringing about a technological revolution in the country. Given this, country A has ________ structural unemployment and ________ frictional unemployment than country B.

* lower, lower
* higher, lower
* lower, higher
* higher, higher

That answer is correct!

Frictional employment arises because of the fact that employers do not known about all the available workers and their qualifications while job-seekers are not fully aware of the available job opportunities matching their interests and skills. This leads to a longer job placement time and also causes a higher employee turnover due to job mismatches. The resulting contribution to the unemployment rate is called "frictional unemployment." Since younger workers tend to have a higher job mobility, a younger workforce will also have a higher frictional unemployment.

Changes due to technology, public policy or demands in the market place lead to people with outdated skills or skills which do not match the jobs being offered. The resultant contribution to unemployment is referred to as "structural unemployment." Hence, a rapidly growing economy will tend to generate a higher level of structural unemployment since in such an economy, skills tend to get outdated faster.

Which of the following is not true about monetary policy?

* The money supply is neutral in the long-run.
* Monetary policy can only serve to decrease economic volatility.
* In the long-run, the price level is a function of production and money supply.
* Without interference, the money supply would remain constant.
* The money supply will have no impact on real income if changes in the price level are anticipated.

That answer is incorrect.
Correct answer:
Without interference, the money supply would remain constant.

Usually we think of the Central Bank being in control of the money supply, but several factors outside of the baker's control can impact the money supply. Most notably is the currency deposit ratio, which measures how much currency consumers actually hold. If consumers hold more physical currency, this decreases banks' ability to create more money by lending funds.

Rich owns a shoe factory. He believes that a recent monetary policy announcement will cause 5% inflation over the next year, equally effecting the price of shoes, the cost of inputs, and wages. How will Rich change his production plans considering this forecast?

 * He will try to hide this information from his laborers.
 * Cannot determine, this depends on how much prices actually inflate over the next year.
 * He will increase shoe production because the expansionary monetary policy should boost consumer confidence and hence shoe demand.
 * No changes.
 * He will increase shoe production to take advantage of higher prices.

That answer is incorrect.
Correct answer:
No changes.

Anticipated inflation is always a wash for both consumers and producers, therefore Rich would not change his production plans. Remember that possible secondary effects, like an increase in consumer confidence, cannot be assumed. How high actual inflation is during the year is irrelevant since planning is based on forecasted inflation. This is an important concept for understanding how policy effects decision making. Note that if the entire economy thought exactly as Rich did, the expansionary monetary policy will have no real impact on the economy.

A shoe manufacturer believes inflation will increase dramatically over the next year. What incentives does this create for this firm?

 * The firm will manufacture less, knowing that prices will be higher in the future.
 * The firm will respond to demand from retailers, regardless of inflation.
 * If inflation is widely expected, it will have no impact on the firm's strategy.
 * The firm will want to decrease inventories now because future inventories will be more costly and therefore less profitable.
 * The firm will attempt to store shoes in inventory, knowing that in the future these shoes will be worth more.

That answer is incorrect.
Correct answer:
The firm will attempt to store shoes in inventory, knowing that in the future these shoes will be worth more.

Inflation will cause the manufacturer's costs to increase in terms of raw materials and wages. In addition, the price of shoes should also increase. Therefore the firm has an incentive to produce now, and store these goods in inventory until prices rise.

Which of the following will most likely occur in the short-run if there is an unanticipated increase in aggregate demand?

* an increase in output and a higher price level
* a decrease in prices, while output remains unchanged
* a decrease in output and a higher price level
* a decrease in output and a lower price level
* an increase in output, while prices remain unchanged

That answer is correct!

In response to an unanticipated increase in aggregate demand prices will rise and output will temporarily exceed full employment capacity. In the long run, output will return to its long run potential.

An economy is currently in equilibrium at full employment. If there is an anticipated decrease in demand, which of the following effects can be seen in the short run?

I. Real GDP decreases.
II. The supply curve shifts to the right.
III. The demand curve moves to the left.
IV. Prices decrease.

* IV only
* I, II, III & IV
* III & IV
* II, III & IV

That answer is incorrect.
Correct answer:
II, III & IV

If the buyers and sellers in the resource market completely anticipate the effects of a decrease in demand, then they will correctly forecast the lower future inflation. This will prompt buyers to postpone current consumption and wait till prices drop. On the other hand, suppliers would prefer to sell today, while prices are high, instead of waiting till the prices fall. The demand curve will therefore quickly move to the left and the supply curve will move to the right. An equilibrium will be reached at a lower price which leaves the real quantities unaffected, changing only the nominal variables.

Employment is the number of persons employed divided by the number of persons

* in the civilian population age 16 and over.
* employed plus the number unemployed.
* unemployed.
* in the labor force.

That answer is correct!

The employment/population ratio is the number of persons aged 16 years and over employed as civilians divided by the total civilian population 16 years of age and over. The ratio is expressed as a percentage. This rate does not make a subjective judgment as to whether a person is actually "available for work" or "actively seeking employment."

Which economic model supports the theory that budget deficits cause inflation?

 * The supply-side model
 * The crowding-out model
 * None of these models support the theory
 * The new classical model
 * The Keynesian model

That answer is incorrect.
Correct answer:
The crowding-out model

The crowding out model indicates that, when the supply of money is constant, budget deficits will simply lead to higher real interest rates and a fall in net exports, which will crowd out private spending and thereby dampen the stimulus effect of the deficit.

An unfortunate consequence of ________ and monetary instability is that people spend less time producing and more time trying to protect their wealth.

 * unemployment
 * all of these answers
 * monetary contraction
 * inflation
 * none of these answers

That answer is incorrect.
Correct answer:
inflation

Since failure to anticipate the rate of inflation has substantial effects on one's wealth, individuals divert scarce resources away from the production of goods and services and apply them into the acquisition of business decision makers to forecast the price changes. Thus, speculative practices are encouraged while productive activities are discouraged.

Inflation the last 5 years has been as follows:

Year 1: 4.4%
Year 2: 4.7%
Year 3: 4.9%
Year 4: 5.2%
Year 5: 5.8%

Given this information, what would the consensus inflation forecast most likely be under both the adaptive expectations hypothesis and the rational expectations hypothesis?

 * unknown; 5.8%
 * 5.8%; 6.4%
 * 6.2%; 5.8%
 * 5.0%; 6.2%

* not enough information to determine either
* 5.0%; unknown
* 6.2%; 5.0%

That answer is incorrect.
Correct answer:
5.0%; unknown

Adaptive expectations hypothesis states that economic participants will most likely form expectations based on the past. Most often, we imagine that individuals will simply take an average of past years' inflation, or 5% in this case. The rational expectations hypothesis states that forecasts will be based on all available information. Since we are given no information other than historical figures, there is no way to make an estimation under rational expectations.

If the money velocity is 4 and the nominal GDP is $200 million, then the stock of money in circulation is

* $40 million.
* $800 million.
* $200 million.
* $50 million.

That answer is incorrect.
Correct answer:
$50 million.

Velocity of money is defined as GDP divided by the stock of money. Thus, we need to solve for M if 4=$200 million/M. This implies that M=$50 million.

Producers generally believe inflation will be 5%. An unexpected shift in monetary policy causes inflation to actually be 7%. If the economy has slack resources, how might this impact nominal and real GDP in the short run?

* nominal GDP does not change while real GDP increases
* nominal GDP rises but real GDP does not change
* neither changes
* nominal GDP increases but it is impossible to determine how real GDP might be impacted
* both would rise

That answer is incorrect.
Correct answer:
both would rise

If inflation is greater than expected, producers realize an increase in the price of their products and may not be initially able to distinguish between inflationary a real price changes. This may cause an increase in production, and therefore an increase in real GDP. Nominal GDP will increase both because of the real increase in production and the increase in the price level.

"While expansionary macroeconomic policies cause inflation, invariably they also stimulate real output and employment." This statement is

* false; when people accurately anticipate the side effects of expansionary policies, the policies do not stimulate real output and employment.
* essentially correct.
* false; expansionary macroeconomic policies do not cause inflation.
* false; expansionary policies cannot stimulate output and employment.

That answer is correct!

This statement is fall because fully anticipated expansionary policies lead only to inflation. Real output and employment are not affected since the real wage is constant.

During a presidential debate, one candidate proposes cutting the highest marginal tax rate without changing spending level to stimulate the economy. The opposing candidate claims that this would be ineffective. Which of the following theories would support the tax cut plan?

* fiscal policy
* none of these answers is correct
* Keynesian
* supply-side
* all of these

That answer is incorrect.
Correct answer:
all of these

Cutting taxes with no decrease in spending is essentially fiscal policy. This sort of demand-side stimulus is a hallmark of Keynesian theory. Since marginal tax rates were also being reduced, this would also be a supply-side stimulus.

If actual unemployment exceeds the natural unemployment, the AD/AS model indicates that full employment

* cannot be restored without an increase in aggregate demand.
* will be restored, but only through using monetary policy.
* will be restored quickly.
* cannot be restored without a permanent reduction in output.
* will eventually be restored, but it does not indicate the speed at which the move to long-run equilibrium will occur.

That answer is incorrect.
Correct answer:
will eventually be restored, but it does not indicate the speed at which the move to long-run equilibrium will occur.

Full employment will be restored in such a situation by falling interest rates and resource prices. As a result, production costs will fall and stimulate aggregate supply toward the full employment level. However, there is no time frame for this adjustment.

Use the table below to answer the following question.

Income (Dollars)	Consumption (Dollars)
20,000	19,000
22,000	20,500

What is the marginal propensity to consume?

* 0.75
* 1.11
* 0.90
* 0.95
* 0.99

That answer is correct!

Since the MPC is determined according to the ratio: MPC = additional consumption divided by additional income, the MPC here equals: 1,500/2,000 = 0.75.

In the long-run, increases in the money supply have ________ impact on real production. In the short-run, increases in the money supply can have ________ impact on real production.

* a positive, an indeterminate
* a positive, no
* no, a positive
* a positive, a positive
* an indeterminate, a positive
* an indeterminate, an indeterminate
* no, no

That answer is incorrect.
Correct answer:
no, a positive

Monetary expansion always causes inflation and nothing more in the long run. In the short-term, however, imperfect information can lead to temporary increases in production.

The increase in money supply increases consumers' money stock. Consumers cannot initially distinguish between inflationary growth and real wealth growth. Demand for goods increases, causing prices to rise. Producers cannot initially distinguish between higher prices for their products due to inflation or due to real demand. Therefore producers respond by producing more goods, temporarily expanding output. Eventually, higher prices will prevail for both finished goods and inputs, and these higher costs will cause producers to decrease output. A new equilibrium is set at a higher price level but the same aggregate supply.

Which of the following explains why a $100 reduction in consumption spending might decrease equilibrium output by more than $100?

* the multiplier principle
* the quantity theory of money
* flexible resource prices
* Say's law

That answer is correct!

Within the framework of the Keynesian model, the multiplier expands why small changes in investment, government, or consumption spending can trigger much larger changes in output. The multiplier magnifies the fluctuations in output and employment that emanate from autonomous changes in spending.

The Great Depression provided support for Keynes's declaration that

* falling interest rates would stimulate spending by consumers.
* average propensity to consume was directly related to disposable income.
* government action was necessary to ensure interest rates remained at the equilibrium level.
* prolonged periods of high unemployment were possible.

That answer is incorrect.
Correct answer:
prolonged periods of high unemployment were possible.

Keynes suggested that the recessionary phase in an economy can be quite lengthy and that neither lower interest rates nor falling prices are able to reverse the tide of falling incomes.

An economy is currently experiencing high inflation. A Keynesian would suggest:

* an expansionary monetary policy.
* an expansionary fiscal and a restrictive monetary policy.
* a restrictive fiscal policy.
* an expansionary fiscal policy.

That answer is incorrect.
Correct answer:
a restrictive fiscal policy.

To control high inflation, Keynesians suggest cutting back on aggregate demand by either raising taxes or decreasing the size of the budget deficit. They thus recommend a restrictive fiscal policy to combat high inflation.

If the long-run equilibrium of an economy is disrupted by an unanticipated increase in aggregate demand (such as might result from unexpectedly strong demand for export goods due to the rapid growth of income abroad), then

* the real price of resources will decline.
* prices will decline.
* actual unemployment will temporarily fall below the natural rate.
* the natural unemployment will fall.

That answer is incorrect.
Correct answer:
actual unemployment will temporarily fall below the natural rate.

An unanticipated increase in aggregate demand will cause prices to rise and output will temporarily exceed full employment capacity. This will cause the demand for labor to rise and the actual rate of unemployment will be lower than the natural rate of unemployment.

A shift to a more restrictive macroeconomic policy to halt an inflation that has been going on for years

* will likely reduce unemployment as inflation decelerates.
* is unlikely to exert an impact on actual unemployment.
* will likely increase unemployment until people adjust to the slower inflation rate.
* will cause a permanent increase in unemployment.

That answer is incorrect.
Correct answer:
will likely increase unemployment until people adjust to the slower inflation rate.

An unanticipated deflation will cause the real wage to rise and consequently, unemployment to increase. Once individuals adjust to the slower inflation rate unemployment will stabilize.

To assume that private investment is autonomous is to assume that it

* depends on the other variables in the model under consideration.
* does not depend on interest rates.
* depends on saving.
* is independent of other variables in the model.
* is determined by the "animal spirits" of business decision makers.

That answer is incorrect.
Correct answer:
is independent of other variables in the model.

Autonomous expenditures are those that do not vary with the level of income. They are determined by factors that are outside the basic income expenditure model.

Which of the following best describes how available credit on charge cards are handled in the M1 supply calculation?

* It is excluded, since credit does not fit the full definition of money.

 * It is included, because consumers use credit cards as a medium of exchange.
 * It is excluded, as credit purchases represent a small percentage of all purchasing power.
 * It is included, as it represents purchasing power.
 * It is excluded, because heavy consumer debt is not desirable.

That answer is correct!

Credit card expenditures are not considered money. Credit is simply a loan, and the money used to repay that loan represents purchasing power, not the loan itself. Credit also fails to fit the definition of money in that it is neither an accounting unit nor a store of value.

Which of the following describes the sequence in a business cycle?

 * Boom, Recession, Contraction, Expansion.
 * Recession, Expansion, Contraction, Boom.
 * Boom, Contraction, Recession, Expansion.
 * Contraction, Boom, Recession, Expansion.

That answer is incorrect.
Correct answer:
Boom, Contraction, Recession, Expansion.

A general economy goes through phases of expansions and contractions, which together constitute "business cycles." In the expansion phase, productivity and real GDP rise rapidly, leading to a business "boom" or "peak." After that, the economy starts to slow down and contract, leading up to a recessive trough. Over time, the economy once again gets out of the recession and starts expanding, completing one business cycle. Note that this business cycle definition is an idealized picture. In reality, the economy could exhibit many smaller swings up and down while completing a larger cycle of boom and bust.
In passing, remember that recession is defined as a decline in real GDP for two or more successive quarters.

Which of the following presents a problem in executing successful fiscal policy?

 * all of these are correct
 * time lag between implementation of fiscal policy and impact in the economy
 * difficulty in quickly enacting spending or tax legislation
 * level of fiscal stimulus/contraction needed is unknown
 * difficulty in recognizing economic problems before they become serious
 * political bias towards spending and against taxation

That answer is correct!

Fiscal policy is fraught with implementation problems. First is it difficult for policy makers to recognize and/or agree that a problem exists before it becomes serious. Second, politicians tend to be more willing to spend more and tax less than the opposite, meaning that disinflationary fiscal policy legislation is nearly impossible to pass. The speed of the legislative process is another problem. Stimulative fiscal policy often takes so long to pass the legislature, the economy has already recovered. Fiscal policy is often called a "blunt weapon" by economists, meaning that the impact of a fiscal measure is hard to measure. Finally, a fiscal policy initiative will take time for its full impact to hit the economy. These are all significant obstacles to successful fiscal policy.

The new classical model implies that substitution of debt for tax financing

* leaves wealth, and therefore aggregate demand, unchanged since the debt implies higher future taxes.
* reduces consumption because it increases both the current and future tax liability of households.
* is highly effective against inflation.
* increases aggregate demand and exerts a multiplier effect leading to an expansion in real output.

That answer is correct!

New classical economists stress that debt financing merely affects the timing of taxes, not their magnitude. Debt merely substitutes higher future taxes for lower current taxes. Since wealth represents your current holdings and future liabilities, it is unchanged under tax financing through debt. (The future liability is higher future taxes)

When the planned spending of consumers, businesses, government and foreigners (net exports) is less than the income level of the economy, the Keynesian model suggests that

* unemployment will fall.
* output will fall.
* equilibrium real GDP will increase.
* prices will rise.

That answer is incorrect.
Correct answer:
output will fall.

Equilibrium in the Keynesian model occurs when aggregate expenditures are equal to the income of the economy. If aggregate expenditures are less than income, output must fall in order to restore equilibrium. In this model, aggregate expenditures determine the level of output.

Empirical evidence suggests that changes in monetary policy influence real GDP ________.

* only through the rate of unemployment
* through exchange rates
* in the short run
* in the long run
* none of these answers

That answer is incorrect.
Correct answer:
in the short run

Shifts toward monetary acceleration tend to be associated with a temporary increase in the growth rate of real GDP. This increase is not sustained in the long run since aggregate supply will be expected to return to its initial level (if near or at full capacity).

The central quantity driving Keynesian economics is

 * Keynesian constant.
 * expenditure multiplier.
 * aggregate output.
 * demand elasticity.

That answer is incorrect.
Correct answer:
expenditure multiplier.

In Keynesian economics, fluctuations in aggregate demand are a major source of movements in the economy. The effect is supposed to be driven by the fact that one man's expenditure is another man's income. This idea is embodied in the expenditure multiplier, which measures the aggregate change in output for an initial expenditure of a single dollar.

If a country's population (age 16 and over) is 110 million, with 3 million unemployed and 55 million holding jobs, the unemployment rate is

 * 5.2 percent and the labor force participation rate 52.7 percent.
 * 5.5 percent and the labor force participation rate 52.7 percent.
 * 2.7 percent and the labor force participation rate 50 percent.
 * 50 percent and the labor force participation rate 50 percent.
 * 5.2 percent and the labor force participation rate 50 percent.

That answer is correct!

The civilian population is approximately 110 million and the labor force is comprised of the sum of the employed and the unemployed = 58 million. Therefore the labor force participation rate is (58/110) = 52.7% and the unemployment rate is the number of unemployed divided by the labor force = 3 million/58 million = 5.2%.

Which one of the following persons would be considered unemployed?

 * a blacksmith who has given up looking for work after 18 months without a job
 * a retiree living off Social Security income benefits
 * a full-time college student
 * an auto worker vacationing in Florida during the layoff period, before production of new models begins next month

That answer is incorrect.
Correct answer:
an auto worker vacationing in Florida during the layoff period, before production of new models begins next month

Persons are counted as unemployed only if they are available for and seeking work or awaiting recall from a layoff. The auto worker is considered unemployed because he is not working currently but is waiting to be recalled.

Which of the following is not a component of planned aggregate expenditure?

* Aggregate taxes
* Investment
* Consumption
* Net exports

That answer is correct!

The fourth component of planned aggregate expenditure is planned government expenditures, which can be financed either through taxes or government debt.

Which of the following items is NOT used in calculating the GDP using the expenditure approach?

* Personal consumption expenditure.
* Income payments to resources.
* Gross private domestic investment.
* Net exports of goods and services.

That answer is incorrect.
Correct answer:
Income payments to resources.

The Expenditure approach can be summarized as

"GDP = what you eat + what you invest + what you export"

It then has four components:

1. Personal consumption expenditure.

2. Gross private domestic investment (investments by people residing outside the country are ignored, even if they happen to be citizens of the country).

3. Government consumption & investment.

4. Net exports.

It should be remembered that implicit in the Expenditure approach is the assumption that current consumption is entirely produced in the current period. It thus runs into problems with long-term, durable goods for which an explicit adjustment must be made.

Income payments to resources appear in the "Resource cost-income approach" to measuring GDP, not the Expenditure approach.

Which of the following will most likely occur in the short run as the result of an unanticipated increase in aggregate demand?

* an increase in the natural unemployment
* an increase in output and a move to a lower price level
* an increase in both prices and output
* an increase in prices and a long-run increase in output
* an increase in long-run aggregate supply (LRAS shifts to the right)

That answer is incorrect.
Correct answer:
an increase in both prices and output

The short run effect of an unanticipated increase in aggregate demand is that prices will rise and output will temporarily exceed full employment capacity. This is different from the long run effects in which higher resource prices will contract aggregate supply which will induce a new equilibrium at a higher price level and lower output.

In year 0, $400 could purchase a certain basket of goods. In year 6, the identical basket of goods cost $577. What was the average annualized inflation rate during this period?

* 6.3%
* 9.1%
* 11.2%
* 1.9%
* 4.4%

That answer is correct!

The calculation is as follows: (577/400)^(1/6)-1=0.0630

If the amount of money in circulation is $150 million and the nominal GDP is $900 million, then the money velocity is ________.

* 0.17
* 9.0
* 13.5
* 6.0

That answer is incorrect.
Correct answer:
6.0

Velocity of money is defined as GDP divided by the stock of money. Thus, $900 million divided by $150 million equals 6.0.

Which of the following conditions would be necessary for tax cuts to be an effective fiscal policy measure?

I. Marginal tax rates must be cut
II. The tax cuts are offset by spending cuts
III. The legislation can be enacted and implemented well in advance of problematic unemployment
IV. GDP is currently below potential GDP

* IV only
* III, IV
* I, II, III, IV
* I, IV
* III only
* II only

That answer is incorrect.
Correct answer:
III only

Fiscal policy typically does not make a distinction between across the board and marginal tax cuts. If tax cuts are offset by spending cuts, this would be a neutral fiscal policy. If GDP is currently below potential, this does not indicate whether fiscal stimulus is currently needed, the economy might recover before the stimulus can take effect. In order for fiscal policy to be effective, legislation must be past in advance of the actual economic problem.

A business cycle as a period of up-and-down motion measures economic activity, typically real GDP. The stages of a business cycle, in order, are

* recession, contraction, expansion, boom.
* contraction, recession, expansion, boom.
* boom, expansion, contraction, recession.
* expansion, contraction, recession, boom.

That answer is incorrect.
Correct answer:
contraction, recession, expansion, boom.

When the economy experiences a contraction, sales of most businesses fall, real GDP grows at a slow rate or perhaps declines and unemployment in the aggregate labor market increases. This contraction thus leads to a recession (a downturn in economic activity for two consecutive quarters). The bottom of the contraction phase is referred to as the recessionary trough. After the downturn reaches bottom and economic conditions improve, the economy enters the expansion phase of the cycle. The expansion eventually leads to another business peak or boom.

A bank has demand deposits of 700 million dollars, a reserve level of 98 million dollars with the Fed and outstanding loans worth 636 million dollars. The Fed has imposed a 10% reserve requirement. By how much will the money supply increase if the bank loans out all its excess reserves?

* $280 million
* $28 million
* $980 million
* $63.6 million

That answer is correct!

The Demand Deposit Multiplier, D, in an economy indicates the factor by which the money supply exceeds the monetary base flowing in the economy. Thus, if the monetary base increases by a dollar, the total money supply potentially will increase by D dollars. It can be shown that D is equal to the inverse of the reserve requirement and in this case, D = 1/0.1 = 10.
Now, since the reserve requirement is 10%, the bank must maintain 10% of the 700 million deposits in reserves. Thus, it needs to maintain $70 million in reserves with the Fed, resulting in excess reserves of $28 million. If the bank were to loan out all of these excess dollars, then the total money supply in the economy will increase by 28*10 = $280 million.

Which of the following will most likely accompany an unanticipated reduction in aggregate demand?

* a decrease in employment
* an increase in real GDP
* an increase in prices
* a decrease in unemployment

That answer is correct!

Unanticipated reductions in aggregate demand imply that inventories build up and that the rate of real output will decline. This implies that labor demand (and the demand for other resources) will decline.

Which of the following would most likely lead to a decrease in current consumption?

* a decrease in personal income taxes
* a decrease in the disposable income
* an increase in government spending
* a decrease in the interest rate

That answer is incorrect.
Correct answer:
a decrease in the disposable income

Consumption expenditures are positively related to disposable income. Thus, a decrease in disposable income will lower current consumption. This positive relationship is called the consumption function.

If a market economy has a self-correcting mechanism, when output is higher than potential output,

* resource prices will rise.
* consumption will increase more rapidly than income.
* real interest rates will fall.
* households will allocate less income to savings.

That answer is correct!

Remember that output is synonymous with supply. If output is greater than potential output, this implies intense competition for resources. This forces prices higher. If input prices are higher, marginal cost of production increases, which means a shift to the left for the aggregate supply curve, or in other words, lower output.

An increase in marginal tax rates leads to which of the following effects?

I. Scarce capital is channeled toward less desirable activities which happen to generate tax shelters.

II. Some of the consumption decisions are made on the basis of tax advantages, leading to "consumption waste."

III. People prefer to forego additional productive activity in favor of leisure even if it means giving up potential income.

* I & II
* I & III
* I, II & III
* II & III

That answer is incorrect.
Correct answer:
I, II & III

Marginal tax rates are central to the effects postulated by Supply-side economists. According to this theory, an increase in marginal tax rates decreases the incentive to work. People to shift away from productive work and toward more leisure. Non-productive activities explicitly directed toward avoiding taxes increase and projects are selected at least partly due to their tax benefits and not necessarily due to their intrinsic merits. This leads to inefficient channeling of capital resources.

Other things constant, if the public decides to hold more money in the form of currency rather than checking deposits, then

* bank reserves will increase and the money supply (M1) will also increase over time.
* bank reserves will increase and the money supply (M1) will decline over time.
* bank reserves will decline and the money supply (M1) will also decline over time.
* the money supply (M1) will increase since currency is part of the money supply but bank deposits are not.

That answer is incorrect.
Correct answer:
bank reserves will decline and the money supply (M1) will also decline over time.

If the public holds more money in the form of currency rather than checking deposits bank reserves will decline and the money supply will decline over time because the effect of the deposit expansion multiplier. The transferal of deposits to currency implies that banks can make fewer loans and therefore the work of the deposit expansion multiplier is inhibited. Bank reserves decline with more currency holdings since the public chooses to hold currency rather than storing their money in commercial banks.

As disposable income increases, consumption expenditures will rise but by a smaller amount than the increase in income. Economists refer to this relationship as

 * the crowding-out effect.
 * the multiplier.
 * Say's law.
 * the consumption function.

That answer is incorrect.
Correct answer:
the consumption function.

The consumption function describes the relationship between consumption and disposable income. As disposable income increases, consumption rises but by a smaller amount than the increase in income.

Inflation tends to retard economic progress because it distorts the information delivered by ________ and changes the results of long-term contracts from those that are intended, in unpredictable ways.

 * loanable funds
 * all of these answers
 * the Fed
 * none of these answers
 * prices

That answer is incorrect.
Correct answer:
prices

Since prices change according to different schedules, unanticipated inflation will change relative prices as well as the general price level. Thus, producers and resource suppliers are often led astray by the unreliable price level. This additional uncertainty will force many decision makers to forego capital investment and other transactions when the rate of inflation is highly variable and therefore unpredictable. As a result, potential gains from production and exchange will be lost.

The type of unemployment that increases as the economy sinks into a recession is called

 * cyclical unemployment.
 * frictional unemployment.
 * seasonal unemployment.
 * natural unemployment.

That answer is correct!

Cyclical unemployment occurs when there is a general downturn in business activity. Fewer goods are being produced so that fewer workers are required to produce them. Employers lay off workers and cut back employment.

Which one of the following factors will most likely cause an increase in long-run aggregate supply?

 * a technological breakthrough that reduces the cost of refined petroleum products by 50 percent
 * an increase in the expected inflation rate
 * a decline in capital formation due to higher interest rates
 * a decline in net exports

That answer is correct!

Improvements in technology permit us to squeeze a large output from a specific resource supply. Thus, improvements in technology enhance productivity and thereby shift the long run aggregate supply curve to the right.

The Keynesian analysis of fiscal policy implies that

 * the government's taxation and expenditure policies should be used to maintain aggregate demand at a level consistent with the economy's full-employment capacity.
 * fiscal policy should generally be restrictive.
 * the federal budget should be balanced annually except during war.
 * fiscal policy should generally be expansionary.

That answer is correct!

Keynesian economists suggest that the government should operate under budget deficits when the economy is in a recession and under a surplus when the economy is growing very quickly. Thus, the government should spend more when the economy requires an aggregate demand stimulus and should spend less when the economy's aggregate demand is too high. Expenditure and taxation determine if the government is operating a deficit or surplus and therefore should reflect this "counter-cyclical" policy. The consequence of this "counter-cyclical" policy will be a stabilization of the economy orchestrated through the government's contribution to aggregate demand. The government should attempt to stabilize the economy through its contribution to aggregate demand.

Which of the following recent developments may distort the meaning of aggregate money supply measurements, such as M1 or M2, in the United States?

I. Individuals are increasingly using bank debit cards and carrying less currency
II. Individuals can now use money market accounts as checking accounts
III. Credit cards allow individuals to spend more than their actual money income

 * I, III
 * II only
 * I, II
 * III only
 * I, II, III
 * I only

That answer is incorrect.
Correct answer:

I, II

The introduction of new financial products, such as money market accounts and debit cards, have not changed the way individuals use money but have changed the vehicles in which money is stored and transacted. Many individuals carry less cash and use a debit card instead. This results in more money stored with banks, increasing the required reserves. Money held in a money market fund is not subject to reserve requirements and is not directly lent out by the bank as opposed to a traditional checking account. Therefore the increased use of these financial products may distort money aggregate measures such as M1 or M2.

Credit cards are not money, they are debt instruments. In other words, the use of a credit card simply delays payment in actual money, it does not replace the need for money.

In the Keynesian aggregate expenditure model, the larger the marginal propensity to consume, the

* greater the marginal propensity to save.
* more consumption expands as the result of a decline in investment.
* smaller the multiplier.
* greater the change in income derived from a given change in private investment.

That answer is incorrect.
Correct answer:
greater the change in income derived from a given change in private investment.

The multiplier is defined as 1/(1-MPC), thus the greater the MPC, the larger the multiplier. The multiplier is the ratio that determines the increase in total income associated with an increase in private investment.

If nominal or money GDP increases 3 percent in 1993 (compared to 1992) while real GDP increases 5 percent over the same period, which of the following must be true?

* The general price level as measured by the GDP deflator fell during 1993.
* Exports exceeded imports.
* The economy entered a recession in 1993.
* Inflation during 1993 was 2 percent.

That answer is correct!

Since real GDP is nominal GDP multiplied by the GDP deflator ratio it must be true that prices fell over the period considered. This is because in order for the change on the left hand side of the equation to be greater than the change in the right hand side of the equation, the change in nominal GDP must be multiplied by a fraction that is greater than one. Therefore, the GDP deflator must be greater than one which implies that the GDP deflator for the current year is less than 100 (while the GDP deflator for the base year is 100).

Which of the following would most likely lead to a decrease in current consumption?

* an increase in government spending

* a decrease in the disposable income
* a decrease in the interest rate
* a decrease in personal income taxes

That answer is incorrect.
Correct answer:
a decrease in the disposable income

There is a positive relationship between consumption and disposable income such that a decrease in disposable income will reduce current consumption.

The law of demand states that:

* As prices increase, demand for goods decreases.
* As prices decrease, quantity demanded increases.
* In equilibrium, demand decreases to a level equal to the supply.
* As disposable income increases, demand for goods increases.
* All of these answers.

That answer is incorrect.
Correct answer:
As prices decrease, quantity demanded increases.

Remember that quantity demanded is impacted by changes in prices. When it is said that demand changes, this implies a shift in the demand curve, which does not occur due to changes in price.

If the money supply is constant, an increase in the demand for money will most likely

* increase the velocity of money.
* reduce the nominal interest rate.
* increase the nominal interest rate.
* increase aggregate demand in the goods and services market.

That answer is incorrect.
Correct answer:
increase the nominal interest rate.

The nominal interest rate is the "price" of holding money. If the demand for money increases under a constant supply of money, as with any other good, the price of money will increase. Thus, the nominal interest rate will rise.

If the consumer price index (CPI) was 100 at year-end 1991 and 107 at year-end 1992, inflation during 1992 was

* 7 percent.
* 107 percent.
* zero; prices were stable during 1989.

* 117 percent.

That answer is correct!

The inflation rate is equal to:

(this year's CPI - last year's CPI) / last year's CPI

According to this formula inflation over this period was: (107 - 100)/100 = 7%.

If the full impact of an expansionary demand-stimulus policy is completely anticipated, the primary impact of the policy will be on:

* total output.
* real interest rates.
* inflation.
* total employment.

That answer is incorrect.
Correct answer:
inflation.

If the buyers and sellers in the resource market completely anticipate the effects of an increase in demand, then they will correctly forecast the higher future inflation. This will prompt buyers to try and buy the goods today, at lower prices. On the other hand, suppliers would prefer to sell in the future, at higher prices. The demand curve will quickly move to the right and the supply curve will move to the left. An equilibrium will be reached at a higher price which leaves the real quantities unaffected, changing only the nominal variables.

The natural unemployment rate reflects

* only structural factors.
* only frictional factors.
* frictional, structural and cyclical factors.
* only cyclical factors.
* both frictional and structural factors.

That answer is incorrect.
Correct answer:
both frictional and structural factors.

The natural unemployment rate is the long run average unemployment rate due to frictional and structural conditions of labor markets. The rate is affected both by dynamic change and by public policy. It is sustainable into the future.

Within the Keynesian aggregate expenditure model, which of the following autonomous changes would increase the equilibrium output?

* an increase in imports
* an increase in investment
* an increase in saving
* higher real interest rates
* an increase in taxes

That answer is incorrect.
Correct answer:
an increase in investment

An increase in investment is called autonomous because it does not vary with the level of income. However, it is a component of aggregate expenditure and therefore an increase in investment will cause equilibrium output to rise. This is because under the Keynesian model, aggregate expenditures determine the level of output (and income).

According to the Keynesian view, the government's expenditure and taxation policies should be determined by

* level of aggregate demand necessary to promote full employment and price stability.
* the Board of Governors of the Federal Reserve System.
* political rather than economic considerations.
* constitutional mandate requiring the federal government to balance its budget.

That answer is correct!

Keynesian economists suggest that the government should operate under budget deficits when the economy is in a recession and under a surplus when the economy is growing very quickly. Thus, the government should spend more when the economy requires an aggregate demand stimulus and should spend less when the economy's aggregate demand is too high. Expenditure and taxation determine if the government is operating a deficit or surplus and therefore should reflect this "counter-cyclical" policy. The consequence of this "counter-cyclical" policy will be a stabilization of the economy orchestrated through the government's contribution to aggregate demand. The government should attempt to stabilize the economy through its contribution to aggregate demand.

Producers expect prices to generally increase by 3% per year for the foreseeable future. The economy currently is under utilizing capacity, and the Central Bank decides to increase the money supply to spur the economy. To what degree should the Central Bank increase the money supply in order to have a real impact on GDP in the short-run?

* an amount consistent with inflation greater than 3%
* an amount consistent with inflation less than 3%
* an amount consistent with inflation of 3%
* impossible to determine without knowing the velocity of money
* increasing the money supply cannot impact real GDP

That answer is correct!

If inflation is greater than the expected 3%, producers will initially react to the higher prices for their products as if they were real price increases. In other words, initially there will be an increase in the aggregate quantity supplied and hence an increase in real GDP.

The demand for money to meet unplanned expenditures is known as

 * precautionary demand.
 * opportunity demand.
 * transaction demand.
 * risk demand.

That answer is correct!

Risk averse households and firms hold additional cash, checking account balances and other liquid assets as a precaution against unforeseen circumstances. The motivation for holding money for this reason is called precautionary demand for money.

Which of the following is/are true about the Fed's control of money supply?

I. The monetary base increases when the Fed sells government securities.

II. The money supply increases when the discount rate is increased.

III. The money supply increases when the Fed purchases government bonds.

IV. The money supply decreases when the reserve ratio is decreased.

 * I & IV
 * III only
 * II & III
 * I & IV

That answer is incorrect.
Correct answer:
III only

Buying releases money in the economy, increasing the money supply and vice versa. Decreasing the reserve ratio allows member banks to loan out greater amounts, increasing the monetary base flowing in the economy. A similar effect is seen when the discount rate charged by the Fed on its loans to the member banks is decreased.

The monetary base is the sum of ________ plus ________.

 * bank reserves, checkable deposits
 * checkable deposits, credit card liability
 * currency in circulation, credit card liability
 * currency in circulation, bank reserves
 * none of these answers

That answer is incorrect.

Correct answer:
currency in circulation, bank reserves

The monetary base reflects the stock of U.S. securities held by the Fed. The monetary base provides the foundation for the supply of money in the U.S.

When aggregate demand is strong, an increase in aggregate demand will have the primary impact on:

 * imports.
 * output.
 * all of these answers.
 * prices.

That answer is incorrect.
Correct answer:
prices.

In the Keynesian model, total spending in excess of the full-employment capacity is inflationary.

According to the Keynesian model, which of the following policies would be most appropriate during a period of rapid inflation?

 * a budget deficit
 * a budget surplus
 * an increase in the money supply
 * an increase in government expenditures
 * a tax cut

That answer is incorrect.
Correct answer:
a budget surplus

According to the Keynesian view, an economy moving toward a period of rapid inflation should experience government budget surpluses in order to curb aggregate demand and reduce the overall competition for goods and services. In addition to decreasing government expenditures, tax rates should be increased to lower the disposable income of consumers, thus reducing aggregate demand.

Keynesian analysis implies that a planned budget surplus is

 * proper during slack economic conditions but highly inappropriate if the economy is already operating at capacity.
 * of little consequence unless there is a corresponding change in the money supply.
 * effective in dealing with a recession.
 * proper during periods of inflationary economic growth.
 * always necessary to ensure full employment.

That answer is incorrect.

Correct answer:
proper during periods of inflationary economic growth.

A budget surplus is appropriate during a period of inflationary economic growth since it will serve to contract aggregate demand. During a period of inflationary economic growth the economy is faced with a high aggregate demand and a fixed level of aggregate supply. The competition for the scarce resources in the market thus drives prices up (i.e., there is inflation). To combat this intense competition for goods and services, the government should increase tax rates (thus reducing consumer disposable income and therefore aggregate demand) and decrease expenditures (thus contracting aggregate demand directly).

Modern economists who believe that changes in marginal tax rates exert important effects on aggregate supply are known as ________.

 * supply-side economists
 * Keynesian economists
 * new classical economists
 * aggregate economists

That answer is correct!

Since the marginal tax rate determines the breakdown of one's additional income between tax payments on the one hand and personal income on the other. A reduction in marginal tax rates increases the reward derived from added work, investment, saving and other activities that become less heavily taxed. People shift into these activities away from leisure, tax shelters and other forms of tax avoidance. Supply-side economists believe that these substitutions both enlarge the effective resource based and improve the efficiency with which the resources are applied.

Each month, the Bureau of Labor Statistics calculates unemployment by

 * surveying a random sample of households.
 * surveying large business and government employers.
 * surveying all workers in the economy.
 * making projections based on census data.

That answer is correct!

The BLS randomly samples 59,500 households drawn from 729 different locations in the U.S. to calculate the unemployment rate. This is done because it would be too burdensome to contact each person in the U.S. to determine his or her employment status.

When an economy is temporarily operating at an output less than full-employment capacity, then

 * lower wages and prices will quickly restore full employment.
 * only expansionary fiscal policy will direct the economy back to full employment.
 * excess demand in resource markets will lead to higher resource prices, which will increase production costs and direct the economy toward full employment.
 * excess supply of resources will cause their price to fall, which reduces production costs and directs

the economy toward full employment.

That answer is incorrect.
Correct answer:
excess supply of resources will cause their price to fall, which reduces production costs and directs the economy toward full employment.

An economy below long run potential will have an excess supply of resources; this causes the price of resources. As a result, production becomes cheaper and aggregate supply increases toward the full employment level.

A reserve requirement of 25 percent implies a potential money deposit multiplier of ________.

 * 5
 * 20
 * 4
 * 1
 * 25

That answer is incorrect.
Correct answer:
4

The potential money deposit multiplier is the reciprocal (inverse) of the required reserve ratio. Thus, a reserve requirement of .25 implies a potential money deposit multiplier of 1/.25 = 4.

The crowding-out effect suggests that

 * the reduction in private spending resulting from the higher interest rates caused by a budget deficit will largely offset the expansionary impact of a pure fiscal action.
 * expansionary fiscal policy causes inflation.
 * a budget surplus will cause the private demand for loanable funds, the interest rate and aggregate demand to fall.
 * restrictive fiscal policy is an effective weapon against inflation.

That answer is correct!

Crowding out refers to a situation in which government budget deficits raise the interest rate and therefore reduce private investment spending. Thus, government deficit spending effectively "crowds out" private investment spending. Deficit spending by the government raises the interest rate since such expenditures must be financed with loanable funds from the economy. Under a fixed supply of such funds, the interest rate will rise as the government competes with private investors for these funds.

An economy is currently operating at full employment, with an inflation rate of 8%. If the Central Bank adopts an anti-inflationary measure consistent with an inflation rate of 4% but people anticipate an inflation of 5%, the unemployment in the short run will be ________ the natural rate and ________ the natural rate in the long run, as predicted by the Rational Expectations Model.

* above, same as
* below, above
* below, same as
* same as, below

That answer is correct!

When you see a question involving inflation and unemployment, think about the Phillips curve, both the classical version and the Rational Expectations version. In this case, if people do not accurately anticipate the effects of the anti-inflationary policy, then the short-run equilibrium will be affected. Specifically, since workers over-estimate the future inflation, they will demand higher wages than those consistent with the actual inflation. Consequently, the Phillips curve predicts that unemployment will increase in the short run. Since the economy is currently at full employment, the unemployment rate will climb above the natural rate. Over the long run, people will correct their erroneous predictions and wages will fall back to a level where full employment will prevail once again.

If unanticipated restrictive monetary policy causes actual inflation to be lower than expected, then in the short run,

* the real interest rate will increase and unemployment decrease.
* both the real interest rate and unemployment will increase.
* the real interest rate will decrease and unemployment will increase.
* both the real interest rate and unemployment will decrease.

That answer is incorrect.
Correct answer:
both the real interest rate and unemployment will increase.

The difference between the actual and expected inflation rate (lower than expected) causes the real wage to rise, thereby discouraging employment. Another consequence of the policy is a reduction in the supply of money which increases the real interest rate in the economy.

First National Bank currently does not have the legally required cash reserves on hand. The bank expects this situation will only last a day or two. In order to rectify the reserve problem, the bank treasurer borrows cash on the intra-bank loan market. Main Street bank has excess reserves and uses these funds to buy First National's loan. How has this impacted the money supply, and how will this effect the price level?

* expanded, increase
* expanded, no change
* contracted, no change
* none of these answers is correct
* contracted, decrease

That answer is incorrect.
Correct answer:
none of these answers is correct

At any given moment, there is a certain level of excess reserves in the entire banking system. With no interference, the excess reserves of one bank would be lent to another at a rate that would be determined by the supply and demand for excess reserves. If the rate paid for intra-bank loans were high, banks would have an incentive to lend on this market rather than to the economy as a whole. This would have no impact on the money supply or the price level, as cash in one bank would simply be transferred to another.

However, if the Central Bank interferes and provides loans itself, then the need for reserves would be satisfied with excess loanable funds left over. These funds would probably be lent to consumers or businesses, which increases the level of money in circulation.

Which of the following constitute the reserves of a bank?

I. Vault cash.
II. Savings deposits.
III. Deposits with the Fed.
IV. Overnight loans to other banks.

* II & III
* I, II & III
* I, II, III & IV
* I & III

That answer is incorrect.
Correct answer:
I & III

Note that IV is not a valid choice. In fact, the primary reason for the existence of the overnight Fed funds market is to allow banks who are short on minimum reserves to borrow from banks who have excess reserves. Once a bank loans its excess reserves, they are no longer considered part of its reserves till the borrower return the loan.

Which of the following is true?

* The money deposit expansion multiplier tends to rise as the required reserve ratio increases.
* If a bank has demand deposits of $100,000, reserves of $15,000 and is subject to a 10 percent reserve requirement, it cannot extend any additional loans.
* Excess reserves equal demand deposits minus required reserves.
* Credit card balances are not included in any measure of the money supply.

That answer is incorrect.
Correct answer:
Credit card balances are not included in any measure of the money supply.

Credit card balances are not included in any measure of the money supply because they do not represent purchasing power. They are merely a convenient means of arranging a loan. Credit card purchases are not money; they are not an asset representing future purchasing power and therefore are not included in any measure of the money supply.

The Fed has just purchased government bonds worth $100 million in the open market. The reserve ratio it has set equals 20%. Which of the following is/are true?

I. It has reduced national debt by $100 million.
II. It has increased monetary base by $100 million.
III. It has potentially decreased the money supply by $500 million.
IV. It has increased bank reserves by $20 million.

 * II only
 * I & III
 * III only
 * I & IV

That answer is correct!

With the reserve ratio at 20%, the potential deposit expansion multiplier equals 1/0.2 = 5. Therefore, the money supply has potentially increased by $500 million.
The monetary base, which is the actual money in circulation, has increased by $100 million since this is the amount injected into the economy by the Fed. However, the purchase of bonds by the Fed does not reduce national debt since the government still owes the payments to the Fed.

Finally, the total bank reserves increase by $500 * 0.2 = $100 million, assuming banks do not hold excess reserves. If they do, this number would be higher.

Given:

	(Dollars)	
Corporate profits -	100	
Interest income -	200	
Indirect business tax -	180	
Depreciation -	200	
Employee compensation		1,160
Proprietor's income -		100
Rents		20
Personal consumption -		1,350
Government purchases -		400
Net exports -	10	
Income received by citizens for factors of production supplied abroad -		300
Income paid to foreigners for contribution to domestic output -	150	

Gross domestic product equals ________.

 * $1,960
 * $1,760
 * $1,810
 * $2,110

That answer is incorrect.
Correct answer:
$1,810

GDP is equal to the sum of compensation of employees, income of self employed proprietors, rents, profits, interest, indirect business taxes, depreciation minus the net income of Americans earned abroad. Therefore GDP = 1,160 + 100 + 20 + 100 + 200 + 180 + 200 - (300-150) = $1,810.

If innovation in automation allows cars to be produced with fewer resources, buyers and sellers will plan for lower prices and greater supplies of cars. This is an example of

* supply shock.
* expansionary fiscal policy.
* anticipated change.
* unforeseeable change.

That answer is incorrect.
Correct answer:
anticipated change.

Improvements in technology are generally predicted by the market. Therefore, if the automation is foreseen by consumers and producers alike, the change is referred to as anticipated.

Which of the following would be considered an automatic stabilizer?

I. progressive tax structure
II. unemployment insurance
III. balanced budget requirements

* II, III
* II only
* I only
* I, II
* I, II, III
* I, III

That answer is incorrect.
Correct answer:
I, II

An automatic stabilizer is anything that would decrease the government budget surplus during slow economies and increase the surplus during strong economic periods. Progressive taxes are an example since during good economic times more individuals will be in higher tax brackets, while the reverse would be true during weaker economic periods. Similarly, spending on unemployment would increase during weak economic periods, but fall during stronger times. A balanced budget requirement would require the government cut back on spending when tax revenue was down, which would actually exacerbate a demand shortage.

The best definition of inflation is a(n)

* temporary increase in prices due to higher tax rates.
* large increase in food and gasoline prices.
* sustained increase in the general price level as measured by a price index.
* increase in the purchasing power of the dollar.

That answer is incorrect.
Correct answer:
sustained increase in the general price level as measured by a price index.

Inflation refers to a continuing rise in the general level of prices of goods and services. The purchasing power of the monetary unit declines when inflation is present.

Checking account deposits are classified as money because

* they earn interest income for the depositor.
* they are ultimately the obligation of the Treasury.
* banks hold currency equal to the value of their outstanding checking account deposits.
* they are "backed" with gold bullion.
* they can readily be used in the making of purchases and payments of debts.

That answer is incorrect.
Correct answer:
they can readily be used in the making of purchases and payments of debts.

Checking account deposits are classified as money because such accounts can be used as a medium of exchange (one of the essential functions of money).

Calculate real GDP for period 2 given the following information:

	Nominal GDP	GDP Deflator
Period 1	1,022	100
Period 2	1,053	101

* 1,032
* 1,078
* 1,064
* 1,053
* 1,043

That answer is incorrect.
Correct answer:
1,043

Real GDP p2 = Nominal GDP p2 * GDP Deflator p1 / GDP Deflator p2, or 1053*100/101 = 1,043.

If prices have been increasing from the base year to the current period, the GDP deflator will be

* falling.
* less than 100.
* greater than 100.
* uncertain; there is not enough information to tell.

That answer is incorrect.
Correct answer:
greater than 100.

The GDP deflator for a given year is a price index that reveals the cost of purchasing the items included in GDP during the period relative to the cost of purchasing the items during a base year. Therefore, if prices have been rising since the base year, the GDP deflator for the current year will be greater than 100, since the GDP deflator for the base year is 100.

Use the table below to choose the correct answer.

Government purchases		$1,000
Employee compensation		2,000
Depreciation	400	
Gross investment		900
Personal consumption		2,200
Net exports	-50	
Indirect business tax		150

Gross domestic product equals ________.

* $3,950
* $6,550
* $4,050
* $6,500
* $4,300

That answer is incorrect.
Correct answer:
$4,050

According to the expenditure approach, GDP is calculated as the sum of expenditures on the "final-user" goods and services purchased by consumers, investors, governments and foreigners. Therefore, GDP is the sum of: $2,200 + $1,000 + $900 - $50 = $4,050.

If an economy starts out in long-run equilibrium, an unexpected increase in aggregate demand will

* temporarily reduce prices but permanently increase output.
* permanently increase both output and prices.
* permanently increase output and permanently reduce prices.
* temporarily increase output but permanently increase prices.

That answer is incorrect.
Correct answer:
temporarily increase output but permanently increase prices.

When aggregate demand increases the price level will increase in the short run and output will temporarily exceed full employment potential. In the long run, prices will remain higher and cause aggregate supply to fall. Thus, the increase in output is temporary while the increase in prices is permanent.

In the simple Keynesian model, the equilibrium level of aggregate output is determined by

* the real interest rate.
* the nominal interest rate.
* aggregate supply.
* prices.
* aggregate demand.

That answer is incorrect.
Correct answer:
aggregate demand.

Keynesian economists believe that aggregate demand is the catalyst for equilibrium. Thus, supply is always accommodative and will adjust to aggregate expenditures.

If an unanticipated increase in aggregate demand results in an output beyond the economy's long-run capacity, long-run equilibrium will eventually be restored by

* an increase in the natural unemployment.
* higher resource prices, a decrease in SRAS and an increase in prices.
* an increase in the economy's productive capacity (LRAS shifts to the right).
* higher resource prices, an increase in SRAS and a decrease in prices.
* a decline in the natural unemployment.

That answer is incorrect.
Correct answer:
higher resource prices, a decrease in SRAS and an increase in prices.

In order to achieve an output greater than the long run potential of the economy, more resources such as labor, must be employed. The heightened demand for resources causes the price of such resources to increase and thus a decline in aggregate supply. Equilibrium is restored under these rising prices which then contract aggregate demand.

The central bank decides to increase their target rate for over-night bank loans. All else equal, this would cause both the ________ and the ________ to decrease.

* real rate, money supply
* unemployment, budget deficit
* money supply, price level
* output level, production capacity
* none of these answers is correct

That answer is incorrect.
Correct answer:
money supply, price level

In order to increase this over-night interest rate, the central bank must sell bank loans in the open market. This results in cash extracted from the economy, and a contraction of the money supply. If there is less money with no change in output, then the price of goods must fall. To see why this must happen, remember the equation P = M/Y, or Price Level = Money Supply / Output.

Actual contraction of the money supply, and hence deflation, is rare. Typically a disinflationary policy seeks to slow the growth of money rather than actually contract.

The crowding-out effect refers to the possibility that

 * an increase in consumption spending will crowd out government spending.
 * government borrowing may cause interest rates to decline and private investment to decline.
 * an increase in private saving will crowd out private investment.
 * an increase in the federal deficit will result in higher interest rates, which will crowd out private investment and consumption.
 * an increase in the money supply will result in a decline in taxes.

That answer is incorrect.
Correct answer:
an increase in the federal deficit will result in higher interest rates, which will crowd out private investment and consumption.

The crowding out effect refers to the possibility of government deficit spending leading to an increase in the real interest rate and therefore a decline in private investment and consumption. The real interest rate represents the cost of borrowing: as this cost rises, private investment and consumption will decline.

The ________ market is a loanable funds market in which banks seeking additional reserves borrow short-term funds from banks with excess reserves.

 * none of these answers
 * loanable funds
 * Federal funds
 * excess reserves
 * discount window

That answer is incorrect.
Correct answer:
Federal funds

The federal funds market is a market in which banks with excess reserves extend short-term loans to other banks at the federal funds interest rate. The discount window is where banks can borrow funds from the Fed, but banks rarely utilize this option as it is considered a sign of deep internal problems.

Within the Keynesian aggregate expenditure model, which of the following autonomous changes would increase the equilibrium output?

 * a decrease in consumption expenditures
 * an increase in saving
 * higher real interest rates

* an increase in net exports

That answer is incorrect.
Correct answer:
an increase in net exports

An increase in net exports raises aggregate expenditures within the economy and increases the equilibrium level of output. This is because net exports are a component of aggregate demand which dictates the level of output in equilibrium.

In the simple Keynesian model, if equilibrium output is less than the level required for full employment, then

* prices will decline and restore full employment.
* prices must rise if full employment will be achieved.
* aggregate demand must increase if full employment will be achieved.
* interest rates must increase if full employment will be achieved.
* aggregate demand must decline if full employment will be achieved.

That answer is incorrect.
Correct answer:
aggregate demand must increase if full employment will be achieved.

When equilibrium output is less than the economy's capacity, only an increase in expenditures will lead to full employment.

On the "Keynesian cross" diagram, the 45-degree line shows

* the marginal propensity to consume.
* equilibrium combinations of income and aggregate expenditures.
* the trade-off between inflation and unemployment.
* aggregate demand and aggregate supply.

That answer is incorrect.
Correct answer:
equilibrium combinations of income and aggregate expenditures.

The 45 degree line in the Keynesian diagram plots where aggregate expenditures is equal to total output.

An increase in the discount rate is significant because it

* results in a proportional increase in the interest rate that commercial banks charge to customers.
* decreases the willingness of commercial banks to borrow from the Federal Reserve.
* increases the Federal Reserve System's earnings and thereby expands the money supply.
* decreases the interest yield on new issues of U.S. securities.

That answer is incorrect.
Correct answer:
decreases the willingness of commercial banks to borrow from the Federal Reserve.

The discount rate represents the interest rate that commercial banks must pay to the Fed if they are not able to make the required reserve ratio. Thus, banks are less likely to borrow from the Fed if the price of such borrowing increases.

The short-run effects of an adverse supply shock will include a(n)

 * decrease in prices and an increase in real output.
 * increase in prices and a decrease in real output.
 * increase in prices and an increase in real output.
 * decrease in prices and a decrease in real output.

That answer is incorrect.
Correct answer:
increase in prices and a decrease in real output.

A reduction in the supply of resources (or a supply shock) causes resource prices to shift upward which contracts the short run aggregate supply curve. This increases prices and leads to a lower level of real output.

In the Keynesian aggregate expenditure model, which of the following would be the most likely result of an autonomous $6 billion increase in investment?

 * an increase of $6 billion in the national income
 * an increase in the equilibrium level of income by more than $6 billion
 * a decrease in taxes to offset the increase in investment
 * a decrease in the cost of loans for investment

That answer is incorrect.
Correct answer:
an increase in the equilibrium level of income by more than $6 billion

The presence of the multiplier means that an increase of $6 billion in investment will shift the equilibrium level of income by more than that amount. The multiplier builds on the point that one individual's expenditure becomes the income of another and is defined as the change in total income divided by the autonomous expenditure change that brought about the enlarged income. Thus, the $6 billion increase in investment multiplied by the multiplier will yield increase in total income that results.

Which of the following economic events might be caused by a government deficit?

I. higher national income
II. increasing price level
III. higher interest rates

* I, II, III
* III only
* II, III
* I, III
* II only
* I only

That answer is correct!

A budget deficit is, in effect, a fiscal stimulus. Therefore the deficit might cause higher GDP, inflation, or both. Deficits also cause interest rates to rise, primarily because the government must fund the deficit by issuing debt. This amounts to an increase in the demand for loanable funds, which drives the price (i.e. interest rates) higher.

Which of the following is most likely to be effective monetary policy aimed at decreasing unemployment?

* Congress passes a new spending bill without increasing taxes.
* Congress decreases the minimum wage.
* The Central Bank announces that it will work to stamp out inflation, while in fact it is printing new currency.
* The Central Bank announces that it will order its bond traders to lower the short-term interest rate by 1%.
* The Central Bank maintains inflation at a consistent level, improving long-term planning.

That answer is incorrect.
Correct answer:
The Central Bank announces that it will work to stamp out inflation, while in fact it is printing new currency.

In order for monetary policy to be effective, producers have to be caught off-guard by inflation. The best example of this is where the Central Bank misleads the economy into thinking it was following a disinflationary policy when in fact it was expanding the money supply.

Which one of the following factors would most likely cause a decrease in aggregate demand?

* a reduction in corporate taxes
* an increase in the budget deficit
* an increase in personal income tax rates
* a decrease in interest rates

That answer is incorrect.
Correct answer:
an increase in personal income tax rates

An increase in the personal income tax rate will increase consumer disposable income. This will increase aggregate demand as consumers have more money to spend.

Which of the following would reduce the ability of the self-correcting mechanism to direct an economy out of a recession quickly?

* an increase in aggregate demand
* a low level of savings as implied by the permanent income hypothesis
* a decline in the real rate of interest
* resource prices that are inflexible in a downward direction

That answer is incorrect.
Correct answer:
resource prices that are inflexible in a downward direction

Inflexible resource prices imply that during a recession resource prices will not fall and therefore will not work to increase demand for resources. The mechanism that should adjust the economy toward recovery suggests that a fall in resource prices will stimulate demand for those resources and will consequently increase aggregate supply, since production costs will be lower.

With a constant monetary base, an increase in the reserve ratio will _______ the money supply.

* insufficient information
* decrease
* increase
* not affect

That answer is incorrect.
Correct answer:
decrease

The money supply equals the monetary base divided by the reserve requirement. Hence, an increase in the reserve requirement reduces the money supply. To fix this in your mind, remember that minimum reserves are locked up in the vaults (either with the Fed or its own vaults) and are not available for circulation in the general economy. Hence, increasing the reserves takes money out of the economy.

In the Keynesian model, the major determinant of consumption expenditures is

* investment.
* inflation.
* disposable income.
* the interest rate.

That answer is incorrect.
Correct answer:
disposable income.

There is a positive relationship between consumption and disposable income such that a decrease in disposable income will reduce current consumption.

In the U.S., an employment rate between 94 percent and 95 percent indicates that the

* economy is in a recession.
* economy has inefficiently high unemployment.
* government has not done enough to provide jobs.
* economy is at full employment.

That answer is incorrect.
Correct answer:
economy is at full employment.

Economists define full employment as the level of employment that results when the rate of unemployment is normal, considering both frictional and structural factors. In the U.S. this figure is at 94 to 95% of the labor force.

Economists use the phrase "business cycle" when referring to fluctuations in

* aggregate measures of economic output and real income.
* the money supply.
* the general level of prices.
* interest rates.

That answer is correct!

The business cycle refers to swings in the rate of output. The cycle is characterized by periods of growth in real output and other aggregate measures of economic activity followed by periods of decline.

A situation in which the actual money balances of individuals and business firms are in excess of their desired level is known as ________.

* Monetarism
* anticipated monetary stability
* the quantity theory of growth rates
* excess supply of money

That answer is incorrect.
Correct answer:
excess supply of money

Decision makers counteract such a situation by increasing their spending on other assets and goods until they reduce their actual balances to the desired level. An excess supply of money simply means you are holding more cash and checking account deposits than you desire. You solve this situation by saving, investing or consuming the excess amount.

In year 1, the government has a deficit of $100 billion. In year 2, real interest rates rise, but the price level declines. Which of the following in isolation could have caused this to occur?

* A shift downward of the aggregate supply curve
* A monetary expansion
* A rise in productivity
* A decreased government deficit
* None of these, if real rates rise, inflation must also rise

That answer is incorrect.
Correct answer:
A decreased government deficit

If the government decreases its deficit, but does not run a surplus, the effect will be as described, all else remaining equal. First of all, the real rate would rise because the government demand for debt has increased on an absolute basis. The price level would decline, however, because the government portion of aggregate demand would be less than previous periods, causes a downward shift in the curve, and a lower equilibrium price level.

Reading a 20 year-old newspaper, you note that a bottle of soda which now costs $1, is advertised for 5 cents! If the price increase was due entirely to inflation, what would the average annualized rate of inflation have been over this period?

* 16.16%
* 4.75%
* 15.12%
* 22.68%
* 95%

That answer is correct!

The calculation is as follows: (1/0.05)^(1/20)-1=0.1616

If people reduce their holdings of money per dollar of GDP, this indicates that

* prices have risen.
* the velocity of money has fallen.
* the velocity of money has risen.
* prices have fallen.

That answer is incorrect.
Correct answer:
the velocity of money has risen.

Velocity is defined as the average number of times that a given dollar is used to purchase final goods and services in a year. Thus, if individuals reduce their money holdings per dollar of GDP this implies that a smaller amount of money is being used to conduct the same number of transactions in a given year. This implies that the velocity of money has increased.

The quantity of money that households and businesses will demand is likely to increase if

 * income rises but is unaffected by interest rates.
 * interest rates rise but is unaffected by changes in income.
 * income rises but fall if interest rates rise.
 * either income or interest rates rise.

That answer is incorrect.
Correct answer:
income rises but fall if interest rates rise.

A rise in income will create additional demand for money as individuals conduct more transactions (under higher incomes, people purchase more goods and services). However, a rise in the nominal interest rate increases the "cost" of holding money and therefore the demand for money will fall under increasing nominal interest rates.

An economy is currently in a state of equilibrium. If a sudden supply shock were to increase aggregate supply, which of the following effects will occur in the long run?

I. Real interest rates will increase.
II. Prices will remain unaffected.
III. Aggregate demand will increase.

 * I only
 * I & III
 * II only
 * II & III

That answer is incorrect.
Correct answer:
II only

In the long run, since the resource base is not affected, the potential GDP is not affected and the LRAS does not move. Therefore, even though prices fall in the short run due to the increased supply, they rise back up over the long run as resource prices increase.

Fiat money is money

 * that has little intrinsic value.
 * used in Italy.
 * backed by gold only.
 * backed by gold and silver.
 * backed by silver only.

That answer is correct!

Fiat money has neither intrinsic value nor the backing of a commodity with intrinsic value; U.S. dollars are an example of fiat money.

Assume General Motors has decided to build an assembly plant in St. Louis. The plant will employ 1,000 full-time workers, brought in from another city, at an annual wage of $30,000 each. If the marginal propensity to consume in St. Louis is 2/3, what change in income will result from operation of the plant for one year?

 * $0
 * $20 million
 * $90 million
 * $30 million
 * $60 million

That answer is incorrect.
Correct answer:
$90 million

The increase in incomes is initially 1,000 workers multiplied by $30,000 or $30 million. The multiplier is equal to 1/(1-MPC) or 1/(1-2/3)= 3. The total increase in income then is 3 x $30 million = $90 million.

Keynesian analysis suggests that if planned spending (aggregate demand) were $700 billion but GDP were $800 billion, then

 * production would be stimulated and output would increase, unless the full-capacity output was less than $950 billion.
 * output would rise, incomes would rise and tax revenues would automatically increase.
 * businesses would accumulate inventories and output would fall.
 * the Federal Reserve would eventually lower interest rates.

That answer is incorrect.
Correct answer:
businesses would accumulate inventories and output would fall.

If purchasers buy fewer goods and services than expected business firms are unable to sell as much of their current output as they had anticipated. Their actual inventories would increase as they unintentionally made larger inventory investments than they planned. As a result, they will decrease their output.

Which of the following is not a leakage that will dampen the effect of the multiplier?

 * taxes
 * savings
 * imports
 * domestic spending

That answer is incorrect.
Correct answer:
domestic spending

Since taxes and savings reduce disposable income, they represent leakages in the consumption. Imports also represent a leakage since they are subtracted from exports to calculate net exports. Domestic spending is not a leakage since it contributes directly to aggregate expenditures.

Use the table below to choose the correct answer.

Corporate profits		$250
Interest income		100
Indirect business taxes	180	
Depreciation	200	
Employee compensation		1,400
Proprietor's income		100
Rents	20	
Personal consumption		1,350
Government purchases		400
Net exports	10	
Net income earned abroad		15

Gross domestic product equals ________.

 * $2,810
 * $2,090
 * $1,750
 * $1,930
 * $2,235

That answer is incorrect.
Correct answer:
$2,235

According to the resource cost-income approach, GDP is the sum of income payments to resource owners, non-income cost items and a GNP-GDP adjustment. Therefore, GDP here equals the sum of $1,400 + $100 + $20 + $250 + $100 + $180 + $200 - 15 = $2,235.

Classical economists believe that

 * the velocity of money is unaffected by the frequency of income payments.
 * there is no link between the money supply and prices.
 * the variables that change the velocity of money usually change rapidly.
 * the velocity of money is constant in the short run.

That answer is incorrect.
Correct answer:
the velocity of money is constant in the short run.

Classical economists thought the velocity of money was determined primarily by institutional factors such as the organization of banking and credit, the rapidity of transportation and the communication system. These factors would change quite slowly. Thus, classical economists thought that for all practical purposes, the velocity, or turnover rte, of money in the short run was constant.

When the demand for money declines, the ________ increases.

* velocity of money
* nominal interest rate
* GNP
* growth of real output

That answer is correct!

As individuals hold fewer money balances (due to diminished demand) in order to conduct the same amount of business, each dollar must be used more times during the year. That is, each dollar is used more often to purchase final goods and services since there are fewer actual dollars in the economy.

If the Fed has overrun its current budget and decides to purchase securities in the open market to increase money supply, it must:

* all of these answers can be done.
* borrow from the U.S. Treasury.
* borrow from the member banks.
* create the requisite money.

That answer is incorrect.
Correct answer:
create the requisite money.

The Fed has the ability to simply print money and add it into the economy by purchasing securities. Although this power is used judiciously, it is commonly done.

How does working "off the books" affect the accuracy of the measured unemployment rate in the economy?

* It causes the number of discouraged workers to rise.
* "Off the books" work and other parts of the underground economy do not affect the accuracy of the unemployment rate.
* It causes the natural unemployment to rise.
* It causes the unemployment rate to overstate the number of people who are not earning income.

That answer is incorrect.
Correct answer:
It causes the unemployment rate to overstate the number of people who are not earning income.

If individuals are working off the books in the underground economy they may be counted as unemployed, despite the fact that they are working and earning income. Such workers are said to work in the underground economy.

Susie Smith has $1,000 in a traditional checking account, which pays no interest. She discovers her bank is offering money market accounts which pay 4% interest and would allow her to use checks the same way she had in her traditional checking account. She transfers her cash from the checking account to the money market account.

How does this impact the monetary base and the effective money supply?

* increase, decrease
* both increase
* decrease, increase
* both decrease
* no change, decrease
* decrease, no change
* no change for either

That answer is incorrect.
Correct answer:
decrease, no change

Effectively, Susie can use her money the same way she always had, so the effective money supply has not changed. However, Susie's bank is no longer obligated to keep 10% of Susie's checking account on reserve. Therefore reserves would decrease, and hence, the monetary base would also decrease. This might give the appearance that the money supply has fallen, even though effectively it has not.

The modern view of the Phillips curve suggests that

* when inflation is less than anticipated, unemployment will rise above the natural rate.
* when inflation exceeds anticipated, the natural unemployment rate will rise.
* demand stimulus policies will be unable to affect prices.
* when people accurately anticipate inflation, demand stimulus policies will reduce unemployment.

That answer is correct!

The difference between actual and anticipated inflation is the impetus to the rise in unemployment because it causes the real wage to rise. Wage contracts are negotiated too high in expectation of higher than actual inflation. The result is a reduction in employment as labor now costs more.

If inventory investment during a year was $6 billion, then producers must have

* sold $6 billion more goods and services during the year than they were able to produce.
* reduced their stock of unsold goods and raw materials by $6 billion during the year.
* produced $6 billion of new capital assets during the year.
* added goods valued at $6 billion to their stock of unsold goods and raw materials.

That answer is incorrect.
Correct answer:
added goods valued at $6 billion to their stock of unsold goods and raw materials.

Inventory investment refers to changes in the stock of unsold goods and raw materials held during a period. These goods are produced during the given period but are unsold; they do contribute to GDP calculation.

Money differs from credit since money is a financial asset that provides the holder with future ________ while credit is liability acquired when one borrows funds.

* interest
* none of these answers
* funds
* purchasing power
* liability

That answer is incorrect.
Correct answer:
purchasing power

Credit card purchases are not money since they are not an asset representing future purchasing power. In contrast, money allows the holder to purchase goods and services some time in the future.

Expansionary fiscal policy, expanding deficits, will exert less impact on sustaining aggregate demand. This is called ________.

* the crowding-in effect
* economic instability
* Keynesian Policy
* the crowding-out effect

That answer is incorrect.
Correct answer:
the crowding-out effect

The higher interest rates generated by budget deficits (the result of expansionary fiscal policy) reduces private spending. Private spending is sensitive to interest rates through investment and consumer borrowing. Such a reduction in private spending is called the "crowding out" of private spending by government spending.

Use the table below to choose the correct answer.

Personal consumption expenditures		$300
Government purchases of goods and services		150
Rent income	75	
Net investment expenditures		100
Gross imports	15	
Personal savings		125
Gross exports	10	
Depreciation	50	

Gross domestic product equals

* $550.
* $610.
* $595.
* $560.

That answer is incorrect.
Correct answer:
$595.

When GDP is derived by the expenditure approach there are four components: personal consumption expenditures, gross domestic private investment, government consumption and gross investment and net exports to foreigners. Net investment is simply gross investment minus an allowance for depreciation. Therefore gross investment is 150. So GDP is the sum of: $300 + $150 + 100 + 50 + (10-15) = $595.

The natural unemployment is

* the highest unemployment obtainable without generating inflationary pressures in the aggregate economy.
* a nonsensical idea that serves as an excuse for politicians to allow some individuals to be deprived of a job.
* unemployment that allows everyone who wants a job to have one.
* the lowest unemployment rate that can be achieved without generating inflationary pressures.
* less than 3 percent in the U.S.

That answer is incorrect.
Correct answer:
the lowest unemployment rate that can be achieved without generating inflationary pressures.

The natural rate of unemployment is a rate that is sustainable in the long run. Unemployment below the natural rate will lead to inflation as incomes rise and demand for goods increases. Unemployment above the natural rate leads to deflation since incomes are falling and aggregate demand declines.

The crowding-out effect postulates

* an inverse relationship between budget deficit and foreign investment.
* all of these answers.
* an inverse relationship between government expenditure and interest rates.
* an inverse relationship between the demands from the public and private sectors.

That answer is incorrect.
Correct answer:
an inverse relationship between the demands from the public and private sectors.

When the government increases its expenditure, it finances these either by borrowing in the open market or by raising taxes. In the former case, some of the private investment gets crowded out due to an increase in real interest rates. In the latter case, higher taxes lead to a decrease in private spending. In either case, an inverse relationship shows up between public and private sector expenditure.
Note that there is a direct relationship between government expenditure and interest rates. Further, when interest rates rise, foreign funds flow in, establishing a positive relationship between

governmental spending and foreign investment.

In the Keynesian model, a planned budget deficit

 * will stimulate aggregate demand more than the same level of expenditures with a balanced budget.
 * is widely accepted as an effective policy to combat inflation.
 * is likely to reduce demand and cause a recession.
 * means tax revenues exceed government spending.

That answer is correct!

A planned budget deficit will stimulate aggregate demand more than the same level for expenditures under a balanced budget because of the implication of the government deficits. If a government is operating under a budget deficit it implies that the economy is below full capacity production. Therefore, an increase in expenditures is a "counter-cyclical" policy designed to stimulate aggregate demand and jump-start the economy. If the economy is below full capacity, the increase in aggregate demand stimulated by government spending will not be inflationary. The same is not true for an economy operating at full capacity (a situation in which the government is operating under a balanced budget). Government deficit spending in this situation is inflationary and will therefore lead to higher interest rates and a reduction in private investment.

The fiscal policy which increases the budget deficit during recessions and decreases it during economic booms is known as:

 * a counter-cyclical policy.
 * a discretionary fiscal policy.
 * a cyclical policy.
 * an automatic stabilizer.

That answer is correct!

Keynesians recommend increasing aggregate demand during times of low productivity and cutting back when the economy is over-heated. This recommended fiscal policy is counter-cyclical in that when the economy goes into a recession, the budget deficit expands and governmental demand increases and when the economy is booming, the deficit contracts due to governmental cutbacks.

The permanent income hypothesis indicates that a temporary increase in income will

 * lead to a larger increase in saving than a similar increase in income that was expected to be permanent (continue in the future).
 * lead people to increase their saving by a larger amount than their increase in income.
 * lead people to increase their spending by a larger amount than their increase in income.
 * lead to a larger increase in aggregate demand than a similar increase in income that was expected to be permanent (continue in the future).

That answer is correct!

The permanent income hypothesis implies that consumption depends on some measure of long run expected income rather than on current income. Thus, households determine consumption largely by their long-range expected income. When the incomes of many households increase rapidly during an economic expansion, a substantial amount of the above normal gains in income will be allocated to saving. So consumption demand increases less rapidly than income during the expansion.

For Keynesians, the primary source of economic instability is

* unequal levels of saving and investment.
* a highly unstable interest rate.
* a recession occurring when the marginal propensity to consume exceeds 1.
* instability in private capital investment.

That answer is incorrect.
Correct answer:
instability in private capital investment.

Autonomous changes in expenditures, such as in private investment, are very destabilizing to the economy since they are amplified by the multiplier and changes in optimism.

An unexpected hurricane in Florida has destroyed a large part of the orange crop. As far as oranges go, this supply shock will:

* move the long-run supply curve to the left.
* move the long-run supply curve to the right.
* move the short-run supply curve to the left.
* move the short-run supply curve to the right.

That answer is incorrect.
Correct answer:
move the short-run supply curve to the left.

The crop destruction is a short-run supply shock which will move the SRAS curve for oranges to the left, since at any given price, producers will be able to supply a lower quantity than before.

Which of the following is true of inflation?

* The purchasing power of money increases as the result of inflation.
* Debtors always gain at the expense of creditors as the result of inflation.
* Inflation is similar to interest payments on future money income, such as pensions and receipts from outstanding loans.
* It is an increase in the general price level of goods and services.
* Inflation has no effect on real resources.

That answer is incorrect.
Correct answer:
It is an increase in the general price level of goods and services.

Inflation implies a continuing rise in the general level of prices of goods and services. The purchasing power of the monetary unit declines when inflation is present.

It would be necessary for resource prices to fall and for short-run aggregate supply to increase if

* output was temporarily above potential output.
* there was a reduction in long-run aggregate supply.
* there was a reduction in aggregate demand.
* unemployment was below the natural rate.

That answer is incorrect.
Correct answer:
there was a reduction in aggregate demand.

A reduction in aggregate demand causes business firms to reduce output and cut prices which implies that unemployment increases. The weak demand and excess supply of labor causes resource prices to fall and short run aggregate supply to decline.

Under which of the following conditions is actual unemployment likely to be less than natural unemployment?

* inflation is 3 percent and was widely anticipated more than a year ago
* restrictive monetary policies led to an unexpected reduction in inflation from 6 percent to 2 percent
* prices are stable and have been for the last four years
* expansionary monetary policies led to an unexpected increase in inflation from 3 percent to 7 percent

That answer is incorrect.
Correct answer:
expansionary monetary policies led to an unexpected increase in inflation from 3 percent to 7 percent

An unexpected increase in inflation implies that the real wage falls since nominal wage contracts were written to keep pace with a lower rate of inflation. Thus, this rise precipitates a fall in the real wage and a consequent increase in employment. Unemployment is likely then to decrease below the natural rate.

Within the Keynesian aggregate expenditure model, what happens when purchasers buy more goods and services than businesses anticipate?

* Wage rates decline.
* The unemployment rate increases.
* Inventories decline.
* Prices declines.
* Households reduce their consumption.

That answer is incorrect.

Correct answer:
Inventories decline.

If purchasers buy more goods and services than businesses expected, inventories would be drawn down and result in less inventory investment than business firms planned. Thus, actual inventory investment will be lower than planned investment.

Money velocity is

* GDP divided by the money supply.
* money supply divided by prices.
* spending divided by output.
* required monetary reserves divided by income.

That answer is correct!

The definition of the velocity of money is GDP divided by the stock of money.

Assuming a 10 percent legal reserve requirement, a new deposit of $1,000 in a single small bank in a multi-bank system will leave that bank in a position to lend out an additional ________.

* $900
* $10,000
* $20,000
* $1,000

That answer is correct!

The required reserve ratio implies that 10 percent of the new deposit must be held by the bank. 10 percent of the new deposit of 1000 dollars is 100 dollars. Thus, the bank must hold at least 100 dollars of the new deposit which leaves 900 dollars available to be extended as loans.

Use the table below to answer the following question.

Income (Dollars)	Consumption (Dollars)
30,000	29,000
33,000	30,500

What is the marginal propensity to consume?

* 0.67
* 0.33
* 0.97
* 0.92
* 0.50

That answer is incorrect.
Correct answer:
0.50

Since the MPC is determined according to the ratio: MPC = additional consumption divided by additional income, the MPC here equals: 1,500/3,000 = .5.

An economy operates on the Keynesian range of its SRAS curve and the marginal propensity to consume is 4/5. If the government wants to boost real output $400 billion to move the economy toward full employment, by how much should it increase autonomous expenditure?

* $100 billion
* $80 billion
* $400 billion
* $300 billion
* $500 billion

That answer is incorrect.
Correct answer:
$80 billion

The expenditure multiplier is found by M = 1/(1-MPC). Here, M = 1/(1-4/5) = 5. Therefore, in order to increase output by $400 billion, an increase in expenditure equal to 1/5 of that amount is required (or $80 billion).

Keynesians believe that a discretionary fiscal policy:

* should be used in conjunction with the monetary policy to promote full employment.
* should be used to promote aggregate demand and control unemployment.
* none of these answers.
* is destabilizing due to difficulty in timing and should not be used actively.

That answer is incorrect.
Correct answer:
should be used to promote aggregate demand and control unemployment.

Keynesians believe that aggregate demand has a major influence. They maintain that suppliers will produce at a level consistent with anticipated aggregate demand. Hence, to increase economic production when the economy is operating below capacity, Keynesians advocate spurring the demand in the market through the use of an expansionary fiscal policy.

John anticipates inflation will be at least 10% per year for the foreseeable future. John has decided to purchase a boat, and must decide to use cash to purchase the boat, or else finance the purchase at 9% over five years. John is currently keeping his cash in a non-interest bearing account. Which action is John most likely to follow?

* finance the boat and spend the cash elsewhere

 * save the cash as a hedge against inflation and pass on purchasing the boat entirely
 * buy the boat with cash, to avoid paying the 9% interest
 * buy the boat with cash, and use the boat as collateral for a loan in the future when interest rates fall
 * finance the boat and save the extra cash to meet the loan payments

That answer is correct!

Note that the borrowing rate is less than his inflation expectations. This means that he can repay his loans with dollars worth less than the dollars he borrowed. The following illustrates this point: he buys the boat now for $1,000. Over the five years inflation would make that boat worth $1,610 (we can assume depreciation is equal to the enjoyment he had using the boat over the five years), or a difference of $610. His total interest payments on the boat would be only $539. He therefore comes out $71 ahead by spending now and paying later.

He would also spend the cash he has on hand. This is because he knows the purchasing power of his cash will decline, and his bank account does not pay interest to compensate him for this loss of purchasing power.

This is an important consequence of inflation. Consumers will have an incentive to spend and borrow to fund their spending. This fuels demand and may spark even higher inflation.

A bank receives a demand deposit of $1,000. The bank can loan out $600 of this deposit and still increase its excess reserves by $300. What is the legal reserve requirement?

 * 20 percent
 * 10 percent
 * 60 percent
 * 70 percent

That answer is incorrect.
Correct answer:
10 percent

Since the reserve requirement ratio is that which the bank must keep on hand (i.e., cannot be loaned and does not qualify as excess reserves) the amount of the reserve requirement held by the bank = 1000 - 600 - 300 = 100 or reserve requirement = deposit - loans - excess reserves.

An increase in resource prices will

 * move the short-run supply curve to the right.
 * move the long-run supply curve to the right.
 * move the long-run supply curve to the left.
 * move the short-run supply curve to the left.

That answer is incorrect.
Correct answer:
move the short-run supply curve to the left.

The long-run aggregate supply curve (LRAS) is primarily determined by resource constraints like aggregate available resources, technological level and governmental policies. As such it is harder to affect than the SRAS. An increase in resource prices will make it costlier for producers to produce goods so they would produce a lower quantity at any given price. Hence, the supply curve will move to the left.

Which of the following help stabilize aggregate demand over a business cycle?

I. Consumption stability.
II. Fluctuations in real interest rates.
III. Changes in real resources prices.
IV. Change in inflation rate.

* I, II, III & IV
* II & III
* I & III
* I, II & III

That answer is correct!

There are some variables which automatically change directions in response to changes in business cycle and serve to stabilize the economy. Some of these variables include consumption stability, interest rates, inflation and resource prices.

How would buying a good produced domestically by a foreign citizen change GDP and GNP?

* It would increase GDP and leave GNP unchanged.
* It would leave both GDP and GNP unchanged.
* It would increase GNP and leave GDP unchanged.
* It would increase GNP and GDP.

That answer is correct!

GDP is a measure of the output that is produced by labor and capital within the geographic borders of a country, regardless of whether the laborer or owner of the capital is a citizen of the country or a foreigner. On the other hand, GNP measures the output generated by the labor and capital owned by the citizens of the country, regardless of whether that output is produced domestically or abroad. Therefore a domestically produced good whose owner is not a domestic citizen contributes positively to GDP (since it was produced within the country's borders) and does not affect GNP since the owner is foreign.

The U.S. economy is experiencing high unemployment. This has caused producers to generally expect a 3% increase in the money supply next month. Which of the following monetary policy measures is most likely to impact unemployment if enacted next month?

* increase the money supply by 6%
* borrow to fund current government spending
* decrease the money supply by 5%
* sell securities in the open market
* hold the money supply constant
* increase the money supply by 2%

That answer is correct!

If the expansion in money is greater than the expected 3%, this will cause inflation to also be higher than expected. Producers will initially react to the higher prices for their products as if they were real price increases. In other words, initially there will be an increase in the aggregate quantity supplied and hence a decrease in unemployment.

In the Keynesian model, unemployment

* can be reduced by decreasing taxes or by an increase in government spending.
* is usually the result of the federal government's failure to balance its budget.
* cannot occur except for brief, isolated periods.
* is not a problem, since it implies only a redistribution of income rather than a change in real GDP.

That answer is correct!

In order for unemployment to fall under the Keynesian model, aggregate expenditures must rise. This can be accomplished by reducing taxes (i.e., increasing disposable income) or by increasing government expenditures.

Which of the following does GDP exclude?

I. Total value of all intermediate goods.
II. Total value of all services not related to production of goods.
III. All services rendered by foreign nationals residing within the country.
IV. All second hand sales.

* IV only
* I & IV
* II only
* II & III
* III only
* II, III & IV
* I, II & III
* I only

That answer is incorrect.
Correct answer:
I & IV

The GDP measures the total value of all final goods and services produced in the economy during a period. It does not matter whether the production was carried out by some foreign nationals residing in the country. That becomes a concern while calculating the GNP (This is a very important distinction between GDP and GNP that you must remember.). Further, second hand sales are not a part of GDP, though efforts and services required to complete the transaction, such as commissions, are counted in the GDP.

Monetarists believe that discretionary monetary policy:

 * should be used in conjunction with a discretionary fiscal policy.
 * has a destabilizing effect on the economy.
 * is an effective tool in controlling recession.
 * none of these answers.

That answer is incorrect.
Correct answer:
has a destabilizing effect on the economy.

Monetarists believe that monetary policy has a powerful influence on the economy but that a discretionary monetary policy is highly destabilizing because of the considerable lag between policy implementation and the realization of its effects.

Which one of the following is the largest component of the money supply (M1) in the U.S.?

 * Federal Reserve notes
 * gold certificates
 * credit cards and traveler's checks
 * checking deposits

That answer is incorrect.
Correct answer:
checking deposits

Currently, demand and other checkable deposits account for 71 percent of the M1 money supply. This percentage reflects the fact that most of the nation's business-more than 70 percent-is conducted by check.

Which of the following will lead to an increase in the demand for wheat bread?

 * A bumper wheat crop.
 * all of these answers.
 * An increase in the price of butter.
 * A decrease in the price of sandwich spread.

That answer is incorrect.
Correct answer:
A decrease in the price of sandwich spread.

Wheat bread and sandwich spread are complementary goods and hence, a decrease in the sandwich spread price will move the entire demand curve for wheat bread to the right.

Gross domestic product minus depreciation equals

* national income.
* disposable income.
* gross national product.
* net domestic product.

That answer is incorrect.
Correct answer:
net domestic product.

Net domestic product is gross domestic product minus a depreciation allowance for the wearing out of machines and buildings during the period.

During 1974-81, inflation in the U.S. averaged nearly 9 percent, almost four times that of the 1950s and 1960s. However, real GDP grew at a very slow rate and unemployment was high. These data suggest that the U.S. economy experienced

* an economic boom from 1974 to 1981.
* a decline in the natural unemployment during 1974-81.
* an economic depression during the 1950s and 1960s.
* stagflation during 1974-81.

That answer is incorrect.
Correct answer:
stagflation during 1974-81.

Stagflation is a period in which an economy is experiencing both substantial inflation and either declining or slow growth in output. Thus, this combination of high inflation coupled with high unemployment is evidence of stagflation.

In a market setting, public policy can influence the natural rate of employment primarily by

* instructing employers to hire more workers.
* influencing the opportunity cost of job searches.
* encouraging more workers to go to college to upgrade their job skills.
* instructing workers to search harder for available jobs.

That answer is incorrect.
Correct answer:
influencing the opportunity cost of job searches.

Public policy can affect the natural rate of unemployment by encouraging workers to reject job offers and continue to search for employment. Such policies include increasing the unemployment benefits.

The reserve ratio has been currently set by the Central bank at 10%. Banks tend to maintain excess reserves of about 2% and the actual deposit expansion multiplier is about 2.7. If the Fed injects $10 million of new money in the economy, the money supply will increase by:

* $27 million
* $125 million
* $83.3 million
* $33.12 million

That answer is correct!

Since the actual multiplier is 2.7, an increase of $10 million in the monetary base will increase the money supply by 2.7*10 = $27 million.

Suppose the discovery of a new technique to extract oil reserves substantially reduces the world price of crude oil. For an oil-importing country such as the U.S., in the short run the lower oil prices will tend to

* increase prices and increase real output.
* decrease prices and increase real output.
* decrease prices and decrease real output.
* increase prices and decrease real output.

That answer is incorrect.
Correct answer:
decrease prices and increase real output.

Since the U.S. imports oil and oil is a resource for the production of many goods, a reduction in the price of oil will expand the real output, at least in the short run. This expansion in real output causes prices to decline.

Cyclical unemployment refers to the unemployment due to:

* business downturn and falling profits.
* constant changes in the economy which make some skills obsolete.
* characteristics of the economy which prevent a matching of jobs and skills.
* strikes caused by unionization.

That answer is correct!

When business conditions turn for the worse, firms try to cut costs and reduce production, leading to an increase in unemployment. When business conditions improve, the unemployment rate tends to fall. This cyclical component is referred to as "Cyclical unemployment."

A ________ asset is one that can be easily and quickly converted to purchasing power without loss of value.

* non-transferable
* checkable
* transferable
* liquid

* illiquid

That answer is incorrect.
Correct answer:
liquid

Money, an example of a liquid asset, can be easily and quickly transformed into other goods at a low transaction cost and without an appreciable loss in its nominal value. Liquid assets are preferable for individuals who want to have easy access to their resources to take advantage of profitable opportunities. Investments offering such easy access often pay lower interest rates than less liquid investments.

Which of the following would contribute to GDP?

* An American company buys stock in another American company.
* An American company produces goods in Canada.
* A Canadian company produces goods in the U.S.
* A Canadian company buys stock in an American company.

That answer is incorrect.
Correct answer:
A Canadian company produces goods in the U.S.

Since GDP is the total market value of all final goods and services produced domestically during a specific period, the output generated by a Canadian company on U.S. soil will contribute positively to GDP.

Which of the following is an example of an automatic stabilizer?

* Tax rates are increased during a recession to maintain a balanced budget.
* A regressive income tax system reduces tax revenues (as a share of income) as income expands.
* Congress legislates lower tax rates to increase consumption and investment.
* Revenues from the corporate income tax increase sharply during a business boom but decline substantially during a recession even though no new tax legislation is enacted.

That answer is incorrect.
Correct answer:
Revenues from the corporate income tax increase sharply during a business boom but decline substantially during a recession even though no new tax legislation is enacted.

Automatic stabilizers refer to built-in economic reactions which serve to counteract an economic instability. Thus, the increase in corporate taxes during a boom serves to reduce the budget deficit of the government and therefore reduces government deficit spending. This "stabilizes" the economy since the reduction in government spending inhibits growth in aggregate demand and reduces the likelihood of out of control inflation. A similar scenario develops when the economy declines: corporate tax revenues decline and the government must increase its budget deficit.

The government has increased its budgetary deficit by 120 billion dollars. According to a neo-classical economist, this will lead to:

* an aggregate demand increase of 120 billion dollars.
* no change in aggregate demand.
* increase real GDP by about 120 billion dollars.
* increase real interest rates.

That answer is incorrect.
Correct answer:
no change in aggregate demand.

According to neo-classicists, effects of government actions are rationally anticipated by the people, who take offsetting actions in response. In this case, they anticipate higher future taxes which will be used to quench the increased budget deficit i.e. they view the current increase in spending as additional borrowing from the future which will have to be repaid by them. Hence, they cut down on their current consumption to save more, leaving aggregate demand, real interest rates and real GDP unchanged.

First National Bank currently does not have the legally required cash reserves on hand. The bank expects this situation will only last a day or two. In order to rectify the reserve problem, the bank treasurer borrows cash on the intra-bank loan market. Main Street bank has excess reserves and wants to loan cash on the intra-bank market. The Central Bank steps in and buys First National's loan at a lower rate than Main Street offered. Which of the following actions is Main Street to pursue likely to now pursue?

I. Buy another intra-bank loan at this lower rate.
II. Loan the excess cash to consumers and/or businesses.
III. Buy another intra-bank loan at the originally offered rate.

* III only
* I, II
* I only
* II, III
* II only

That answer is incorrect.
Correct answer:
I, II

At any given moment, there is a certain level of excess reserves in the entire banking system. With no interference, the excess reserves of one bank would be lent to another at a rate that would be determined by the supply and demand for excess reserves. If the Central Bank interferes and provides loans itself, this would decrease the interest rate paid on these loans as the loanable funds supply curve would shift upward.

In this case Main Street bank could either choose to lend their excess reserves to other banks at a lower rate or else increase their traditional loan portfolio. The higher, originally offered rate, is probably not available. Remember that the loanable funds supply curve shifts with the Central Bank's interference, therefore the market price level has fallen.

A general mismatch between the skills of unemployed workers and the skills needed by employers with job openings results in

 * structural unemployment.
 * frictional unemployment.
 * a higher labor force participation rate.
 * cyclical unemployment.

That answer is correct!

Structural unemployment is due to the structural characteristics of the economy that make it difficult for job seekers to find employment and employers to hire workers.

The public decides to increase its holdings of currency and reduce its holdings of checking account funds by an equal amount. If the Fed takes no offsetting actions, how will the money supply be affected?

 * It will increase.
 * While the action does not directly affect the money supply, it will increase the excess reserves of banks and tend to indirectly increase the money supply.
 * While the action does not directly affect the money supply, it will reduce the excess reserves of banks and tend to indirectly reduce the money supply.
 * It will decrease since checking deposits are part of the money supply but currency is not.

That answer is incorrect.
Correct answer:
While the action does not directly affect the money supply, it will reduce the excess reserves of banks and tend to indirectly reduce the money supply.

The money supply will indirectly contract through the deposit expansion multiplier: that is, since individuals do not extend formal loans, the amount of loans will decrease as individuals hold more cash and fewer deposits. Since banks satisfy withdrawals with their excess reserves, the excess reserves of banks must fall under high withdrawals.

Within the AD/AS model, what market adjustment will cause the economy to return to its long-run capacity when output is temporarily greater than the economy's long-run potential?

 * A decrease in prices reduces aggregate demand.
 * Higher interest rates increase savings and thereby stimulate consumption and output.
 * Lower interest rates increase aggregate demand and thereby stimulate output.
 * Lower wage rates and resource prices reduce short-run aggregate supply.
 * Higher wage rates and resource prices reduce short-run aggregate supply.

That answer is incorrect.
Correct answer:
Higher wage rates and resource prices reduce short-run aggregate supply.

Higher than long run potential output will cause the price of resources used in production to rise. As a result the costs of production will increase and reduce aggregate supply inward, toward the full employment level.

If actual inflation exceeds what people anticipate, then

 * real wage rates will decline and employment will expand.
 * all of these answers.
 * the real wages of workers whose money wage rates are determined by long-term contracts will fall.
 * in a world of imperfect information, job seekers may fail to recognize how much money wage rates have fallen.

That answer is incorrect.
Correct answer:
all of these answers.

When actual inflation exceeds anticipated inflation the result is an erosion in the real wage: since wage contracts will not reflect rising prices, nominal wages will not rise enough to maintain a constant real wage. Job seekers will accept real wage rates which are lower since they fail to recognize the erosion of the nominal wage by the rising price level.

The AD-AS model indicates that during periods of weak resource demand and high unemployment

 * rising product prices will tend to stimulate aggregate demand.
 * real interest rates and real wage rates will tend to decline.
 * expansion in business investment will tend to stimulate aggregate demand.
 * real interest rates and real wage rates will tend to rise.

That answer is incorrect.
Correct answer:
real interest rates and real wage rates will tend to decline.

Weak resource demand implies that the economy is operating below its long run potential. The price of resources will fall as will the real interest rate, since aggregate demand for loanable funds will be low. This will serve to stimulate aggregate demand and help move the economy toward its long run equilibrium.

The ________ multiplier is the multiple by which an increase in reserves will increase the money supply.

 * reserve
 * none of these answers
 * loan
 * all of these answers
 * deposit expansion
 * money

That answer is incorrect.
Correct answer:
deposit expansion

The deposit expansion multiplier is the multiple by which new reserves increase the stock of money.

The amount by which additional reserves can increase the supply of money is determined by the ratio of required reserves to demand deposits. The multiplier is inversely related to the required reserve ratio.

Use the table below to choose the correct answer.

Gross domestic product		$3,000
Government expenditures		400
Consumption expenditures		1,000
Indirect business taxes		50
Business transfers		30
Depreciation	200	
Saving	300	

The gross domestic product and other economic indicators for Econoland are presented above. What is the net domestic product of Econoland?

 * $4,480
 * $2,500
 * $2,800
 * $4,980
 * $2,700

That answer is incorrect.
Correct answer:
$2,800

Net domestic product is gross domestic product minus a depreciation allowance for the wearing out of machines and buildings during the period. Therefore, GDP is equal to $3,000 and depreciation is equal to $200 so net domestic product is equal to $2,800.

Which of the following is true of GDP?

 * It measures material well-being.
 * It is an indicator of domestic production.
 * It measures social progress.
 * It measures social welfare.

That answer is incorrect.
Correct answer:
It is an indicator of domestic production.

GDP is the total market value of all final goods and services produced domestically during a specific period. GDP is a good measure of the value of the goods and services purchased by households, governments, investors and foreigners and therefore is also a good indicator of domestic production.

When the planned spending of consumers, businesses, government and foreigners (net exports) is less than the income level of the economy, the Keynesian model suggests that

* output will fall.
* prices will rise.
* equilibrium real GDP will increase.
* unemployment will fall.

That answer is correct!

If total output exceeds the level of planned expenditures, unwanted inventories will develop and will signal to producers to cut back production. Thus, output will fall.

Which one of the following groups will most likely oppose legislation mandating that the federal government maintain a balanced budget annually?

* Supply-Side Economics
* New Classical Economists
* Monetarists
* Keynesians

That answer is incorrect.
Correct answer:
Keynesians

Keynesians promote counter-cyclical economic policy whereby the government should operate under budget deficits during economic recessions and budget surpluses during economic booms.

Which of the following does not present a problem in executing successful fiscal policy?

* none of these answers is correct
* inflation level distorts the price signals conveyed by interest rates
* political bias towards spending and against taxation
* difficulty in quickly enacting spending or tax legislation
* time lag between implementation of fiscal policy and impact in the economy
* level of fiscal stimulus/contraction needed is unknown
* difficulty in recognizing economic problems before they become serious

That answer is incorrect.
Correct answer:
inflation level distorts the price signals conveyed by interest rates

Fiscal policy has several inherent problems that prevent it from being a commonly used economic management tool. It is very difficult for policy makers to determine either the level of timing of a fiscal policy, and even more difficult to get measures through the legislature in a timely manner. Although the inflation level does distort interest rate signals, this is a concern for monetary policy, not fiscal policy.

Which of the following will most likely increase aggregate demand?

* a reduction in stock market prices
* a reduction in real GDP
* a decrease in the expected inflation rate
* a lower real interest rate

That answer is incorrect.
Correct answer:
a lower real interest rate

A change in the real interest rate in the loanable funds market will influence the choices of consumers and investors in the goods and services market. A lower real interest rate makes it cheaper for consumers to buy consumer durables and investors to spend more on capital goods. As a result aggregate demand increases.

Gross investment includes which of the following?

I. Total rental income on newly constructed buildings.
II. Replacement of depreciated assets.
III. Net addition to capital stock.
IV. Allowance for obsolete machinery.

* II & IV
* I & III
* III & IV
* II & III

That answer is incorrect.
Correct answer:
II & III

Gross investment includes expenditures for both replacement of old and depreciated capital assets as well as the net addition to existing capital stock.

In the graphic illustration of the Keynesian model, the 45-degree line on a chart that relates planned aggregate spending and output shows

* all income levels at which the planned spending of decision makers just equals total output.
* amounts households plan to save at each possible level of income.
* all income levels at which the marginal propensity to consume is constant.
* all income levels at which the marginal propensity to consume exceeds one.
* amounts households plan to spend at each possible level of income.

That answer is correct!

Along the 45 degree line in the Keynesian diagram aggregate expenditures equal output. Thus, income equals expenditure along the line since total output is equivalent to output.

Which of the following is true?

* During a recession, widespread unemployment will cause inflation to increase.
* During a recession, actual unemployment will tend to exceed the natural unemployment.
* During a recession, the output of the economy will exceed its long-run potential output.
* During a recession, the natural unemployment rises above actual unemployment.

That answer is incorrect.
Correct answer:
During a recession, actual unemployment will tend to exceed the natural unemployment.

The actual rate of unemployment generally rises above the natural rate during a recession and falls below the natural rate when the economy is in the midst of an economic boom. This is because during a recession GDP falls and the aggregate demand for labor falls.

Calculate real GDP for period 2 given the following information:

	Nominal GDP	GDP Deflator
Period 1	1,234	106
Period 2	1,288	111

* 54
* 1,349
* 1,224
* 1,288
* 1,230

That answer is incorrect.
Correct answer:
1,230

Real GDP p2 = Nominal GDP p2 * GDP Deflator p1 / GDP Deflator p2

In contrast to nominal GDP, real GDP refers to nominal GDP

* corrected for price changes.
* corrected for depreciation.
* minus exports.
* minus personal income taxes.

That answer is correct!

Real GDP refers to gross domestic product adjusted for changes in the price level. This adjustment involves the use of either a price index or the GDP deflator.

Monetarists reject using discretionary monetary policy as an effective stabilization tool because

* lengthy and variable time lags are involved.
* they do not believe that changes in the money stock affect output or prices.
* they believe monetary policy can hold back the economy but cannot stimulate aggregate demand.
* it would require the money supply to grow at a rate equal to the economy's long-run rate of economic growth.

That answer is correct!

Monetarists cite lengthy and unpredictable time lags between the implementation of a monetary policy change and the observation of its primary effects as a justification for not using discretionary monetary policy as a stabilization tool.

The Central Bank increases the money supply. Initially, how will this impact real aggregate output, all else being equal?

* Real output will increase by an amount less than the level of the money supply expansion
* Real output will increase by the amount of the monetary expansion
* Impossible to determine
* Real output will not change
* Real output will increase by the amount of the monetary expansion times some multiplier

That answer is correct!

Monetary expansion always causes inflation and nothing more in the long run. In the short-term, however, imperfect information can lead to temporary increases in production.

The increase in money supply increases consumers' money stock. Consumers cannot initially distinguish between inflationary growth and real wealth growth. Demand for goods increases, causing prices to rise. Producers cannot initially distinguish between higher prices for their products due to inflation or due to real demand. Therefore producers respond by producing more goods, temporarily expanding output. Eventually, higher prices will prevail for both finished goods and inputs, and these higher costs will cause producers to decrease output. A new equilibrium is set at a higher price level but the same aggregate supply.

The increase in real GDP would be something less than the increase in the money supply. Some of the money supply increase would turn into price inflation rather than new production. Remember that the money multiplier determines how much a physical increase in currency will increase the actual money supply. When it is said that the money supply increases, the multiplier is already figured in.

If the economy is below full capacity, this short-term output stimulus might stabilize GDP and allow the economy to recover naturally without suffering through a severe recession. In this scenario, monetary policy has acted like a bridge across an economic downturn, it did not increase real output by itself. Remember, if printing money really increased income, the presses would run non-stop.

The rational expectations hypothesis assumes that individuals will

* be as likely to overestimate as to underestimate inflation.
* ignore past forecasting errors when formulating predictions.
* never make forecasting errors.
* continually make systematic forecasting errors.

That answer is correct!

The rational expectations hypothesis implies that individuals make random errors in their estimation of future inflation and therefore are just as likely to overestimate inflation as they are to underestimate inflation.

Which of the following will most likely be hurt if government borrowing causes interest rates to rise (i.e., crowding-out occurs)?

 * all of these answers
 * borrowers who have fixed-rate mortgages
 * residential housing construction companies
 * domestic savers
 * foreign lenders

That answer is incorrect.
Correct answer:
residential housing construction companies

Increased interest rates as the result of government borrowing will affect private investment spending since investors compete in the same market for loanable funds as the government. Residential housing construction companies fall under the category of private investors.

Jenna and Colleen both own rival clothing factories, and each is working on next year's production plans. Jenna assumes that inflation will probably be 5%, since this is about what it has been the last 5 years. Colleen has been reading in the news that the Federal Reserve may be changing their policy and lowering interest rates in the near-term. If Colleen makes her inflation judgement based on the rational expectations hypothesis, how will her estimation differ from Jenna's?

 * This cannot be determined because the money supply does not impact the price of clothes.
 * Colleen will expect greater inflation than Jenna.
 * Colleen will expect less inflation that Jenna.
 * Colleen will expect exactly the same inflation rate as Jenna.
 * This cannot be determined without knowing Jenna's expectations of Fed maneuvers.

That answer is incorrect.
Correct answer:
Colleen will expect greater inflation than Jenna.

Jenna has arrived at her inflation expectation based on the adaptive expectations hypothesis. In other words, she has simply assumed that the future will be like the past. If Colleen acts according to the rational expectations hypothesis, she will make her estimation based on her interpretation of current and potential future conditions. According to her source, the Fed will be lowering interest rates, which would increase the money supply and cause inflation. Since this is a change in policy, we know that this will be different than recent history. Colleen will therefore expect greater inflation than Jenna.

If the resource and goods and services markets adjust slowly, an unanticipated reduction in aggregate demand will lead to

 * an increase in real output and a decline in employment.
 * rising interest rates and resource prices.
 * a decline in both real output and employment.
 * a decline in prices, with little change in output and employment.

That answer is incorrect.
Correct answer:
a decline in both real output and employment.

Under inflexibility resource and other prices, the market's self-correcting mechanism will be slow to work. Therefore reductions in aggregate demand will not be counteracted by falling prices and interest rates. Therefore both employment and output will fall.

Within the Keynesian model, the multiplier effect tends to

 * ameliorate upswings and downswings in business activity.
 * promote price stability.
 * reduce the impact of an increase in investment on output and employment.
 * magnify small changes in spending into much larger changes in output and employment.
 * reduce the marginal propensity to consume.

That answer is incorrect.
Correct answer:
magnify small changes in spending into much larger changes in output and employment.

The multiplier explains why small changes in investment, government or consumption spending triggers much larger changes in output. It does so through the phenomenon that one individual's expenditure becomes the income of another.

If the government were to raise marginal tax rates substantially and yet find a decrease in tax revenues, it would be an empirical support for which of the following theories?

 * Supply-side model.
 * Taxation model.
 * Keynesian theory.
 * Rational Expectations model.

That answer is correct!

Marginal tax rates are central to the effects postulated by Supply-side economists. According to this theory, an increase in marginal tax rates decreases the incentive to work. People to shift away from productive work and toward more leisure. Beyond a threshold tax rate, aggregate income and hence, total tax revenues decrease.

Use the table below to choose the correct answer.

Gross domestic product	900	
Government expenditures		200
Consumption expenditures		500
Indirect business taxes		25
Business transfers		0
Depreciation	100	
Saving	150	

The gross domestic product and various other economic indicators for Econoland are presented above. What is the net domestic product of Econoland?

* 1,875
* 800
* 775
* 725

That answer is incorrect.
Correct answer:
800

Net domestic product is calculated as GDP minus depreciation. Since GDP = 900 and depreciation equals 100, net domestic product is 800.

After listening to testimony from leading economists, several Senators group together to propose major tax cuts and spending increases to stimulate the economy. It takes two months of negotiating with other members of the Senate to garner enough votes to pass the stimulus package, and another month to convince the House to pass the same set of bills. As part of a compromise, the spending measures in the bill are phased in over a two year period, and the tax cuts do not take effect until the following year, nine months away. By the time these measures are actually enacted, the economy has largely recovered and the fiscal measures actually spur inflation. Which of the following problems does this illustrate?

* public choice problem
* time lag
* recognition lag
* legislative lag
* impact lag

That answer is incorrect.
Correct answer:
recognition lag

Recognition lag is the time that lapses between when a problem is recognized and when legislation can be implemented. Even if we assume that the senators correctly identified the problem, months or even years can pass before the legislature actually acts on a problem and the legislation goes into effect.

Which of the following is primarily responsible for controlling the money supply in the U.S.?

* the Council of Economic Advisors
* the Board of Governors of the Federal Reserve System

* the U.S. Congress
* the U.S. Treasury

That answer is incorrect.
Correct answer:
the Board of Governors of the Federal Reserve System

The Federal Reserve System (the Fed) controls the money supply in the U.S. by controlling the discount rate (the interest rate paid by commercial banks to the Fed when they borrow money), the required reserve ratio (the fraction of demand deposits banks must keep in their vaults) and by the purchase and sale of bonds.

Given the strict quantity theory of money, if the quantity of money fell by half, prices would

* increase somewhat but less than double.
* remain constant.
* fall by half.
* double.
* fall to zero.

That answer is incorrect.
Correct answer:
fall by half.

The equation of exchange is defined as: MV = PY where M is the money stock, V is velocity, P is the price level and Y is real output. In order to maintain this equality when the quantity of money fell by one half, prices would also have to fall by one half.

Which one of the following will reduce short-run aggregate supply (SRAS shifts to the left) in the U.S. ?

* a reduction in the world price of oil
* an increase in technological improvements
* an increase in capital formation
* a flood in the Midwest agricultural states
* a decrease in resource prices

That answer is incorrect.
Correct answer:
a flood in the Midwest agricultural states

A flood in the Midwest will cause a supply shock for resources in production. This will cause resource prices to increase and increase the costs of production. When this occurs, short run aggregate supply decreases (moves leftward).

If the government borrows to fund a bridge construction project, this would initially cause the aggregate demand curve would shift to the ________ and the aggregate supply curve would shift to the ________.

* right, right
* left, right
* unknown, left
* right, left
* right, unknown
* left, left

That answer is incorrect.
Correct answer:
right, unknown

The borrowed funds amounts to an increase in aggregate demand, shifting the aggregate demand curve to the right. Any change this would have in aggregate supply is unknown.

Modern analysis indicates that expansionary macroeconomic policy will

* both stimulate aggregate demand and real output when the effects of the policy are unanticipated and exert its primary impact on prices when the effects of the demand stimulus policies are fully anticipated by decision makers.
* exert its primary impact on prices when the effects of the demand stimulus policies are fully participated by decision makers.
* stimulate both aggregate demand and real output when the effects of the policy are unanticipated.
* reduce aggregate demand and lead to a reduction in inflation.
* reduce aggregate demand and cause an increase in inflation.

That answer is correct!

Expansionary macroeconomic policy affect aggregate demand and real output when inflation is unanticipated because it leads to a decline in the real wage and a stimulation to employment. When inflationary effects are fully anticipated the only effect of these policies is inflation since all economic agents adjust contracts to account for rising prices.

Which of the following is a major insight of the Keynesian aggregate expenditure model?

* Higher interest rates reduce private investment when the federal government runs a budget deficit.
* Flexible wages and prices will direct a market economy to the full-employment output level.
* When people expect higher prices as the result of demand stimulus policies, increases in aggregate demand may not stimulate real output.
* The responsiveness of real output to changes in aggregate demand will be directly related to the availability of unemployed resources.

That answer is incorrect.
Correct answer:
The responsiveness of real output to changes in aggregate demand will be directly related to the availability of unemployed resources.

Keynes emphasized that when idle resources are present, output will be highly responsive to changes in aggregate demand. Conversely, when an economy is operating near or at its capacity, real output will be much less sensitive to changes in demand.

Compared to a barter economy, using money increases efficiency by reducing

* transaction costs.
* inflation.
* the need to exchange goods.
* the benefits (utility) derived from goods.
* the need to specialize.

That answer is correct!

Transaction costs are incurred through bartering. There must be a mutual coincidence of the desire to trade.

If the Fed follows an expansionary monetary policy and decision makers anticipate the effects of this policy perfectly:

I. The demand curve will shift to the right.
II. The supply curve will shift to the left.
III. Prices will fall.
IV. Aggregate output will rise.

* II, III & IV
* II & III
* I & II
* I, II & III

That answer is incorrect.
Correct answer:
I & II

If the effects of an expansionary monetary policy are anticipated perfectly, then the consumers will correctly forecast the future inflation that will be caused by the monetary expansion. Hence, they would prefer to buy goods today rather than wait for the prices to rise. This moves the demand curve to the right. On the other hand, businesses will be reluctant to sell goods at current prices and would rather wait till the prices do rise. Thus, the supply curve moves to the left. These movements will cause an immediate increase in prices but leave the aggregate output unchanged.

If a reduction in the money supply were desired as part of an anti-inflation policy, the Federal Reserve might

* buy U.S. securities directly from the Treasury.
* decrease the reserve requirements.
* raise the discount rate.
* buy U.S. securities on the open market.

That answer is incorrect.
Correct answer:

raise the discount rate.

Raising the discount rate makes it more expensive for commercial banks to fail to meet the required reserve ratio. Thus, banks are less willing to extend loans under a higher discount rate because the discount rate represents the interest rate banks must pay to the Fed if they must borrow money to meet the required reserve ratio. Restricting loans reduces the money supply through the deposit expansion multiplier.

The velocity of money is

* the multiple by which an increase in government expenditures will cause output to rise.
* set by the Board of Governors of the Federal Reserve System
* the rate at which the price index for consumer goods rises.
* the average number of times one dollar buys final goods and services during a year.

That answer is incorrect.
Correct answer:
the average number of times one dollar buys final goods and services during a year.

The velocity of money can be thought of as the number of hands that a given dollars passes through over the course of one year.

The transactions motive for holding money is likely to increase if

* transactions fees in stock and bond markets fall.
* deflation begins.
* the nominal national income increases.
* the nominal interest rate rises.

That answer is incorrect.
Correct answer:
the nominal national income increases.

Higher national income implies a greater number of transactions. Higher income implies that households will make additional purchases of goods and services. This implies that the number of transactions in the economy will increase, thus increasing the transaction demand for money.

The Central Bank increases the money supply. In the long run, how will this impact real aggregate output, all else being equal?

* Real output will increase by an amount less than the level of the monetary expansion
* Impossible to determine
* Real output will increase by the amount of the monetary expansion times some multiplier
* Real output will increase by the amount of the monetary expansion
* Real output will not change

That answer is incorrect.

Correct answer:
Real output will not change

Monetary expansion always causes inflation and nothing more in the long run. In the short-term, however, imperfect information can lead to temporary increases in production.

The increase in money supply increases consumers' money stock. Consumers cannot initially distinguish between inflationary growth and real wealth growth. Demand for goods increases, causing prices to rise. Producers cannot initially distinguish between higher prices for their products due to inflation or due to real demand. Therefore producers respond by producing more goods, temporarily expanding output. Eventually, higher prices will prevail for both finished goods and inputs, and these higher costs will cause producers to decrease output. A new equilibrium is set at a higher price level but the same aggregate supply.

If the economy is below full capacity, this short-term output stimulus might stabilize GDP and allow the economy to recover naturally without suffering through a severe recession. In this scenario, monetary policy has acted like a bridge across an economic downturn, it did not increase real output by itself. Remember, if printing money really increased income, the presses would run non-stop.

Which of the following best expresses the central idea of counter-cyclical fiscal policy?

 * deficits are planned during economic recessions and surpluses are utilized to restrain inflationary booms.
 * planned deficits are experienced during economic booms and planned surpluses during economic recessions.
 * actual deficits should equal actual surpluses during a period of deflation.
 * the balanced-budget approach is the proper criterion for determining annual budget policy.

That answer is correct!

Counter-cyclical fiscal policy refers to using government expenditures and taxation to stabilize aggregate demand and therefore, the economy as a whole. Counter-cyclical policy implies that government expenditures should rise and taxation should fall during economic recessions; alternatively, government expenditures should fall and taxation should rise during economic booms.

Economists who are confident that discretionary changes in macroeconomic policy will help reduce economic instability generally believe that

 * the self-correcting mechanism of a market economy works with reasonable speed.
 * inflexible macro policy rules will prevent policy makers from responding to unanticipated shocks; thus they will reduce stability.
 * perverse policies are the primary source of instability, so rules providing for stable monetary and fiscal policy will reduce instability.
 * the self-correcting mechanism of a market economy works slowly and ineffectually.

That answer is incorrect.
Correct answer:
the self-correcting mechanism of a market economy works slowly and ineffectually.

If the self corrective process works slowly then market economies will still experience prolonged periods o abnormally high unemployment and below capacity output. Therefore economists holding this belief suggest that discretionary monetary and fiscal policy can help promote stability and prosperity better than the economy's self correcting mechanism.

Which of the following compose the reserves of a commercial bank?

* U.S. securities and stock equity
* demand deposits and time deposits
* vault cash and deposits of the bank with the Federal Reserve
* cash and U.S. securities

That answer is incorrect.
Correct answer:
vault cash and deposits of the bank with the Federal Reserve

Bank reserves represent vault cash plus deposits of the bank with the Federal Reserve.

The GDP deflator in the base year equaled 100. The current GDP deflator is 111.2. If the current gross GDP equals 5,000, the current real GDP equals ________.

* insufficient information
* 5,560
* 4,496
* 4986

That answer is incorrect.
Correct answer:
4,496

The fact that the GDP deflator has increased implies that prices have risen since the base year and risen by 111.2/100 - 1 = 11.2%. The current GDP, measured in terms of base year dollars, equals 5000*100/111.2 = 4,496.

The unemployment rate equals the number of persons

* unemployed divided by the number in the labor force.
* not working divided by the population age 16 and over.
* unemployed divided by the population age 16 and over.
* unemployed divided by the number employed.

That answer is correct!

The unemployment rate is the percent of persons in the labor force who are unemployed.
Mathematically this is equal to:

(number of persons unemployed / number in the labor force) x (100)

If the Federal Reserve wanted to reduce the money supply as part of an anti-inflation policy, it might

* sell U.S. securities.
* reduce the discount rate.
* reduce reserve requirements.
* urge the Treasury to issue more U.S. securities.

That answer is correct!

By selling U.S. securities the Fed contracts the money supply because individuals who formerly held money balances now hold security notes.

Which of the following contribute(s) to the natural rate of unemployment?

I. Structural unemployment
II. Cyclical unemployment
III. Frictional unemployment
IV. Part-time employment

* I & III
* I & II
* I, II & III
* I, II, III & IV

That answer is correct!

The rate of unemployment caused by structural and frictional aspects of an economy is characteristic of the economy and changes only very slowly. This employment rate is known as the "natural rate of unemployment." It thus represents the unemployment rate associated with the maximum sustainable output of an economy. Economists define "full employment" as the state of economy in which the rate of unemployment equals the natural rate.

An economy is currently in equilibrium at full employment. If there is an unanticipated increase in demand, which of the following effects can be seen in the short run?

I. Prices increase.
II. Real GDP increases.
III. The supply curve shifts to the left.
IV. The demand curve moves to the left.

* I, II & III
* II & III
* I & II
* I only

That answer is incorrect.
Correct answer:
I & II

If there is an unanticipated increase in demand, the demand curve will move to the right. The supply curve will not move in the short run since the demand stimulus is unanticipated. This will lead to a temporary decrease in the unemployment rate. Since the economy is already at full employment, this means that the unemployment rate will fall below the natural rate and output will exceed the potential real GDP. Prices will also increase as a result of increased demand.

A decline in the real interest rate in the loanable funds market will cause the

* aggregate demand curve to shift to the right.
* natural unemployment to fall.
* aggregate demand curve to shift to the left.
* long-run aggregate supply curve to shift to the left.

That answer is correct!

A decline in the real interest rate stimulates investment and encourages the purchase of consumer durables. This shifts aggregate demand to the right.

Within the Keynesian aggregate expenditure model, what happens when buyers buy fewer goods and services than businesses anticipate?

* Unplanned increases in inventories occur.
* Households increase their consumption.
* Prices increase.
* Unemployment decreases.

That answer is correct!

If the planned expenditures of consumers, investors, governments and foreigners on goods and services were less than expected, then business firms would be unable to sell as much of their current output as they anticipated. Thus, actual inventories would increase as they unintentionally made larger inventory investments than they planned.

Assume that between 1982 and 1990, nominal GDP increased from $3 trillion to $5.2 trillion and that the price index rose from 100 to 130. Which of the following expresses GDP for 1990 in terms of 1982 prices?

* $4 trillion
* $3.9 trillion
* $6.76 trillion
* $5.2 trillion

That answer is correct!

GDP in 1990 is found by the following equation:

$5.2 trillion/ 1.30 = $4 trillion

Classical equilibrium occurs where

 * quantity demanded equals quantity supplied
 * unemployment is at a minimal level consistent with reasonable inflation
 * the maximum point on the production possibilities curve
 * inflation is zero
 * aggregate demand is maximized given stable prices

That answer is correct!

Classical equilibrium is similar to microeconomic equilibrium in an industry. It is where the aggregate supply curve intersects the aggregate demand curve.

Producers expect prices to generally increase by 5% per year for the foreseeable future. The Central Bank increases the money supply by an amount consistent with 10% inflation. Assuming there are slack resources in the economy, how would this change impact short-term and long-term real GDP?

 * increase, increase
 * not change, increase
 * not change, not change
 * increase, not change
 * impossible to determine without knowing the actual change in the money supply

That answer is incorrect.
Correct answer:
increase, not change

If inflation is greater than the expected 5%, producers will initially react to the higher prices for their products as if they were real price increases. In other words, initially there will be an increase in the aggregate quantity supplied and hence an increase in real GDP.

In the long-run, however, producers will realize higher costs of production, i.e. wage increases, higher input prices, etc. This will cause the aggregate supply curve to shift to the left. The end result is the same production level as before at a higher price level.

"The market economy, left to its own devices, is unstable and likely to languish in prolonged periods of recession." This view is advocated by:

 * Keynesian economists.
 * Neo-classical economists.
 * Modern economists.
 * Classical economists.

That answer is correct!

Keynesians believe that balanced aggregate spending is key to maintaining a healthy economy.

Demand will generate supply and pull the economy toward higher employment. However, an equilibrium can be attained at any level of production consistent with aggregate demand. If this demand is low, the economy can remain stuck in a low production phase for a prolonged period of time.

An economic researcher publishes evidence that inflation expectations seem to be too high following years of high inflation and too low following years of tame inflation. Which of the following theories would this evidence support?

 * adaptive expectations hypothesis
 * monetarist theory
 * rational expectations hypothesis
 * efficient markets hypothesis
 * mean reversion
 * greater fool theory

That answer is correct!

Adaptive expectations hypothesis suggests that individuals will base their views of the future on their recent experience. This suggests that individuals will make systematic errors in their judgement about inflation. If inflation has recently been quite high, adaptive expectations suggests that individuals will expect it to remain high and vice versa. They will not expect reversion to the mean.

Which of the following would increase GDP?

 * a Mexican citizen purchases an orange produced in the U.S.
 * buying hamburger buns by McDonald's
 * giving $100 to a homeless man on the street
 * buying a 5-year old house

That answer is correct!

Since GDP is the total market value of all final goods and services produced domestically during a specific period, output that is generated on U.S. soil but is sold abroad is included in the calculation of GDP.

Which of the following would be included in this year's GDP?

 * the value of the time I spend working around my house, for example, pruning a hedge, repairing a window hinge, or shoveling snow off the walk.
 * the value of furniture I recently purchased at a used furniture auction.
 * the opportunity cost of time spent cleaning my house this spring.
 * the sales commission I paid a real estate agent when I purchased a three-year-old home earlier this year.

That answer is incorrect.
Correct answer:

the sales commission I paid a real estate agent when I purchased a three-year-old home earlier this year.

GDP is the total market value of all final goods and services produced domestically during a specific period. The sales commission paid to a real estate agent represents a domestically generated service payment and contributes positively to GDP.

Which of the following would cause an increase in both real interest rates and inflation?

I. an increase in productivity
II. a marginal tax increase
III. a government budget deficit

* II, III
* I, II, III
* III only
* I only
* II only
* I, III

That answer is incorrect.
Correct answer:
III only

A budget deficit causes a shift in aggregate demand, which tends to cause an increase in the price level. At the same time, increased government borrowing would result in an increase in the cost of borrowing, or the real interest rate. Note that an increase in productivity would shift the supply curve outward, resulting in a lower price level. A tax increase would probably decrease government borrowing, and therefore lower interest rates.

Unanticipated increases in inflation will temporarily reduce unemployment because such increases

* raise the real wage rate, stimulate output and thereby reduce unemployment.
* increase the nominal interest rate and thereby stimulate investment and employment.
* lower the real wage rate, stimulate output and thereby reduce unemployment.
* lower bond prices and thereby stimulate investment and employment.
* lower the nominal wage rate, stimulate output and thereby reduce unemployment.

That answer is incorrect.
Correct answer:
lower the real wage rate, stimulate output and thereby reduce unemployment.

The effects of unanticipated inflation are clear: since wage and other contracts will not reflect rising prices, the real wage will be eroded. As labor is now cheaper, employment rises as does output.

Which of the following is not a component of the money supply (M1)?

* traveler's checks

* Federal Reserve notes in circulation
* checkable deposits of individuals held by a savings and loan association
* gold held by the U.S. Treasury at Fort Knox

That answer is incorrect.
Correct answer:
gold held by the U.S. Treasury at Fort Knox

M1 is the sum of currency in circulation, demand deposits, other checkable deposits or depository institutions and travelers' checks.

An economy is currently operating at full employment. If the Fed unexpectedly sells $75 million worth of bonds in the market, in the short run, the aggregate output will ________. The employment rate will ________.

* rise, rise
* rise, fall
* fall, fall
* fall, rise

That answer is incorrect.
Correct answer:
fall, fall

The sale of bonds implies that the Fed takes out money from the economy. This reduces the monetary base and the total money supply in the economy, causing the real interest rates to rise in the short run. Businesses cut back on production, causing an increase in the unemployment rate and a fall in the aggregate output.

An economy is operating at the full-employment level of income and the government budget is in balance. According to the Keynesian view, if the government's spending policy is unchanged, a reduction in planned private investment will most likely lead to

* a decline in output and a government budget surplus.
* an increase in output and a government budget deficit.
* a decline in output and a government budget deficit.
* no change in output and a government budget surplus.

That answer is incorrect.
Correct answer:
a decline in output and a government budget deficit.

Since total output is equal to planned consumption, investment, government expenditures and net exports, a decline in planned investment would lead to a decline in output. Declining output implies lower income levels and thus lower government revenue. Thus, the government moves toward a deficit.

How would the Bureau of Labor Statistics count a person not working who refuses an offer of employment to keep looking for a better job?

 * not in the labor force
 * employed
 * unemployed
 * a discouraged worker

That answer is incorrect.
Correct answer:
unemployed

A person is unemployed according to the BLS if they do not have a job, are available for work and have actively looked for work during the past four weeks.

Keynesian analysis stresses that a tax cut that increases the government's budget deficit

 * is appropriate during a period of inflation.
 * will stimulate aggregate demand and thereby promote employment.
 * will result in national bankruptcy.
 * will stimulate aggregate supply and thereby promote employment.

That answer is incorrect.
Correct answer:
will stimulate aggregate demand and thereby promote employment.

Tax cuts stimulate consumer spending since individual disposable income (income available to the consumer after taxes) has risen. Consumers will both save and consume more, thus stimulating aggregate demand. The consequence of higher aggregate demand will be a decline in unemployment.

If business decision makers become pessimistic about the future, the most likely result is

 * an increase in planned investment, which will cause employment and income to rise.
 * a reduction in planned investment, which will cause employment and income to rise.
 * an increase in planned investment, which will cause employment and income to decline.
 * a reduction in planned investment, which will cause employment and income to decline.

That answer is incorrect.
Correct answer:
a reduction in planned investment, which will cause employment and income to decline.

Since investment is dependent on expected future sales, pessimism about the future will imply that private investment will fall. Business owners will anticipate falling demand and will not invest in order to take advantage of future opportunities. As a component of aggregate demand, this decline will cause output to fall along with employment and income.

The best source of information concerning the government's fiscal policy can be found by examining

* reserve requirements of the Federal Reserve.
* changes in the discount rate.
* open market operations of the Federal Reserve.
* both open market operations and reserve requirements of the Federal Reserve.
* the federal budget.

That answer is incorrect.
Correct answer:
the federal budget.

Fiscal policy has important effects on aggregate demand and supply. The federal budget is the best source of information on the direction of the government's fiscal policy. The other choices in this question address the government's monetary policy.

________ cause(s) the value of the U.S. dollar to rise and hence causes the trade deficit to ________.

* Falling foreign tariffs, decrease
* Rising interest rates, decrease
* Disinflation, increase
* Unemployment, increase
* A federal budget deficit, increase
* Deregulation, decrease

That answer is incorrect.
Correct answer:
A federal budget deficit, increase

Government deficits cause interest rates to rise, which in turn causes the foreign exchange value of the dollar to increase. A strong dollar makes American products expensive abroad and foreign products cheap domestically, resulting in more imports and fewer exports.

For a person over 16 to be counted among the unemployed, he

* must be a person of less than retirement age who is "not working at the present time."
* must be "not working, available for work and actively looking for work."
* must be willing to accept employment; if he is willing to accept a job, he is counted regardless of other circumstances.
* only needs to be "not working at the present time."

That answer is incorrect.
Correct answer:
must be "not working, available for work and actively looking for work."

Persons are counted as unemployed only if they are available for and seeking work or awaiting recall from a layoff.

The Keynesian model implies that the basis of sound macroeconomic policy is

* a balanced federal budget.
* regulating aggregate expenditures.
* low tax rates.
* maintenance of low interest rates.

That answer is incorrect.
Correct answer:
regulating aggregate expenditures.

Aggregate expenditures are the catalyst of the Keynesian model. The model implies that maintaining aggregate expenditures at the level consistent with full employment and stable prices is the primary function of sound macroeconomic policy.

When decision makers ________ the effects of monetary expansion, it does not alter real output even in the short run.

* ignore
* none of these answers
* are surprised by
* fully anticipate

That answer is incorrect.
Correct answer:
fully anticipate

When decision makers fully anticipate the effects of monetary expansion, suppliers build the expected price rise into their decisions. The anticipated inflation leads to a rise in nominal costs, causing aggregate supply to decline. Thus, while nominal wages, prices and interest rates rise, their real counterparts are unchanged. Thus, there is inflation without any change in real output.

Which of the following is/are true about aggregate demand?

I. An increase in the total income of a trading partner country causes an increase in aggregate demand.

II. An appreciation of the domestic currency will increase aggregate demand.

III. A decrease in the real rates of interest will increase aggregate demand.

* I & III
* I, II & III
* II & III
* I & II

That answer is correct!

Aggregate demand refers to demand for domestic goods. Therefore, an increase in the total income of a trading partner country leads to an increase in exports, thus causing an increase in aggregate demand. Similarly, a decrease in real rates will lower the opportunity cost of current consumption and increase current demand. However, if the domestic currency becomes stronger, exports will fall since foreign consumers will find them more expensive in terms of their own currencies.

Given the strict quantity theory of money, if the quantity of money were doubled, prices would

* increase fourfold.
* increase to an unknown degree.
* double.
* increase by 50 percent.

That answer is incorrect.
Correct answer:
double.

The quantity theory of money implies that the existing money stock M multiplied by velocity V equals the nominal GDP (output times the price level). Thus, a doubling of M would require a doubling of the price level in order to maintain the equality.

Inflation over the last 20 years has averaged 3%. If you had put $100 under your bed 20 years ago, how much would it be worth in today's terms due to inflation?

* $97.00
* $54.38
* $55.36
* $62.45
* $40.00

That answer is incorrect.
Correct answer:
$54.38

Inflation causes the value of money to erode. Therefore $100 from 20 years ago is worth far less today. This calculation is exactly the same as if you had a $100 investment that had a -3% average annualized return. (1-0.03)^20*100=$54.38

A wealthy individual investor believes that the stock market is about to decline severely. She decides to sell her stocks and put the proceeds temporarily in a money market account. She plans to re-invest this money in the stock market after the anticipated crash.

How will this immediately impact M2 and the effective amount money available for transactions?

* both decrease
* no change, decrease
* increase, no change
* increase, decrease
* no change for either
* both increase
* decrease, increase

That answer is incorrect.
Correct answer:
increase, no change

Effectively, there is no difference in how the investor is using money, simply a different investment vehicle. Therefore the effective level of money in circulation has not changed. However, since money market investments by individuals are part of M2 and stock investment are not, M2 would increase. If an economist is tracking M2 in an attempt to determine when inflation will hit, this transaction would give the appearance that M2 has increased. In fact, this money will not be spent on goods in the near term and will therefore not contribute to inflation.

Which of the following is/are true about the natural rate of unemployment?

I. It's the rate consistent with the structural and frictional factors in the economy.

II. It corresponds to the rate at which the economy is at full employment.

III. It corresponds to the rate accompanying the maximum sustainable output of an economy.

IV. It varies over time but is hard to influence through public policy.

* I, II & III
* II & III
* I & III
* I, II, III & IV

That answer is correct!

The rate of unemployment caused by structural and frictional aspects of an economy is characteristic of the economy and changes only very slowly. This employment rate is known as the "natural rate of unemployment." It thus represents the unemployment rate associated with the maximum sustainable output of an economy. The natural rate is affected by workforce demographics as well as public policy.

Marcus Taylor is 29, and has $20,000 in a bank issued Certificate of Deposit about to mature in his IRA. He has been researching bond mutual funds and discovers he can purchase a U.S. Treasury bond fund with a similar degree of risk compared with CD's, but which offer much more attractive yields. Marcus will not be able to withdraw from his IRA until he is 60 years old. When the CD matures, he decides to invest the proceeds in the bond mutual fund.

How does this impact the monetary base and the effective amount money available for transactions?

* no change, decrease
* decrease, increase
* increase, decrease
* both increase
* no change for either
* decrease, no change
* both decrease

That answer is incorrect.

Correct answer:
decrease, no change

Effectively, there is no difference in how Marcus' money is impacting the level of money available for transactions. Regardless of whether the money was in CDs or in the mutual fund, it was not going to be used for purchasing goods. However, Marcus' bank is no longer obligated to keep 10% of his CD value on reserve. Therefore reserves would decrease, and hence, the monetary base would also decrease. This might give the appearance that the money supply has fallen, even though effectively it has not.

The expansionary effects of an increase in government expenditures may be offset if

 * government borrowing drives up interest rates.
 * the economy operates well below its full-employment capacity.
 * taxes are not also increased.
 * business decision makers and consumers become more optimistic as the result of the fiscal stimulus.

That answer is correct!

The expansionary effect induced by an increase in government borrowing will be inhibited by the effect of the government competing in the market for loanable funds. By borrowing the government effectively drives up the real interest rate by competing with private investors. Consequently the positive impetus to aggregate demand created by increased government spending is tempered by the negative impact of increasing the interest rate and thus decreasing private investment.

In the Keynesian model, if an economy operates at its full-employment capacity and the marginal propensity to consume is 3/4, an increase in government spending of $100 billion will cause real output to increase ________.

 * $750 billion
 * zero; only inflation will occur
 * $75 billion
 * $400 billion
 * $100 billion

That answer is incorrect.
Correct answer:
zero; only inflation will occur

At full capacity, increases in aggregate demand cannot increase real output. It will have the effect of increases prices only, since there now exists heightened demand for a limited amount of output.

The value of money

 * varies inversely with the general price level.
 * remains constant during periods of deflation.
 * varies directly with the general price level.

 * varies indirectly with output.

That answer is correct!

Because inflation implies high prices, a dollar purchases less under inflation than it did when prices were constant. Therefore, the value of a given quantity of money declines under inflation.

"Potential GDP" refers to:

 * the maximum attainable level of output in an economy in the absence of structural and frictional unemployment.
 * the maximum sustainable level of output in an economy under normal conditions.
 * the maximum attainable level of output in an economy consistent with aggregate demand.
 * the maximum attainable level of output in an economy under ideal conditions.

That answer is incorrect.
Correct answer:
the maximum sustainable level of output in an economy under normal conditions.

The Council of Economic Advisors defines potential output as, "The amount of output that could be expected at full employment." The potential output does not represent the absolute maximum that can be produced by an economy. For e.g. in short bursts during wartime, the output can exceed the potential output substantially. However, such abnormal levels are not sustainable. Only the output that can be steadily sustained for a long time with a high but normal rate of resource utilization is considered as "potential output."

According to Say's law, there cannot be a general overproduction of goods because:

 * all of these answers.
 * the production will create its own demand by increasing income.
 * people always want more rather than less.
 * the increase in inventories will reduce employment and output.

That answer is incorrect.
Correct answer:
the production will create its own demand by increasing income.

The 19th century French economist, J. B. Say, believed that there was no such thing as "overproduction." People would consume whatever was produced, so that supply would create its own demand. The argument proffered was that production of goods created purchasing power for producers, who would then use it in their role as consumers to purchase whatever was available.

When people speak of the labor force participation rate, they are actually talking about

 * the percentage of new entrants in the labor force.
 * the percentage of working-age people who are either working or looking for work.
 * the percentage of people not working but actively seeking work.

* the percentage of people actively participating in meaningful economic activity.
* the percentage of working-age people who are either working or out of the labor force.

That answer is incorrect.
Correct answer:
the percentage of working-age people who are either working or looking for work.

The labor force participation rate is the number of persons in the civilian labor force 16 years of age or over who are either actively seeking employment or are employed as a percentage of the total civilian population 16 years of age and over.

Which of the following will lead to a reduction in aggregate demand in the U.S. ?

* an increase in the exchange rate of the dollar
* a reduction in the real interest rate
* rapid growth in real income in Japan and Western Europe
* a higher price level

That answer is correct!

An increase in the exchange rate value of the dollar will stimulate American imports and retard U.S. exports. Net exports decline which retards aggregate demand.

"Fluctuations in business investment are a major source of economic instability. A high level of aggregate demand is essential, or otherwise spending may be insufficient to provide the business sector with the incentive to expand, invest and employ all the workers of the economy." According to the Keynesian view, this statement is

* incorrect because shifts in investment are not the major source of economic instability.
* incorrect because it ignores the fact that investment is highly responsive to changing interest rates.
* incorrect because high aggregate demand will mean a decline in the saving necessary for investment.
* essentially correct.

That answer is incorrect.
Correct answer:
essentially correct.

Keynesians believe that autonomous changes (such as in private investment) are very destabilizing since they are amplified by the multiplier.

Use the table below to choose the correct answer.

Time period	Observed rate of inflation
1	2 percent
2	4 percent

3	6 percent
4	8 percent

According to the adaptive expectations hypothesis, at the beginning of time period 4, decision makers would expect inflation to be ________.

 * 8 percent
 * 4 percent
 * 10 percent
 * 6 percent
 * 12 percent

That answer is incorrect.
Correct answer:
6 percent

Under the adaptive expectations hypothesis economic agents base their future expectations on actual outcomes observed during recent periods. Thus, the most recent periods suggest an inflation rate of 6 percent will persist in the future.

The Central Bank increases the money supply by 5%, in a widely anticipated move. Which of the following are likely to increase due to this monetary policy measure?

I.   the price level
II. real GDP
III. employment rate

 * II, III
 * I only
 * I, II, III
 * none of these answers is correct
 * III only
 * I, II

That answer is incorrect.
Correct answer:
I only

If producers anticipate inflation due to an increase in the money supply, then an increase in both revenues and expenses will be calculated into their production decisions. There will be no real increase in production, and hence no change in real GDP. Similarly, there would be no increase in employment because there has been no change in production. Therefore increasing the money supply only causes inflation.

Frustrated by the low interest rate available in bank CD's, Tom Smith decides to invest in a stock mutual fund when his current $10,000 CD matures.

How will this immediately impact M2 and the effective amount money available?

 * increase, decrease
 * no change, decrease
 * decrease, no change

 * both increase
 * no change for either
 * both decrease
 * decrease, increase

That answer is incorrect.
Correct answer:
decrease, no change

Effectively, there is no difference in how Tom is using money, simply a different investment vehicle. Therefore the effective level of money in circulation has not changed. However, since CD's are part of M2 and stock investments are not, M2 would decline. This might give the impression that the money supply is declining, when in fact it is not.

A nation has run a continually larger budget deficit for the last five years. Which of the following is probably not occurring in this nation?

 * nominal output growth
 * rising interest rates
 * inflation
 * strong local currency
 * capital account surplus
 * trade surplus

That answer is incorrect.
Correct answer:
trade surplus

Government budget deficits are typically linked with trade deficits, due to both a strengthening of currency and an investment shortfall.

In Keynesian theory, if an economy is in equilibrium below full employment, unemployment can be decreased by:

 * increased aggregate demand.
 * falling prices.
 * falling wages.
 * increased aggregate supply.

That answer is correct!

Central to the Keynesian economics is the notion that supply is driven by aggregate demand. Businesses produce at a level which they anticipate to be the aggregate demand. Any output level which equals the spending level corresponds to an equilibrium. Only a change in the aggregate demand is assumed to move the economy from one equilibrium output to another. Hence, an increase in demand leads to an increase in output, supported by increased employment and resource utilization.

A pervasive increase in prices is the result of

* too many dollars chasing too few goods
* an economic boom
* monopolistic practices by producers
* a sudden increase in oil prices
* an increase in interest rates

That answer is correct!

All dollars are eventually spent, and therefore too many dollars will result in the price of goods being "bid up" by consumers. This is the basic cause of inflation, or a pervasive increase in prices. While inflation is common in the late stages of an economic boom, it is important to remember that one does not cause the other. In fact, an increase in production with no increase in the money supply would result in deflation. Interest rates might increase because of inflation, not the other way around.

As the result of deregulation during the 1980s,

* a much clearer distinction exists between the functions of commercial banks and savings and loan associations.
* the money supply (M1) has decreased substantially.
* interest-earning checkable deposits are now a substantial component of the money supply (M1).
* the Fed is unable to control the money supply (M1).

That answer is incorrect.
Correct answer:
interest-earning checkable deposits are now a substantial component of the money supply (M1).

Deregulation during the 1980s allowed depository institutions to offer interest-bearing checkable deposits. This change lead to a large transferal of depositors' savings from savings accounts to checkable deposits. By the 1990s interest earning other checkable deposits exceeded demand deposits and they now comprise more than one-third of the M1 money supply.

Which of the following most accurately describes the post-World War II U.S. economy?

* Despite minor fluctuations in employment, income and prices, the real growth rate has exceeded 8 percent per year.
* The U.S. economy has experienced sustained high employment and production as well as price stability.
* Economic upswings and downswings have been virtually eliminated by an aggressive stabilization policy.
* Employment, production and growth have fluctuated, but not as severely as during the Depression and the war years.

That answer is incorrect.
Correct answer:
Employment, production and growth have fluctuated, but not as severely as during the Depression and the war years.

Historically, real GDP in the U.S. has grown unevenly. Periods of rapid real growth have been followed by economic slowdowns. Compared to the first half of the century, the growth of real GDP has been more stable during the last four decades.

If a bank had a reserve requirement of 10 percent and excess reserves of $2,000, the largest loan it could legally extend would be ________.

 * $20,000
 * $2,000
 * $1,800
 * $200

That answer is incorrect.
Correct answer:
$2,000

The bank is legally allowed only to lend the amount of its excess reserves. If it lends more than this amount, it cannot satisfy its reserve requirement.

An American-owned McDonald's opens in Russia. How would a Russian citizen's purchase of a hamburger from this store change American GDP and GNP?

 * It would increase GNP and GDP.
 * It would increase GNP and leave GDP unchanged.
 * It would leave both GDP and GNP unchanged.
 * It would increase GDP and leave GNP unchanged.

That answer is incorrect.
Correct answer:
It would increase GNP and leave GDP unchanged.

GNP is defined as the market value of all final goods and services produced by the citizens of a country. It is equal to GDP plus the income the nationals earned abroad minus the income foreigners earned domestically. Since the price of the hamburger represents revenue for a U.S. national it will contribute to GNP but since it was generated abroad, it is not included in GDP.

Which of the following is/are true?

I. An increase in unemployment benefits will increase the rate of unemployment.

II. Keeping the total number of people employed constant, an increase in the number of people working part-time will increase unemployment rate.

III. "Discouraged workers" are not counted as part of the "unemployed" population or the labor force.

 * III only
 * II & II
 * I & II
 * II only

* I, II & III
* I & III
* I only

That answer is incorrect.
Correct answer:
I & III

"Discouraged workers" are those who are no longer seeking employment, though they would accept it if it were offered to them. For this reason, they are not considered part of the labor force and hence, not "unemployed" (only people in the labor force can be "unemployed.")

An increase in unemployment benefits decreases the opportunity cost of staying unemployed. This tends to increase the time workers remain unemployed, increasing the unemployment rate.

Even if a person works part-time, he is considered fully employed while compiling the employment statistics. Therefore, II is not true.

The demand curve for money

* reflects the open market operations policy of the Federal Reserve.
* shows the amount of money balances that individuals and businesses wish to hold at various interest rates.
* shows the amount of money individuals and businesses wish to hold at various price levels.
* reflects the discount rate policy of the Federal Reserve.

That answer is incorrect.
Correct answer:
shows the amount of money balances that individuals and businesses wish to hold at various interest rates.

The demand curve for money is downward sloping line with the price of holding money balances (the nominal interest rate) on the vertical axis and the amount of money held as cash on the horizontal axis. The nominal interest rate appears on the vertical axis because it represents the price of holding money as cash.

Keynesians assume that:

* all of these answers.
* wages and prices are inflexible in the downward direction.
* inflation moves an overheated economy toward equilibrium.
* unemployment causes lower resources prices, moving an economy toward equilibrium.

That answer is incorrect.
Correct answer:
wages and prices are inflexible in the downward direction.

Classical economics assumes that any disequilibrium in the market place will be corrected by changes in wages and prices. This is the famous "invisible hand" principle. Keynesian economics, while not directly disputing this, maintain that the effect is far too slow to extricate stagnating economies from recessions over a short period of time. Even when demand is weak, they believe large firms and trade unions resist wage and price reductions, causing these variables to be particularly inflexible in the downward direction.

The marginal propensity to consume (MPC) is

* consumption expenditures divided by disposable income.
* consumption expenditures divided by personal income.
* additional consumption expenditures divided by additional disposable income.
* consumption expenditures divided by saving.

That answer is incorrect.
Correct answer:
additional consumption expenditures divided by additional disposable income.

The MPC is found by determining the proportion of a total increase in income that is spent on consumption. Thus, the MPC is a number less than or equal to one.

The equation of exchange states that the money

* velocity multiplied by prices equals real GDP.
* velocity multiplied by prices equals nominal GDP.
* supply multiplied by nominal GDP equals velocity.
* velocity multiplied by the money supply equals nominal GDP.
* supply multiplied by nominal GDP equals velocity.

That answer is incorrect.
Correct answer:
velocity multiplied by the money supply equals nominal GDP.

The equation of exchange is defined as: MV = PY where M is the money stock, V is velocity, P is the price level and Y is real output. Multiplying the price level by the real output gives the nominal GDP as the answer implies.

The best definition of inflation is a(n)

* large increase in food and gasoline prices.
* sustained increase in the general price level as measured by a price index.
* temporary increase in prices due to higher tax rates.
* increase in the purchasing power of the dollar.

That answer is incorrect.
Correct answer:
sustained increase in the general price level as measured by a price index.

Inflation reflects a continuing rise in the general level of prices of goods and services. The purchasing power of the monetary unit, such as the dollar, declines with inflation is present.

According to Keynesians, when unemployment is widespread, an increase in aggregate demand will have the primary impact on:

 * prices.
 * imports.
 * all of these answers.
 * output.

That answer is incorrect.
Correct answer:
output.

Keynesians believe that demand drives supply. When the economy is sluggish, an increase in demand leads to producers expanding their output by utilizing more resources, including human capital.

You deposit $1,000 cash into a checking account at a commercial bank. The immediate effect is

 * a $1,000 decrease in the money supply.
 * no change in the money supply, but in the future the money supply may expand because the bank has excess reserves.
 * a $2,000 increase in the money supply.
 * a $2,000 decrease in the money supply.

That answer is incorrect.
Correct answer:
no change in the money supply, but in the future the money supply may expand because the bank has excess reserves.

There is no immediate increase in the money supply. The money supply will increase in the future once your bank extends loans in the amount of their excess reserves. Their excess reserves (according to your new deposit) is $1,000 x (1 - reserve requirement ratio).

If inventory investment during a year was $6 billion, then producers must have

 * produced new capital assets that exceeded the depreciation allowance by $6 billion.
 * added goods valued at $6 billion to their stock of unsold goods and raw materials.
 * produced $6 billion of new capital assets during the year.
 * produced $6 billion more goods and services during the year than they sold.

That answer is incorrect.
Correct answer:
produced $6 billion more goods and services during the year than they sold.

Inventory investment refers to changes in the stock of unsold goods and raw materials held during a period. Even though inventory is not sold during the current period, it was produced during the current period and therefore contributes positively to GDP.

Suppose there is a sharp decrease in the world price of oil. Which of the following will most likely occur in an oil-importing country such as the U.S. ?

 * a decrease in both prices and real output
 * an increase in both prices and real output
 * a decrease in prices and an increase in real output
 * an increase in prices and a decline in real output
 * an increase in prices and no change in real output

That answer is incorrect.
Correct answer:
a decrease in prices and an increase in real output

A shock that causes resource prices to fall will expand the short run aggregate supply of the U.S. This is because the costs of production fall under such a reduction. A rightward shift of the aggregate supply curve (in the short run) will cause prices to fall and real output to increase.

Company X deposits $100,000 in cash in commercial Bank A. If no excess reserves were present at the time this deposit was made and the required reserve ratio was 10 percent, Bank A could increase the money supply by a maximum of ________.

 * $200,000
 * $10,000
 * $1,000,000
 * $900,000
 * $100,000

That answer is incorrect.
Correct answer:
$1,000,000

The deposit expansion multiplier is equal to 10 (the reciprocal of the required reserve ratio of .1). Thus, multiplying the deposit expansion multiplier by the value of the new reserves ($100,000) implies a potential expansion of the money supply of $1,000,000.

The Central Bank increases the money supply by 5%. If this increase was _________, real GDP may increase in the ________.

 * temporary, short-term
 * temporary, long-term
 * unanticipated, short-term
 * anticipated, short-term
 * permanent, short-term
 * unanticipated, long-term

That answer is incorrect.
Correct answer:

unanticipated, short-term

Increases in the money supply can sometimes "fool" producers into increasing production in the short-run in response to higher prices. In the long-run, firms will realize the price increase was only inflationary and return to the previous production level, in the absence of other effects. Therefore unanticipated increases in the money supply can cause short-term increases in real GDP.

ABC Construction is considering entering into an agreement to build a new office building. The tenants of this building are unwilling to pay up front in cash, but are offering to pay a fixed dollar amount over a period of 20 years. The tenant plans to take immediate and full ownership of the building. Assuming that the tenants are adequately compensating ABC for the time value of money, which of the following factors are most likely to impede ABC agreeing to these terms?

* government regulations might change over the term
* the tenant might grow too large for the building to serve their needs
* all of these are correct
* technology in the building industry may change substantially over this period
* inflation over the next 20 years is unknown

That answer is incorrect.
Correct answer:
inflation over the next 20 years is unknown

Since the tenant is planning on taking all ownership responsibilities, factors like technological, regulatory, or the size of the building are the tenant's problem, not the builder. The builder, who is set to receive a fixed dollar payment, however, could be significantly impacted by inflation above expectations. This highlights one of the primary problems with inflation, in that it discourages long-term contracts of this type. Note that the time value of money is a separate concept from inflation.

Why do individuals and businesses want to hold money?

* money provides purchasing power, which facilitates exchange.
* money places one in a position to take advantage of unexpected profit-making opportunities.
* all of these answers.
* money acts as an insurance policy against expenditures that may be required as the result of unforeseen circumstances.

That answer is incorrect.
Correct answer:
all of these answers.

These three types of demand represent the transaction demand, the precautionary demand and the speculative demand for holding money.

Classical economists believe that a recession could be reversed by

* increasing government spending to increase aggregate demand.
* expanding the money supply, a tactic that would stimulate aggregate demand and reduce

unemployment.
 * increasing wages, a tactic that would stimulate aggregate demand and depress unemployment.
 * decreasing wages, a tactic that would increase the quantity of labor demanded, thus reducing unemployment.

That answer is incorrect.
Correct answer:
decreasing wages, a tactic that would increase the quantity of labor demanded, thus reducing unemployment.

Classical economists believed that the pricing system would correct imbalances between production and demand. The price of goods in excess supply would fall and the prices of goods in excess demand would rise. Thus, wages would fall during times of high unemployment which would increase demand for labor and reduce the number unemployed.

Which of the following is/are true about GDP?

I. It equals the sum total of all the nation's cash registers.
II. It counts only the final goods and services produced during a period.
III. It excludes all financial transactions.
IV. It excludes income transfers.

 * II, III & IV
 * III only
 * IV only
 * I, II & III
 * II only
 * II & III
 * I & IV
 * I only

That answer is correct!

I is false in part due to II and III. The cash registers include intermediate goods but exclude many of the payments for services, like employee salaries.

In the Keynesian aggregate expenditure model, the equilibrium level of income is achieved when

 * actual output equals planned aggregate expenditures.
 * planned aggregate expenditures exceed actual output.
 * the employment rate equals approximately 96 percent.
 * consumption equals income times the marginal propensity to consume.
 * actual saving equals actual investment.

That answer is correct!

At any other output level than the equilibrium level the plans of producers and purchasers conflict; that is, it is only at equilibrium that what is produced is the amount of output that is purchased.

Use the table below to choose the correct answer.

Income (Dollars)	Consumption (Dollars)
1,000	900
1,200	1,025
1,400	1,150

The marginal propensity to consume for this hypothetical economy is ________.

* 0.75
* 0.625
* 0.50
* 0.77
* 0.80

That answer is incorrect.
Correct answer:
0.625

Since the MPC is determined according to the ratio: MPC = additional consumption divided by additional income, the MPC here equals: 125/200 = .625.

When the marginal propensity to consume is 2/3 and an economy operates well below its full-employment capacity, in the Keynesian model a $25 billion increase in investment expenditures will cause GDP to rise (assuming the full impact of the multiplier is instantaneous)

* $25 billion.
* $100 billion.
* $75 billion.
* $50 billion.

That answer is incorrect.
Correct answer:
$75 billion.

The expenditure multiplier is found by M = 1/(1-MPC). Thus, here M = 1/(1-2/3) = 3. Therefore the $25 billion increase in aggregate expenditures is magnified three times to $75 billion.

The Drof Company, one of the world's largest automobile manufacturers, is negotiating with the Auto Workers Union. They sign a three year contract that includes automatic 4% "cost of living" pay increases each year. Drof is free to hire or fire workers as needed, and new employees are paid the same union wages negotiated in the three year deal.

In the second year of this contract, the nation's economy is suffering from high unemployment. Which of the following might entice Drof to hire more workers?

* the Federal Government borrows to fund current spending
* aggressive "factory incentives" cut the price of autos
* none of these answers is correct

* the Central Bank begins printing currency rapidly, causing inflation of over 10%
* the Federal Government bans organized labor and orders all collective bargaining agreements null and void
* the Central Bank curbs inflation to near zero

That answer is incorrect.
Correct answer:
the Central Bank begins printing currency rapidly, causing inflation of over 10%

Union contracts often include some automatic "cost of living" pay increase. This is meant to compensate workers for inflation that is expected during the life of the contract. This tells us that Drof's cost structure has an assumed inflation rate of 4%.

If inflation is greater than 4%, this tells us that the price of autos is rising faster than Drof's costs, increasing Drof's profits and giving them an incentive to produce more cars and hire more employees.

The Central Bank wishes to increase the long-run GDP potential for the economy. Which of the following monetary policy strategies should be pursued?

* publicly increase the money supply
* quietly increase the money supply
* none of these answers is correct
* switch to a gold standard
* pursue lower interest rates
* hold the money supply constant

That answer is incorrect.
Correct answer:
none of these answers is correct

Monetary policy cannot change the long-run potential for an economy. Although timely increases in the money supply may temporarily pull GDP up from a recessionary position, this impact will fade without real improvement in economic conditions.

In the aggregate demand/aggregate supply model, an increase in a country's sustainable potential output is represented by an increase in

* actual unemployment.
* aggregate demand.
* prices.
* long-run aggregate supply.

That answer is incorrect.
Correct answer:
long-run aggregate supply.

Only increase in the country's long run aggregate supply are counted as increases in the country's sustainable potential output. Short run increases beyond the full employment level are not sustainable.

An oil shock causes production to be more expensive. Assuming no change in income, would this cause inflation?

 * Yes, because producers would pass new costs onto consumers
 * Yes, because higher costs result in less production and lead to higher prices
 * Not enough information is given to make a determination
 * No, because if only oil prices rise this would not fit the definition of pervasively higher prices
 * Yes, because oil alone would result in an increase in CPI

That answer is incorrect.
Correct answer:
Yes, because higher costs result in less production and lead to higher prices

If an increase in oil prices resulted in higher cost curves for firms, this would decrease the level of output. Assuming no change in income, there would be too many dollars (i.e. income) chasing too few goods (i.e. production). Although it may be tempting to say that costs are being "passed on" to consumers, this explanation is not economically viable. If demand for the product would support a higher price, then firms would have been charging a higher price prior to the oil shock and reaping higher profits.

Which of the following is/may be caused by deficit spending?

 * shift in the aggregate supply curve
 * decline in aggregate demand
 * currency appreciation
 * rise in exported savings
 * disinflation

That answer is incorrect.
Correct answer:
currency appreciation

Currency appreciation tends to occur when interest rates rise. Since deficit spending results in an increase in rates, the value of the local currency in foreign markets also tends to rise.

Structural unemployment refers to the unemployment due to:

 * constant changes in the economy which make some skills obsolete.
 * characteristics of the economy which prevent a matching of jobs and skills.
 * strikes caused by unionization.
 * business downturn and falling profits.

That answer is incorrect.
Correct answer:
characteristics of the economy which prevent a matching of jobs and skills.

Changes due to technology, public policy or demands in the market place lead to people with outdated skills or skills which do not match the jobs being offered. This feature of an economy leads to "structural unemployment."

You buy 50 shares of stock in a telecommunications company for $20 a share and pay $100 commission. How much will this transaction add to GDP?

 * $1,100
 * $100
 * $1,100 plus any dividend paid by the company during the year
 * $1,000
 * zero

That answer is incorrect.
Correct answer:
$100

Financial transactions and income transfers are excluded because they are not additions to current output. The commission is included in the calculation of GDP because it represents a service that was generated during the current period.

An economy is currently in a state of equilibrium, at full employment. If a sudden supply shock were to increase aggregate supply, which of the following effects will occur in the short run?

I. Real interest rates will decline.
II. Prices will fall.
III. Aggregate demand will increase.
IV. The demand curve will shift to the right.

 * II & III
 * I, II, III & IV
 * I, II & III
 * I & III

That answer is incorrect.
Correct answer:
I, II & III

The increase in the aggregate supply curve will be represented by a movement of the supply curve to the right. In the short run, this will cause a decline in prices since the demand curve does not move. Unemployment will fall below the natural rate and aggregate output will rise to accommodate the increased aggregate demand. The total disposable income in the economy will increase, part of which will end up as increased savings. This will increase the supply of loanable funds, lowering interest rates in the short run.

When the expenditure approach is used to measure GDP, the major components of GDP are

 * consumption, investment, indirect business taxes and depreciation.
 * employee compensation, rents, interest, self-employment income and corporate profits.
 * consumption, investment, government purchases and net exports.
 * employee compensation, corporate profits, depreciation and indirect business taxes.

That answer is incorrect.
Correct answer:
consumption, investment, government purchases and net exports.

When GDP is derived by the expenditure approach there are four components: personal consumption expenditures, gross domestic private investment, government consumption and gross investment and net exports to foreigners.

If the consumer price index (CPI) was 131 at year-end 1990 and 125 at year-end 1989, then inflation during 1990 was

* zero; prices were stable during 1990.
* 125 percent.
* 131 percent.
* 4.8 percent.
* 6.0 percent.

That answer is incorrect.
Correct answer:
4.8 percent.

Inflation is calculated as: I = (131-125)/(125) = .048 or 4.8%.

Which of the following will most likely result in an increase in the per capita GDP of a country?

* an increase in population
* an increase in youthful workers as a proportion of the labor force
* an increase in the GDP deflator
* improvement in the average skill level of the labor force
* an increase in the number of retired workers

That answer is incorrect.
Correct answer:
improvement in the average skill level of the labor force

Increases in education, training and skill-enhancing experience can improve the quality of the labor force and thereby expand the supply of human resources, This could cause the cost of resources to decline (permanently) and expand long run sustainable output. This implies that per capita GDP will also increase.

Which one of the following would most likely increase aggregate supply?

* a decrease in private saving
* an increase in the nation's investment rate
* an increase in the minimum wage
* an increase in the world price of an imported resource

That answer is incorrect.
Correct answer:
an increase in the nation's investment rate

An increase in the rate of investment will cause economic growth and will shift the economy's long run aggregate supply curve to the right. Investment increases the productive capacity of the economy and thus allows a higher level of output to be produced in the long-term.

In year 0, $1 could purchase a certain basket of goods. In year 6, the identical basket of goods cost $1.15. What was the inflation rate during this period?

 * 15.0%
 * 9.3%
 * 6.1%
 * 2.4%
 * 1.5%

That answer is correct!

Prices over this period have risen 15% (1.15/1.00), therefore total inflation has been 15%

Within the aggregate demand/aggregate supply model, how does an economy adjust to an output beyond the economy's long-run capacity that results from an unanticipated increase in aggregate demand?

 * Long-run aggregate supply increases, leading to a new equilibrium at a lower price level.
 * A higher real interest rate reduces aggregate demand and restores equilibrium at the initial price level.
 * Wage rates and resource prices rise, causing a decrease in aggregate demand and the restoration of equilibrium at a higher price level.
 * A lower real interest rate leads to an expansion in short-run aggregate supply and restoration of equilibrium at a lower price level.
 * Increasing wage rates and resource prices reduce the SRAS and restore equilibrium at a higher price level.

That answer is incorrect.
Correct answer:
Increasing wage rates and resource prices reduce the SRAS and restore equilibrium at a higher price level.

Output beyond the economy's full employment potential will experience increases prices in the market for resources (due to strong demand). This will mean higher costs and will cause aggregate supply to contact. Equilibrium will be restored at a higher price level at the output level consistent with full employment.

In defining the money supply (M1), economists exclude savings deposits on the grounds that

* savings deposits are liabilities of commercial banks, whereas checkable deposits are assets of the banks.
* savings deposits are not generally used as a means of payment.
* the purchasing power of savings deposits is much less stable than that of checkable deposits and currency.
* savings deposits are a form of investment and thus a better store of value than money.

That answer is incorrect.
Correct answer:
savings deposits are not generally used as a means of payment.

M1 focuses on the function of money as a medium of exchange and therefore includes only assets that are directly used that way (i.e., currency in circulation, demand deposits, other checkable deposits or depository institutions and travelers' checks).

In year 1, the nation of Economica has no government debt, production is at potential, the nominal interest rate is 7.2% and the real rate is 5.1%. In year 2, the nominal rate is 8.5% and the real rate is 7.3%. Which of the following would be most likely to cause such a situation?

* Federal budget deficit
* Monetary expansion
* Recession
* Stagflation
* None of these answers is correct

That answer is incorrect.
Correct answer:
None of these answers is correct

In this case, the real rate has risen, but the rate of inflation has actually declined. This is unlikely to occur because of any of these reasons. A monetary expansion would increase the inflation rate, as would a budget deficit. Both a recession and stagflation imply poor economic growth, which would not explain why real rates increased.

A presidential candidate proposes a debt reduction plan, claiming that it would help cure one of the biggest economic problems facing the nation. If the candidate knows fiscal policy, which problem might she be referring to?

* over regulation
* inflation
* surplus consumer savings
* weak infrastructure
* unemployment

That answer is incorrect.
Correct answer:
inflation

Debt reduction implies that the government is spending less than it collects in taxes. This is contractionary fiscal policy, which may be effective in reducing inflation.

You withdraw $100 from your checking account. How does this immediately affect the money supply and the resources of your bank, assuming the bank has more than $100 in excess reserves?

 * There is no change in the money supply and the reserves of your bank decline.
 * The money supply decreases and the reserves of your bank increase.
 * The money supply increases and the reserves of your bank decline.
 * Both money supply and the reserves of your bank increase.

That answer is correct!

The money supply does not immediately change as the result of this withdrawal. The $100 is treated the same whether it is in currency or in the checking account. Since the bank had excess reserves of more than $100, this withdraw does not immediately effect its ability to make loans. If you were to hold the $100 in cash and not spend it or re-deposit it, eventually this would have an adverse effect on the money supply.

According to the Keynesian theory, a discretionary increase in budget deficit:

 * should always be supplemented with a strong monetary policy.
 * is advisable only during economic booms, due to timing problems.
 * should be implemented only during a recession and never when the economy is at full capacity.
 * is necessary to maintain low unemployment levels.

That answer is incorrect.
Correct answer:
should be implemented only during a recession and never when the economy is at full capacity.

A budget deficit implies an increase in governmental expenditure. This increase in aggregate expenditure works well in jump-starting a sluggish economy and move it toward higher output and employment. However, if the economy is already operating at its peak, then such an increase in aggregate demand serves to mainly increase inflation, without much impact on real output. So Keynesian suggest a discretionary increase in budgetary deficit only during recessive conditions.

In the Keynesian model, pessimism on the part of business decision makers can cause income to fall because

 * business saving increases and the multiplier magnifies this increase, resulting in an increase in national income.
 * investment is likely to decrease, igniting the multiplier reaction and decreasing the equilibrium income.
 * such pessimism will also cause the multiplier to fall.
 * consumers, affected by this pessimism, increase their consumption, thus starting a chain reaction.

That answer is incorrect.
Correct answer:
investment is likely to decrease, igniting the multiplier reaction and decreasing the equilibrium income.

Pessimism among decision makers will cause private investment to contract. This will affect other sectors of the economy, specifically, aggregate demand will fall along with income.

________ policy tends to move the economy in an opposite direction from the forces of the business cycle.

 * Expansionary
 * Automatic
 * None of these answers
 * Contractionary
 * Counter-cyclical

That answer is incorrect.
Correct answer:
Counter-cyclical

Counter-cyclical policy is used to stimulate demand during a contraction in the business cycle and is used to restrain demand during an expansionary phase. Such a policy is used to counteract an economic disruption such as inflation or a recession.

If the full impact of a contractionary demand-stimulus policy is completely anticipated, the primary impact of the policy will be on:

 * inflation.
 * real interest rates.
 * total output.
 * total employment.

That answer is correct!

If the buyers and sellers in the resource market completely anticipate the effects of a decrease in demand, then they will correctly forecast the lower future inflation. This will prompt buyers to postpone current consumption and wait till prices drop. On the other hand, suppliers would prefer to sell today, while prices are high, instead of waiting till the prices fall. The demand curve will therefore quickly move to the left and the supply curve will move to the right. An equilibrium will be reached at a lower price which leaves the real quantities unaffected, changing only the nominal variables.

Both the empirical evidence and the AD-AS model indicate that during an economic recession

 * real wage rates increase rapidly and the real interest rate tends to fall.
 * real wage rates increase rapidly and the real interest rate tends to rise.
 * real wage rates decline (or increase quite slowly) and the real interest rate tends to rise.
 * real wage rates decline (or increase quite slowly) and the real interest rate tends to fall.

That answer is incorrect.
Correct answer:

real wage rates decline (or increase quite slowly) and the real interest rate tends to fall.

The price of resources used in production fall during an economic recession because demand for these resources is low. This suggests that the real wage rate declines during such periods. Empirical evidence shows that the real interest rate decreases during economic recessions; this is one of the self correcting mechanisms of the economy.

The crowding out effect refers to the fact that a greater government presence in the markets:

 * all of these answers.
 * squeezes out small businesses.
 * raises real interest rate, crowding out private investment.
 * increases aggregate demand.

That answer is incorrect.
Correct answer:
raises real interest rate, crowding out private investment.

When the government borrows in the open market by issuing bonds, the demand for loanable funds increases, increasing the real interest rates. This leads to private businesses competing for funds at higher rates, crowding out some of them.

Under adaptive expectations hypothesis, an unexpected shift to a more expansionary monetary policy will:

 * permanently reduce unemployment rate.
 * has no effect in the short or the long run.
 * reduce unemployment in the long run only.
 * reduce unemployment in the short run only.

That answer is incorrect.
Correct answer:
reduce unemployment in the short run only.

According to the Adaptive Expectations hypothesis, people consider the recent past as the best predictor of the immediate future. Therefore, when the expansionary policy leads to higher inflation, workers using adaptive expectations will underestimate the future inflation. Hence, they will get into wage contracts that will under-compensate for the higher inflation. Over a short run, this will lead to improved profit margins for businesses, who will expand the output by utilizing more resources. In the short run, unemployment rate will fall.

The quantity theory equation can also be written in terms of ________.

 * none of these answers
 * the demand for money
 * growth rates
 * cash balances
 * intermediate outputs

* all of these answers

That answer is incorrect.
Correct answer:
growth rates

The quantity theory equation can be rewritten in the following way: Growth of real output + rate of inflation Growth rate of the money supply + Growth rate of velocity.

In year 0, $1,000 could purchase a certain basket of goods. In year 20, the identical basket of goods cost $2,191. What was the average annualized inflation rate during this period?

* 4.00%
* 3.12%
* 7.88%
* 8.21%
* 5.67%

That answer is correct!

The calculation is as follows: (2,191/1,000)^(1/20)-1=0.0400

Which of the following best describes the Keynesian view of the interrelationships among total output, spending and the general level of prices?

* Prices decrease until full employment is reached; at this point, any additional spending is inflationary.
* Increases in spending will increase real output when the economy is operating below capacity, but result in inflation at spending levels beyond capacity.
* Spending and output are directly related, but spending and prices are related inversely.
* Output, spending and prices all increase in specific proportion.

That answer is incorrect.
Correct answer:
Increases in spending will increase real output when the economy is operating below capacity, but result in inflation at spending levels beyond capacity.

When the economy operates below full employment capacity, increases in aggregate demand (and therefore output) will have little effect on the price level. this is why the SRAS is flat until full employment is reached. Once full employment is reached, prices will increase under increases in aggregate demand (and output).

After an extended period of steady inflation at a constant rate, people will

* actual unemployment will be less than natural unemployment.
* actual unemployment will approximate the natural unemployment rate.
* anticipate inflation.

* anticipate inflation and actual unemployment will approximate the natural unemployment rate.

That answer is incorrect.
Correct answer:
anticipate inflation and actual unemployment will approximate the natural unemployment rate.

Steady inflation over time allows people to anticipate correctly the actual inflation rate. Under these conditions, the actual and natural rate of unemployment will be the same.

The Central Bank decides to have the money supply increase by exactly 5% each year. If the money multiplier increases how will this impact the Central Bank's activities?

* the Central Bank will be forced to increase the monetary base by a greater degree
* it will not increase the monetary base by as much
* the Central Bank will still increase the monetary base by 5%
* the Central Bank would be forced to change the reserve requirement to maintain the 5% policy rule
* impossible to determine

That answer is incorrect.
Correct answer:
it will not increase the monetary base by as much

The money supply increases by the increase in the monetary base times the money multiplier. If the money multiplier changes, the Central Bank must adjust how much it changes the monetary base to have the same end effect on the money supply.

Leading economists predict that in one year's time, GDP will be 5% below potential. Congress considers a fiscal stimulus package to help avert this problem. Assume that it will take one year for the full impact of the stimulus to take effect. Which of the following problems might still prevent the measure from improving the economic outlook?

* multiplier effect
* recognition lag
* impact lag
* public choice problem
* Keynesian Cross

That answer is incorrect.
Correct answer:
recognition lag

Recognition lag is the time it takes from the recognition of an economic problem to the enactment and implementation of a fiscal solution. Since the question assumes that impact lag will be one year, recognition lag will probably prevent the fiscal stimulus from being particularly timely.

"Demand creates its own supply." This statement is essentially true

* when the economy operates at its full-employment, supply-constrained output.
* for outputs beyond the economy's full-employment supply constraint.
* when the aggregate supply curve is vertical.
* for the Keynesian range of the aggregate supply curve.

That answer is incorrect.
Correct answer:
for the Keynesian range of the aggregate supply curve.

Keynes considered aggregate demand to be the catalyst for supply. Thus, increases in aggregate demand would be accommodated by increases in supply and vice versa. Therefore, in a sense, demand creates its own supply.

Under Rational Expectations, decision makers will ________ the future inflation rate when inflation is falling.

* underestimate
* sometimes overestimate and sometimes underestimate
* correctly anticipate
* overestimate

That answer is incorrect.
Correct answer:
sometimes overestimate and sometimes underestimate

The Rational Expectations hypothesis postulates that decision makers are not completely swayed by the recent past alone. Rather, they analyze the possible future impact of policy variables and make their decisions accordingly. While they may not accurately predict the outcomes of current and anticipated changes in policy, they will also not systematically under- or over-estimate the effects. Thus, the errors they commit will be random. The predicted future inflation rate will sometimes exceed and sometimes be lower than the actual, realized rate.

The government borrows to fund a series of public works projects. Consumers generally believe taxes will be increased in the near future to pay for these projects. Which of the following are likely to increase due to this fiscal policy measure?

I. marginal propensity to save
II. real GDP
III. inflation

* none of these answers is correct
* II, III
* I, II
* I, II, III
* I only
* III only

That answer is incorrect.
Correct answer:
I only

Consumers anticipate higher taxes in the future, and will probably increase their savings rate to compensate. We would not expect real GDP to increase, as what was gained by government funded production will be lost as consumers spend less. There is also no real reason for inflation to increase, as there has been no overall increase in aggregate demand. As a fiscal policy measure, this would have failed to increase income.

When the Federal Reserve purchases government bonds, this is essentially the same as

 * restrictive monetary policy.
 * a reduction in prices.
 * a reduction in inflation.
 * printing money.

That answer is incorrect.
Correct answer:
printing money.

The government purchase of bonds infuses the economy with money since the Fed replaces bonds held by the public with money. This action has essentially the same effect of printing money since both increase the money supply.

First National Bank currently does not have the legally required cash reserves on hand. The bank expects this situation will only last a day or two. In order to rectify the reserve problem, the bank treasurer borrows cash on the intra-bank loan market. Main Street bank has excess reserves and wants to loan cash on the intra-bank market. The Central Bank steps in and buys First National's loan at a lower rate than Main Street offered. Main Street must now decide whether to loan in the intra-bank market at a lower rate than they expected, or else increase their traditional loan portfolio (i.e. mortgages, business loans, etc.).

Under which of these two scenarios would the money supply increase?

 * intra-bank loan only
 * impossible to determine
 * either
 * traditional loan only
 * neither

That answer is incorrect.
Correct answer:
either

In this case Main Street bank could either choose to lend their excess reserves to other banks at a lower rate or else increase their traditional loan portfolio. Regardless, the money supply will increase, because the Central Bank's actions have already increased bank reserves overall, and this cash will eventually be lent into the economy.

The Fed has imposed a reserve requirement of 15% on commercial banks. If the monetary base equals 20 billion dollars, the money supply equals ________.

* none of these answers
* 20 billion
* 133 billion
* 3 billion

That answer is incorrect.
Correct answer:
133 billion

The money supply equals the monetary base divided by the reserve requirement. Hence, the money supply equals 20/0.15 = 133.33 billion dollars.

If the money velocity is 3 and the nominal GDP is $150 million, then the stock of money in circulation is

* $5 million.
* $450 million.
* $50 million.
* $150 million.

That answer is incorrect.
Correct answer:
$50 million.

Velocity of money is defined as GDP divided by the stock of money. Thus, we need to solve for M if 3=$150 million/M. This implies that M=$50 million.

The GDP of a country has been calculated at 4,300. The income earned by its citizens abroad equals 235 while the income earned by foreigners in the country equals 169. The personal consumption amounted to 2,100 while government investments in public goods were 1,400. The GNP of the country equals ________.

* 4,234
* 5,219
* 7,734
* 4,366

That answer is incorrect.
Correct answer:
4,366

GNP = GDP + income earned by citizens living abroad - income earned by foreigners living inside the country = 4,300 + 235 - 169 = 4,366.

Which of the following transactions would be included in this year's GDP?

* Jones purchases a five-year-old house from Smith.
* Jones purchases 100 shares of AT&T stock from Smith.
* Jones purchases an antique at Smith's garage sale.
* Jones rents a five-year-old house from Smith.

That answer is incorrect.
Correct answer:
Jones rents a five-year-old house from Smith.

GDP is the total market value of all final goods and services produced domestically during a specific period. Rent is considered a payment for housing services and if it is domestically generated (the property is on American soil) it contributes positively to GDP.

Price stability is desirable because

* inflation increases the purchasing power of money.
* it helps creditors at the expense of debtors.
* inflation creates uncertainty, making it difficult to plan.
* it increases the profitability of the Fed.
* it helps debtors at the expense of creditors.

That answer is incorrect.
Correct answer:
inflation creates uncertainty, making it difficult to plan.

Inflation introduces uncertainty into long-term contracts with fixed interest rates. This is because if inflation is higher than expected, the real value of the loan will diminish. When the rate of inflation is high and variable, it will be impossible for decision makers to anticipate future rates accurately and long range planning will be extremely difficult. Given the uncertainty that inflation creates, many decision makers will forgo capital investments and other transactions involving long-term commitments when the rate of inflation is highly variable and therefore unpredictable.

An economy is currently in a state of full employment equilibrium. If an unexpected and permanent reduction in aggregate demand were to occur, which of the following effects will be seen in the long run?

* In the short run, the economy will slow.
* In the short run, prices will increase.
* none of these answers.
* Over the long run, resource prices will increase.

That answer is correct!

The downward demand shock moves the aggregate demand curve to the left. The supply curve does not move in the short run, leading to a reduction in price levels. Profit margins fall and firms cut back on production. Total employment falls and a short-term slowdown ensues. Over time, resource prices fall to adjust to the new economic conditions, causing the supply curve to move to the right. This leads to a further decline in prices and equilibrium is restored at full employment level with the output back up to the level of the potential GDP.

Congress passes a law that requires government spending rise each year by exactly the growth rate of GDP. The year the law was passed the budget was balanced, inflation was moderate, and unemployment was at the natural rate. Assuming tax policy remains constant, which of the following statements would be true?

 * During a boom, this law may help to fuel inflation.
 * This law will have very little impact on the economy.
 * This law will cause inflation to be more consistent, since monetary expansions will become more predictable.
 * Such laws are called automatic monetary policy tools.
 * During a recession, this law will help prevent widespread unemployment.

That answer is incorrect.
Correct answer:
This law will have very little impact on the economy.

This law would basically cause government spending and income to be roughly the same. We think of GDP as a measure of national income, therefore if the growth rate of GDP is high, then tax receipts will increasing also. Such a law would allow the government to increase spending in this circumstance. This law would basically be neutral fiscal policy, having little impact on the economy.

If income increases from $20,000 to $24,000 and consumption from $18,000 to $21,000, then the marginal propensity to consume is ________.

 * 0.90
 * 3.0
 * 0.75
 * 0.875

That answer is incorrect.
Correct answer:
0.75

Since the MPC is determined according to the ratio: MPC = additional consumption divided by additional income, the MPC here equals: 3,000/4,000 = .75.

If the central bank wishes to slow price growth, it would attempt to ________ the money supply by ________ short-term interest rates.

 * stabilize, increasing
 * decrease, increasing
 * increase, increasing
 * stabilize, decreasing
 * increase, decreasing
 * decrease, decreasing
 * stabilize, stabilizing

That answer is incorrect.

Correct answer:
decrease, increasing

The central bank would decrease the money supply in an attempt to slow inflation. This can be accomplished by increasing short-term rates.

The table below shows tax revenue and national income for the country of Economica over a five year period. Economic has a progressive tax system. Assume that the number of tax payers remains constant and government spending does not change.

Year	Tax Revenue	# of Taxpayers in top bracket	GDP
1	1,248	578	4,221
2	1,412	623	4,348
3	1,501	650	4,412
4	1,425	614	4,280
5	1,396	583	4,237

What does the graph above insinuate about Economica's progressive tax system?

* It serves as an automatic stabilizer.
* No conclusion can be drawn.
* Economica is benefiting from supply-side effects.
* It is hindering economic growth, suggesting a crowding out effect.
* Economica is suffering from "bracket-creep" due to inflation.

That answer is correct!

Since we know that government spending is constant, we know that lower tax revenues will cause an increase in deficit spending. We can also see that as GDP grows (falls), more (fewer) tax payers are in the top tax bracket. This illustrates how a progressive tax system serves as an automatic stabilizer for Economica.

Which of the following would cause the prices to fall in the long run and increase aggregate output?

* Increased productivity per worker.
* An increase in money supply.
* all of these answers.
* A decrease in expected rate of inflation.

That answer is correct!

The LRAS is affected only by factors that affect real quantities, not nominal variables.

The average number of times a dollar is used to purchase a final product or service during a year is the ________.

* velocity of money

 * relative reserve ratio
 * opportunity cost of holding money
 * equation of exchange

That answer is correct!

The velocity of money is equal to GDP divided by the stock of money. It is a rough measure of the number of times that each dollar is used to purchase final goods or services during one year.

A large corporation works just as hard to restrain its unnecessary cash and demand-deposit balances as it does to keep down unnecessary inventories of goods. This is because

 * cost is incurred in terms of sacrificed interest when funds are held in the form of cash and demand deposits.
 * holding unnecessary cash and demand deposits leads to an increase in the money supply, a known cause of inflation.
 * cost is incurred in terms of decreased flexibility when funds are held in the form of cash and demand deposits.
 * holding unnecessary cash and demand deposits leads to a decrease in the money supply, a known cause of recession.

That answer is correct!

The "cost" of holding excess cash is the interest that money could be earning in an interest-bearing account. Thus, firms will reduce their excess cash since such money is losing the opportunity to earn a positive return.

When the disposable income equals 300, consumption equals 235. When the disposable income increases to 310, consumption increases to 240. In this economy, an initial expenditure of 100 will cause the real GDP to increase by:

 * 50
 * 375
 * 239
 * 200

That answer is incorrect.
Correct answer:
200

The expenditure multiplier is directly linked to the "marginal propensity to consume" (MPC), which reflects the amount of each additional dollar in income that is spent on current consumption. In this case, the MPC equals (240 - 235)/(310 - 300) = 0.5. The ideal expenditure multiplier equals 1/(1-MPC); here it equals 1/(1-0.5) = 2. Therefore, a initial expenditure of 100 will ideally increase the real GDP by 200.

If the money supply is increased with no immediate change in production, what results?

* lower interest rates
* an increase in GDP
* inflation
* higher real interest rates
* a decrease in unemployment

That answer is incorrect.
Correct answer:
inflation

The circumstances described would cause inflation, as there would be too many dollars (i.e. money supply) chasing too few goods (i.e. production). Note that although intentionally increasing the money supply is sometimes used in an attempt to increase GDP and decrease unemployment, the question states there is no change in production and therefore these effects cannot possibly follow.

When the Keynesian aggregate expenditure model is presented graphically, the marginal propensity to consume is

* the intercept of the aggregate consumption function line with the 45-degree line.
* the height of the aggregate consumption function line.
* the slope of the aggregate consumption function line.
* the slope of the aggregate saving function line.
* always equal to one.

That answer is incorrect.
Correct answer:
the slope of the aggregate consumption function line.

The MPC is determined according to the ratio: MPC = additional consumption divided by additional income. Therefore the slope of the consumption function is the MPC since it represents how much consumption will increase for a given increase in income.

If an economy is operating in a range where its aggregate supply curve is flat (horizontal), then

* a reduction in aggregate demand will lead to both a lower price level and less real output.
* the economy must be at or near its full-employment output.
* an increase in aggregate demand will lead to an increase in real GDP without any increase in prices.
* an increase in aggregate demand will expand nominal GDP but not real GDP.

That answer is incorrect.
Correct answer:
an increase in aggregate demand will lead to an increase in real GDP without any increase in prices.

Below the full employment capacity of the economy, increases in aggregate supply have little effect on the price level. This is the result of the Keynesian assumption that at less than full employment output levels, prices and wages are fixed since they are inflexible in a downward direction.

The Central Bank publicly declares that it will attempt to increase the money supply by exactly 5% each year. Which of the following might this policy cause?

I.   consistent price increases
II. short-term production increases
III. variable levels of new currency issuance

 * I, II, III
 * I, III
 * II, III
 * I only
 * I, II
 * III only

That answer is incorrect.
Correct answer:
I, III

The price level would most likely increase by about 5% each year. The Central Bank would not issue the same amount of new currency each year, because the money multiplier might change from year to year. Remember that the increase in the money supply is equal to the increase in the monetary base (i.e. currency issued) times the money multiplier.

Monetary policy can be used to promote short-term growth if producers and consumers can be mislead by higher prices and more nominal income. However, if the inflation rate is very consistent, producers and consumers will not react to price increases unless they exceed the normal 5% level. Therefore a constant growth policy will have no impact on national income.

An earthquake recently caused estimated total damages of about 8 billion dollars. By the year end, 3 billion dollars worth of damage had been repaired. The GDP for the year,

 * will include the 3 billion dollar repairs but not subtract the 8 billion in damages.
 * will include the 3 billion dollar repairs and subtract the 8 billion in damages.
 * will exclude the 3 billion dollar repairs and subtract the 8 billion in damages.
 * will exclude the 3 billion dollar repairs but not subtract the 8 billion in damages.

That answer is correct!

You should remember that GDP is a flow concept. It measures the total final value of goods and services created during a period but does not represent the total value of the economy itself. To illustrate with an analogy, if a nation is likened to a firm, then its GDP is analogous to the earnings and not to the net equity of the firm. The 8 billion dollar damage leads to a reduction in the "equity" of the nation but not to the "earnings of the nation; the rebuilding activity contributes $3 billion to the GDP. It should be noted, however, that depreciation of goods used up in productive active do reduce the GDP, just as they reduce earnings.

Cyclical unemployment is a result of

 * a downturn in economic activity.
 * insufficient employment in the building trades.
 * an inadequate matching of qualified workers and available jobs.

* not enough employees to fill available jobs.
* inaccurate and/or costly information about job opportunities.

That answer is correct!

Cyclical unemployment occurs when there is a general downturn in business activity. Fewer goods are being produced so that fewer workers are required to produce them. Employers lay off workers and cut back employment.

Use the table below to choose the correct answer.

Time period	Observed rate of inflation
1	5 percent
2	5 percent
3	8 percent
4	10 percent

According to the adaptive expectations hypothesis, at the beginning of period 3, decision makers would expect inflation during period 3 to be ________.

* 8 percent
* 7.5 percent
* 2.5 percent
* 5 percent
* 10 percent

That answer is incorrect.
Correct answer:
5 percent

Under the adaptive expectations hypothesis economic agents base their future expectations on actual outcomes observed during recent periods. Thus, the most recent periods suggest an inflation rate of 5 percent will persist in the future.

According to Keynesian theory, which of the following would most likely stimulate an expansion in real output if the economy were in a recession?

* a budget surplus
* an increase in tax rates
* a budget deficit
* a balanced budget

That answer is incorrect.
Correct answer:
a budget deficit

Government budget deficits will stimulate an expansion in real output under a recession since increased government expenditure and reduced taxation stimulate aggregate demand.

Which of the following will most likely accompany an unanticipated increase in aggregate demand?

* a decrease in prices
* an increase in unemployment
* a decrease in real GDP
* an increase in real GDP
* a decrease in resource prices

That answer is incorrect.
Correct answer:
an increase in real GDP

An unanticipated increase in aggregate demand causes prices to rise in the short run and a temporary increase of output beyond the full employment potential. There will be an increase in real GDP above the economy's long run potential, that is temporary. It lasts only until there is an opportunity to alter the temporarily fixed resource prices upward.

According to Say's law,

* demand creates its own supply.
* consumption remains relatively stable over a business cycle.
* production creates its own demand.
* production creates its own demand and demand creates its own supply.

That answer is incorrect.
Correct answer:
production creates its own demand.

The 19th century French economist, J. B. Say, believed that there was no such thing as "overproduction." People would consume whatever was produced, so that supply would create its own demand. The argument proffered was that production of goods created purchasing power for producers, who would then use it in their role as consumers to purchase whatever was available. Clearly, Say missed the fact that people get satiated at some point and in any case, try to store the purchasing power for future use.

An increase in the velocity of money will tend to promote additional spending when

* the price level decreases.
* monetary policy shifts are dampened as the result of changes in interest rates.
* the money supply expands more rapidly.
* expansionary policy leads to inflation and lower real interest rates.

That answer is incorrect.
Correct answer:
expansionary policy leads to inflation and lower real interest rates.

An increase in the velocity of money refers to an increase in the average number of times that each dollar is used to purchase final goods and services during the year. Such an increase promotes additional spending under expansionary monetary policy since individuals hold excess money balances-thus they either consume (which drives prices upward) or they invest/save (which increases the supply of loanable funds and therefore decreases the real interest rate).

Which of the following will most likely accompany an unanticipated reduction in aggregate demand?

* a decrease in employment
* a decrease in unemployment
* an increase in real GDP
* an increase in prices

That answer is correct!

The short run impact of an unanticipated reduction in aggregate demand is a decline in output, a decline in profit margins and an increase in unemployment above its natural rate.

If an economy operates at a short-run equilibrium output that exceeds its long-run capacity, which of the following will be most likely to occur?

* Real output will increase, causing an increase in long-run aggregate supply.
* Resource prices will rise, causing the SRAS curve to shift to the left.
* The unemployment rate will rise, causing the economy's aggregate supply constraint to shift to the right.
* Interest rates will fall.

That answer is incorrect.
Correct answer:
Resource prices will rise, causing the SRAS curve to shift to the left.

Strong demand accompanying an economic boom will increase both real interest rates and the real prices of resources. This will serve to contract aggregate supply closer to the economy's maximum sustainable output.

During an economic boom, the actual unemployment rate is generally

* equal to between 9 percent and 10 percent of the labor force.
* equal to the natural unemployment.
* greater than the natural unemployment.
* less than the natural unemployment.

That answer is incorrect.
Correct answer:
less than the natural unemployment.

The actual rate of unemployment will be lower than the natural rate of unemployment during an economic boom because such a time is characterized by rapid growth in GDP and consequently, increased aggregate demand for labor.

Which of the following will most likely occur during the contraction phase of a business cycle?

* GDP rises sharply and unemployment falls.
* Interest rates rise and the number of housing starts declines.
* Real GDP declines and unemployment rises.
* Inflation rises and employment falls.
* Real GDP increases and inflation rises sharply.

That answer is incorrect.
Correct answer:
Real GDP declines and unemployment rises.

During a contraction phase of a business cycle, sales of most businesses fall, real GDP grows at a slow rate or even declines and unemployment in the aggregate labor market increases.

Within the Keynesian aggregate expenditure model, an unexpected decline in spending will

* increase the demand for goods and services.
* raise business inventories and lead to a decline in output.
* lead to a lower price level, which will quickly guide the economy to full-employment equilibrium.
* lead to lower interest rates, which will stimulate aggregate demand and keep the economy at full employment.

That answer is incorrect.
Correct answer:
raise business inventories and lead to a decline in output.

If aggregate demand falls due to a decline in spending unanticipated inventory investment will occur and business owners will contract production.

In the U.S., which statement best characterizes the labor force participation rates of men and women over the past three decades?

* The participation rate of women has increased while the participation rate of men has decreased.
* They have increased.
* The participation rate of women has decreased while the participation rate of men has increased.
* They have decreased.

That answer is correct!

The labor force participation rate for women as steadily increased since 1948 while the rate for men has been declining.

A government budget deficit will lead to higher real interest rates if

 * Individuals anticipate a future tax increase.
 * The increase in aggregate demand causes the price level to rise.
 * The deficit does not create an economic stimulus.
 * None of these answers is correct.
 * The deficit requires debt issuance.

That answer is incorrect.
Correct answer:
None of these answers is correct.

A government budget deficit will always lead to higher interest rates, all else equal. Although we typically think of the government as financing deficit spending with debt issuance, it is important to note that the economic effect is the same even if the deficit was financed with cash reserves. If the government has cash reserves, this is basically savings, which creates supply of loanable funds. If some of the reserves are spent, this is equivalent to a decrease in loanable funds supply, which would lead to a price (i.e. interest rate) increase.

Which of the following is/are true?

I. Robberies decrease GDP.
II. Payments for professional house cleaning services increase GDP.
III. Payments made to a telemarketer who did not make any sales increase GDP.
IV. Payment made on a lost bet between friends decrease GDP.

 * II & IV
 * II & III
 * I, II & III
 * II only

That answer is incorrect.
Correct answer:
II & III

Robberies and payments on lost bets represent simple wealth transfers without adding to the productive output of the society. On the other hand, telemarketers who do not make any sales are still providing services - even if annoying at times - which represent productive activity.

Mr. Jones purchases a newly constructed house. His spending on the house is included in GDP as a part of

 * personal consumption expenditures.
 * investment.
 * personal saving.
 * inventories.
 * capital consumption allowance.

That answer is incorrect.
Correct answer:

investment.

Investment refers to the flow of expenditures on durable assets. This is referred to as fixed investment. Housing represents a durable asset because it provides a stream of services long into the future.

The crowding-out model implies that restrictive fiscal policy will

 * be highly effective against inflation.
 * increase aggregate demand and employment.
 * decrease aggregate demand and lead to a significant increase in unemployment.
 * reduce the real rate of interest.

That answer is incorrect.
Correct answer:
reduce the real rate of interest.

Restrictive fiscal policy involves a contraction of government spending and therefore zero to negative budget deficits. The crowding out model implies that heavy government borrowing drives up the real rate of interest as the government competes with the private sector for loanable funds. Under restriction fiscal policy then, the real interest rate would be expected to fall as the government is not competing in the market for loanable funds.

Which one of the following persons would be considered employed?

 * a full-time college student
 * a blacksmith who has quit looking for work after 18 months without a job
 * a high school student working at a fast-food restaurant
 * an auto worker vacationing in Florida during the layoff period, before production of new models begins next month
 * a retiree living off Social Security income benefits

That answer is incorrect.
Correct answer:
a high school student working at a fast-food restaurant

A person who is not actively searching for work is not considered unemployed; a person who is not working, however, is not considered employed. The only person characterized as employed above is the high school student because he works more than one hour per week.

In the Keynesian model, unemployment

 * can be reduced by decreasing taxes or increasing government spending.
 * is primarily the result of the federal government's failure to balance its budget.
 * is not a problem since it implies a redistribution of income with no effect on GDP.
 * automatically leads to inflation.

That answer is correct!

Decreasing taxes increases consumer disposable incomes and thus stimulates aggregate demand. Increased aggregate demand reduces unemployment. Similarly, an increase in government expenditures stimulates aggregate demand which reduces unemployment.

Which of the following recent developments may distort the meaning of aggregate money supply measurements, such as M1 or M2, in the United States?

I.   The U.S. dollar is widely used by foreign governments as a reserve
II. Individuals have increasingly been using mutual funds as an alternative to bank time deposits
III. Unusually large stock market gains created a wealth effect

 * III only
 * I only
 * II only
 * I, II, III
 * I, III
 * I, II

That answer is incorrect.
Correct answer:
I, II

Currency that is held by foreign governments as reserve is still counted as part of the money supply, but will not be used domestically for the purchase of goods. Therefore it is technically still money, but has ceased to function as such.

Most forms of time deposits, such as savings accounts and CD's, are part of some money supply measure. As mutual funds become more popular, use of time deposits has declined. Not only does this shift directly impact money supply measures, but also changes bank reserve requirements. Although this changes the money supply measure, it has not really changed the way the money would have been used, i.e. money invested in a CD or a mutual fund would probably not have been used for making purchases in the near-term regardless.

The Dual Deficit theory postulates that budget deficits and trade deficits are linked. Which of the following impacts of a budget deficit is not linked to a trade deficit?

 * increase in foreign investment
 * currency appreciation
 * importation of savings
 * rising interest rates
 * increase in nominal output

That answer is incorrect.
Correct answer:
increase in nominal output

A budget deficit causes interest rates to rise, which causes the local currency to appreciate on the foreign exchange market. This causes the local cost of foreign goods to decrease and the foreign cost of local goods to increase, hence the trade deficit widens.

The debt incurred to finance deficit spending is, in effect, negative savings. Since net savings cannot be negative, where debt is increased, savings must also increase. This savings might be imported in the form of foreign investment. Since currency flows must net to zero, where foreign investment occurs, consumption of foreign goods will increase. Hence the trade deficit widens.

The government currently has no debt. To alleviate an economic slow down, Congress proposes an increase in spending partially offset by an increase in the highest marginal tax rate. This will force the Treasury to issue new debt. According to which of the following economic theories would this fail to stimulate the economy?

I. fiscal policy
II. supply-side
III. crowding out

* II, III
* III only
* none of these answers is correct
* I only
* I, III
* I, II, III

That answer is correct!

Anytime the government runs a deficit, it can be considered a fiscal stimulus. However, since marginal tax rates were increased, the supply-side effect would be negative. The crowding out effect suggests that government borrowing will increase interest rates and partially offset the stimulate effects of the new spending.

Which of the following about restrictive monetary policy is true?

* Open market purchases lead to an excess money supply and a reduction in interest rates.
* Open market purchases lead to an excess money supply and a reduction in the interest rate.
* Open market sales lead to an excess demand for money and an increase in interest rates.
* Open market sales lead to an excess money supply and a reduction in interest rates.

That answer is incorrect.
Correct answer:
Open market sales lead to an excess demand for money and an increase in interest rates.

Restrictive monetary policy leads to a contraction in the money supply. The Fed can achieve this result by selling U.S. securities to the public-thus individuals who previously held money now hold a security. The contraction of the money supply then leads to an increase in the interest rate.

If consumption expenditures are $180, total planned investment is $50, government purchases are $40, exports are $20, imports are $40 and taxes are $25, then aggregate demand must be

* $275.
* $330.
* $250.

 * $225.

That answer is incorrect.
Correct answer:
$250.

Aggregate expenditure is comprised of planned consumption expenditures, planned investment expenditures, planned government expenditures and planned net exports. Thus, $180 + $50 + $40 +($20-$40) = $250.

Economists use the phrase "business cycle" when referring to fluctuations in

 * the various monetary aggregates.
 * interest rates as measured by the prime bank-loan rate.
 * the real output rate of the economy.
 * the general level of prices as measured by the consumer price index.
 * federal budget surpluses or deficits.

That answer is incorrect.
Correct answer:
the real output rate of the economy.

The business cycle refers to swings in the rate of output as the business cycle.

If an economy is experiencing both full employment and price stability, within the Keynesian model a major tax reduction probably would cause a(n)

 * decrease in consumption unless the expected budget deficit is financed by selling bonds to foreigners.
 * increase in unemployment in the near future.
 * increase in the interest rate since individuals will reduce their saving in response to the tax cut.
 * increase in prices unless government expenditures are also reduced.

That answer is incorrect.
Correct answer:
increase in prices unless government expenditures are also reduced.

When the economy is at full employment and prices are stable a decrease in taxation will cause consumer disposable income to rise. Under higher disposable incomes, consumer demand will rise thus increasing aggregate demand. Higher aggregate demand at full employment causes inflation. Thus, a decrease in taxes must be coupled with a decline in government expenditures to counteract the expansionary effect on aggregate demand of decreased taxes.

Within the aggregate expenditure model, what happens if the planned expenditures of consumers, investors, governments and foreigners are less than output?

 * Prices will increase and interest rates will rise.

* Wage rates will increase and unemployment fall.
* Inventories will rise and producers will reduce output.
* Consumption expenditures will increase.

That answer is incorrect.
Correct answer:
Inventories will rise and producers will reduce output.

If the planned expenditures of consumers, investors, governments and foreigners on goods and services were less than expected, then business firms would be unable to sell as much of their current output as they anticipated. Thus, actual inventories would increase as they unintentionally made larger inventory investments than they planned. When firms observe their positive additions to inventory, they will cut back output and draw down their inventories instead.

If the central bank wishes to slow income growth, it would attempt to ________ the money supply by ________ short-term interest rates.

* decrease, increasing
* decrease, decreasing
* stabilize, increasing
* stabilize, decreasing
* stabilize, stabilizing
* increase, increasing
* increase, decreasing

That answer is correct!

The central bank would decrease the money supply in an attempt to slow the growth of the economy. This can be accomplished by increasing short-term rates.

An economy is currently in a state of equilibrium. If a sudden supply shock were to decrease aggregate supply, which of the following effects will occur in the long run?

I. Real interest rates will increase.
II. Prices will remain increase.
III. Aggregate demand will remain unaffected.

* I & III
* III only
* II only
* I, II & III

That answer is incorrect.
Correct answer:
III only

In the long run, since the resource base is not affected, the potential GDP is not affected and the LRAS does not move. Therefore, even though prices rise in the short run due to the decreased supply, they fall back over the long run as resource prices decrease.

When the government implements a restrictive fiscal policy, the trade deficit would tend to ________.

 * increase
 * all of these answers can happen
 * reduce
 * remains unaffected

That answer is incorrect.
Correct answer:
reduce

When the government implements a restrictive fiscal policy, the aggregate demand decreases, lowering prices. Since the demand for loanable funds decreases due to reduced government borrowing, the real interest rate decreases. This causes investment funds to move out of the domestic market into economies which offer higher rates. The domestic currency therefore depreciates in response. The exports become cheaper and imports costlier, causing the trade deficit to decline.

The modern view of the Phillips curve suggests that demand stimulus policies will

 * temporarily reduce prices while leaving unemployment unchanged.
 * permanently reduce unemployment if the economy is initially below full employment.
 * lead to inflation without permanently reducing unemployment.
 * reduce the natural unemployment rate and lead to higher prices.

That answer is incorrect.
Correct answer:
lead to inflation without permanently reducing unemployment.

Demand stimulus policies will lead to inflation without permanently reducing unemployment because people will start to anticipate the inflationary side effects of expansionary policies, resource prices will rise, profit margins will normalize and unemployment will return to its natural rate. Higher prices will persist and real wages will be constant (thus not encouraging an increase in employment).

When workers are unemployed due to a mismatch between their skills and the jobs available, economists call this

 * frictional unemployment.
 * transitional unemployment.
 * cyclical unemployment.
 * structural unemployment.

That answer is incorrect.
Correct answer:
structural unemployment.

Structural unemployment occurs due to the structural characteristics of the economy that make it difficult for job seekers to find employment and employers to hire workers. Although job openings are available, they generally require skills that differ from those of the unemployed workers.

A reduction in the money supply will cause ________ to fall.

 * none of these answers
 * money demand
 * the interest rate
 * prices

That answer is incorrect.
Correct answer:
prices

A reduction in the money supply implies that there will be excess demand for money balances. As a result, individuals will restore money balances by drawing on their savings, purchasing fewer bonds and will spend less on consumption. Aggregate demand will fall causing prices to also fall.

Use the chart below to choose the correct answer.

Employee compensation		$800
Rents	90	
Government expenditures		240
Depreciation	240	
Gross private investment		400
Personal income taxes	140	
Net exports	90	
Personal consumption		640
Interest income	100	

Given the above information, the net domestic product equals ________.

 * $2,730
 * $1,370
 * $1,130
 * $1,650

That answer is incorrect.
Correct answer:
$1,130

Net domestic product is gross domestic product minus a depreciation allowance for the wearing out of machines and buildings during the period. Thus, GDP here equals employee compensation plus rents plus interest income plus personal income taxes plus government expenditures = $1,370. When depreciation is subtracted from this amount, the net domestic product equals $1,130.

In a situation where information is costly to acquire and individuals must spend time searching for jobs, which type of unemployment will result?

 * seasonal

* cyclical
* frictional
* structural

That answer is incorrect.
Correct answer:
frictional

Frictional unemployment occurs because employers are not fully aware of all available workers and their job qualifications and available workers are not fully aware of the jobs being offered by employers. The basic cause of frictional unemployment is imperfect information.

The four components of planned aggregate expenditures are

* consumption, planned investment, unplanned changes in inventory and exports.
* consumption, investment, government purchases and net exports.
* consumption, investment, inventories and government purchases.
* consumption, investment, exports and imports.

That answer is incorrect.
Correct answer:
consumption, investment, government purchases and net exports.

Aggregate expenditure is comprised of planned consumption expenditures, planned investment expenditures, planned government expenditures and planned net exports.

Which of the following is true about the Federal Reserve in the U.S.?

I. It has complete control over the monetary base.
II. It commonly prints new money.
III. It controls interest rates.

* I, II
* I only
* II, III
* I, II, III
* III only
* II only
* none of these answers is correct

That answer is correct!

The Federal Reserve has control over two important items related to the money supply. It controls the reserve requirement for depository banks. It also controls the level of physical currency by either printing money (which it often does), or by selling short-term securities in the open market (which takes currency out of circulation and into the Fed's coffers.) Currency and cash held in reserve make up the monetary base.

The Fed does not control interest rates. It does attempt to target the Federal Funds rate, which is the rate banks pay each other for over-night loans. However, the Fed has no control over mortgage rates, corporate and U.S. government bond rates, the Prime rate, LIBOR, and other important interest rates.

The Fed Funds rate may have some impact on these rates, but it cannot be said that the Fed controls interest rates.

Which of the following would be the initial effect of an increase in taxes to pay down government debt?

 * the price level increases
 * the aggregate quantity supplied decreases
 * interest rates fall
 * the aggregate demand curve shifts to the left
 * unemployment falls
 * the trade deficit increases

That answer is incorrect.
Correct answer:
the aggregate demand curve shifts to the left

Government spending initially shifts the aggregate demand curve to the right. This is because government funds create new demand for goods and services at all price levels.

In the Keynesian model, if the inventories of firms start to rise above the desired levels, then in the near future the business sector could be expected to

 * hire more workers.
 * decrease output.
 * increase investment.
 * increase output.

That answer is incorrect.
Correct answer:
decrease output.

If business owners observe higher than planned inventory investment they will lower production. This is because greater than planned inventory investment suggests that purchasers are not spending the anticipated amount on expenditures and therefore output should be slowed.

On the "Keynesian cross" diagram, the 45-degree line shows

 * that planned aggregate demand equals saving.
 * equilibrium combinations of income and aggregate expenditures.
 * that MPC always equals the MPS.
 * that consumption always equals investment.

That answer is incorrect.
Correct answer:
equilibrium combinations of income and aggregate expenditures.

Along the 45 degree line in the Keynesian diagram, equilibrium exists whereby aggregate expenditures are equal to output.

Although the economy was in the Great Depression, the Hoover administration followed a fiscal policy of balancing the budget. A Keynesian would have found this policy

* inappropriate, because it probably would have depressed economic activity and led to further increases in unemployment.
* inappropriate, because it probably would have impaired the ability of monetary policy to end the Depression.
* appropriate, because it probably would have led to a significant increase in the money supply and thereby increased employment.
* appropriate, because it probably would have stimulated economic activity and helped end the Depression.

That answer is correct!

Keynesians believe that to relieve an economy trapped in a recession, the government should increase spending to stimulate (i.e., jumpstart) the economy.

The Adams family purchased a new waterbed at Swanson's Furniture Store in March 1994. How will this affect the 1994 GDP?

* Only the commission received by the salesman will be included in the 1994 GDP.
* Both the sale value of the bed and the commission will be included in the 1994 GDP.
* The sale will have no effect on the 1994 GDP.
* Only the sale value of the waterbed will be included in the 1994 GDP.
* Without knowing the actual price paid and percentage markup, there is no way of knowing how this transaction will affect 1990 GDP.

That answer is incorrect.
Correct answer:
Both the sale value of the bed and the commission will be included in the 1994 GDP.

Since both the bed and the sales commission represent goods and services generated in the domestic U.S., they will contribute positively to GDP.

Which of the following will most likely increase aggregate demand?

* a decrease in the expected inflation rate
* a reduction in real GDP
* a lower real interest rate
* a reduction in stock market prices

That answer is incorrect.
Correct answer:
a lower real interest rate

A reduction in the real interest rate makes both consumer and investment goods cheaper so that both households and investors will increase their current expenditures. This additional expenditure increases aggregate demand.

In an economy, the expenditure multiplier equals 2.6. If income increases by 500, consumption will increase by ________.

 * 435
 * 192
 * 308
 * 278

That answer is incorrect.
Correct answer:
308

Expenditure multiplier equals 1/(1-MPC), where MPC, the marginal propensity to consume, is defined as the change in consumption caused by a unit change in disposable income. From the given information, 2.6 = 1/(1-MPC), giving MPC = 0.6154. Therefore, if the income increases by 500, consumption will increase by 500 * 0.6154 = 307.7.

A reduction in the money supply creates an excess demand for ________.

 * money balances
 * goods and services
 * transactions
 * foreign investments

That answer is correct!

Money balances are cash and checking-account deposits. Thus, at any given interest rate, if the money supply contracts, people will demand more cash and deposits than are available. The result will be deflation and/or a rise in interest rates.

If the Fed sells bonds and thereby unexpectedly shifts to a more restrictive monetary policy, in the short run this policy will tend to

 * increase long-term interest rates.
 * increase inflation.
 * reduce unemployment.
 * increase short-term interest rates.

That answer is incorrect.
Correct answer:
increase short-term interest rates.

A contraction of the money supply automatically increases the interest rate as money becomes more "scarce" and therefore "costs" more to hold.

GDP can be calculated by adding either

* the amount received by business firms for final consumer goods produced or the spending of firms on final product goods and services.
* the amount spent on final goods produced or the cost incurred in producing final goods.
* all exchanges on products or all exchanges on factors of production.
* all household spending on final products or all business spending on factors of production.

That answer is incorrect.
Correct answer:
the amount spent on final goods produced or the cost incurred in producing final goods.

There are two methods for calculating GDP. It can be calculated either by summing the expenditures on the "final user" goods and services purchased by consumers, investors, governments and foreigners (net exports) or by summing the income payments and direct cost items (plus the GNP-GDP adjustment) that accompany the production of goods and services.

Which of the following will most likely occur as the result of a temporary increase in aggregate supply?

* an increase in actual unemployment
* an increase in the natural unemployment
* an increase in prices
* a reduction in the real interest rate

That answer is incorrect.
Correct answer:
a reduction in the real interest rate

A temporary increase in aggregate supply causes individuals to increase a substantial portion of their higher level of income for use at a future time that is not as prosperous. This increased saving expands the supply of loanable funds, causing the real interest rate to fall.

Within the AD/AS model, if consumers and investors decide to spend more on goods and services, then

* increased borrowing (or less saving) will increase the real rate of interest, which will discourage additions to spending.
* producers will expand output without increasing prices to accommodate the stronger demand.
* additional spending will increase the supply of loanable funds, which will reduce the real interest rate and thereby trigger additional spending.
* the economy's long-run capacity (LRAS) will expand to accommodate the stronger demand.

That answer is correct!

Increased spending implies less savings and more borrowing to finance higher consumption and investment. This causes the real rate of interest to rise (as demand for loanable funds increases). This makes financing current consumption more costly, and will therefore discourage spending. This is an example of a self correcting mechanism within the economy.

The GDP deflator is used to:

* calculate the GDP in terms of base year currency value.
* reduce the gross GDP to allow for net income earned abroad.
* adjust the gross GDP for net exports and depreciation.
* calculate net GDP given gross GDP.

That answer is correct!

The GDP deflator is used to calculate real GDP from nominal GDP by adjusting appropriately for inflation. For this, a base year is arbitrarily selected and all values are expressed in terms of the base year currency value (e.g. 1990 U.S. dollars). This is done by dividing the nominal GDP by the GDP deflator. The result indicates the GDP in terms of the purchasing power which prevailed in the base year.

In a dynamic economy under ideal conditions

* the unemployment rate should hover around zero.
* unemployment would tend to move slightly upward as prices rose.
* unemployment would tend to move slightly downward as prices fell.
* there would still be some frictional unemployment as people switched jobs and moved in and out of the labor force.
* some unemployment would probably be present, due to workers in the labor force becoming discouraged and discontinuing their job search.

That answer is incorrect.
Correct answer:
there would still be some frictional unemployment as people switched jobs and moved in and out of the labor force.

As long as workers are mobile-as long as they can voluntarily quit and search for better opportunities in a changing world, switching from one job to another and reallocating work responsibilities within the family-some unemployment will be present.

Mr. and Mrs. Nary and their three children are a typical household. Which of the following will most likely increase their demand for consumption of goods and services?

* The legislature enacts a law increasing the sales tax.
* The value of 500 shares of blue-chip stock owned by the Narys increases sharply.
* Mr. Nary reads an article stating that prices are expected to drop sharply in the next few months.
* Mrs. Nary's boss has just informed her that she will be laid off.

That answer is incorrect.

Correct answer:
The value of 500 shares of blue-chip stock owned by the Narys increases sharply.

An increase in the price of stocks owned by the Narys will increase their real wealth. As a result, their demand for goods and services increases. This causes the entire aggregate demand curve to shift to the right.

An economy is in a severe recession. Businesses are so pessimistic that they will not undertake any more investment projects, regardless of the interest rate. According to the Keynesian model, which of the following policies would be most appropriate?

 * a reduction in government expenditures
 * a decrease in the money supply
 * a tax increase
 * a tax cut

That answer is incorrect.
Correct answer:
a tax cut

A tax cut will raise consumer disposable income. The consequence will be an increase in aggregate demand and therefore a demand for more business investment to meet higher aggregate demand.

If an economy is already experiencing inflation, efforts to reduce unemployment by stimulating aggregate demand are most likely to cause

 * inflation to accelerate.
 * a decline in prices coupled with a sharp increase in unemployment.
 * unemployment to rise in the short run.
 * real income to expand, but money income is likely to remain unchanged.

That answer is correct!

Demand stimulating policies serve to increase prices because there is increased competition of a fixed amount of goods. As a result, prices rise in order to allocate the goods to individuals with the highest demand.

If an economy operates at its long-run potential, a proportional increase in resource prices and producer prices will

 * reduce the economy's potential output.
 * leave the economy's potential output unchanged.
 * increase SRAS but not LRAS.
 * increase LRAS but not SRAS.

That answer is incorrect.
Correct answer:

leave the economy's potential output unchanged.

If both resource prices and output prices increase by the same proportion, the change in the benefits associated with production (i.e. the price in the market) and the change in the costs associated with production (i.e., resource prices) leave the producer in exactly the same position as before the changes occurred. Therefore, there will be no change in the production level.

Which of the following is true about intermediate goods in relation to GDP calculations?

I. Inclusion of intermediate goods directly would result in double counting.
II. Intermediate goods are considered income transfers.
III. Intermediate goods are always counted as corporate investments.
IV. Intermediate goods add value to final goods and are therefore indirectly included.

 * III only
 * II & III
 * IV only
 * I & IV
 * I & II
 * I only

That answer is incorrect.
Correct answer:
I & IV

GDP measures only the value of the final goods produced, ignoring the intermediate products. This is because the value of intermediate goods is embedded in the value of a final good. For example, when you buy a car, you are not just buying the final assembly, but all the parts and equipment that were produced along the way. If GDP counted both the purchase price of the car, and the price paid by the manufacturer for each of the parts within, this would result in double counting. Therefore the correct answers are I and IV.

Within the Keynesian aggregate expenditure model, an unexpected decline in spending will

 * lead to a decline in output.
 * lead to lower interest rates, which will stimulate aggregate demand and keep the economy at full employment.
 * increase the demand for goods and services.
 * lower business inventories and lead to an increase in output.
 * lead to a lower price level, which will quickly guide the economy to full-employment equilibrium.

That answer is correct!

Aggregate expenditures are the catalyst of the Keynesian model; that is, changes in expenditure made things happen. A decrease in aggregate expenditures cause a decrease in real output and employment. Supply under this model is accommodative.

A Keynesian would claim that unemployment

 * results when the government fails to effectively use the fiscal policy.
 * leads to inflation in the economy.
 * may be reduced by a judicious use of expansionary fiscal policy.
 * can be eliminated if an expansionary fiscal policy is implemented.

That answer is incorrect.
Correct answer:
may be reduced by a judicious use of expansionary fiscal policy.

Keynesians believe that controlling aggregate demand is the way to control the direction of an economy. Increasing this demand during sluggish conditions can spur the economy into action and move it toward higher output and employment. To do this, the government can either increase its own expenditures and widen the budget deficit or cut taxes to encourage aggregate spending at the personal level. In either case, aggregate demand expands, leading to lower unemployment. Note that "can be eliminated if an expansionary fiscal policy is implemented" is incorrect since Keynesians realize there is a natural rate of unemployment which cannot be eliminated for any sustained period.

The Drof Company, one of the world's largest automobile manufacturers, is negotiating with the Auto Workers Union. They sign a three year contract that includes automatic 6% "cost of living" pay increases each year. Drof is free to hire or fire workers as needed, and new employees are paid the same union wages negotiated in the three year deal.

The day after the contract is signed, the Central Bank increases the money supply by a far greater degree than anyone expected. How would such a policy impact Drof's profits and production decisions during the duration of this contract?

 * profits would fall, causing layoffs and decreased production levels
 * initially profits and production would be higher, but as inflation impacted costs, both would return to previous levels
 * profits would rise as would production levels
 * none of these answers is correct
 * nominal profits would rise, but real profits would not change, production levels would remain static

That answer is incorrect.
Correct answer:
profits would rise as would production levels

Union contracts often include some automatic "cost of living" pay increase. This is meant to compensate workers for inflation that is expected during the life of the contract. This tells us that Drof's cost structure has an assumed inflation rate of 6%.

If inflation is greater than 6%, this tells us that the price of autos is rising faster than Drof's costs, increasing Drof's profits and giving them an incentive to produce more cars and hire more employees. Since the Central Bank has increased the money supply by an unexpected amount, we can assume that inflation will be greater than expected.

The increase in profits would be in real dollars. If we assume that revenues increase at the level of inflation, we know that labor costs will only rise 6% regardless. If inflation is greater than 6%, then Drof's labor cost is decreasing in real terms while its revenues are remaining static in real terms.

Normally we might expect this profit increase to erase over time, but Drof's labor costs are fixed for the duration of this contract. As long as this labor contract remains in effect, Drof will benefit from inflation greater than 6%, and the union will benefit from inflation of less than 6%.

When the output of an economy exceeds the rate consistent with long-run equilibrium, then

 * real interest rates will generally decline.
 * prices in the goods and services market will tend to decline.
 * unemployment will tend to decline.
 * real resource prices will tend to rise.

That answer is incorrect.
Correct answer:
real resource prices will tend to rise.

Strong demand accompanying an economic boom will increase both real interest rates and the real prices of resources. This will dampen aggregate demand and increase costs which will redirect the economy toward its maximum sustainable output.

In an attempt to stimulate the economy, the government decides to increase spending without increasing tax revenues. Which of the following impacts of this action might mitigate any stimulate effects of the spending increase?

I.   movement along the aggregate supply curve
II. shift in the aggregate demand curve
III. increased demand for loanable funds

 * I only
 * III only
 * II only
 * I, II
 * I, II, III
 * II, III

That answer is incorrect.
Correct answer:
III only

The proposed spending plan would create a government deficit, and the government must fund the deficit by issuing debt. This amounts to an increase in the demand for loanable funds, which drives the price (i.e. interest rates) higher. Higher interest rates will cause a decrease in the investment portion of GDP, mitigating the stimulate impact of the spending program.

John has been laid off for 30 days from his shipbuilding job in Connecticut. He is taking advantage of this time to visit some relatives in Montana. Under the definition of unemployment, John is counted as

 * out of the labor force.
 * unemployed but not part of the labor force.
 * part of the employed labor force.
 * a discouraged worker who is neither unemployed nor employed.
 * part of the unemployed labor force.

That answer is incorrect.
Correct answer:
part of the unemployed labor force.

Persons are counted as unemployed only if they are available for and seeking work or awaiting recall from a layoff. Since John is going to be recalled after 30 to work, he is counted as unemployed in the interim.

Which of the following will most likely result from an unanticipated decrease in aggregate supply due to unfavorable weather conditions in agricultural areas?

* an increase in the natural unemployment
* a decrease in inflation
* a decrease in unemployment
* an increase in prices

That answer is incorrect.
Correct answer:
an increase in prices

An unanticipated decline in aggregate supply causes resource prices to rise which shifts the short run aggregate supply inward.

Use the table below to answer the following question.

Income (Dollars)	Consumption (Dollars)
20,000	18,000
24,000	21,000

What is the marginal propensity to consume?

* 0.90
* 3.0
* 0.875
* 0.75

That answer is incorrect.
Correct answer:
0.75

Since the MPC is determined according to the ratio: MPC = additional consumption divided by additional income, the MPC here equals: 3,000/4,000 = .75.

If decision makers underestimate inflation, the real wage will

* fall, increasing unemployment.

 * rise, increasing unemployment.
 * rise, reducing unemployment.
 * fall, reducing unemployment.

That answer is incorrect.
Correct answer:
fall, reducing unemployment.

Underestimation inflation erodes the real wage as wage contracts fail to increase with rising prices. Erosion of the real wage increases employment because labor is now "cheaper."

Other things constant, a reduction in resource prices will

 * increase the cost of producing goods and services, leading to a higher price level.
 * increase the demand for goods and services.
 * increase short-run aggregate supply.
 * increase costs and lower profit margins, leading to a decrease in aggregate supply in the goods and services market.
 * cause natural unemployment to rise.

That answer is incorrect.
Correct answer:
increase short-run aggregate supply.

A change in resource prices will alter SRAS but not necessarily LRAS. A reduction in resource prices will lower costs and therefore shift the SRAS curve to the right.

What would be the effect of a fall in the real interest rate and a rise in the expected inflation rate?

 * Both changes would increase aggregate demand.
 * Both changes would reduce aggregate demand.
 * The fall in interest rates would increase long-run aggregate supply; the fall in expected inflation would increase short-run aggregate supply.
 * Both changes would increase short-run aggregate supply.

That answer is correct!

A change in the real interest rate in the loanable funds market will influence the choices of consumers and investors in the goods and services market. A lower real interest rate makes it cheaper for consumers to buy consumer durables and investors to spend more on capital goods (the opposite holds when the real interest rate rises). When consumers and investors believe that the inflation rate is going to accelerate in the future, they an incentive to spend more during the current period (the opposite also holds).

The most important component of planned aggregate expenditures is

 * planned investment.

* planned aggregate consumption.
* planned exports.
* unplanned changes in inventory.

That answer is incorrect.
Correct answer:
planned aggregate consumption.

According to Keynes, disposable income is by far the major determinant of current consumption. If disposable income increases, consumers will increase their planned expenditures.

Which of the following correctly describes how contractionary fiscal policy through tax policy eventually impacts the price level?

* Higher taxes causes a drop in quantity demand. This causes a shift to the left in the aggregate supply curve fall in the price level.
* Contractionary fiscal policy usually leads to higher interest rates due to the debt factor. Higher interest rates in turn will cause disinflation.
* The increase in taxes effectively decreases individuals' income level. This tends to cause individuals to feel more pessimistic about the future, causing less spending and eventually a lower price level.
* The tax hike would shift the aggregate demand curve to the left. The new equilibrium output would then be at a lower price level.
* Increased government revenue results in less government debt which causes the interest rate to fall and therefore disinflation.
* Fiscal policy involves setting price ceilings and floors, which can directly impact the price level in the short run.

That answer is incorrect.
Correct answer:
The tax hike would shift the aggregate demand curve to the left. The new equilibrium output would then be at a lower price level.

Contractionary fiscal policy would involve either an increase in taxes or a decrease in spending, but not both. When taxes are raised, this effectively decreases income, which causes less demand for goods and services at every price level. The demand curve would therefore shift to the left. This causes movement along the supply curve, decreasing output. The equilibrium output level would now be at a lower price level.

If consumption expenditures are $180, total planned investment is $50, government purchases are $40, exports are $20, imports are $40 and taxes are $25, then aggregate demand must be ________.

* $250
* $275
* $225
* $330

That answer is correct!

Aggregate expenditures is comprised of planned consumption, investment government purchases and the difference between exports and imports. Therefore AD = $180 + $50 + $40 + ($20-$40) = $250.

When the economy operates at an output beyond its full-employment potential, the

 * the actual unemployment rate will decline until full employment is reached.
 * natural unemployment will return to long-run equilibrium.
 * actual level of unemployment will exceed natural unemployment.
 * strong demand for resources will place upward pressure on resource prices.

That answer is incorrect.
Correct answer:
strong demand for resources will place upward pressure on resource prices.

As producers compete for a limited amount of resources (the competition for such resources increases when output exceeds full employment) the price of these resources increases. Therefore, the price of resources increases during such a period.

Which of the following is/are true?

I. The GDP measures the total output of goods and services produced by the nationals of a country.

II. The GNP measures the total income of a country's residents.

III. Exports are excluded from GNP.

IV. Income of foreign nationals residing in the country is excluded from GNP.

 * I & II
 * I only
 * I & IV
 * IV only

That answer is incorrect.
Correct answer:
IV only

GNP measures the productive value generated by the labor and capital owned by the citizens of a country, regardless of whether those citizens and assets reside within the country or out of it. Hence, while calculating GNP, the income generated by foreign nationals residing in the country as well as by assets owned by foreign nationals is excluded. On the other hand, GDP measures the productive activity within the country, regardless of who produces it.

Within the AD/AS model, the short-run equilibrium output in the goods and services market may either be less than or greater than the economy's long-run capacity (LRAS). However, in the long run the equilibrium output

 * will be less than the economy's long-run capacity.
 * must equal approximately 94 percent of the economy's long-run capacity.
 * will exceed the economy's long-run capacity.
 * must equal the economy's long-run capacity when prices are falling.

* will equal the economy's long-run capacity.

That answer is incorrect.
Correct answer:
will equal the economy's long-run capacity.

If the economy operates anywhere other than the long run sustainable output, self-correcting mechanisms within the economy will work to move the economy toward this goal. As a result, the economy will always be moving towards long-run equilibrium.

The Central bank has set the reserve ratio to 17%. An increase in the monetary base of 100 million is found to change the money supply by 490 million. Ignoring all other effects, the excess reserves maintained by the banks on average equal:

* 3.41%
* 3.02%
* 3.77%
* 2.98%

That answer is correct!

The Effective Deposit Expansion Multiplier equals 490/100 = 4.9. Hence, the effective reserve ratio equals 1/4.9 = 20.41%. Thus, on average, banks tend to hold 20.41 - 17 = 3.41% in excess reserves. Note that this assumes that the entire effect on the deposit multiplier arises from excess reserves and not through any other causes like the tendency of people to hold currency.

When an economy is operating below full capacity, Keynesians advocate

* a restrictive fiscal policy.
* an expansionary fiscal policy.
* an expansionary fiscal and a restrictive monetary policy.
* an expansionary monetary policy.

That answer is incorrect.
Correct answer:
an expansionary fiscal policy.

Keynesians believe that aggregate demand is the major controller of the economic direction. They maintain that suppliers will produce at a level consistent with anticipated aggregate demand. Hence, to increase economic production when the economy is operating below capacity, Keynesians advocate spurring the demand in the market through the use of an expansionary fiscal policy.

When the planned spending of consumers, businesses, government and foreigners (net exports) is less than the income level of the economy, the Keynesian model suggests that

* unemployment will fall.
* output will fall.

 * output will rise.
 * equilibrium real GDP will increase.
 * prices will rise.

That answer is incorrect.
Correct answer:
output will fall.

When aggregate expenditures are less than the income level of the economy, unwanted inventories accumulate in businesses and firms will reduce their future production. Thus, output declines.

"The large budget deficits of the 1980s have been accompanied by historically high real interest rates." This statement most closely reflects which of the following views of fiscal policy?

 * crowding-out
 * new classical
 * Keynesian
 * supply-side

That answer is correct!

The crowding out theory implies that government borrowing drives up real interest rates and thus "crowds out" private investment. Private investment falls under higher interest rates because the cost of investment (the real interest rate) rises if the government borrows heavily. Under the usual law of supply and demand, the government causes the interest rate to rise under deficit spending because there is a limited supply of loanable funds. The government competes with the private sector for these resources and thus drives up the price (i.e., the interest rate).

A bumper grain crop due to favorable weather in the Midwest is an example of a(n)

 * technological improvement that will increase long-run aggregate supply.
 * supply shock that will increase short-run aggregate supply.
 * unexpected development that will reduce the natural unemployment.
 * unexpected development that will lead to excess supply and widespread unemployment.
 * supply shock that will reduce short-run aggregate supply.

That answer is incorrect.
Correct answer:
supply shock that will increase short-run aggregate supply.

A supply shock is an unexpected event that temporarily either increases or decreases aggregate supply. A bumper crop increases the aggregate supply.

Which of the following would most likely occur if the federal government increased its spending without increasing its tax revenues during a period of full employment?

 * a recession would develop

* inflation would rise
* inflation would fall
* the national debt would diminish
* interest rates would fall

That answer is incorrect.
Correct answer:
inflation would rise

A recession would develop if the government increases spending without increasing tax revenues during a period of full employment because they have effectively increased aggregate demand. A rise in government expenditures increases aggregate demand; without a counteracting increase in tax rates (which would lower aggregate demand), the economy will experience even higher aggregate demand and further price inflation. Remember that inflation is the result of competition for goods and services: if the government increases their consumption of goods and services, the competition becomes even greater and prices will rise even further.

When an economy operates at its full-employment capacity and the marginal propensity to consume is 3/4, a $100 billion increase in autonomous investment will cause

* real income to increase $400 billion.
* real income to increase $150 billion.
* inflation to increase.
* real income to increase $100 billion.
* real income to increase $200 billion.

That answer is incorrect.
Correct answer:
inflation to increase.

When the economy operates at full employment capacity increases in aggregate demand cannot be accommodated by increases in real output. Therefore, the only effect of increased aggregate demand will be an increase in prices.

In the Keynesian model, if the marginal propensity to consume were 0.6, an independent decline in investment of $10 billion would cause equilibrium income to decline

* $10 billion.
* $40 billion.
* $25 billion.
* $50 billion.
* $80 billion.

That answer is incorrect.
Correct answer:
$25 billion.

The expenditure multiplier is found by M = 1/(1-MPC). Thus, here M = 1/(1-.6) = 2.5. Therefore the $10 billion decrease in aggregate expenditures is magnified 2.5 times to $25 billion.

In simple terms, real GDP = nominal GDP less

 * CPI
 * GDP deflator
 * PPI
 * GDP inflator
 * real rate of interest

That answer is incorrect.
Correct answer:
GDP deflator

The GDP deflator is the measure of inflation used to translate nominal GDP to real GDP. Other inflation measures such as CPI or PPI are not typically used as they only reflect a portion of price changes in the overall economy.

Which one of the following would most likely increase aggregate supply in the future?

 * a decrease in the nation's investment rate
 * a decrease in the world price of goods exported by the nation
 * an increase in research and development expenditures that results in more rapid improvements in technology
 * an increase in the minimum wage
 * a decrease in private saving

That answer is incorrect.
Correct answer:
an increase in research and development expenditures that results in more rapid improvements in technology

Search, discovery and technological change can increase the supply of natural resources. Such an increase in the economy's resource base will make it possible to produce and sustain a larger rate of output. Thus, both SRAS and LRAS will shift to the right.

The government, facing a serious economic crisis, decides to borrow funds to finance building a gigantic statue of Adam Smith. Once completed, the project will serve no economic, social, or political purpose. Which of the following economic problems might such a project alleviate.

 * unemployment
 * trade deficits
 * high interest rates
 * wasteful government programs will not improve any of these problems
 * inflation
 * weak infrastructure

That answer is correct!

It is important to remember that fiscal policy does not depend on the actual project undertaken. Here, the government is embarking on an obviously wasteful project. However, the project will create demand for building supplies, contractors, architects, etc. This will shift the aggregate demand curve, which in turn will cause output to increase.

If Federal Reserve policy increases the excess reserves of banks, why will banks want to expand their loans and investments?

* The banks would interpret the Fed's action as reducing uncertainty and thus increasing the demand for loans and improving investment opportunities.
* Since excess reserves are a non-interest-earning asset, the banks will want to extend loans and make investments rather than hold the reserves.
* Banks are legally required to expand loans and investments when the Fed expands reserves.
* If the banks did not extend additional loans and make additional investments, the interest rate would fall and reduce the banks' profitability.

That answer is incorrect.
Correct answer:
Since excess reserves are a non-interest-earning asset, the banks will want to extend loans and make investments rather than hold the reserves.

If the Fed increases the excess reserves of banks, this implies that the Fed has reduced the reserve requirement ratio. As result, banks will extend more loans since they must hold a smaller fraction of their total deposits as reserves. Banks choose not to hold excess reserves because such reserves are non-interest earning. In contrast, the extension of loans earns the bank a positive interest rate which will increase bank profits.

Which of the following will most likely cause an increase in the quantity supplied in the goods and services market?

* an increase in the expected inflation rate
* an increase in prices
* an increase in resource prices
* a reduction in resource prices
* a decline in the productivity of labor

That answer is incorrect.
Correct answer:
an increase in prices

A reduction in resource prices causes costs to lower and will sift the SRAS curve to the right. Unless these lower prices reflect a long-term increase in the supply of resources, LRAS will not be affected.

If the money velocity is 10, the amount of money in circulation $250 million and real GDP $50 million, then prices are ________.

* 1,250
* 2
* 50

* 200

That answer is incorrect.
Correct answer:
50

According to the equation of exchange which is defined as MV = PY we must solve for P in the following way: ($250 million x 10) = ($50 million x P). This implies that P=50.

If an economy experiencing 10 percent inflation operates at its full-employment output capacity, the initial impact of an unanticipated shift toward restrictive monetary and fiscal policy will probably be a

* decrease in unemployment.
* decline in inflation, with the growth rate of real output remaining unchanged.
* decline in real output, followed by a deceleration in inflation.
* decline in nominal income, with the growth rate of real income remaining unchanged.

That answer is incorrect.
Correct answer:
decline in real output, followed by a deceleration in inflation.

The decline in real output will be a result of an increase in the real wage. This in turn decelerates the rate of inflation.

If the output of an economy is below full-employment capacity, the AD-AS model indicates that

* lower real resource prices and declining real interest rates will help direct the economy to a full-employment equilibrium.
* higher real resource prices and rising real interest rates will help direct the economy to a full-employment equilibrium.
* aggregate demand will automatically increase and direct the economy back to a full-employment output.
* economy will continue to stagnate at an output below full employment unless policy makers intervene.

That answer is correct!

Lower real resource prices will prevail under a recession because of sluggish demand. Similarly, real interest rates will decline since investment and consumption are low and hence demand for loanable funds is low. The combination of low resource prices and interest rates will stimulate aggregate demand for resources and loanable funds which will help the economy to self-correct toward full employment.

Both empirical evidence and the AD-AS model indicate that during an economic recession

* inflation tends to accelerate, causing the natural unemployment to increase.
* real wage rates decline (or increase quite slowly) and the real interest rate tends to fall.

 * real wage rates increase rapidly and the real interest rate tends to fall.
 * real wage rates decline (or increase quite slowly) and the real interest rate tends to rise.
 * real wage rates increase rapidly and the real interest rate tends to rise.

That answer is incorrect.
Correct answer:
real wage rates decline (or increase quite slowly) and the real interest rate tends to fall.

Lower real resource prices will prevail under a recession because of sluggish demand. Similarly, real interest rates will decline since investment and consumption are low and hence demand for loanable funds is low. There is evidence of both these adjustments in the economy and theory predicts their occurrence.

If the economy is producing more than the full-employment output level, which of the following would most likely direct the economy back to long-run equilibrium?

 * a decrease in the real rate of interest
 * an increase in technology
 * an increase in resource prices
 * a decrease in resource prices

That answer is incorrect.
Correct answer:
an increase in resource prices

Strong demand accompanying an economic boom will increase both real interest rates and the real prices of resources. This will dampen aggregate demand and increase costs which will redirect the economy toward its maximum sustainable output.

An economy is currently at full employment. If the Fed were to suddenly cut interest rates, which of the following effects would occur in the short run?

I. Aggregate demand will increase.
II. Unemployment rate will decrease below the natural rate of unemployment.
III. Price levels will rise.
IV. Aggregate supply curve will move to the left

 * I, II & III
 * I, II, III & IV
 * II & III
 * II only

That answer is correct!

The reduction in interest rates will cause an increase in aggregate demand, causing the demand curve to move to the right. The supply curve will not move in the short run thus leading to an increase in prices and employment. Unemployment rate will fall below the natural rate in the short run.
Note that since the economy is at full employment, the supply curve can move to the right only if the resource base is increased due to the change in interest rates.

Countries A and B have the same monetary base and reserve requirement. However, banks in country A are more conservative and tend to have larger excess reserves than banks in B. The money supply will be:

 * insufficient information.
 * higher in B.
 * same in the two countries.
 * higher in A.

That answer is incorrect.
Correct answer:
higher in B.

Increasing the reserves takes a greater amount of money out of the general circulation in the economy, lowering the money supply, even though the monetary base remains constant.

Within the Keynesian model, if the marginal propensity to consume is 0.8, which of the following is true?

 * When investment increases by $1, consumption increases by $5.
 * When investment increases by $1, income increases by $5.
 * When consumption increases by $5, investment increases by $1.
 * When consumption increases by $5, saving increases by $1.

That answer is incorrect.
Correct answer:
When investment increases by $1, income increases by $5.

The expenditure multiplier is found according to the equation M= 1/(1-MPC). Therefore, M = 1/(1-.8) = 5. This implies that a $1 increase in investment is magnified five times to $5.

The economy's potential output is

 * the maximum sustainable output consistent with the stable prices.
 * the maximum output that could be achieved temporarily during war.
 * the maximum output that could be achieved temporarily during a time of peace.
 * present when 100 percent of the labor force is employed.

That answer is correct!

Potential output is the amount of output that is consistent with full employment. It should be expected from high utilization rates obtainable under normal circumstances.

An economy is currently in a state of equilibrium, at full employment. If a sudden demand shock were to increase aggregate demand, which of the following effects will occur in the short run?

I. Profit margins will improve.
II. Resource prices will stay relatively unchanged.
III. Prices will increase.
IV. Employment will increase.

* I, II, III & IV
* II, III & IV
* III & IV
* I, III & IV

That answer is correct!

It is extremely important to read such questions very carefully because the answers will depend on whether the effects are being considered over long run or short run. In the short run, resource prices are not very flexible since they are based on contracts which are not negotiated continuously. Thus, in the short run, the supply curve will not be affected by the jump in the aggregate demand. The increased demand means the entire demand curve moves to the right. This raises the equilibrium price and the aggregate output. Since the resources costs do not increase correspondingly, profit margins improve. Finally, since the economy was already at full employment with an output equal to the maximum sustainable, the only way output can increase is by a reduction in the unemployment rate, which dips below the natural rate.

The Keynesian range (the horizontal range) of a short-run aggregate supply curve illustrates that changes in aggregate demand exert little impact on prices and a great deal of impact on output when

* widespread unemployment of resources is present.
* the money rate of interest exceeds the real rate of interest.
* the economy operates at full employment.
* the natural unemployment exceeds actual unemployment.
* aggregate demand exceeds aggregate supply.

That answer is correct!

Below the full employment capacity of the economy, increases in aggregate supply have little effect on the price level. This is the result of the Keynesian assumption that at less than full employment output levels, prices and wages are fixed since they are inflexible in a downward direction. Thus, when resources are idle (the economy operates below full capacity) increases in aggregate demand will increase output but not prices.

Unemployment is currently 10%, and the natural rate is assumed to be 5%. Without other interference, inflation is expected to be 6%. If the Central Bank wishes to decrease unemployment, which of the following actions may have some impact?

* Increase the money supply to cause inflation of 5%
* Decrease the money supply to reign in inflation by some degree
* None of these answers is correct
* Increase the money supply to cause inflation greater than 6%
* Increase short-term interest rates

That answer is incorrect.
Correct answer:
Increase the money supply to cause inflation greater than 6%

If inflation is greater than the expected 6%, producers will find the price they receive for their goods greater than they expected. Producers will initially react to the higher prices for their products as if they were real price increases. In other words, initially there will be an increase in the aggregate quantity supplied and hence a decrease in unemployment.

Which of the following correctly describes how contractionary fiscal policy through government spending eventually impacts the price level?

* Contractionary fiscal policy usually leads to higher interest rates due to the debt factor. Higher interest rates in turn will cause disinflation.
* Lower government spending tends to cause individuals to feel more pessimistic about the future, causing less spending and eventually a lower price level.
* The decrease in government spending shifts the aggregate demand curve to the left. The new equilibrium output would then be at a lower price level.
* Decreased government spending results in less government debt which causes the interest rate to fall and therefore disinflation.
* Decreased government spending causes a drop in quantity demand. This causes a shift to the left in the aggregate supply curve fall in the price level.
* Fiscal policy involves setting price ceilings and floors, which can directly impact the price level in the short run.

That answer is incorrect.
Correct answer:
The decrease in government spending shifts the aggregate demand curve to the left. The new equilibrium output would then be at a lower price level.

Contractionary fiscal policy would involve either an increase in taxes or a decrease in spending, but not both. When the government decreases spending, this causes less demand for goods and services at every price level. The demand curve would therefore shift to the left. This causes movement along the supply curve, decreasing output. The equilibrium output level would now be at a lower price level.

An economy is currently operating at full employment. If the Fed unexpectedly adopts an expansionary monetary policy, in the long run, the aggregate output will ________. Inflation will ________.

* fall, remain unaffected
* remain unaffected, rise
* fall, rise
* fall, fall

That answer is incorrect.
Correct answer:
remain unaffected, rise

Over the long run, the effects of an expansionary monetary policy will be fully anticipated and no real term effects will remain. All of the expansion in the money supply will go into increasing prices and thus funnel into inflation.

Which of the following is true of GDP?

 * It measures material well-being.
 * It measures social progress.
 * It is an indicator of domestic production.
 * It measures social welfare.

That answer is incorrect.
Correct answer:
It is an indicator of domestic production.

GDP is the total market value of all final goods and services produced domestically during a specific period. Therefore it indicates the level of production occurring within the boundaries of a country. It is a good indicator of the level of production occurring within a country.

Which one of the following is not a component of the money supply (M1)?

 * demand deposits
 * overnight Eurodollar dollar deposits of U.S. residents
 * currency in circulation
 * interest earning checkable deposits
 * traveler's checks

That answer is incorrect.
Correct answer:
overnight Eurodollar dollar deposits of U.S. residents

The M1 money supply is the sum of currency in circulation (including coins), demand deposits, other checkable deposits of depository institutions and traveler's checks.

To decrease money supply, which of the following actions can the Fed take?

I. Raise taxes
II. Raise the discount rate
III. Raise the reserve ratio
IV. Purchase Treasury bonds in the open market

 * II & IV
 * II, III & IV
 * I, II, III & IV
 * II & III

That answer is incorrect.
Correct answer:
II & III

The Fed has no control over fiscal policy so (I) is not a valid choice. Purchasing bonds releases money in the economy, increasing the supply. Only II and III will result in an increase in money supply.

Which of the following best describes the difference between gross domestic product (GDP) and gross national product (GNP)?

 * GDP measures output produced within domestic borders, while GNP measures output produced by domestic citizens.
 * GDP measures output produced by domestic citizens, while GNP measures output produced within domestic borders.
 * GDP measures output produced by domestic citizens within domestic borders, while GNP measures all output produced within domestic borders.
 * GDP measures all output produced within domestic borders, while GNP measures output produced by domestic citizens within domestic borders.

That answer is correct!

GNP will differ significantly from GDP when there is a substantial difference between the income citizens earn abroad and the domestic income generated by foreigners.

The value (purchasing power) of each unit of money

 * tends to decline as the money supply contracts relative to the availability of goods and services.
 * is inversely related to prices.
 * tends to increase as the money supply expands.
 * increases as prices rise.
 * is largely independent of the money supply.

That answer is incorrect.
Correct answer:
is inversely related to prices.

The purchasing power of money is determined by the amount of money necessary to buy a specific good. If the price of a good doubles, it takes twice as much money to procure that good. Therefore the purchasing power of money has been halved.

Several government income-assistance programs require recipients to register for work to qualify for assistance. This policy

 * reduces the ability of those receiving assistance to acquire job information.
 * reduces the measured unemployment rate.
 * increases the number of discouraged workers.
 * increases the number of people who are counted as unemployed.

That answer is incorrect.
Correct answer:
increases the number of people who are counted as unemployed.

When individuals are required to register for work in order to receive government benefits, they become part of the labor force. If they were not part of the labor force prior to registration the number of unemployed members of the labor force increases once they enlist.

Economists usually use the term "recession" to refer to

 * a slowdown in the growth of real GDP.
 * zero real GDP growth.
 * two or more consecutive quarters of declining real GDP.
 * a reduction in nominal GDP lasting more than six months.

That answer is incorrect.
Correct answer:
two or more consecutive quarters of declining real GDP.

A recession refers to a downturn in economic activity characterized by declining real GDP and rising unemployment. Many economists define a recession as two consecutive quarters in which there is decline in real GDP.

An asset that is used to buy and sell goods or services is known as ________.

 * a medium of exchange
 * fiat money
 * none of these answers
 * a liquid asset
 * a checkable deposit

That answer is correct!

The use of money as a medium of exchange allows individuals to specialize in the supply of those things that they do best and allows them to purchase a broad cross section of goods and services consistent with individual preferences. The alternative to the use of money as a medium of exchange is the barter system, where goods are traded for other goods.

Suppose that in 1998 the government decides to reduce unemployment benefits and simultaneously eliminate the State Employment Service, a government-provided service available to employers and job seekers. As a result, frictional unemployment will probably

 * decrease.
 * remain the same, since neither action should affect frictional unemployment.
 * increase.
 * change, but economic theory cannot predict the direction of the change since the two actions will exert opposite effects on frictional unemployment.

That answer is incorrect.
Correct answer:
change, but economic theory cannot predict the direction of the change since the two actions will exert opposite effects on frictional unemployment.

Frictional unemployment results from the scarcity of information and the search activities of both employees and employers for information that will help them make better employment choices. The first action will work to decrease unemployment because a decrease in unemployment benefits increases the cost of job search and thus unemployed workers will reduce their job search time and accept jobs more quickly. The second action works in the opposite direction: by reducing the information that unemployed workers and employers have about each other, frictional unemployment could be expected to increase. Which direction prevails is indeterminate.

Keynesian theory differs from Classical theory in that

 * Keynesian economics calls for deficit spending to make up for any short-fall in aggregate expenditures, while Classical theory extols the benefits of balanced budgets.
 * Classical economics did not consider fair wealth distribution, which is important in Keynesian equilibrium.
 * Keynesian theory postulates that the business cycle can be manipulated through interest rates, while Classical theory focuses on aggregate supply.
 * Keynesian theory focuses heavily on curbing inflation, while Classical theory ignores this factor.
 * Classical economics focuses on aggregate supply, while Keynesian theory focuses on aggregate demand.

That answer is incorrect.
Correct answer:
Classical economics focuses on aggregate supply, while Keynesian theory focuses on aggregate demand.

Classical economics holds that supply creates its own demand. Keynesian economists believed that fiscal policy could be devised to stimulate aggregate demand, which would eventually cause an expansion in supply.

When the economy operates at an output beyond its full-employment potential, the

 * strong demand for resources will place upward pressure on resource prices.
 * actual level of unemployment will exceed the natural unemployment.
 * natural unemployment will return to long-run equilibrium.
 * actual unemployment rate will decline until full employment is reached.

That answer is correct!

Output beyond the full employment level can only occur in the short-term. In order to generate output beyond this level the demand for labor and other resources increases which causes the prices in resource markets to increase.

The crowding-out model implies that restrictive fiscal policy will

 * increase the real rate of interest.
 * increase aggregate demand and employment.
 * reduce the real rate of interest.

* be highly effective against inflation.
* decrease aggregate demand and lead to a significant increase in unemployment.

That answer is correct!

Restrictive fiscal policy involves a contraction of government spending and therefore zero to negative budget deficits. The crowding out model implies that heavy government borrowing drives up the real rate of interest as the government competes with the private sector for loanable funds. Under restriction fiscal policy then, the real interest rate would be expected to fall as the government is not competing in the market for loanable funds.

Which one of the following types of budget deficits is least likely to be inflationary?

* a deficit financed by borrowing, perhaps indirectly, from the Federal Reserve.
* a deficit that occurs even though the resources of the economy are fully employed.
* a deficit that occurs because of a sharp increase in governmental income transfer payments while the economy operates at its full-employment output level.
* a deficit that occurs because tax revenues fall as the result of a business recession.

That answer is incorrect.
Correct answer:
a deficit that occurs because tax revenues fall as the result of a business recession.

A budget deficit that occurs due to declining tax revenues will not likely be inflationary because the economy is operating below full employment. The stimulation of increased government expenditure will increase aggregate demand and help to move the economy out of the recession. A deficit occurring when the economy is at or close to full capacity will induce inflation.

In a given economy, A, there are strict controls currently in place on imports. If these restrictions were to be relaxed, the expenditure multiplier in the economy will:

* remain unaffected.
* all of these answers can happen.
* decrease.
* increase.

That answer is incorrect.
Correct answer:
decrease.

The expenditure multiplier idea is based on the fact that one man's expenditure is another man's income. Hence, an initial expenditure tends to generate a cascade of expenditures, fueling additional production. Now, if the import restrictions are relaxed, the expenses on imports will generate an income for foreigners, in economy B. Most of this income will spur additional production in economy B and not in A (of course, this will raise the demand for exports from A to B and cause some additional production in A, too). This will reduce the multiplier effect compared to the case where the entire recycling takes place in a closed economy.

The labor force participation rate refers to:

* the employment rate.
* The number of people employed as a fraction of people of age 16 or above.
* all of these answers.
* The number of people in the civilian labor force as a fraction of people of age 16 or above.

That answer is incorrect.
Correct answer:
The number of people in the civilian labor force as a fraction of people of age 16 or above.

Remember that even people who are unemployed but are actively seeking work are included as part of the labor force. Then, the labor force participation rate expresses the percentage of adults (defined as being of age 16 and above) who are either contributing to or are ready to contribute to the productive capacity of the economy.

Other things constant, an unanticipated increase in short-run aggregate supply such as might result from a bumper crop due to favorable weather conditions will lead to a(n)

* increase in output and a higher price level.
* decrease in output and no charge in prices.
* increase in output and a higher real interest rate.
* increase in output and a lower interest rate.
* decrease in output and a lower price level.

That answer is incorrect.
Correct answer:
increase in output and a lower interest rate.

A bumper crop will decrease the marginal cost of additional units of production. This causes the short run aggregate supply curve to move rightward. All else equal, this will result in lower inflation, which will cause interest rates to drop. Note that this does not necessarily mean that real rates will fall.

Which of the following would not be included in GNP?

* the cost of a new condominium
* a maid's wages
* a lawyer's fee
* the sale price of a corporate stock buy

That answer is incorrect.
Correct answer:
the sale price of a corporate stock buy

Financial transactions and income transfers are excluded from GDP because they are not additions to current output.

Which of the following would increase GNP but leave GDP unchanged?

 * the sale of a good produced by a foreign citizen who lives in the U.S.
 * the sale of a good produced by a domestic citizen who lives in another country
 * the sale of a good produced by a domestic citizen who lives in the U.S.
 * the sale of a good produced by a foreign citizen who lives in another country

That answer is incorrect.
Correct answer:
the sale of a good produced by a domestic citizen who lives in another country

GNP is defined as the market value of all final goods and services produced by the citizens of a country. It is equal to GDP plus the income the nationals earned abroad minus the income foreigners earned domestically. If a U.S. citizen lives abroad and sells a good to another individual the price of the good contributes to U.S. GNP but not to U.S. GDP because GDP must be generated domestically (on American soil).

Which of the following will most likely accompany an unanticipated increase in aggregate demand?

 * a decrease in prices
 * an increase in real GDP
 * an increase in unemployment
 * a decrease in resource prices

That answer is incorrect.
Correct answer:
an increase in real GDP

An unanticipated increase in aggregate demand causes prices to rise in the short run and output to temporarily exceed full employment capacity. Thus, real GDP increases in the short run.

John Maynard Keynes and his followers argued that the Great Depression was primarily the result of

 * insufficient aggregate spending on goods and services.
 * excessive government spending.
 * large budget deficits.
 * perverse monetary policies of the Fed.

That answer is correct!

According to Keynes, the prolonged depression with high unemployment and low output was due to insufficient aggregate expenditure by consumers and investors. Less spending led to less output.

Under a monetary expansion, the real interest rate ________.

 * falls

* rises, then falls
* falls, then rises
* rises
* stays the same

That answer is correct!

The real interest rate under a monetary expansion falls because the supply of loanable funds increases. Since individuals now hold more money balances they invest/save more, thus increasing money in banks. The result of this increased supply of loanable funds is that the cost of borrowing money (i.e. the interest rate) falls.

In year 0, $100 could purchase a certain basket of goods. In year 5, the identical basket of goods cost $200. What was the average annualized inflation rate during this period?

* 50%
* 20%
* 14%
* 15%
* 100%

That answer is incorrect.
Correct answer:
15%

The calculation is as follows: (200/100)^(1/5)-1=0.1487

Which of the following correctly describes how expansionary fiscal policy through government spending eventually impacts employment? (Ignore direct government hiring.)

* Government spending results in a multiplier effect, as politicians showing confidence in the economy encourages businesses to spend on expansions.
* Higher government spending shifts the aggregate demand curve upward, which increases the price level. This inflationary effect encourages firms to use more flexible labor and less inflexible capital.
* Increased government spending causes an increase in quantity demand. This causes an outward shift in the aggregate supply curve and hence more employment.
* The increase in government spending shifts the aggregate demand curve out. This causes upward movement along the aggregate supply curve, which increases resource utilization.
* Government spending projects improve the economy's infrastructure. This causes an upward shift in aggregate supply and hence improves employment.
* Increased government spending results in more government debt which causes the interest rate to rise and therefore unemployment to fall.

That answer is incorrect.
Correct answer:
The increase in government spending shifts the aggregate demand curve out. This causes upward movement along the aggregate supply curve, which increases resource utilization.

When the government increases spending, this causes more demand for goods and services at every price level. The demand curve would therefore shift to the right. This causes movement along the supply curve, expanding output. This expansion in output should reduce slack resources, i.e.

unemployment.

A ________ expansion creates an excess supply of money balances which induces individuals to purchase more bonds and thereby expand the supply of loanable funds.

 * none of these answers
 * fiscal
 * discount rate
 * federal
 * monetary

That answer is incorrect.
Correct answer:
monetary

Expansionary monetary policy is an acceleration in the growth rate of the money supply. The consequence of such a policy move is to increase the money holdings of individuals. Individuals choose to either consumer or invest/save this new money. If they save/invest, the supply of loanable funds increases (since banks now have more money to loan).

Classical economic theory states that in the long-run, supply will create its own demand. Keynes countered by stating that "in the long run, we're all dead." Which of the following statements summarizes the differences between the two theories in more economic terms?

 * Keynes did not disagree that eventually the price level would adjust to changes in aggregate supply or demand, but that this process might take many years, and the economy may suffer for long periods.
 * Keynes believed that unemployment was a blight on the economy and needed to be eradicated through government spending.
 * Keynes feared that democracy would crumble during the Great Depression without some economic stimulus.
 * Keynes theorized that deflation would create incentives for suppliers to produce more and therefore eventually pull the economy out of recession.

That answer is correct!

Keynes did not disagree that eventually the price level would adjust to changes in aggregate supply or demand, but that this process might take many years, and the economy may suffer for long periods.

First National Bank currently does not have the legally required cash reserves on hand. The bank expects this situation will only last a day or two. In order to rectify the reserve problem, the bank treasurer borrows cash on the intra-bank loan market. The loan was actually granted by the Central Bank. This is the only action by the Central Bank that day. What has happened to the money supply and why?

 * The money supply has not changed, as cash was exchanged for a loan.
 * The money supply has increased, as cash held by the Central Bank will now be put in circulation.
 * The money supply has contracted, because when the loan is repaid, the cash will not be put back into circulation.

* The money supply has contracted because the Central Bank's cash is now tied up in a loan portfolio.
* The money supply has increased, because the Central Bank's actions will cause interest rates to rise.

That answer is incorrect.
Correct answer:
The money supply has increased, as cash held by the Central Bank will now be put in circulation.

When a bank lacks reserves it has essentially loaned too much money, i.e. it has put too much money into circulation. If the Central Bank lends money to the bank to cover the shortfall, then the cash from the excess loans can stay in circulation.

If the reserve loan had come from another bank, then this would have simply transferred excess reserves from one bank to another. Since the Central Bank stepped in, banks with excess reserves will now choose to make more traditional loans and further expand the money supply.

Full employment is that rate of employment that results when

* aggregate demand is such that the cyclical unemployment rate is between 4 percent and 5 percent of the labor force.
* everybody who wants a job can find one.
* only frictional and structural unemployment are present.
* cyclical unemployment has reached its maximum.
* all the labor resources of the economy are fully employed.

That answer is incorrect.
Correct answer:
only frictional and structural unemployment are present.

Full employment occurs when the rate of unemployment is normal, considering both frictional and structural factors. Full employment for the U.S. is thought to be at about 94 to 95% of the labor force.

The "employment/population ratio" is ________ the employment rate.

* greater than
* can be all of these answers, depending on demographics.
* less than
* equal to.

That answer is incorrect.
Correct answer:
less than

The employment rate is the fraction of the labor force employed. Since the labor force is always smaller than the entire population, the employment/population ratio is always lower than the employment rate.

"According to the Keynesian view, a market economy will fluctuate between economic booms fueled by a high rate of investment and economic recessions magnified by business pessimism and a decline in investment." This statement

 * illustrates the fallacy of composition.
 * is essentially a correct statement of the Keynesian view.
 * is incorrect because Keynesians believe monetary disturbances, rather than fluctuations in investment expenditures, are the major source of economic instability.
 * confuses cause and effect as perceived by Keynesian economists.

That answer is incorrect.
Correct answer:
is essentially a correct statement of the Keynesian view.

According to Keynes, a boom is followed by a decline in optimism due to slower growth rates and leads to lower investment and consumption. This pessimism is fueled and leads to lower output. The opposite occurs when a recession is followed by a higher growth rate, high optimism and increases in investment and consumption.

The Federal Reserve's most frequently used monetary tool is

 * moral persuasion.
 * open market operations.
 * the discount rate.
 * the reserve requirements.

That answer is incorrect.
Correct answer:
open market operations.

The Fed most often uses open market operations to control the money supply. Open market operations refers to the buying and selling of U.S. government securities by the Federal Reserve.

If decision makers quickly anticipate the inflationary effects of demand stimulus policies, those policies will

 * increase both inflation and the nominal interest rate but exert little impact on real output and employment.
 * lead primarily to larger output and high employment.
 * reduce the real interest rate.
 * increase the real interest rate.

That answer is correct!

Anticipated demand stimulus policies imply that economic agents will create contracts which automatically account for rising prices. Thus, price inflation will occur. There will be no effect on employment since labor contracts will account for rising prices, thus keeping the real wage constant.

How will an unanticipated increase in aggregate demand emanating from an increase in business and consumer optimism influence equilibrium output in the goods and services market?

* Output will decrease and prices will remain unchanged.
* Output will increase and prices decline.
* Output will increase and prices rise.
* Output will decrease and prices rise.
* Output will decrease and prices fall.

That answer is incorrect.
Correct answer:
Output will increase and prices rise.

An increase in aggregate demand as the result of increased consumer and investor optimism will cause output to increase. There will also be upward pressure on prices because of heightened demand: greater demand for goods always works to increase the price level since there is more competition among consumers and investors.

Which of the following is true?

* The Federal Reserve System guarantees the deposits in almost all banks up to a $100,000 limit per account.
* The FDIC sets the reserve requirements for commercial banks.
* If a bank should fail, the FDIC guarantees that depositors can get their funds up to a $100,000 limit per account.
* Since the Federal Reserve System was established in 1913, bank failures due to panic withdrawals have been virtually eliminated.

That answer is incorrect.
Correct answer:
If a bank should fail, the FDIC guarantees that depositors can get their funds up to a $100,000 limit per account.

The Federal Deposit Insurance Corporation (FDIC) is a federally chartered corporation that insures the deposits held by commercial banks and thrift institutions. Individual member banks pay a small insurance premium to reimburse depositors with funds in a bank that fails.