The CFA Aficionado

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1081 Questions + Answers

of the

CFA EXAM

Level 1

Study Session : Macroeconomics

(Part B)

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.

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And now here we go :

An economy is currently operating at full employment, with an inflation rate of 6%. The Central Bank adopts an inflationary measure consistent with an inflation rate of 8% but people anticipate an inflation of 7%. Then, the unemployment in the short run will be ________ the natural rate, as predicted by the Rational Expectations Model.

* could be above or below.
* same as
* below
* above

That answer is incorrect.
Correct answer:
below

The short-run equilibrium is affected by the accuracy of the predictions made by decision-makers. Since workers under-estimate the future inflation resulting from the changed policy, they will settle for lower wages than those consistent with the actual inflation. Consequently, the Rational Expectations Phillips curve predicts that unemployment will decrease in the short run. With the economy currently at full employment, the unemployment rate will fall below the natural rate, temporarily expanding the real GDP beyond the potential level. Over the long run, people will correct their erroneous predictions and wages will rise to a level where full employment will prevail once again.

Which of the following would increase GDP?

* Mercedes-Benz begins to produce and sell cars in Alabama.
* An American investor buys 100 shares of Ford stock.
* Ford Motor Company begins to produce and sell cars in Japan.
* An American investor purchases 100 shares of Mercedes-Benz stock.

That answer is correct!

Since GDP represents the total market value of all final goods and services produced domestically during a specific period, GDP would rise if a foreign company starts to produce cars domestically.

If the marginal propensity to consume (MPC) is .75 or 3/4, what is the expenditure multiplier?

* 0.25
* 4.0
* 3.0
* 2.0

That answer is incorrect.
Correct answer:
4.0

The expenditure multiplier is found according to the equation M= 1/(1-MPC). Thus, M = 1/(1-3/4) = 4.

Which of the following would be an example of non-activist monetary policy?

* The Central Bank attempts to counter-act negative developments in the economy.
* Inflation is the only target for the Central Bank.
* The Central Bank tries to keep the money supply constant.
* The government keeps spending constant and allows tax revenues to rise or fall to compensate for changes in aggregate income.
* The Central Bank increases the money supply by 5% every year.

That answer is incorrect.
Correct answer:
The Central Bank increases the money supply by 5% every year.

The classic non-activist monetary policy example is to increase the money supply by a particular level every year. Activist or discretionary monetary policy involves changing the supply of money to counter-act negative developments in the economy.

"Counter-cyclical macroeconomic policy will be ineffective as a stabilization tool because people will undermine the policy by adjusting their choices once they expect a systematic policy response to recessions and booms." This statement most clearly reflects the

* Keynesian view.
* rational expectations view.
* supply-side view.
* 1960 view of the Phillips curve.

That answer is incorrect.

Correct answer:
rational expectations view.

Rational agents will weigh all of the likely economic policies in their estimation of future inflation rates. Therefore, once a systematic policy response to recessions and booms is established, counter-cyclical macroeconomic policy will be ineffective since it will be fully anticipated.

An economy which is experiencing substantial inflation and slow economic growth is said to be in:

 * a contraction.
 * a stagflation.
 * a hyperinflation.
 * a recession.

That answer is incorrect.
Correct answer:
a stagflation.

High and variable inflation rates have severe negative impact on an economy. At times, the economy spirals into a cycle of extremely slow growth and very high inflation. This stagnant state battered by rising prices is called "stagflation."

Congress proposes to stimulate the economy by cutting taxes for middle income families but raising taxes for wealthier tax payers. The effect will be the same net taxes collected, but most tax payers would pay less in taxes. According to which of the following economic theories would this stimulate the economy?

I. fiscal policy
II. supply-side
III. monetary policy

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

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

Since there was no net reduction in taxes, the tax plan would not create a fiscal stimulus. Marginal tax rates have effectively increased under this plan, implying a negative supply-side impact. Monetary policy involves changing the money supply, which is not applicable here.

An increase in the nominal interest rate would

* encourage people to hold larger money balances.
* cause households to increase consumption.
* encourage people to hold smaller money balances.
* force the Fed to reduce the money supply.

That answer is incorrect.
Correct answer:
encourage people to hold smaller money balances.

The nominal interest rate represents the opportunity cost of holding money as cash-money held as cash earns no interest. Money held in some checking accounting or other interest bearing accounts earns a positive interest rate. Thus, money held as cash could be earning this interest rate. An increase in the nominal interest rate encourages people to hold less money as cash and to hold more money in interest bearing accounts since they can now earn a greater return by doing so.

An increase in the long-run aggregate supply curve indicates that

* unemployment has increased.
* employment has increased.
* natural unemployment has increased.
* potential real GDP has increased.

That answer is incorrect.
Correct answer:
potential real GDP has increased.

Short run increases in aggregate supply do not shift the long run potential of the economy; only increases in the long run aggregate supply curve will effectively increase potential GDP. Short run aggregate supply may exceed the long run potential of the economy but only temporarily.

Which of the following will most likely occur in the short run when the long-run equilibrium of an economy is disturbed by an unanticipated decrease in aggregate demand?

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

That answer is incorrect.
Correct answer:
a decrease in output and a lower price level

In response to a decline in aggregate demand, resources may be inflexible; that is, they may not decline sufficiently to adjust to the reduction in aggregate demand. As a result, there will be a recession in which output declines and prices in other markets decline.

In year 0, $10 could purchase a certain basket of goods. In year 20, the identical basket of goods cost

$36. What was the average annualized inflation rate during this period?

* 4.51%
* 7.88%
* 12.21%
* 30.00%
* 6.61%

That answer is incorrect.
Correct answer:
6.61%

The calculation is as follows: (36/10)^(1/20)-1=0.0661

Which of the following would increase GDP?

* buying a 10-year-old house
* giving $100 to a charity
* buying a new automobile made in Indiana by a Japanese owned firm
* buying hamburger buns by McDonald's

That answer is incorrect.
Correct answer:
buying a new automobile made in Indiana by a Japanese owned firm

Since GDP is the total market value of all final goods and services produced domestically during a specific period, the purchase of any good that was produced within the U.S. will positively contribute to the calculation of GDP. Despite the fact that the transaction profits a foreign company, the good was produced within the U.S. and therefore is counted in GDP.

The hamburger buns do not contribute to GDP because they are an intermediate good. The house is a re-sold item, which would have been counted in GDP when it was produced, therefore is not recounted when sold.

According to the quantity theory of money, which one of the following economic variables would change in response to an increase in the money supply?

* prices
* velocity
* real income
* employment

That answer is correct!

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). In order to maintain the equality, if M increases, the price level P must also increase.

Higher unemployment insurance benefits tend to increase unemployment because they

 * reduce the opportunity cost of job search and hence decrease the search time.
 * increase the opportunity cost of job search and hence increase the search time.
 * reduce the opportunity cost of job search and hence increase the search time.
 * increase the opportunity cost of job search and hence decrease the search time.

That answer is incorrect.
Correct answer:
reduce the opportunity cost of job search and hence increase the search time.

A change that reduced the job seeker's cost of continued search would lead to more lengthy periods of search. If unemployment benefits increase, it is less costly to continue looking for a preferred job. This reduction in the cost of job search would induce job seekers to expand their search time. Unemployment would be pushed upward.

Which one of the following would be classified as employed?

 * an auto worker vacationing in Florida during a layoff at a General Motors plant due to an annual change-over in models
 * a parent who works 50-60 hours per week caring for family members
 * a 21-year-old full-time college student
 * a 17-year-old high school student who works six hours per week as a route person for the local newspaper

That answer is incorrect.
Correct answer:
a 17-year-old high school student who works six hours per week as a route person for the local newspaper

A person who is not actively looking for a job is not a member of the labor force and therefore is not employed. An individual who is not a member of the formal market and works at home without wages is not a member of the formal labor force. An auto worker who is waiting to be re-hired or who was laid off is considered unemployed.

If unemployment was deemed too high by policy makers, which of the following policy tools might be utilized?

 * decrease the money supply
 * borrow to finance new military spending
 * reduce government debt
 * increase target interest rates
 * reduce both taxes and government spending
 * raise tariffs to help domestic workers

That answer is incorrect.
Correct answer:
borrow to finance new military spending

One method to reduce unemployment is to engage in expansionary fiscal policy. This requires the government to spend more than it collects in taxes. The result is a net increase in aggregate demand, which will increase the quantity supplied, and therefore reduce unemployment.

An increase in the expected future inflation rate will:

 * move the short-run supply curve to the left.
 * 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.

That answer is correct!

An increase in the expected future inflation rate will have two impacts. First, sellers will have reduced incentive to sell at current prices; they would rather store the current production for future sales at higher prices. Secondly, resource suppliers, to the extent that they anticipate the higher inflation, will increase the resource prices in their contracts. Both these factors will serve to reduce the quantity the producers will be ready to supply at any given price, moving the short run supply curve to the left. The long-run supply curve will not be affected since over that period, all adjustments to the expected future conditions will have been made, restoring the equilibrium.

Countries A and B have the same monetary base and reserve requirement. People in A tend to hold more currency than people in B. The money supply will be:

 * higher in B
 * same in the two countries.
 * insufficient information.
 * higher in A

That answer is correct!

When people hold currency instead of bank deposits, the money goes out of circulation temporarily and the full impact of the deposit expansion multiplier is not felt. The higher this tendency to hold currency, the lower will be the money supply, even though the monetary base has not been affected.

According to Say's law, there cannot be overproduction of goods and services because

 * overproduction will lead to higher unemployment, which will reduce production.
 * demand creates its own supply.
 * less fortunate countries will always buy the excess output.
 * producing goods generates enough income to buy the total output.

That answer is incorrect.
Correct answer:
producing goods generates enough income to buy the total output.

Say's Law is the view that production creates its own demand. Demand will always be sufficient to purchase the goods produced because the income payments to the resource suppliers will equal the value of the goods produced.

The crowding-out model implies that a

* budget surplus will be highly effective against inflation.
* budget deficit is likely to stimulate aggregate demand and trigger a multiplier effect that will lead to inflation.
* budget deficit will increase the real interest rate and thereby retard private spending.
* budget surplus will retard aggregate demand and throw the economy into a downward spiral.

That answer is incorrect.
Correct answer:
budget deficit will increase the real interest rate and thereby retard private spending.

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).

Within the Keynesian model, equilibrium output takes place ________.

* when actual and expected rates of inflation are equal
* when the nominal interest rate and real interest rate are equal
* when spending equals output
* at full employment

That answer is incorrect.
Correct answer:
when spending equals output

Equilibrium is defined in this model as when aggregate expenditures are equal to output. Thus, the sum of planned consumption, investment government purchases and the difference between exports and imports must equal GDP.

If a broad increase in the price of stocks causes an increase in the real wealth of individuals, then the

* aggregate demand curve will shift to the left.
* aggregate demand curve will shift to the right.
* general price level will fall.
* aggregate quantity demanded must rise.

That answer is incorrect.
Correct answer:
aggregate demand curve will shift to the right.

As the real wealth of households increases, people demand more goods and services. This causes the entire aggregate demand curve to shift to the right.

A client tells you that he currently earns $100,000 per year and is comfortable with his lifestyle at that income level. He says he is planning on retiring in 5 years. If inflation averages 8% over the next 5 years, approximately what income level will this client require to maintain his current lifestyle?

* $147,000
* Not enough information
* $169,000
* $122,000
* $140,000

That answer is correct!

The calculation is as follows: (1.08)^(5)*100000=$146,933

Use the table below to choose the correct answer.

Time Period	Actual Inflation
1	4 percent
2	4 percent
3	6 percent
4	8 percent

According to the adaptive expectations hypothesis, at the beginning of period 3, decision makers would expect inflation during period 3 to be ________.

* 6 percent
* 5 percent
* 8 percent
* 4 percent

That answer is incorrect.
Correct answer:
4 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 4 percent will persist in the future.

Which of the following is/are components of the M3 money supply?

I. Overnight repos
II. Overnight Eurodollar deposits
III. M1 supply
IV. M2 supply

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

That answer is correct!

Note that the M3 supply is the broadest definition of money supply and hence, anything that fits into the definition of money supply is automatically a part of M3.

Congress passes a law requiring the government to pay certain debts of companies that have declared bankruptcy. Which of the following terms most accurately describes this program?

 * supply-side
 * automatic stabilizer
 * expansionary fiscal policy
 * moral hazard
 * none of these answers is correct
 * monetary policy

That answer is incorrect.
Correct answer:
automatic stabilizer

An automatic stabilizer is anything that would decrease the government budget surplus during slow economies and increase the surplus during strong economic periods. During slow economic periods, bankruptcies are likely to rise, and by paying a portion of the defunct firms' debts, the government is injecting demand into the economy. This should be distinguished from an expansionary fiscal policy, because the program is not designed to expand national income, but to stabilize a slowdown without the need for further government action.

The "extra" money you take on a trip in case your car breaks down is an example of the

 * transactions demand for money.
 * inflationary demand for money.
 * restrictive demand for money.
 * speculative demand for money.
 * precautionary demand for money.

That answer is incorrect.
Correct answer:
precautionary demand for money.

Precautionary demand for money is defined as a demand for cash balances in case of unforeseen circumstances which require money.

Mr. Taylor states in his will that his $50,000 portfolio of bank CD's will go to his only son. Upon Mr. Taylor's death, the son sells the CD's and invests the proceeds in a stock mutual fund.

How does this immediately impact M2 and the effective amount money available for transactions?

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

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

Prior to Mr. Taylor's death, the CD's were counted as part of M2. In addition, this money was not used for current consumption. After the sale of the CD's, the money is still not being used for current consumption, but it is now not counted as part of M2. The real level of money in circulation has not changed here, but the measure of the money supply has decreased. This is an example of a distortion of money supply measures.

Given the information below, during which quarters does real income decline?

	Nominal GDP	GDP Deflator
Q 0 (base)	981	100
Q 1	993	101
Q 2	1,001	106
Q 3	1,042	111
Q 4	1,040	107

* all four quarters
* none of these answers is correct
* 2,3
* 4 only
* 2,3,and 4
* not enough information given

That answer is incorrect.
Correct answer:
2,3

Real income is measure by real GDP. The first step in this problem is to calculate real GDP in each period by multiplying nominal GDP by the base GDP deflator and then dividing by the current GDP deflator. The result is as follows:

Q1 983
Q2 944
Q3 939
Q4 972

Therefore real income declines in the second and third quarters.

Within the Keynesian model, when planned aggregate demand equals total output,

* the employment rate will equal the labor force participation rate.
* government expenditures will equal revenues.
* the output level will tend to persist into the future.
* income in the future will tend to rise.

That answer is incorrect.
Correct answer:
the output level will tend to persist into the future.

Because Keynesian equilibrium is dependent on equality between planned aggregate expenditures and output, it need not take place at full employment. An economy in Keynesian equilibrium has no tendency for output to change even if output is well below full employment capacity.

Suppose that the Central Bank announces that it will increase the money supply by 5%. Producers collectively determine that this will cause a 5% increase in both the price of their products and the cost of their inputs. How will this impact real GDP?

* increase by more than 5% in the short-run
* increase by an indeterminate degree in the short-run
* cannot determine without knowing whether GDP is below potential
* increase by less than 5% in the short-run
* increase by 5%
* no impact

That answer is incorrect.
Correct answer:
no impact

In order for an increase in the money supply to cause a temporary increase in production, firms must essentially be fooled by inflationary price increases that are misread as an increase in demand. In the scenario described, producers know of the change in money and expect inflation, therefore the increase in the money supply has no impact.

If the amount of money in circulation is $200 million and the nominal GDP is $950 million, then the money velocity is ________.

* 1.90
* 4.75
* 0.21
* 19.0

That answer is incorrect.
Correct answer:
4.75

Velocity of money is defined as GDP divided by the stock of money. It is simply the average number of times a dollar is used to purchase a final product or service during a year. Thus, $950 million divided by $200 million equals 4.75.

According to the Keynesian view of the business cycle, a decline in income generally follows an economic boom because a(n)

 * decrease in the growth rate of consumption (as the full-employment output is reached) leads to a consequent decline in investment, employment and income.
 * increase in the growth rate of consumption (as the full-employment output is reached) sets off an inflationary spiral as the multiplier interacts with the accelerator.
 * decrease in the investment multiplier leads to an increase in saving.
 * increase in the investment multiplier leads to a decrease in saving.

That answer is correct!

Slower growth must follow an expansionary period; this dampens optimism among decision makers and causes fixed investment and consumption to fall. The multiplier magnifies increased pessimism and leads to a reduction in output and income.

If unemployment were 3 percent and prices were rising 12 percent annually, which of the following would be the most appropriate policy?

 * the sale of U.S. securities by the Federal Reserve
 * a decrease in the Fed's reserve requirements
 * a reduction in the discount rate
 * an increase in planned government expenditures

That answer is correct!

The sale of U.S. securities by the Fed will result in a contraction of the money supply. This contraction will precipitate price deflation as the same number of transactions must now be conducted with a smaller amount of money. The Fed's policy would serve to contain inflation.

Each month, the Bureau of Labor Statistics calculates unemployment by

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

That answer is incorrect.
Correct answer:
surveying a random sample of households.

The BLS does not contact each person in the U.S. to determine his or her employment status. Instead, it randomly samples 59,500 households drawn from 729 locations in the U.S. The survey is designed to reflect geographic and demographic groups in proportion to their representation in the nation as a whole.

If the Fed conducts a demand stimulus policy, the rational expectations theory implies that

* the slope of the Phillips curve will increase.
* unemployment will temporarily fall below the natural rate.
* the Phillips curve immediately shifts upward.
* the natural unemployment will rise.

That answer is incorrect.
Correct answer:
the Phillips curve immediately shifts upward.

Under rational expectations people quickly anticipate the effect of policy changes and adjust their actions accordingly. Thus, under a demand stimulus policy the Phillips curve immediately shifts upward because individuals anticipate an acceleration in the inflation rate due to the more expansionary macropolicy.

If the resources of an economy were fully employed and the marginal propensity to consume were 0.75, a $10 billion increase in investment would cause

* real income to rise $40 billion.
* real income to rise $80 billion.
* real income to rise $20 billion.
* inflation to increase.

That answer is incorrect.
Correct answer:
inflation to increase.

When the economy is operating at full employment capacity, increases in aggregate demand cannot be accommodated by increases in output. Instead, increases in aggregate demand are met simply by price increases due to the heightened competition for output.

The consumer price index (CPI) is calculated

* using a fixed basket of goods and will tend to understate inflation.
* using a constantly changing basket of goods and will tend to understate inflation.
* using a constantly changing basket of goods and will tend to overstate inflation.
* using a fixed basket of goods and will tend to overstate inflation.

That answer is incorrect.
Correct answer:
using a fixed basket of goods and will tend to overstate inflation.

The consumer price index is calculated using a market basket based on the Consumer Expenditure Survey of urban consumers. There are 364 items in the market basket. The CPI compares the price of the fixed market basket in the base year with the price of the fixed market basket in the current year to determine how prices have changed over time.

Which of the following will most likely result in an increase in the per capita GDP of a country?

 * an increase in population
 * improvement in the average skill level of the labor force
 * an increase in youthful workers as a proportion of the labor force
 * an increase in the number of retired workers
 * an increase in the GDP deflator

That answer is incorrect.
Correct answer:
improvement in the average skill level of the labor force

Education, training and skill enhancing experience can improve the quality of the labor force and expand the supply of human resources. Such a change causes the potential output of the country to increase so that it is possible to produce and sustain a larger rate of output (in nominal and per capita terms).

In a situation where information is costly to acquire and individuals must spend time searching for jobs, which type of unemployment will result?

 * structural
 * seasonal
 * frictional
 * cyclical

That answer is incorrect.
Correct answer:
frictional

Frictional unemployment is due to constant changes in the economy that prevent qualified unemployed workers from being immediately matched up with existing job opening. It results from the scarcity of information and the search activities of both employers and employees for information that will help them make better employment choices.

Which of the following would be considered non-activist monetary policy?

 * The government allows tax revenues to rise and fall with the business cycle, while keeping spending constant.
 * The Central Bank acts to smooth the business cycle.
 * The Central Bank attempts to keep inflation at a minimum, ignoring unemployment.
 * The Central Bank prints new currency each year in order to increase the money supply by 3%.
 * The Central Bank targets short-term interest rates.

That answer is incorrect.
Correct answer:

The Central Bank prints new currency each year in order to increase the money supply by 3%.

An activist monetary policy involves a changing policy in reaction to economic events. A classic example of non-activist policy would be one that increases the money supply by a certain amount each year.

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

* more consumption expands as the result of a decline in investment.
* greater the marginal propensity to save.
* the 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 expenditure multiplier is found by M = 1/(1-MPC). Thus, the larger the MPC the larger the multiplier. The multiplier magnifies changes in aggregate expenditure into larger changes in aggregate output. the larger the multiplier then, the greater the change in income derived from a given change in private investment.

When financing a budget deficit, the government might borrow money from ________.

* a central bank
* individuals
* all of these answers
* businesses
* foreigners

That answer is incorrect.
Correct answer:
all of these answers

The government can borrow money from the central bank, from private businesses, private citizens and foreigners.

If consumption equals 1,100 when disposable income is 1,200 and increases to 1,400 when disposable income goes to 1,600, what are the marginal propensities to consume and to save?

* MPC = 1/5; MPS = 4/5
* MPC = 2/3; MPS = 1/3
* MPC = 3/4; MPS = 1/4
* MPC = 1/3; MPS = 2/3

That answer is incorrect.
Correct answer:

MPC = 3/4; MPS = 1/4

Since the MPC is determined according to the ratio: MPC = additional consumption divided by additional income, the MPC here equals: 300/400 = .75. MPS = 1-MPC so MPS = .25.

Keynesians believe that a discretionary fiscal policy:

* is destabilizing due to difficulty in timing and should not be used actively.
* is ineffective since people rationally anticipate its future effects.
* none of these answers.
* is not as effective as the monetary policy in controlling unemployment.

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

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.

Which of the following is/are true about monetary policy?

I. The money supply is neutral in the long-run.
II. Monetary policy can only serve to decrease economic volatility.
III. Of the monetary aggregates, Central Bankers only have direct control over the monetary base.

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

That answer is correct!

In the long-run, relative prices are important, not the price level itself. To understand why, imagine if your salary increased by ten times but so did the price of all the goods you buy. This would be a neutral event.

If money is neutral, then monetary policy can have no long-term effect. However, in the short-term, changes in the price level can cause producers to change their production choices, ostensibly helping to smooth out the business cycle.

Central Bankers generally have control over the bank reserve requirement and the level of currency. They do not have control over the amount of currency individuals put into deposit accounts which could later be lent out by banks. Hence, Bankers control the monetary base, but not other money aggregates such as M2 and M3.

Keynesian analysis suggests that a planned budget surplus

* will affect aggregate demand only if the money supply decreases by the size of the surplus.
* is proper during periods of inflation but may increase unemployment if timed improperly.
* will stimulate output and employment.
* will stimulate both consumption and income.

That answer is incorrect.
Correct answer:
is proper during periods of inflation but may increase unemployment if timed improperly.

Keynesians support "counter-cyclical" polices: that is, under an inflationary/full capacity economy, the government should reduce spending (operate under a budget surplus) to contract aggregate demand and control economic growth so as to avoid high levels of inflation. Thus, a budget surplus is appropriate during periods of inflation. If such a policy is enacted when the economy is below full capacity, the proper counter-cyclical policy for the government is to deficit spend. Thus, if the government operates under a budget surplus in this situation, aggregate demand will further contract and unemployment will increase.

Within the Keynesian aggregate expenditure model, the central catalyst that leads to changes in output and employment is changes in

* prices.
* aggregate supply.
* wage rates.
* aggregate expenditures.

That answer is incorrect.
Correct answer:
aggregate expenditures.

Aggregate expenditures are the catalyst of the Keynesian model. Until full employment is attained, supply is always accommodative. Increases in aggregate expenditures thus lead to an expansion in both output and employment as long as the economy is operating below potential capacity.

Built-in features that tend to promote a budget deficit during a recession and a budget surplus during an inflationary boom are known as ________.

* automatic stabilizers
* counter-cyclical policies
* active budget deficits
* restrictive fiscal policies

That answer is correct!

Such built-in stabilizers exist independently of any policy change: tax revenues necessarily fall during a recession (as the economy contracts, there is less income to tax) and government expenditures necessarily rise (more individuals receive government transfers such as unemployment benefits or welfare payments). The converse is true for an inflationary environment: tax revenues are in excess of government expenditures creating a budget surplus. The consequence of these automatic reactions is that during a recession, the economy is stimulated by higher government spending and during inflation economic activity is reduced by smaller government spending.

If business decision makers suddenly become more optimistic about future sales and profits, which of the following will most likely occur?

* The interest rate will fall, causing both investment and GDP to rise.
* Income will increase and actual saving will remain constant.
* Actual investment will increase but consumption will decrease, leaving GDP unchanged.
* Investment will increase, causing both aggregate demand and GDP to increase.

That answer is incorrect.
Correct answer:
Investment will increase, causing both aggregate demand and GDP to increase.

If business decision makers are optimistic about the future, they will increase their private investment and stimulate other parts of the economy. Thus, aggregate demand and aggregate output will increase.

Which one of the following will most likely cause a future increase in a country's sustainable level of real output?

* an increase in income redistribution payments from high- to low-income recipients
* a decline in the nation's oil reserves
* higher marginal tax rates
* an increase in the national debt
* an increase in the economy's net investment rate

That answer is incorrect.
Correct answer:
an increase in the economy's net investment rate

Net investment can increase the supply of physical capital which makes it feasible for the economy to produce a higher level of output permanently into the future. Investment in physical capital can expand the supply of buildings, machines and other physical assets. This allows the economy to produce and sustain a large rate of output, shifting both LRAS and SRAS to the right.

Assume that Polaroid decides to build a camera-research facility in Twin Falls, Idaho. The plant will employ 1,000 workers who will be guaranteed full-time jobs at annual earnings of $25,000. If the marginal propensity to consume in Twin Falls is 3/4, what change in income will result from operation of the plant for one year?

* $75 million
* $50 million
* $25 million
* $100 million

That answer is incorrect.
Correct answer:
$100 million

The expenditure multiplier is found by M = 1/(1-MPC). Thus, here M = 1/(1-3/4) = 4. Therefore the 1,000 x $25,000 = $25 million increase in aggregate expenditures is magnified four times to $100 million.

In the basic Keynesian model of national income determination, aggregate expenditures refer to

 * the amount of demand for consumer goods that would arise if all citizens had all the income they wanted.
 * the combined expenditures of consumers and businesses minus government spending.
 * spending for consumption, investment and exports less imports plus government purchases of goods and services.
 * consumer spending measured in constant prices.
 * the amount of GDP that could be produced if unemployment were zero.

That answer is incorrect.
Correct answer:
spending for consumption, investment and exports less imports plus government purchases of goods and services.

Aggregate expenditures are the sum of planned consumption, investment, government expenditures and net exports.

Fiscal policy designed to increase aggregate demand during economic downturns and decrease aggregate demand during economic booms is called

 * expansionary fiscal policy.
 * supply-side fiscal policy.
 * new classical fiscal policy.
 * counter-cyclical fiscal policy.

That answer is incorrect.
Correct answer:
counter-cyclical fiscal policy.

Counter-cyclical fiscal policy promotes the economy's use of its "automatic stabilizers": government expenditures should rise during recessions (increasing aggregate demand) and should fall during economic booms (decreasing aggregate demand).

________ policy may be used by government officials to deliberately generate a budget deficit.

 * Discretionary fiscal
 * Active fiscal
 * Discretionary monetary
 * Active monetary

That answer is correct!

Discretionary fiscal policy is defined as policymakers instituting deliberate changes in tax laws or spending on government programs that are designed to generate a budget deficit. Deficits emanating from this source are referred to as active budget deficits.

Deposits denominated in U.S. dollars at banks and other financial institutions outside the U.S. are known as ________.

* Federal reserves
* Money market deposit accounts
* Foreign bank reserves
* Fiat money
* Eurodollar deposits

That answer is incorrect.
Correct answer:
Eurodollar deposits

Although this name originated because of the large amounts of such deposits held at banks in Western Europe, similar deposits in other parts of the world are also called Eurodollars.

The prevailing budget philosophy prior to Keynes called for a balanced budget. Keynes argued that the government's tax and spending policies should be determined by the

* demand requirements necessary to attain full employment of resources.
* public's willingness to accept or reject tax changes.
* size and quality of the labor force.
* demand for public goods.

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. 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.

A reserve requirement of 5 percent implies a potential money deposit multiplier of ________.

* 20
* 5
* 10
* 25
* 100

That answer is correct!

The potential money deposit multiplier is the reciprocal (inverse) of the required reserve ratio. Thus, a reserve requirement of .5 implies a potential money deposit multiplier of 1/.5 = 20.

Inflation is problematic for which of the following reasons

I. Purchasing power declines at a faster rate than incomes rise
II. Inflation causes nominal interest rates to rise
III. Inflation creates a disincentive to enter into otherwise beneficial long-term agreements

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

That answer is incorrect.
Correct answer:
III only

Inflation generally implies that all prices, including the price of labor, increase at the same rate. Therefore inflation does not cause a real decline in income. Although nominal interest rates would rise with increased inflation, this does not cause a fundamental economic problem. However, because inflation tends to create long-term uncertainty, many long-term agreements are foregone that would otherwise be beneficial.

The unemployment rate of teen-agers is substantially higher than the unemployment rate of prime-age workers primarily because teen-agers

* are more likely to be in the armed forces and therefore they end up being counted as unemployed.
* are less likely to be in the labor force than older workers since many teenagers are still attending school.
* are less likely to switch jobs and move into and out of the labor force than older workers.
* are more likely to switch jobs and move into and out of the labor force than older workers.
* if they search more diligently, can generally find high-paying jobs that are available only to experienced, highly skilled workers.

That answer is incorrect.
Correct answer:
are more likely to switch jobs and move into and out of the labor force than older workers.

Youthful workers experience more unemployment because they change jobs and move in and out of the labor force often.

Frictional unemployment means

* there is a decline in the demand for labor in the aggregate, due to recessionary tendencies in the economy.
* there are not enough jobs to go around.
* jobs are plentiful but workers scarce.
* imperfect information prevents qualified workers from matching up with the available jobs.

That answer is incorrect.
Correct answer:
imperfect information prevents qualified workers from matching up with the available jobs.

Frictional unemployment refers to unemployment due to constant changes in the economy that prevent qualified unemployed workers from being immediately matched up with existing job openings. It results from the scarcity of information and the search activities of both employers and employees for information that will help them make better employment choices.

Mr. Brown was in the habit of cashing his weekly paycheck and using this cash for his daily expenses. However, he now gets his paycheck direct deposited into his checking account and uses a debit card exclusively instead of cash. This represents an increase in which of the following types of money demand for Mr. Brown?

* transactions demand
* electronic demand
* speculative demand
* store-of-wealth demand
* all of these answers are correct
* none of these answers is correct

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

Mr. Brown money demand has not changed. He is still using his weekly paycheck to satisfy normal expenses, or transactions demand. Although he is "storing" his cash in a checking account until it is to be used, this does not represent store-of-wealth demand. Store-of-wealth implies money that is either invested or accumulated for some future need.

Note that although Mr. Brown's money spending habits have not changed, the way his money is measured by economists has changed. Previously his money was held entirely in currency, whereas now a portion of his money is held in reserve by his bank. Although effectively there has been no change in the use of money, certain monetary aggregates will change.

Inflation has been about 5% for the last several years. There is widespread fear that oil and natural gas prices are about to spike at the same time there is unusually high unemployment.

If inflation were actually 6% next year, and this causes no change in real GDP, what can be said about the general expectation for inflation?

* producers were forming inflation forecasts based on rational expectations
* the general consensus inflation forecast must have been less than 6%
* producers were basing their inflation views on adaptive expectations
* consumers must have foreseen inflation of 6% and increased savings accordingly

* the oil scare held down GDP
* none of these answers is correct

That answer is correct!

If actual inflation were 6%, and this caused no change in real GDP, we know that inflation expectations were probably higher than 6%. There are two major theories as to how inflation expectations are formed. One is adaptive expectations theory. This states that economic participants will expect inflation to be about what it was in the past. The rational expectations hypothesis states that economic participants will consider all available information and make an estimation based on this knowledge.

In this case, we are told that inflation has been about 5% the last several years. Therefore if producers are generally following the adaptive expectations hypothesis, they would have expected 5% inflation. However, we are also told that there may be inflationary pressure from the commodities market. Therefore under the rational expectations hypothesis, market participants would expect inflation to be something higher than 5%. Since we know that expectations must be higher than 6%, we also know that market participants must be forming their expectations rationally.

Which of the following correctly describes how expansionary fiscal policy through tax cuts eventually impacts employment?

* Tax cuts result in more income for consumers, which 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.
* A tax cut shifts the aggregate demand curve out. This causes upward movement along the aggregate supply curve, which increases resource utilization.
* Tax cuts result in more government debt which causes the interest rate to rise and therefore unemployment to fall.
* Tax cuts result in a multiplier effect, as politicians showing confidence in the economy encourages businesses to spend on expansions.
* The tax cut causes an increase in quantity demand. This causes an outward shift in the aggregate supply curve and hence more employment.

That answer is incorrect.
Correct answer:
A tax cut shifts the aggregate demand curve out. This causes upward movement along the aggregate supply curve, which increases resource utilization.

Consumers react to tax cuts as if it were an increase in income. 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.

If the money supply is held constant, an increase in nominal GDP leads to ________ in the velocity of money.

* all of these answers are possible.
* no change
* a decrease
* an increase

That answer is incorrect.
Correct answer:
an increase

The velocity of money, V, satisfies the equation, MV = GDP, where M is the money supply. If M is held constant while GDP increases, then V must increases. Intuitively, this says that if the money supply is not changed, then for production and consumption of a higher GDP, each dollar must change hands more frequently.

In the Keynesian model, if the multiplier is 3, then ________.

* MPS must be approximately .30
* MPC must be approximately 2/3
* MPC must be approximately .30
* MPC must be approximately 1/3
* MPS must be approximately 2/3

That answer is incorrect.
Correct answer:
MPC must be approximately 1/3

The expenditure multiplier is found by M = 1/(1-MPC). Therefore, 3= 1/(1-MPC) implies that MPC is .333)

If the government moves the entire tax schedule upward by 5%, the primary effect on the economy will be through:

* all of these answers.
* the demand side, wherein disposable income and private demand goes down.
* a decrease in the budget deficit due to increase in tax revenues.
* the supply side, wherein the relative attractiveness of productive activity goes down in relation to leisure and tax avoidance activities.

That answer is incorrect.
Correct answer:
the demand side, wherein disposable income and private demand goes down.

It is important to realize that "the supply side answer" is not entirely accurate. The supply side effects become important when the marginal tax rates are skewed in such a way that additional productive activity is discouraged due to higher taxes. When the entire tax schedule moves, the effect through the demand side is much bigger.

An economy is currently experiencing high inflation. A Keynesian would suggest which of the following to combat this:

I. Increasing interest rates.
II. Increasing tax rates.
III. Decreasing government expenditure.

IV. Raising reserve requirements.

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

That answer is incorrect.
Correct answer:
II & III

To control high inflation, Keynesians suggest cutting back on aggregate demand by either raising taxes or decreasing the size of the budget deficit by decreasing government expenditures. They thus recommend a restrictive fiscal policy to combat high inflation. Note that changing the reserve requirement is not an option available to the Federal government in the U.S. because the reserve requirement is set by an independent body, The Federal Reserve.

According to monetarists, ________ is a primary source of economic instability:

* fluctuations in aggregate demand for money
* erratic monetary policy
* fluctuations in aggregate demand for money and fluctuations in aggregate consumption demands
* fluctuations in aggregate consumption demands

That answer is incorrect.
Correct answer:
erratic monetary policy

Monetarists believe that monetary policy has a powerful influence on the economy but also realize that there are lengthy and unpredictable time lags between the implementation of a monetary policy and the realization of its primary effects. Hence, they reject the active use of discretionary monetary policy for controlling the economy, prescribing a steady growth in money supply to track the real growth rate.

"Decision makers systematically err in their forecasts of economic variables." This is implied by which of the following:

* Rational Expectations hypothesis.
* Adaptive Expectations hypothesis.
* Random Expectations hypothesis.
* Constant Expectations hypothesis.

That answer is incorrect.
Correct answer:
Adaptive Expectations hypothesis.

According to the Adaptive Expectations hypothesis, people consider the recent past as the best predictor of the immediate future. Hence, when an economic variable is increasing, they will consistently tend to under-estimate the future value of that variable and vice versa. Thus, they systematically err in their decision-making, without learning from past mistakes.

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

That answer is incorrect.
Correct answer:
increase in employment, output and real income.

Since according to the Keynesian model aggregate demand determines the level of output in the economy, an increase in the demand will cause output to increase. Since output is equivalent to income, real income also increases. The increase in output stimulates increases in labor demand and thus unemployment declines. Increases in aggregate demand below the full employment capacity of the economy has no effect on prices.

An economic researcher publishes evidence that the consensus inflation estimation for the following year has no correlation with the actual inflation level the year before. The estimation error is often very large, but does not display a pattern. Which of the following theories would this evidence support?

* rational ignorance
* mean reversion
* heteroskedasticity
* monetarist theory
* rational expectations hypothesis
* adaptive expectations hypothesis

That answer is incorrect.
Correct answer:
rational expectations hypothesis

Under the rational expectations hypothesis, individuals will form inflation expectations based on all relevant information available. Therefore a comparison of expected and realized inflation would show a random estimation error and no correlation with past estimates. The adaptive expectations hypothesis suggests that individuals will base their views of the future on their recent experience. Under this theory, estimations would show a pattern in the error. Expected inflation would tend to be too high following a period of high inflation, and then too low follow a period of limited inflation.

During an economic boom, the AD-AS model indicates that

* both the real interest rate and real wage rates will decline.
* real interest rate will decline and real wage rates will rise.
* real interest rate will rise and real wage rates will decline.
* both the real interest rate and real wage rates will increase.
* real wage rates will remain constant while the real interest rate will rise.

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

High demand for resources (like labor) during an economic boom will increase the price of labor (the real wage rate). Similarly high demand for loanable funds during a boom will cause the real interest rate to rise.

Compared to the adaptive expectations hypothesis (which suggests a downward-sloping Phillips curve in the short run), the rational expectations hypothesis suggests that the Phillips curve is

* vertical.
* slightly less downward sloping.
* horizontal.
* slightly more downward sloping.
* upward sloping.

That answer is correct!

The rational expectations hypothesis predicts a vertical Phillips curve since the unemployment rate always returns to the long run natural rate of unemployment.

An economy is currently operating at full employment. If the Fed unexpectedly decreases the reserve requirement, in the short run, the aggregate output will ________. The unemployment will ________ the natural rate.

* fall, rise above
* rise, fall below
* rise, rise above
* fall, fall below

That answer is incorrect.
Correct answer:
rise, fall below

The unexpected decrease in the reserve requirement causes an unexpected expansion in money supply. In the short run, this leads to lower real interest rates. The increased availability of credit coupled with the rise in demand leads to an increase in real output and employment. Temporarily, the unemployment rate falls below the natural rate.

The population of Tunisia is 100 million; 5 million are unemployed and 90 million hold jobs. The employment rate in Tunisia is

* 90 percent.
* 5 percent.
* 95 percent.
* 85 percent.

That answer is correct!

The employment rate is equal to the number employed/total population or 90 million/100 million = 90%.

When individuals are unemployed because they lack the qualifications to fill available jobs, we call this a form of

 * natural unemployment.
 * frictional unemployment.
 * structural unemployment.
 * cyclical unemployment.

That answer is incorrect.
Correct answer:
structural unemployment.

Structural unemployment implies that changes in the basic characteristics of the economy prevent the "matching up" of available jobs with available workers. Thus, workers possess skills which are not demanded by employers and employers demand skills that unemployed workers do not have.

An expansionary fiscal policy causes which of the following effects?

I. The domestic currency depreciates.
II. Exports decrease.
III. Real interest rates increase.
IV. Capital flows in from abroad.

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

That answer is correct!

When the government adopts an expansionary fiscal policy, the aggregate demand increases, causing an increase in prices. Since the demand for loanable funds increases due to the governmental presence in the market, the real interest rate increases. This attracts foreign investment, raising the demand for domestic currency, which appreciates in response. The appreciation of the domestic currency makes imports cheaper and exports costlier. As a result, exports decline and imports increase over time.

Holding income constant, if consumers and investors decide to spend more on goods and services, then

 * additional spending will require increased borrowing (or less saving), which will drive up the real rate of interest.

 * 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!

Strong aggregate demand will put pressure on the market for loanable funds and will result in higher interest rates (as the demand for funds increases). This will cause aggregate demand to contract from its heightened state. This adjustment represents one of the economy's self-correcting mechanisms.

The Keynesian model indicates that when individuals plan to save more (and spend less), the result may be a(n)

 * increase in investment because investment always equals saving.
 * decline in the equilibrium level of income.
 * increase in the marginal propensity to consume.
 * increase in equilibrium income by some multiple of the increase in saving.

That answer is incorrect.
Correct answer:
decline in the equilibrium level of income.

An increase in savings implies a decrease in disposable income and thus a decline in consumption. As a result aggregate demand will fall and output will follow. Output is equivalent to income and thus the equilibrium level of income also declines.

Given:

Population	50 million
Number in the labor force	30 million
Number employed full time	20 million
Number employed part time	8 million
Number unemployed	2 million

What is the unemployment rate of the economy?

 * 10.0 percent
 * 4.0 percent
 * 7.1 percent
 * 6.7 percent

That answer is incorrect.
Correct answer:
6.7 percent

The unemployment rate is the number of unemployed people divided by the number of people in the labor force or: 2/20 = 6.7%.

Which of the following about the multiplier is false?

* Idle resources are necessary before the multiplier can bring about an increase in real income.
* The size of the multiplier relates directly to the size of the marginal propensity to consume.
* It is defined as 1 / (1 - the marginal propensity to save).
* It takes time for the multiplier to work.

That answer is incorrect.
Correct answer:
It is defined as 1 / (1 - the marginal propensity to save).

The multiplier is defined as M = 1/(1-MPC) rather than 1 / (1 - MPS).

In Keynesian view, the best macroeconomic policy is to:

* increase government investment expenditures during economic booms to offset effects of reduced capacity during the recession to follow.
* regulate aggregate expenditures to match output capacity.
* regulate wages to control inflation and promote full employment.
* control government expenditures to control inflation.

That answer is incorrect.
Correct answer:
regulate aggregate expenditures to match output capacity.

In Keynesian economics, fluctuations in aggregate demand are a major source of movements in the economy. Equilibrium occurs at any output level which equals the spending level. To maintain an equilibrium at the maximum sustainable real GDP, Keynesians prescribe regulating the planned aggregate expenditures to equal the potential real GDP.

If the Fed introduces an expansionary monetary policy:

I. real interest rates fall.
II. the U.S. dollar appreciates.
III. the U.S. exports increase relative to imports.

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

That answer is incorrect.
Correct answer:
I & III

When the Fed introduces an expansionary monetary policy, the money supply increases, causing the real interest rate to fall. This leads to a flow of funds out of the U.S. and into economies with higher real rates. The decreased demand for the U.S. dollar causes it to depreciate. This, in turn, makes the U.S. goods cheaper relative to foreign goods, increasing the U.S. exports and decreasing its imports.

Note that this offsetting increase in the demand for U.S. dollar works more slowly than the initial depreciation caused by the outflow of monetary funds.

The nation of Myopia is having a massive inflation problem. To stabilize prices, the Myopian Central Bank decides to acquire large numbers of Capitalian Dollars (a very stable currency) and offer to exchange five Myopian Pesos for one Capitalian Dollar on demand.

How does this impact the monetary base and the effective money supply for the nation of Capitalia?

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

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

The monetary base is made up of currency and bank reserves. In this case, Myopia has taken large amounts of currency out of circulation in Capitalia, but the expatriated currency is technically still part of the monetary base. Therefore the base has not changed, but the effective money in circulation has decreased. This is one of the problems economists face in attempting to measure the real money supply.

Which one of the following will most likely cause a future increase in the growth rate of real output?

* an increase in income redistribution payments from high- to low-income recipients
* discovery of a new low-cost method of converting oil shale into petroleum
* higher marginal tax rates
* a decrease in the economy's net investment rate

That answer is incorrect.
Correct answer:
discovery of a new low-cost method of converting oil shale into petroleum

Improvements in technology that permit us to squeeze a larger output from a specific resource supply enhance our productivity and thereby shift the long run aggregate supply curve to the right.

Within the AD/AS model, an unanticipated increase in short-run aggregate supply will cause real output to

* decline and prices fall.
* decline and prices rise.
* expand and prices rise.
* expand and prices fall.

That answer is incorrect.
Correct answer:
expand and prices fall.

An unanticipated increase in aggregate supply decreases the price level and increases current output. The long run aggregate supply of the country is not affected.

Within the Keynesian model, if an economy operates below full employment,

* reducing wage rates and resource prices will quickly restore full-employment equilibrium.
* reducing government expenditures will direct the economy back to full- employment equilibrium.
* an increase in the real interest rate will soon restore full-employment equilibrium.
* output will tend to remain below full-employment capacity unless aggregate expenditures increase.
* reducing the real interest rate will soon restore full-employment equilibrium.

That answer is incorrect.
Correct answer:
output will tend to remain below full-employment capacity unless aggregate expenditures increase.

An economy operating below its full employment level can only reach its full employment capacity by increasing aggregate expenditures. This can be achieved only by inducing consumers, investors, governments and foreigners to increase their expenditures.

When an economy operates well below its full-employment capacity and the marginal propensity to consume is 3/4, a $20 billion increase in autonomous investment will cause the equilibrium income to rise

* $80 billion.
* $40 billion.
* $20 billion.
* $15 billion.

That answer is correct!

The expenditure multiplier is found by M = 1/(1-MPC). Thus, here M = 1/(1-3/4) = 4. Therefore $20 billion increase in aggregate expenditures is magnified four times to $80 billion.

Government borrowing to fund current spending tends to cause _________ to rise. Subsequently, the local currency will _________ causing the trade deficit to rise.

* savings rate, depreciate
* national income, depreciate
* inflation, depreciate
* marginal propensity to consume, appreciate
* interest rates, appreciate

That answer is incorrect.
Correct answer:
interest rates, appreciate

Government borrowing creates demand for loanable funds, and therefore increases the price of such funds, i.e. the interest rate. When interest rates rise versus foreign rates, the value of the local currency rises on the foreign exchange market. This causes imports to be less expensive locally and exports to be more expensive abroad, and therefore tends to cause the current account trade deficit to widen.

The relationship between inflation and unemployment rate is known as:

* Phillips curve.
* Equation of exchange
* Lucas curve.
* Inflation-unemployment parity

That answer is correct!

Following earlier work by the British economist, A. Phillips, economists noted an inverse relationship between the rate of unemployment and the rate of inflation. This curve is widely known as the Phillips curve.

The GDP measures:

* the total value of all goods, services and financial transactions during a period.
* the total value of all the earnings in the economy.
* the total value of all goods and services produced in the economy during a period.
* the total value of all final goods and services produced in the economy during a period.

That answer is incorrect.
Correct answer:
the total value of all final goods and services produced in the economy during a period.

Note that the phrase "final goods" is critical. Intermediate goods are ignored in the calculation of GDP, as are all financial transactions. Further, since earnings look at net profits on goods and services but subtract out the employee salaries, for one, a sum of the earnings in an economy will significantly underestimate GDP.

A bank has deposits of $23 billion and reserves of $3.1 billion. If the excess reserves equal $400 million, the deposit expansion multiplier equals ________.

* 9.11
* 8.33
* 8.52
* 7.42

That answer is incorrect.
Correct answer:
8.52

The required reserves equal 3.1 - 0.4 = $2.7 billion on deposits worth $23 billion. Thus, the required reserve ratio equals 2.7/23 = 11.74%. So the deposit expansion multiplier equals 1/0.1174 = 8.52.

Which of the following would not be an expected impact of a debt pay down program?

 * a decrease in aggregate demand
 * a shift to the left in the aggregate supply curve
 * an increase in unemployment
 * a decrease in the price level
 * falling interest rates

That answer is incorrect.
Correct answer:
a shift to the left in the aggregate supply curve

Theoretically, fiscal policy should cause a shift in the aggregate demand curve, which will cause movement along the supply curve. Debt pay down implies that net government spending (spending less taxes) is negative, and therefore the demand curve has shifted to the left, while the supply curve has not moved.

A reserve requirement of 12.5 percent implies a potential money deposit expansion multiplier of ________.

 * 8
 * 12.5
 * 25
 * 5

That answer is correct!

The potential money deposit expansion multiplier is calculated by taking the inverse of the reserve requirement ratio. This is: 1/.125 = 8.

James Morrison is a profit-seeking banker. His bank has $25 million in excess reserves. Mr. Morrison

 * can probably increase his profits by increasing his excess reserves.
 * cannot affect his profits by changing the amount of excess reserves held by his bank.
 * cannot change excess reserves held by his bank because this level is set and strictly enforced by the Fed.
 * can probably increase his profits by reducing his excess reserves.

That answer is incorrect.

Correct answer:
can probably increase his profits by reducing his excess reserves.

A bank holding excess reserves can increase its profits by extending more loans and holding fewer excess reserves. This is because the excess reserves held by the bank do not earn any interest. However, excess reserves extended as loans earn a positive interest rate and therefore will allow the bank to make a positive profit. Excess reserves represent the portion of reserves held by the bank in excess of the required reserve ratio set by the Fed.

Inflation

* causes the purchasing power of a dollar to rise.
* generally benefits the poor at the expense of the rich.
* is measured by changes in the cost of a typical market basket of goods between time periods.
* almost always benefits creditors at the expense of debtors.

That answer is incorrect.
Correct answer:
is measured by changes in the cost of a typical market basket of goods between time periods.

Inflation can be measured by using price indexes. In general, these indexes are constructed by calculating the difference between the price of a basket of consumer goods in earlier and later years and dividing by the price of the basket in the first year.

Which of the following is/are true about aggregate demand?

I. An increase in the real rates of interest increases current demand.
II. An increased optimism about the future direction of the economy will increase current demand.
III. An increase in the expected future inflation rate increases current demand.

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

That answer is correct!

An increase in real interest rates makes current consumption more expensive in terms of opportunity cost. Hence, when real rates rise, current demand falls. On the other hand, if future inflation is expected to be high, then consumers want to buy goods in the current period, raising aggregate demand. Similarly, if they expect the future to be prosperous, they will spend some of that expected future income on current consumption. Hence, both higher expected future inflation and future wealth will increase current demand.

"An erratic monetary policy is the primary sources of business instability and inflation." This view is held by

* Monetarists.

* Keynesians.
* Classical economists.
* Neoclassical economists.

That answer is correct!

Monetarists believe that monetary policy has a powerful influence on the economy but also realize that there are lengthy and unpredictable time lags between the implementation of a monetary policy and the realization of its primary effects. Hence, an erratic monetary policy can lead to big instabilities in the economy.

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 rise.
* Output will decrease and prices fall.
* Output will increase and prices rise.
* Output will increase and prices decline.

That answer is incorrect.
Correct answer:
Output will increase and prices rise.

Optimism concerning the future direction of the economy will stimulate investment. Investment today may be necessary in order to benefit fully from future opportunities. This will cause aggregate demand to rise; in response, output will rise as will prices (due to increased competition for output and resources).

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

* higher wages and prices will quickly restore full employment.
* only expansionary fiscal policy will direct the economy back to full employment.
* excess supply in resource markets will eventually lead to lower resource prices, which will reduce costs and direct the economy toward full employment.
* excess demand in resource markets will lead to higher resource prices, which will increase cost and direct the economy toward full employment.

That answer is incorrect.
Correct answer:
excess supply in resource markets will eventually lead to lower resource prices, which will reduce costs and direct the economy toward full employment.

An economy operating below full employment will have an excess supply of resources which serves to contract the price of these resources. Overall production costs will fall and will stimulate aggregate supply. The economy will expand real output and move closer to full employment output.

Which of the following is most likely to occur in a nation running a current account trade deficit?

* Large investments by domestic citizens in foreign investments
* Unemployment resulting from purchase of foreign goods
* Erosion in domestic currency value on foreign exchange
* Domestic government debt widely bought by foreign investors
* Disinflation

That answer is incorrect.
Correct answer:
Domestic government debt widely bought by foreign investors

A current account trade deficit implies that domestic citizens import more than they export. Any deficit in the current account must be offset exactly by a surplus in the capital account. Therefore, the deficit mentioned in the question implies that more foreign investment is occurring domestically. Since current account deficits and government budget deficits are often linked, this foreign investment might come in the form of a purchase of government bonds.

Inflation is problematic for all of the following reasons except

* it causes real income to fall
* it discourages saving and investing
* it creates incentives toward inefficient allocation of resources
* information communicated by prices is clouded
* long-term planning is made more difficult

That answer is correct!

Inflation generally implies that all prices, including the price of labor, increase at the same rate. Therefore inflation does not cause a real decline in income.

If the Fed wanted to use all three of its major monetary control tools to decrease the money supply, it would

* sell bonds, reduce the discount rate and reduce, reserve requirements.
* buy bonds, reduce the discount rate and reduce reserve requirements.
* sell bonds, reduce the discount rate and increase reserve requirements.
* sell bonds, increase the discount rate and increase reserve requirements.

That answer is incorrect.
Correct answer:
sell bonds, increase the discount rate and increase reserve requirements.

By selling bonds, the Fed exchanges slips of paper representing bonds for currency. Thus, individuals or firms which formerly held money now hold bonds. This serves to reduce the money the supply. By increasing the discount rate, the Fed reduces the likelihood that banks will extend loans. This is because banks realize they must pay a higher interest rate to the Fed (the discount rate) if they fail to satisfy the required reserve ratio at the end of each day. By restricting the likelihood of loans, the Fed can reduce the money supply in the economy. Finally, by increasing the reserve requirement ratio the Fed reduces the likelihood of banks to extend loans since they must keep a higher fraction of their demand deposits in their vaults. This also serves to reduce the money supply.

An economy is currently in a boom phase. Which of the following is likely to occur?

 * resource prices will rise and people will save more, leading to higher incomes and capital investment, moving the economy out of the recession.
 * resources prices will rise, employment will decrease and the economy will move toward full-employment equilibrium.
 * The supply curve will move to the right, leading the economy toward full employment level.
 * The demand curve will move to the left, leading the economy toward full employment level.

That answer is incorrect.
Correct answer:
The supply curve will move to the right, leading the economy toward full employment level.

When aggregate output is less than the full employment output, there will be a downward pressure on resource prices due to weak employment conditions. In turn the lower wages will serve to increase employment and allow suppliers to expand output at any given price. The supply curve will move to the right and output will increase till the economy reaches the maximum sustainable efficiency. At this point, unemployment will equal the natural rate and output will equal the potential GDP.

If an economy is experiencing high unemployment as the result of deficient aggregate demand, according to the Keynesian view which of the following policy alternatives would most likely push the economy to full employment?

 * a tax cut coupled with an equal reduction in government expenditures
 * an increase in government expenditures coupled with an increase in taxes
 * a decrease in tax rates, leaving government expenditures unchanged
 * a level of taxes and government spending that would keep the budget in balance

That answer is incorrect.
Correct answer:
a decrease in tax rates, leaving government expenditures unchanged

A decrease in tax rates will reduce the tax revenues collected by the government. If expenditure is held constant, this will result in budget deficits. Another consequence will be an increase in aggregate demand as consumer disposable incomes rise. This is an example of the "counter-cyclical" policy with Keynesian economists promote.

Which of the following would not be an expected impact of a hike in across the board taxes with no corresponding increase in government spending?

 * a shift to the left of the aggregate demand curve
 * a decrease in interest rates
 * an increase in unemployment
 * an drop in capital utilization
 * a shift to the left of the aggregate supply curve

That answer is incorrect.
Correct answer:
a shift to the left of the aggregate supply curve

Theoretically, fiscal policy should cause a shift in the aggregate demand curve, which will cause movement along the supply curve. Had the question talked about a hike in marginal taxes, then a supply-side argument might have suggested a shift in the supply curve, but across the board taxes would not reshape supply.

The interest rate the Federal Reserve changes banking institutions for borrowing funds is called the ________.

* none of these answers
* federal funds rate
* nominal interest rate
* all of these answers
* discount rate

That answer is incorrect.
Correct answer:
discount rate

Banking institutions borrowing funds from the Federal Reserve pay interest on the loan. This interest rate is the discount rate. Banks borrow from the Fed primarily to meet temporary shortages of reserves. An increase in the discount rate makes it more expensive for banking institutions to borrow from the Fed.

In an economy, the Department of Labor has released the following figures:
Population: 100,000
Full-time employed: 45,000
Part-time employed: 18,000 (averaging one-third work day)
Labor force: 76,000
People above age 16: 83,000

The labor force participation rate, the unemployment rate and employment/population ratio are:

* 91.57%; 17.11%; 63%
* 83%; 32.89%; 63%
* 76%; 82.89%; 63%
* 91.57%; 32.89%; 51%

That answer is correct!

Even people who are employed part-time are considered fully employed. Therefore, the total employment equals 45,000 + 18,000 = 63,000. The total labor force has been given to be 76,000. The unemployment rate is defined as the fraction of the labor force unemployed. In this case, (76 - 63)/76 = 17.11%. The labor force participation rate is defined as the fraction of able-bodied adults who are part of the labor force. The working definition of adults used by Dept. of Labor is "people above the age of 16." Therefore, the labor force participation rate equals 76,000/83,000 = 91.57%. Finally, the employment to population ratio equals 63,000/100,000 = 63%.

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 GDP and leave GNP unchanged.
 * It would leave both GDP and GNP unchanged.
 * It would increase GNP and GDP.
 * It would increase GNP and leave GDP unchanged.

That answer is incorrect.
Correct answer:
It would increase GNP and leave GDP unchanged.

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, since an American owns the capital that generated the product, the purchase of the hamburger contributes positively to GNP.

"A general overproduction of goods relative to demand is impossible since supply creates its own demand." This is associated with:

 * Production possibility frontier.
 * Say's Law.
 * Keynesian Law.
 * Demand-supply equilibrium.

That answer is incorrect.
Correct answer:
Say's Law.

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.

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

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

That answer is correct!

Economic growth and technological progress shifts the economy's long run aggregate supply curve to the right. Such expansions in the productive capacity of an economy takes place gradually and are anticipated by decision makers.

The Central Bank increases the money supply by 1%. This was widely anticipated by economic participants. The economy is operating below potential. In the short-run, this will cause the aggregate supply curve to ________, the aggregate demand curve to ________, and the price level to ________.

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

That answer is incorrect.
Correct answer:
shift left, shift right, increase

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.

In contrast to nominal GDP, real GDP refers to nominal GDP

* corrected for depreciation.
* corrected for price changes.
* minus personal income taxes.
* minus exports.

That answer is incorrect.
Correct answer:
corrected for price changes.

The real gross domestic product is found by adjusting nominal GDP for changes in the price level. This can be done using the GDP deflator.

The yen-crisis in Japan has lead to a significant recession in the country. Many of the firms have experienced big losses or falling profit rates. In an effort to combat this, firms have laid off a sizable population of their workforce. This increase in the nation's unemployment is known as:

* Cyclical unemployment.
* Frictional unemployment.

* Business unemployment.
* Structural unemployment.

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."

When an economy dips into a recession, which of the following occur(s)?

I. Unemployment compensation increases, increasing the budget deficit.

II. Corporate taxes increase, causing a decrease in profits.

III. The government's tax revenues decrease, increasing the budget deficit.

IV. Interest rates automatically fall to increase private investment and pull the economy out of the recession.

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

That answer is correct!

In II, corporate profits decline, causing a fall in the tax revenues. Also, IV is not correct since the changes in real rates do not automatically extricate an economy from a recession. On the other hand, unemployment compensation and the existing progressive tax structure act as automatic stabilizers and serve to increase the budget deficit during recessions.

Demand deposits are

* interest-earning savings deposits of individuals held by mutual savings banks.
* deposits of commercial banks with the U.S. Treasury that are available on demand.
* deposits of individuals that can either be withdrawn or made payable on demand to a third party by a check.
* deposits held by individuals at one of the 12 Federal Reserve banks.

That answer is incorrect.
Correct answer:
deposits of individuals that can either be withdrawn or made payable on demand to a third party by a check.

Demand deposits are non-interest bearing deposits in a bank that either can be withdrawn or made payable on demand to a third party via check. They are in essence, "checkbook money" because they permit transactions to be paid for by check rather than by currency.

The net result of persistent monetary growth will be sustained ________.

 * economic recession
 * inflation
 * deflation
 * none of these answers
 * economic growth

That answer is incorrect.
Correct answer:
inflation

If the economy is operating near or at full capacity, increasing the money supply will result only in raising the price level. Under a rapidly growing supply of money, aggregate demand increases. Real output may increase in the short-term, but eventually the upward pressure on wages and other resource prices will shift aggregate supply inward. Output will return to its initial level but at a higher price level.

Researchers tend to be more interested in real GDP than nominal GDP for all of the following reasons except

 * real GDP shows the impact of growth in the money supply
 * changes in real GDP can be more accurately compared with past periods
 * nominal GDP does not differentiate between changes in output and changes in the price level
 * real GDP excludes the effects of inflation

That answer is correct!

Real GDP is simply nominal GDP less inflation, in this case measured by the GDP deflator. Therefore changes in real GDP represent real changes in output, and subsequently is usually more useful to researchers. Because inflation varies substantially, real GDP is more comparable historically. Real GDP does not show the impact of changes in the money supply, which is another way of describing inflation.

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.
 * Unemployment decreases.
 * Prices increase.

That answer is correct!

If aggregate expenditures are smaller than expected, inventories of unsold goods develop and producers will reduce their output in order to drain their inventories down.

A wealthy stamp collector recently sold a rare stamp for $80,000 that he purchased two years earlier for only $10,000. What impact will this transaction have on GDP?

* There is no change in GDP.
* GDP increases by $80,000.
* GDP increases by $70,000.
* GDP declines by $70,000.

That answer is correct!

GDP is the total market value of all final goods and services produced domestically during a specific period. Since the rare coin was not produced during the period in which GDP is calculated its sale will have no effect on GDP.

"Consumption of a household is largely determined by its long-run expected income." This is associated with:

* Permanent income hypothesis.
* Marginal propensity to consume.
* Say's law.
* Consumption-Income hypothesis.

That answer is correct!

The Permanent Income Hypothesis, proposed by economist Milton Friedman, maintains that households prefer to maintain a smooth pattern of consumption and hate to have it fluctuate too much. Hence, in lean times, they prefer to borrow against their expected future income and save in times of windfall in a manner which maintains a stable consumption level.

A program which increases the budget deficit during recessions and decreases it during economic booms on its own is known as:

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

That answer is incorrect.
Correct answer:
an automatic stabilizer.

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. When a governmental program achieves this counter-cyclical policy automatically due to built-in features of the program, it is known as an "automatic stabilizer" of the economy. Programs like unemployment benefits, progressive income tax and corporate taxes are automatic stabilizers.

Which of the following will lead to a reduction in aggregate demand in the U.S. ?

 * a reduction in the real interest rate
 * an increase in the exchange-rate of the dollar
 * rapid growth in real income in Japan and Western Europe
 * a higher price level

That answer is incorrect.
Correct answer:
an increase in the exchange-rate of the dollar

An increase in the exchange rate value of the dollar will make the dollar price of foreign goods cheaper to U.S. consumers. It will also make U.S. goods more expensive to foreign consumers. As a result net exports will decline which retards aggregate demand.

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

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

That answer is correct!

In order to decrease this over-night interest rate, the central bank must lend cash to banks in the open market. This results in new cash injected into the economy, and an expansion of the money supply. If there is more money with no increase in output, then the price of goods must rise. To see why this must happen, remember the P = M/Y, or Price Level = Money Supply / Output. Usually the central bank's goal in an expansionary money policy is to eventually increase output, but this is not an immediate effect.

If aggregate output is at the full-employment level and the government budget is balanced. Within the Keynesian model, a reduction in planned investment would probably lead to

 * an increase in output and a government budget surplus.
 * no change 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.
 * a decline 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.

Cyclical unemployment is primarily caused by

 * a large proportion of youthful workers in the labor force.
 * a lack of training on the part of job seekers.
 * fluctuations in aggregate demand.
 * the failure of employees to search adequately for the available jobs.

That answer is incorrect.
Correct answer:
fluctuations in aggregate demand.

Cyclical unemployment arises when there is a general downturn in business activity. Unemployment develops due to recessionary business conditions and inadequate aggregate demand for labor.

Inflation is problematic for lenders because

 * Lenders will not be compensated for inflation levels higher than expectations.
 * Lenders are historically poor at gauging inflation expectations.
 * Inflation is rarely a factor in setting interest rates.
 * Usury laws prevent lenders from including the full inflation expectation.
 * Inflation lower than expectations impacts lenders' profits.

That answer is correct!

Some inflation expectation is priced into any loan interest rate. If actual inflation is higher than this over the loan period, then lenders will not receive adequate compensation for the decrease in purchasing power of the loaned principal. For this reason, lenders in a volatile inflation economy will be unwilling to lend funds for long-term fixed rates.

A medium of exchange, an accounting unit and a store of value is the definition of ________.

 * a Eurodollar deposit
 * a checkable deposit
 * currency
 * money supply
 * money
 * the real interest rate

That answer is incorrect.
Correct answer:
money

Money represents an asset that performance these three basic functions. It is its usefulness derives from these three functions. Note that money does not have to come in the form of currency, and not all currency can be considered money. For example, an American cannot buy goods locally with Russian Rubbles, therefore for that American, the Rubbles are not money. Conversely, many times in history gold, silver, salt, or other items have been used as money.

Analysis of the modern expectational Phillips curve indicates that if people

* accurately estimate inflation, actual unemployment will exceed the natural rate.
* overestimate inflation, actual unemployment will exceed the natural rate.
* accurately estimate the rate of inflation, the actual rate of unemployment will be less than the natural rate.
* underestimate inflation, actual unemployment will exceed the natural rate.

That answer is incorrect.
Correct answer:
overestimate inflation, actual unemployment will exceed the natural rate.

The modern view of the Phillips curve is that higher than expected inflation will serve to lower the rate of unemployment through an erosion of the real wage. Since wage contracts are written to reflect the anticipated rate of inflation, nominal wages do not keep pace with the actual rate of inflation. As a result, employment rises since labor is now cheaper.

In the Keynesian aggregate expenditure model, the central catalyst that leads to change in output and employment is change in

* the interest rate.
* prices.
* aggregate supply.
* wage rates.
* aggregate demand.

That answer is incorrect.
Correct answer:
aggregate demand.

Under the Keynesian model, aggregate expenditures are considered the catalyst the change in output; that is, aggregate output is accommodative of aggregate expenditures. As a result, employment is also altered through aggregate expenditures since it is positively related to the level of output in the economy.

The marginal propensity to consume is defined as the

* fraction of a change in income that is saved.
* fraction of income allocated to saving.
* fraction of income spent on consumption.
* fraction of income that is not spent on consumption.
* change in consumption divided by the change in income.

That answer is incorrect.
Correct answer:
change in consumption divided by the change in income.

MPC = additional consumption divided by additional income.

Suppose the Fed has reduced the money supply in an effort to decelerate inflation. If decision makers anticipate that the Fed will soon shift back to a more expansionary monetary policy, the decline in the money supply will

 * be less effective as an anti-inflationary weapon.
 * be more effective as an anti-inflationary weapon.
 * reduce aggregate demand by a larger amount than if decision makers expect the restrictive policy to continue.
 * leave aggregate demand unchanged because expectations do not influence the effectiveness of macropolicy.

That answer is correct!

Temporary reductions in the money supply do not serve to contain inflation because price setters anticipate money expansions in the future. This anticipation will lead price setters to automatically raise prices over time, thus reducing the deflationary effects of a temporary contraction of the money supply.

If inflation were stable at 12%, and this rate was widely expected to continue into the future, which of the following would likely result?

I.   Consumers would increase their spending level
II. Lenders would be unwilling to lend over the long-term
III. Interest rates would rise over time

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

That answer is correct!

This question implies that inflation is relatively high, but very stable. Consumers are said to increase their spending rate when they anticipate inflation increasing in the future. As inflation is stable, consumer spending would already take inflation into account. Lenders are weary of making long-term loans in a highly variable inflation environment. With stable inflation, the inflation rate can be accounted for with higher interest rates. Interest rates would not increase over time because of the high inflation level. The 12% inflation would be priced into interest rates. Inflation is usually only problematic when it is unexpected. This question assumes all inflation is expected.

If the government issues bonds to finance its increased spending, which of the following is/are likely to occur:

I. Real interest rates will fall.
II. Inflation will rise.
III. Private investment will be crowded out.
IV. Foreign funds will flow in.

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

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

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. This effect is mitigated to some extent by the fact that the higher real rates attract foreign investments, raising the supply of loanable funds. Finally, the expansionary fiscal policy causing increased government expenditure leads to higher demand in the goods market, leading to inflation.

Structural unemployment is a result of

* not enough employees to fill available jobs.
* insufficient employment in the building trades.
* inaccurate and/or costly information about job opportunities.
* 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 refers to unemployment 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.

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

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

That answer is incorrect.
Correct answer:
an increase in output and a move to a higher price level

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.

Which of the following is/are components of the M1 money supply?

I. Checking accounts.
II. Credit card loans.
III. Money-market mutual funds.
IV. Traveler's checks.

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

That answer is correct!

The M1 money supply consists of currency, checking account deposits and traveler's checks.

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

 * cannot be restored without an increase in aggregate demand.
 * cannot be restored without a permanent reduction in output.
 * will be restored, but the model does not indicate how rapidly this will occur.
 * will be restored quickly.

That answer is incorrect.
Correct answer:
will be restored, but the model does not indicate how rapidly this 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.

In 1992, GDP equaled $6,039 billion while the M2 money supply was $3,498 billion. What was the velocity of the M2 money stock?

 * 0.6
 * 2.7
 * 1.7
 * 0.4

That answer is incorrect.
Correct answer:
1.7

The velocity of money is defined as GDP divided by the stock of money. Thus, $6,039 billion divided by $3,398 billion is 1.7.

If producers suddenly become more pessimistic about future sales and profits, which of the following will most likely occur?

* Income will increase and actual saving will remain constant.
* Investment will decrease, causing both aggregate demand and GDP to fall.
* Consumption will increase, causing both aggregate demand and GDP to expand.
* Investment will increase, causing both aggregate demand and GDP to increase.
* The interest rate will fall, causing both investment and GDP to rise.

That answer is incorrect.
Correct answer:
Investment will decrease, causing both aggregate demand and GDP to fall.

Pessimism among decision makers makes them invest less. The multiplier will magnify this reduction and lead to increased pessimism and a greater decline in aggregate demand and consequently, aggregate output.

Within the AD/AS model, an increase in capital formation that permits the economy to achieve a larger output will

* increase short-run aggregate supply, but long-run aggregate supply will be unaffected.
* increase the long-run aggregate supply and reduce prices.
* decrease aggregate demand and lead to a lower price level.
* increase aggregate demand and lead to a higher price level.

That answer is incorrect.
Correct answer:
increase the long-run aggregate supply and reduce prices.

Capital formation increases the economy's production possibilities and makes it possible to produce and sustain a higher rate of real output. If the money supply is held constant, the increase in the aggregate supply will lead to a lower price level and will not increase unemployment above the natural rate.

Which one of the following factors would cause the demand for money balances to increase?

* higher interest rates
* an expansion in nominal income
* lower prices
* an increase in the expected inflation rate

That answer is incorrect.
Correct answer:

an expansion in nominal income

Higher income implies that households will make additional purchases of goods and services. Since money is used to conduct these transactions, the demand for money will increase.

Under Classical economic theory, if aggregate demand were to fall with no corresponding drop in aggregate supply, what would result?

* an increase in interest rates
* a decline in inventories
* deflation
* a budget deficit
* Classical theory states that supply creates its own demand, therefore this situation is not consistent with the theory

That answer is incorrect.
Correct answer:
deflation

Classical theory looks at aggregate supply and demand very similarly to a microeconomics analysis supply and demand curves. A drop in aggregate demand would therefore result in a lower price level, or deflation. Note that although the mantra of Classical economics is "supply creates its own demand," Classical economists did not pretend that demand could not move independently of supply in the short-run. In the long-run, however, the theory claimed that these short-term fluctuations would be corrected by changes in the price level, and some equilibrium would be reached. In practice, Keynes observed that deflation was relatively rare, and that Classical equilibrium could persist at levels far below full employment.

Inflation is defined as

* Rising interest rates
* Too many dollars chasing too few goods
* An increase in the price of oil
* A pervasive increase in the value of money

That answer is incorrect.
Correct answer:
Too many dollars chasing too few goods

Inflation results when too many dollars are trying to purchase a scarce amount of goods. The result is a pervasive increase in prices. Rising interest rates may accompany inflation, but do not define it.

The Central Bank determines that for each $1 billion increase in the money supply, the general price level increases by 1%. Inflation is generally expected to be 5% per year. If unemployment is 7%, and the Central Bank wishes to reduce this to the natural rate of 5%, how much could the Central Bank increase the money supply without causing inflation in the long-term?

* $0

* $7 billion
* $2 billion
* $5 billion
* $3 billion
* impossible to determine

That answer is correct!

Increasing the money supply always causes inflation in the long-run. Therefore if inflation must be avoided, there can be no increase in the money supply.

How would buying a good produced domestically by a domestic citizen change GDP and GNP?

* It would increase GNP and GDP.
* It would increase GDP and leave GNP unchanged.
* It would increase GNP and leave GDP unchanged.
* It would leave both GDP and GNP unchanged.

That answer is correct!

Since GNP is the total market value of all final goods and services produced by the citizens of a country a good that is produced by a domestic citizen is included in GNP calculation. GDP inclusion requires that the good be sold domestically; thus, it will also contribute to GDP.

Recession is usually defined by economists as:

* two consecutive quarters of falling growth rate of real GDP.
* two consecutive quarters of falling real GDP.
* a fall in real growth rate of GDP.
* a sharp increase in employment rate accompanied by a decline in corporate profits.

That answer is incorrect.
Correct answer:
two consecutive quarters of falling real GDP.

Technically, a recession is commonly defined as the state in which there have been at least two consecutive quarters in which real GDP has declined. Note that there is no reference to the "growth rate;" rather the GDP level is what is of concern. Indirectly, a recession is characterized by at least two consecutive quarters of negative growth in real GDP.

"An increase in money supply will lead to a proportional increase in prices." This is associated with:

* the quantity theory of money.
* the deposit expansion multiplier.
* the monetary view of economics.
* the equation of exchange.

That answer is correct!

The quantity theory of money maintained by classical economists postulates that the real output, Y, is affected by factors like the resource base available, current technological level, available skill sets and the regulatory environment. Similarly, the velocity of money depends on institutional factors like the communication systems, banking and credit arrangements, etc. Thus, Classical economists believed that any change in the money supply leads to a proportional change in prices, leaving the real GDP unaffected.

The government currently has cash reserves of $10 billion. In the current year, tax revenues declined due to an ailing economy. Spending did not change, and therefore the government had a current budget deficit of $100 million. Considering only the impact of government activity, how will real interest rates be impacted and why?

* Decrease, because national income will fall.
* Increase, because supply of savings has fallen.
* Increase, because demand for loanable funds has increased.
* No change, because the dollar amounts are too small to have an impact.
* No change, because the government did not have to issue debt.
* Increase, because inflation increases due to deficit spending.

That answer is incorrect.
Correct answer:
Increase, because supply of savings has fallen.

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 factors may prevent an increase in the money supply from causing inflation in the long-run?

I. actual GDP is below potential GDP
II. the increase is unanticipated by producers
III. consumer confidence is low

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

That answer is correct!

Increasing the money supply always causes inflation in the long-run, regardless of any of the factors listed.

Which of the following is/are true about monetary policy?

I. If the effects are fully anticipated, real activity remains unaffected in the short and long run.

II. If the effects are unanticipated, real activity is affected in the short but not in the long run.

III. If the effects are fully anticipated, inflation is zero in the short and long run.

IV. If the effects are unanticipated, inflation is zero in the short run but not in the long run.

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

That answer is correct!

If the effects of a monetary policy are anticipated perfectly, decision-makers will immediately adjust their behavior to offset their impact. Since nothing fundamental in the economy is caused to changed by an anticipated monetary policy, real variables remain unaffected. Even if the policy is unanticipated, the surprise lasts only in the short run. Over the long run, the only lingering effect is seen in the nominal variables like prices.

If consumers generally believe prices will be higher in the future for durable goods, what impact will this have on current demand and future inflation?

* neither demand nor inflation will change
* demand will fall, the price level will remain the same
* demand will increase, the price level will rise
* demand will increase, inflation will increase
* demand will not change, the price level will rise

That answer is incorrect.
Correct answer:
demand will increase, the price level will rise

In this scenario, consumers will spend now to avoid the decay of purchasing power they anticipate in the future. This additional demand will cause the price level to rise. Inflation is often a self-fulfilling prophecy. Note that we cannot say whether inflation will be higher in the future than it is in the current period without knowledge of the current level of inflation.

Within the Keynesian aggregate expenditure model, an increase in aggregate demand will

* always lead to an increase in prices.
* lead to an increase in real output and employment until the economy's full employment supply constraint is reached.
* always lead to an increase in real output and employment.
* lead to an increase in prices unless the economy is already operating at its full-employment capacity.

That answer is incorrect.
Correct answer:
lead to an increase in real output and employment until the economy's full employment supply constraint is reached.

When consumers, investors, governments and foreigners increase their expenditures, output expands. However, if output is at full employment capacity, the increase in aggregate demand cannot stimulate further production but will lead only to higher prices.

Economists predict a decline in production. Congress passes a tax cut reducing the top marginal tax bracket. According to which of the following economic theories would this stimulate the economy?

I. fiscal policy
II. supply-side
III. monetary policy

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

That answer is correct!

Fiscal policy suggests that cutting taxes would expand the economy by effectively increasing disposable income. Supply-side suggests that by cutting the top marginal bracket, more resources will be used on productive activity rather than tax avoidance or leisure.

Suppose all banks are subject to a uniform reserve requirement of 20 percent and that the First Guarantee Bank has no excess reserves. If a new customer deposits $10,000, then the bank could extend new loans up to a maximum of ________.

* $8,000
* $2,000
* $50,000
* $10,000

That answer is correct!

The reserve requirement of 20 percent implies that the bank must maintain 20 percent of the new deposit as reserves. 20 percent of the new deposit ($10,000) is $2,000. Therefore, the bank must hold $2,000 of the new deposit and may loan the remaining $8,000.

Net domestic product will always be less than gross domestic product because net domestic product

* only counts indirect business taxes.
* does not count income earned abroad.
* only counts net investment.
* does not count exports.

That answer is incorrect.
Correct answer:
only counts net investment.

Net domestic product is gross domestic product minus a depreciation allowance for the wearing out of machines and buildings during the period.
As long as there is positive depreciation (which there must always be) then net domestic product will be less than gross domestic product.

Which of the following would increase GDP?

* Mercedes begins to produce and sell cars in Alabama.
* An American investor purchases 100 shares of Mercedes stock.
* Ford begins to produce and sell cars in Japan.
* An American investor buys 100 shares of Ford stock.

That answer is correct!

Since GDP is the total market value of all final goods and services produced domestically during a specific period, the output generated by Mercedes on U.S. soil will contribute positively to GDP.

Which of the following would increase GDP?

* buying a domestically produced orange by a Mexican citizen
* buying a 10-year-old house
* giving $100 to a homeless man on the street
* buying hamburger buns by McDonald's

That answer is correct!

Since GDP is the total market value of all final goods and services produced domestically during a specific period, the purchase of any good that was produced within the U.S. would positively contribute to GDP calculation. The fact that a Mexican citizen purchases the good does not affect the fact that it was domestically produced.

According to supply-side theory, if the government were to reduce the marginal tax rates substantially, which of the following effects is/are likely to occur?

I. Real tax revenues might actually increase.
II. Real GDP would increase.
III. The domestic currency would weaken.

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

That answer is incorrect.
Correct answer:
I & II

With a cut in marginal tax rates, the incentives which move resources from leisure and tax-avoidance activities to more productive work increase. This expanded and more efficient resource base leads to an expansion of real GDP and disposable income. The lower tax rates attract more foreign capital for domestic investment, causing the domestic currency to strengthen. This effect will be quite fast because capital movement is swift. Over a slightly longer run, the higher real activity and income as well as the strengthening of the domestic currency will increase imports and reduce exports.

The Fed unexpectedly raises the discount rate by 25 basis points. In the short run, unemployment will ________. Demand for imported goods will ________.

* decrease, decrease
* increase, increase
* decrease, increase
* increase, decrease

That answer is incorrect.
Correct answer:
increase, increase

An increase in the discount rate amounts to a restrictive monetary policy. Banks tend to hold reserves from their deposits rather than through the borrowings from the Fed or the Fed Funds market. This reduces the loans it makes to businesses, causing a decrease in the supply of loanable funds. The real interest rate rises and businesses cut back on production. This leads to an increase in the unemployment rate. Also, the increase in real rates attracts foreign funds, causing the demand for the U.S. dollar to increase. The dollar appreciates against the foreign currencies, making imports cheaper for U.S. residents. Therefore, the demand for imported goods rises.

If the self-correcting mechanism (the mechanism that directs the economy toward full employment) works slowly, then

* policy makers may be able to help stabilize the economy through using discretionary policies.
* periods of unemployment in excess of the economy's natural rate will be brief.
* discretionary monetary policy is likely to do more harm than good.
* discretionary fiscal policy is likely to do more harm than good.
* periods of prolonged unemployment above the economy's natural rate will be experienced unless policy rules are instituted.

That answer is correct!

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.

Classical economists believe that since ________ is derived from the supply of goods and services, then ________ is simply a function of production.

* inflation; the business cycle
* demand; national product
* interest rates; aggregate demand
* income; aggregate demand
* prices; money supply

That answer is incorrect.
Correct answer:
income; aggregate demand

Classical economists believe that the factors of production (including labor and owners of capital) will be paid for their productive activities. Consumers would then want to spend their income. Hence, supply creates its own demand.

Which of the following will most likely occur in the short run when the long-run equilibrium of an economy is disturbed by an unanticipated decrease in aggregate demand?

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

That answer is incorrect.
Correct answer:
a decrease in output and a lower price level

The short run impact of an unanticipated reduction in aggregate demand is a decline in output and a lower price level. This is because aggregate demand shifts inward and the competition for goods declines. This places downward pressure on prices.

Which of the following will increase private consumption (that is, cause the Keynesian consumption schedule to shift upward)?

* increased pessimism about future employment conditions
* a decline in stock prices
* an increase in the real rate of interest
* a decrease in income taxes
* the expectation that consumer prices will decline substantially during the next 12 months

That answer is incorrect.
Correct answer:
a decrease in income taxes

A decline in income taxes serves to increase the disposable income available to consumers. Since there exists a positive relationship between disposable income and consumption, such an decrease will stimulate consumption.

If consumers generally expected inflation to rise, how would this impact their decision making?

* they would generally save more, as more money will be needed in the future to satisfy their current lifestyle
* they would spend less, anticipating future increases in interest rates
* they would spend more, knowing they their money would be worth less in the future
* they would invest more, as time deposits would not pay adequate interest rates
* they would store more currency, fearful of inflationary effects

That answer is incorrect.
Correct answer:
they would spend more, knowing they their money would be worth less in the future

Consumers tend to spend more in the current period when inflation is expected, knowing that their money will be worth less in the future. Remember that inflation causes nominal income to rise also, so savings would not be expected to rise to accommodate inflationary decreases in the value of money. Interest bearing investments include some inflation premium. If consumers expected inflation to be higher than this inflation premium, then the investment would be unwise.

The nation of Aissur is going through a financial crisis, and their currency, the rubble, has become worthless. Citizens begin using the currency of a more stable neighbor, the Namregian kram, to trade goods. Assuming all else remains equal, how would this impact M2 and the price level in Namreg?

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

That answer is correct!

In this case, the actual money supply level has not changed, there are simply more consumers using the kram as their currency of choice. However, we would expect the price level to decline, as the same number of krams are now being used to buy both Namregian and Aissurian goods. Use of the kram outside of Namreg distorts the money supply level there.

Congress passes a new spending bill that will require a future increase in government borrowing. In terms of fiscal policy-related effects, put the following in order of causation:

I. the quantity supplied increases
II. the aggregate demand curve shifts to the right

III. interest rates increase
IV. unemployment falls
V. the price level increases

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

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

In this case, the government is spending without taking funds from consumers. This will push the aggregate demand curve outward. The shift in aggregate demand creates a new equilibrium price level. Suppliers will respond to the new price level by increasing output. This will force suppliers to employ more labor, and therefore decreasing unemployment. Finally, the government will need to borrow to finance the spending project, pushing interest rates higher.

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

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

That answer is incorrect.
Correct answer:
does not depend on the other variables in the model under consideration.

An autonomous expenditure is one that does not vary with the level of income. Thus, it is determined by factors other than those considered in the model.

The cost of holding money balances increases when the

* income of consumers expands.
* price of goods and services falls.
* money interest rate decreases.
* purchasing power of money rises.
* money interest rate increases.

That answer is incorrect.
Correct answer:
money interest rate increases.

The opportunity cost of holding cash balances is reflected in the money interest rate. Thus, the cost of holding money balances increases when the money interest rate rises.

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

 * government spending.
 * inflation.
 * disposable income.
 * interest rate.
 * investment.

That answer is incorrect.
Correct answer:
disposable income.

According to Keynes, disposable income is the major determinant of consumption. This positive relationship between disposable income and consumption is reflected in the consumption function.

The crowding out effect:

 * reduces the effectiveness of discretionary monetary policy.
 * mitigates the impact of fiscal policy on stimulating the economy.
 * refers to the impact of fiscal policy on employment rate.
 * increases the effects of discretionary fiscal policy.

That answer is incorrect.
Correct answer:
mitigates the impact of fiscal policy on stimulating the economy.

A fiscal policy used to stimulate a sluggish economy emphasizes an increase in aggregate demand. However, the presence of the government in the loanable funds market raises real interest rates and shuts out some businesses from investing. Thus, the aggregate demand does not increase by as much as it would in the absence of the crowding-out effect, weakening the impact of the fiscal policy.

Keynesian analysis implies that a planned budget deficit is

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

That answer is incorrect.
Correct answer:
proper during slack economic conditions but highly inappropriate if the economy is already operating at capacity.

A planned budget deficit during a recession will serve to stimulate aggregate demand and with luck, will move the economy out of a recession. If however, an economy is close or near to full capacity, the stimulation to aggregate demand will only result in inflation, with no permanent effect on aggregate supply.

Too many dollars chasing too few goods defines

 * monetary policy
 * a recession
 * an economic boom
 * scarcity
 * inflation

That answer is incorrect.
Correct answer:
inflation

Currency eventually is spent on goods, and when there is too much currency for the present level of production, the result is pervasively higher prices, or inflation. Although this might commonly occur during an economic boom, this is not necessarily so.

Suppose the Fed purchases $150 million of U.S. securities from the public. The reserve requirement is 20 percent and all banks have zero excess reserves. A few weeks after the Fed buys securities, the impact of this action on the money supply, assuming there are no leakages in the system (excess reserves remain at zero), is a

 * $150 million decrease in the money supply.
 * $150 million increase in the money supply.
 * $750 million increase in the money supply.
 * $600 million increase in the money supply.

That answer is incorrect.
Correct answer:
$750 million increase in the money supply.

The deposit expansion multiplier is inversely related to the reserve requirement ratio. Therefore the infusion of $150 million dollars through the purchase of U.S. securities from the public will expand the money supply through the multiplier by 5 times the original infusion. Therefore, the money supply increases by 5x150=$750 million dollars.

Which of the following statements are true?

 * Real GDP is nominal GDP less CPI.
 * Real GDP is nominal GDP less inflation.
 * Real GDP is nominal GDP plus income by citizens abroad.
 * Real GDP is nominal GDP less the net domestic income of foreigners.
 * Real GDP is nominal GDP with a seasonal adjustment.

That answer is incorrect.
Correct answer:
Real GDP is nominal GDP less inflation.

Real GDP measures output adjusted for changes in the general price level, whereas nominal GDP does not differentiate between inflationary growth and productive growth.

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

* must equal the economy's long-run capacity.
* will exceed the economy's long-run capacity.
* must equal approximately 94 percent of the economy's long-run capacity.
* will be less than the economy's long-run capacity.

That answer is correct!

In the long run an economy can only produce at a level equal to its long run capacity or potential. Exceeding this level can only occur temporarily in the short run and will inevitably lead to inflation.

An advantage of the AD/AS model is that it

* is strictly a short-run model.
* does not try to analyze inflation and unemployment together.
* emphasizes sticky prices.
* distinguishes between anticipated and unanticipated changes.

That answer is incorrect.
Correct answer:
distinguishes between anticipated and unanticipated changes.

The AD/AS model recognizes that that when analyzing the impact of a change, it makes a difference whether the change is anticipated or unanticipated.

In the planned aggregate expenditure model, imports will increase and net exports will decline when

* government purchases increase.
* planned investment declines.
* disposable income rises.
* interest rates rise.

That answer is incorrect.
Correct answer:
disposable income rises.

Because exports remain constant and imports increase as aggregate disposable income expands, net exports will decline as income expands. There is a negative relationship between income and net exports.

Economists who stress the store of value function of money argue that M1 is

 * too broad a definition of the money supply.
 * a proper measure of the money supply.
 * a proper definition of the money supply during an expansion but too broad during a contraction.
 * too narrow a definition of the money supply.
 * a proper definition of the money supply during a contraction but too broad during an expansion.

That answer is incorrect.
Correct answer:
too narrow a definition of the money supply.

Many economists, particularly those that stress the store-of-value function of money prefer the broader M2 definition of the money supply to the narrower M1 concept. The M2 money supply is more than three times the M1 money supply.

The empirical evidence indicates that during an economic boom

 * real wage rates decline (or increase quite slowly) and the real interest tends to rise.
 * 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 rise.
 * real wage rates increase rapidly and the real interest rate tends to fall.

That answer is incorrect.
Correct answer:
real wage rates increase rapidly and the real interest rate tends to rise.

Evidence shows that during the periods of economic expansion real interest rates increase and during economic recessions that real interest rate declined. Similarly, real wages rise during a boom and fall during a recession.

Which of the following developments will most likely lead to an increase in the money velocity?

 * an increase in money interest rates
 * a sharp decline in using credit cards
 * a decrease in the expected inflation rate
 * a decrease in real income

That answer is correct!

An increase in the money interest rate will increase the amount of money that individuals hold in interest-bearing accounts. As a result, the demand for money will decline causing an increase in money velocity (i.e., the same number of transactions must now be conducted with fewer actual dollars).

In the Keynesian aggregate expenditure model, inflation

* is associated with high rates of unemployment.
* implies an equilibrium level of income in excess of the full-employment level.
* is impossible; only unemployment can be explained by the model.
* is a problem that arises because of insufficient aggregate demand.

That answer is incorrect.
Correct answer:
implies an equilibrium level of income in excess of the full-employment level.

Once the economy is at full employment capacity, further expansions in expenditures lead only to higher prices, without expanding real output.

The value (purchasing power) of each unit of money

* is determined by central monetary authorities and thus is largely independent of the money supply.
* increases as prices increase, to keep people from falling behind.
* tends to decline as its supply expands relative to the availability of goods and services.
* relates directly to the value of the precious metals (i.e., gold or silver) that back it.

That answer is incorrect.
Correct answer:
tends to decline as its supply expands relative to the availability of goods and services.

According to the usual law of supply and demand, as the supply of money increases in an economy it becomes worth less. Money's main source of value is the same as for other commodities, it is determined by demand relative to supply. People demand money because it reduces the cost of exchange. When the supply of money is limited relative to the demand, money will be valuable.

An individual should continue to spend time searching for a job as long as

* the marginal gain from additional search exceeds the marginal cost.
* job openings are available in the individual's field.
* information is available that the individual has not yet collected.
* the expected salary exceeds all salary offers.

That answer is correct!

The marginal benefit derived from job search declines with time spent searching for a job because it becomes less likely that additional search will lead to a better position. The marginal cost of job search rises with the length of one's job search time, primarily because still more search means forgoing wages on more attractive jobs discovered by prior search. Therefore a rational searcher stops looking for a job once the marginal cost of extending the search equals the marginal benefit.

Suppose the money supply is held constant by the Fed. If wages and prices increase, the money interest rate will ________.

* not be affected
* insufficient information
* decrease
* increase

That answer is incorrect.
Correct answer:
increase

During inflation, the demand for money rises. At constant money supply, this raises the "cost of money," which is the interest rate. Remember that money is like any other good; the greater its demand, the higher its "price."

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

* interest rates as measured by the prime bank-loan rate.
* the money supply.
* aggregate measures of economic output and real income.
* the general price level as measured by the consumer price index.

That answer is incorrect.
Correct answer:
aggregate measures of economic output and real income.

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.

In the U.S., the money supply (M1) consists of

* government bonds, currency, demand deposits, other checkable deposits and traveler's checks.
* coins, paper currency, demand deposits, other checkable deposits and traveler's checks.
* paper currency, coins, demand deposits and savings deposits.
* paper currency and coins.

That answer is incorrect.
Correct answer:
coins, paper currency, demand deposits, other checkable deposits and traveler's checks.

M1 is the narrowest definition of the money supply. M1 reflects the function of money as a medium of exchange in that it includes only assets that are directly used that way (i.e., currency in circulation, demand deposit, other interest earning checkable deposits and travelers' checks).

A client tells you that he currently earns $100,000 per year and is comfortable with his lifestyle at that income level. He says he is planning on retiring in 15 years. If inflation averages 4.3% over the next 15 years, approximately what income level will this client require to maintain his current lifestyle?

* $236,000
* Not enough information
* $188,000
* $123,000
* $192,000

That answer is incorrect.
Correct answer:
$188,000

The calculation is as follows: (1.043)^(15)*100000=188,046

If consumption equals 1,000 when disposable income is 1,300 and increases to 1,200 when disposable income increases to 1,700, what are the marginal propensities to consume and to save?

* MPC = 1/3; MPS = 2/3
* MPC = 3/4; MPS = 1/4
* MPC = 1/5; MPS = 4/5
* MPC = 2/3; MPS = 1/3
* MPC = 1/2; MPS = 1/2

That answer is incorrect.
Correct answer:
MPC = 1/2; MPS = 1/2

MPC is equal to additional consumption divided by additional income. Therefore, here, MPC = 200/400 = .5. MPS = 1-MPC so that MPS = .5 also.

Which of the following is not generally caused by deficit spending?

* inflation
* decline in productivity
* rise in aggregate demand
* current account deficits
* currency appreciation
* rising interest rates

That answer is incorrect.
Correct answer:
decline in productivity

Each of the economic events listed, except for productivity, are generally considered consequences of deficit spending. When the government borrows to fund current spending, this effectively increases aggregate demand for goods and increases demand for loanable funds. Each of the effects are a direct or indirect result of those two primary effects.

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

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

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

Education, training and skill enhancing experience can improve the quality of the labor force and expand the supply of human resources. Such a change causes the potential output of the country to increase so that it is possible to produce and sustain a larger rate of output (in nominal and per capita terms).

A permanent shift to the right in the long-run aggregate supply curve indicates that

 * unemployment has increased.
 * the natural unemployment has increased.
 * potential real GDP has increased.
 * employment has increased.

That answer is incorrect.
Correct answer:
potential real GDP has increased.

This permanent shift in aggregate supply implies that a new sustainable and higher level of real output is attained and real income increases. This suggests that potential real GDP shifts outward if increases in aggregate supply are considered permanent.

In an economy, planned aggregate expenditures equal 10,300. Planned consumption is 4,500 and planned government expenditure is 3,600. If the economy is in Keynesian equilibrium, the real GDP equals ________.

 * 18,400
 * 10,300
 * 4,500
 * 8,100

That answer is incorrect.
Correct answer:
10,300

In the Keynesian model, equilibrium is present when aggregate expenditure equals the value of current output. If the real GDP is less than the planned aggregate expenditures, then producers will increase their output to fill the demand gap and the economy will tend to expand. Hence, in the current example, equilibrium will occur when the real GDP equals 10,300.

According to the Keynesian view, which of the following would most likely decrease aggregate demand, all else equal?

 * a decrease in tax rates
 * an increase in transfer payments
 * an increase in the budget deficit
 * a decrease in government expenditures

That answer is incorrect.
Correct answer:
a decrease in government expenditures

Government expenditures (such as expenditures on national defense, highway projects, government salaries etc.) is an important element in aggregate demand. By decreasing government expenditures, a large part of aggregate demand will be diminished.

MPC equals

 * consumption expenditures divided by saving.
 * consumption expenditures divided by personal income.
 * consumption expenditures divided by income.
 * consumption expenditures divided by disposable income.
 * the change in consumption divided by the change in disposable income.

That answer is incorrect.
Correct answer:
the change in consumption divided by the change in disposable income.

MPC is equal to additional consumption divided by additional income.

In the aggregate demand/aggregate supply model, when the output of an economy is less than its long-run potential capacity, the economy will experience

 * a budget surplus that will stimulate demand and thereby help restore full employment.
 * rising resource prices that will restore equilibrium at a higher price level.
 * falling real wages and resource prices that will stimulate employment and real output.
 * rising interest rates that will stimulate aggregate demand and restore full employment.

That answer is incorrect.
Correct answer:
falling real wages and resource prices that will stimulate employment and real output.

When output is less than capacity, lower interest rates and will stimulate aggregate demand. Lower resource prices will reduce production costs and thereby stimulate short run aggregate supply. Thus, output will move toward the economy's full employment capacity.

Which of the following is true?

 * When actual spending on goods and services exceeds the level business decision makers anticipated, inventories will rise.
 * Within the Keynesian model, planned expenditures will always equal total output.
 * A nation's imports will tend to decline as the nation's income increases.
 * Business inventories will tend to fall when purchasers buy a larger quantity of goods and services than businesses anticipated.

That answer is incorrect.
Correct answer:
Business inventories will tend to fall when purchasers buy a larger quantity of goods and services than businesses anticipated.

If actual expenditure is greater than planned expenditures then the inventories of businesses will decrease since they must sell from their inventories in order to satisfy demand. They did not produce enough to satisfy demand because expenditure was larger than expected.

Which of the following would be included as a government purchase in the national income accounts?

 * excise taxes levied on consumption goods
 * unemployment insurance payments
 * the government's interest payments on the national debt
 * computer hardware bought by the Department of Energy
 * the sale of a used government-owned airplane to a private airline

That answer is incorrect.
Correct answer:
computer hardware bought by the Department of Energy

Government consumption and investment is characterized as government purchases in GDP calculation. Transfer payments are excluded.

According to the Keynesian theory, unemployment can be reduced by:

 * decreasing budget deficits.
 * implementing a cyclical fiscal policy.
 * all of these answers.
 * decreasing taxes.

That answer is incorrect.
Correct answer:
decreasing taxes.

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.

The Great Depression provided support for Keynes's declaration that

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

That answer is correct!

Keynesian theory provides an explanation for prolonged periods of unemployment through the effect of the multiplier and decision maker pessimism.

Which of the following is/are true about monetary policy?

I. The money supply will have no impact on real income if changes in the price level are anticipated.
II. Monetary policy can only serve to decrease economic volatility.
III. Without interference, the money supply would remain constant.

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

That answer is incorrect.
Correct answer:
I, II

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.

The expenditure multiplier equals 3.9. What change in income will decrease consumption by 870?

* 1,000
* 223
* 1,170
* 3,393

That answer is incorrect.
Correct answer:
1,170

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, 3.9 = 1/(1-MPC), giving MPC = 0.7436. Therefore, if consumption decreases by 870, income must have decreased by 870/0.7436 = 1,170.

If people raise their expectations regarding future inflation, which of the following will most likely occur?

* Aggregate demand will decline and there will be no effect on short-run aggregate supply.
* Aggregate demand will decline, leading to an increase in short-run aggregate supply.
* Both aggregate demand and short-run aggregate supply will decline.
* Both aggregate demand and short-run aggregate supply will increase.
* Aggregate demand will increase.

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

If the expectation of future inflation increases then individuals will increase their current consumption to avoid higher future prices. This stimulates aggregate demand, shifting the AD curve to the right.

The primary difference between planned investment and actual investment is

* the presence of an excess supply of funds in the loanable funds market.
* net aggregate saving.
* unplanned changes in inventories.
* planned consumption.

That answer is incorrect.
Correct answer:
unplanned changes in inventories.

Planned investment minus actual investment = addition to inventories. This is true because if addition to inventories is negative, it implies that purchasers bought more goods than the producers expected and thus producers were forced to sell some of their inventories to satisfy demand. If addition to inventories is positive it implies that purchasers spent less on goods than the producers expected and were left with an excess supply of goods that were added to inventory.

If there is an increase in foreign financial investment in the U.S. as the result of large U.S. budget deficits and attractive interest yields, then

* foreign exchange value of the dollar will depreciate, which will lead to an increase in net exports and aggregate demand.
* fiscal policy will be more expansionary since there will be no crowding-out effect.
* foreign exchange value of the dollar will appreciate, which will lead to a decrease in net exports and aggregate demand.
* fiscal policy will be more expansionary since U.S. residents will increase their saving so they can repay the foreigners in the future.

 * both fiscal policy will be more expansionary and the foreign exchange value of the dollar will appreciate.

That answer is incorrect.
Correct answer:
foreign exchange value of the dollar will appreciate, which will lead to a decrease in net exports and aggregate demand.

Foreign financial investors will be attracted to investment in the U.S. if the U.S. interest rate is high (this is because their investment will yield a higher return). As a result of the increased demand for U.S. currency (which is required to invest in the U.S.), the foreign exchange value of the dollar will rise causing net exports to fall. Net exports fall because under the higher exchange rate value of the U.S. dollar, U.S. exports are more expensive abroad. Since net exports are a component of aggregate demand, aggregate demand falls.

An economy is currently in a state of equilibrium at full employment. If a sudden and permanent demand shock were to increase aggregate demand, which of the following effects will occur in the long run?

I. Profit margins will improve.
II. Resource prices will stay relatively unchanged.
III. Prices will increase.
IV. Employment will increase.

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

That answer is incorrect.
Correct answer:
III only

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. The increased demand means the entire demand curve moves to the right. To meet this higher demand, firms try to increase their output by employing more people. Even though the economy is at its peak sustainable efficiency, in the short run, producers are able to hire more people from the unemployment pool at the current level of wages. Hence, in the short run, the supply curve is not be affected by the jump in the aggregate demand. Therefore, unemployment rate falls below the natural rate and profit margins increase.

However, over a longer horizon, resource price contracts are renegotiated and resource prices increase. This moves the supply curve to the left, till an equilibrium is restored at the maximum sustainable output of the economy. Profit margins fall back to their original levels, unemployment rises to the natural rate and the only lingering effect is seen in higher prices.

According to Say's law, a general overproduction of goods and services cannot happen because

 * producing goods generates enough income to buy the total output.
 * government will redistribute the overproduction to the needy.
 * there will always be less fortunate countries willing to buy the excess output.
 * excess output leads to rising prices, which then provide the income necessary to buy the surplus

goods.

That answer is correct!

Say's Law is the view that production creates its own demand. Demand will always be sufficient to purchase the goods produced because the income payments to the resource suppliers will equal the value of the goods produced.

Gross national product is the sum of the buy price of all

 * goods and services exchanged during the period.
 * final goods and services produced during the period minus the estimated depreciation cost arising from production during the period.
 * goods and services produced during the period minus the allowance for the depreciation of productive assets during the period.
 * final goods and services produced during the period.

That answer is incorrect.
Correct answer:
final goods and services produced during the period.

GNP is the total 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.

When the Keynesian aggregate expenditure model is presented graphically, the marginal propensity to consume is the

 * slope of the aggregate saving function line.
 * intercept of the aggregate consumption function line with the 45-degree line.
 * height of the aggregate consumption function line.
 * slope of the aggregate consumption function line.

That answer is incorrect.
Correct answer:
slope of the aggregate consumption function line.

Since the MPC is the proportion of a total increase in income that is spent on consumption, the consumption function has a slope that is less than =1 (or is flatter than the 45 degree line). The higher the MPC the flatter the slope of the consumption function.

According to the Keynesian model, equilibrium and full employment

 * always occur at the same income level.
 * do not necessarily occur at the same income level.
 * could never occur at the same income level.
 * may differ, but there is an automatic mechanism that directs the economy toward full-employment

equilibrium.

That answer is incorrect.
Correct answer:
do not necessarily occur at the same income level.

Because Keynesian equilibrium is dependent on equality between planned aggregate expenditures and output, it need not take place at full employment. An economy in Keynesian equilibrium has no tendency for output to change even if output is well below full employment capacity.

If an economy operating in the Keynesian range of its SRAS has a marginal propensity to consume of 2/3 and the government wants to boost real output by $300 billion, by how much should it increase autonomous expenditure?

 * $300 billion
 * $100 billion
 * $450 billion
 * $200 billion

That answer is incorrect.
Correct answer:
$100 billion

The expenditure multiplier is equal to 1/(1-2/3) = 3. Thus, an increase in government spending will lead to 3 times the amount spent. To induce a $300 billion in output $100 billion must be spent.

A nation has been running a current account trade deficit for each of the last ten years. Which is unlikely to be true about this nation's economy?

 * The marginal propensity to save is relatively low in the nation.
 * The prevailing local interest rate has been high relative to other nations.
 * Their local currency has been appreciating.
 * The nation has a balanced government budget.
 * Foreign investment domestically has been high.

That answer is incorrect.
Correct answer:
The nation has a balanced government budget.

A trade deficit implies the local currency is strong and foreign investment has been high. Both of those are true when interest rates are high relative to other nations. The domestic marginal propensity to save is probably low, given that foreigners are doing some of their savings domestically. However, the government budget is probably in a deficit, since budget and trade deficits tend to be linked.

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

I. government debt high enough to be negatively impacting interest rates
II. the cuts eliminate economically wasteful government programs
III. the legislation can be enacted and implemented well in advance of particularly high inflation.
IV. inflation is currently abnormally high

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

That answer is incorrect.
Correct answer:
III only

Although government debt can negatively impact interest rates, lower rates would eventually stimulate the economy, and a decrease in spending implies inflation is the problem. What spending programs are cut is irrelevant in terms of fiscal policy. If inflation is currently abnormally high, this does not indicate whether fiscal contraction is currently needed, the economy might slow down before the policy can take effect. In order for fiscal policy to be effective, legislation must be past in advance of the actual economic problem.

An economy is currently in a recession. Which of the following is likely to occur?

* resources prices will fall, employment will increase and the economy will move toward full-employment equilibrium.
* resource prices will rise and people will save more, leading to higher incomes and capital investment, moving the economy out of the recession.
* The supply curve will move to the left, leading the economy toward full employment level.
* The demand curve will move to the right, leading the economy toward full employment level.

That answer is correct!

Unemployment is high during a recession and demand is sluggish. Over time, unemployed people will accept jobs at relatively low wages, moving the supply curve to the right. This will lead to lower prices, increased aggregate output and higher employment. The resulting new income will serve to increase aggregate demand over a longer period until finally, the economy climbs out of the recession and moves toward peak efficiency.

Which one of the following persons would be considered employed?

* a fireman who quit his job and is now looking for work as a policeman
* a part-time worker looking for a full-time job
* a full-time college student who is not a member of the labor force
* a retired construction worker
* a northern construction worker laid off due to cold weather

That answer is incorrect.
Correct answer:
a part-time worker looking for a full-time job

Part-time workers who desire full time employment are classified as employed rather than unemployed if they work as much as a single hour per week. These people can be classified as underemployed but not unemployed.

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

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

That answer is incorrect.
Correct answer:
a budget surplus

A budget surplus is the best policy during a period of rapid inflation since such a policy will reduce aggregate demand. Inflation is caused by an excess demand for goods and services in the economy. If the government reduces their consumption of goods and services the overall demand will fall in the economy and prices will stop rising.

In a Keynesian economy, if the equilibrium output is less than that at full employment:

 * prices will fall and demand will increase.
 * wages will fall and employment will rise.
 * output will expand and the additional income will spur demand.
 * demand must increase to increase employment and output.

That answer is incorrect.
Correct answer:
demand must increase to increase employment and output.

Keynesians postulate that demand must increase to increase employment and output, believing that a change in aggregate demand is the instrument that brings about changes in an economic equilibrium. Note that "output will expand and the additional income will spur demand" is Say's law.

Congress passes a law that requires government spending rise each year by exactly the inflation rate. 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?

 * This law will keep the long-term inflation rate down by preventing government borrowing.
 * During a boom, this law would help to fuel inflation.
 * 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 would effectively be expansionary fiscal policy.

That answer is incorrect.
Correct answer:
During a recession, this would effectively be expansionary fiscal policy.

Such laws are called passive fiscal policy. Basically this law suggests that real government spending will remain constant. Therefore when personal income falls, such as during a recession, tax receipts will also fall. This will cause the government to borrow to fund current spending, which by definition, is expansionary fiscal policy. Because the law does not require new legislation each time a recession hits, it is called passive policy.

A country's gross domestic product will most likely exceed its gross national product when

* a large number of a country's citizens work abroad.
* the country has attracted a large amount of foreign investment.
* the country has made substantial investments abroad.
* the income of a country's domestic citizens abroad exceeds the income of foreigners within the country.

That answer is incorrect.
Correct answer:
the country has attracted a large amount of foreign investment.

These two output measures will differ significantly when there is a substantial difference between the income citizens earn abroad and the domestic income generated by foreigners. This is likely to be the case when the country has attracted either a relatively large number of foreign workers or a large amount of foreign investment. If this is true, then GDP will exceed GNP.

The natural unemployment rate is the unemployment rate that

* could only be eliminated by government programs
* is the lowest possible
* would occur in even perfect markets
* is consistent with stable wages

That answer is incorrect.
Correct answer:
is consistent with stable wages

The natural rate of unemployment is the rate consistent with stable wages. Lower unemployment rates are possible but would result in significant wage inflation, as workers would need to be incented to spend less time job hunting. There would be natural unemployment even in a perfect market, but non-perfect markets have natural unemployment too, and the rate would vary.

The impact of expansionary macropolicy usually will

* increase both output and prices proportionally, whether the policy is anticipated or not.

* increase output and leave prices unaffected if the policy is anticipated.
* have no effect on either output or prices if the policy is unanticipated.
* increase prices and leave output unaffected if the policy is unanticipated.
* depend on whether decision makers accurately anticipate the effects of the expansionary policy.

That answer is incorrect.
Correct answer:
depend on whether decision makers accurately anticipate the effects of the expansionary policy.

The impact of expansionary macroeconomic policy full depends on whether or not it is anticipated by economic agents: anticipated policies lead to inflation while unanticipated policies result in greater employment and real output.

Under rational expectations, decision-making errors are assumed to be

* random.
* zero; rational decision makers do not make errors.
* consistently high.
* systematic.
* consistently low.

That answer is correct!

The errors in estimation made under the rational expectations hypothesis are random and are therefore as likely to be errors of overestimation as errors of underestimation.

Which of the following is/are components of M2 money supply?

I. M1 supply.
II. M3 supply.
III. Overnight Eurodollar deposits.
IV. Small denomination money market mutual funds.

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

That answer is incorrect.
Correct answer:
I & IV

M2 = M1 + Savings Deposits + Small Time Deposits + Small Money Market Mutual Funds.

Which of the following will increase investment?

* Texaco acquires Getty Oil Company.

* Japanese investors buy 10,000 acres of prime farm land in Wisconsin.
* General Motors purchases 10,000 shares of its outstanding stock.
* A shoe manufacturer purchases a new leather cutting machine.

That answer is incorrect.
Correct answer:
A shoe manufacturer purchases a new leather cutting machine.

Investment refers to expenditures on fixed assets and changes in the inventories of raw materials and final products. Thus, the purchase of a machine by a shoe manufacturer is an expenditure on a fixed asset and qualifies as investment.

A country like Kuwait, which has substantial income from investments abroad, will generally have

* a gross national product significantly less than its gross domestic product.
* a gross national product and gross domestic product that are approximately equal.
* a gross national product significantly greater than its gross domestic product.
* a negative gross national product and a positive gross domestic product.

That answer is incorrect.
Correct answer:
a gross national product significantly greater than its gross domestic product.

The citizens of Kuwait tend to generate income through investments held abroad. Therefore their income is not considered in GDP since it is generated abroad; rather their income is counted in GNP and thus, GNP is likely to exceed GDP.

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

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

That answer is incorrect.
Correct answer:
the multiplier principle

The multiplier explains by a small increase in expenditure can trigger a much larger increase in output. It does so through the fact that one individual's expenditure becomes another individual's income.

When the government implements an expansionary fiscal policy, which of the following effects occur?

I. Real interest rates increase.
II. Unemployment goes down.

III. Aggregate demand goes up.
IV. The domestic currency strengthens.

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

That answer is correct!

When the government adopts an expansionary fiscal policy, the aggregate demand increases. This causes the demand curve to move to the right, raising prices. Since the demand for loanable funds increases due to the governmental presence in the market, the real interest rate increases. This attracts foreign investment, raising the demand for domestic currency, which appreciates in response. To meet the increased aggregate demand, producers expand their output by utilizing more resources. Hence, unemployment rate falls in the short run.

Which of the following is NOT a part of the modern view of Keynesian theory?

* Discretionary fiscal policy is can be highly destabilizing if not timed correctly.
* Discretionary fiscal policy must be coupled with a consistent monetary policy for it to be effective.
* Fiscal policy is far less potent than previously assumed.
* Automatic stabilizers are better controllers than discretionary fiscal policy.

That answer is incorrect.
Correct answer:
Discretionary fiscal policy must be coupled with a consistent monetary policy for it to be effective.

The modern view of the Keynesian theory is that while discretionary policy can have measurable effects on the economy, the effects are not as strong as previously postulated. Further, timing of fiscal policy is extremely difficult and hence, its use should be avoided as far as possible, letting mechanisms like automatic stabilizers work their way. Monetary policy is not a part of either the classical or modern version of Keynesian theory

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"Last month new highs were reached both in industrial employment and industrial wages. Unemployment is at its lowest mark in years, only slightly over 4 percent of the workforce. The latest monthly report on the cost of living indicated that prices were rising at an annual rate of 16.8 percent, slightly higher than the average increase for the past eight months." According to the Keynesian view, which of the following policies would be most appropriate under these circumstances?

* an increase in government expenditures
* the purchase of securities by the Federal Reserve
* an across the board increase in personal income taxes
* a reduction in corporate income tax rates

That answer is incorrect.
Correct answer:
an across the board increase in personal income taxes

An across the board increase in personal income taxes will cause consumer disposable incomes to fall and aggregate demand to fall. A fall in aggregate demand is necessary to reduce inflation.

If consumption equals 1,100 when disposable income is 1,200 and increases to 1,400 when disposable income goes to 1,600, what are the marginal propensities to consume and to save?

* MPC = 2/3; MPS = 1/3
* MPC = 1/5; MPS = 4/5
* MPC = 3/4; MPS = 1/4
* MPC = 1/3; MPS = 2/3

That answer is incorrect.
Correct answer:
MPC = 3/4; MPS = 1/4

Marginal propensity to consume equals: additional consumption/additional income. Thus, the MPC = 300/400 or 3/4. Since MPS = 1- MPC, the MPS = 1/4.

If the money velocity (V) and real output (Q) were increasing at approximately the same rate, then

* inflation and growth in the money supply would be closely related.
* inflation would be closely related to the long-run rate of economic growth.
* it would be impossible for the monetary authorities to control the money supply.
* it would be impossible for the monetary authorities to control inflation.
* monetary acceleration would stimulate real GDP.

That answer is correct!

This implication is a direct result of the equation of exchange which is defined as: MV = PY where M is the money stock, V is velocity, P is the price level and Y is real output. This equation can also be defined in terms of growth rates whereby Growth of real output + rate of inflation = growth rate of the money supply + growth rate of velocity. Thus, to maintain this equality when velocity and real output are increasing at approximately the same rate, it must be true that inflation and the growth of the money supply are closely related.

Which of the following is not a component of the money supply?

* outstanding balances of credit card accounts
* large-denomination (more than $100) bills
* demand deposits
* interest-earning checking deposits

That answer is correct!

Money is a financial asset that provides the holder with future purchasing power. Credit is liability acquired when one borrows funds. This distinction is important because credit does not represent purchasing power.

If politicians believed that inflation was too high, which of the following might be undertaken?

 * increase government borrowing
 * reduce government debt
 * pass government enforced price supports
 * create government debt vehicles with inflation protection
 * increase government employment

That answer is incorrect.
Correct answer:
reduce government debt

If inflation is too high, one solution would be to reduce aggregate demand. The implication in debt reduction is that the government is either taxing the populace more, or spending less. Either would cause a decrease in aggregate demand, and eventually slow the increasing price level.

________ is the primary tool of fiscal policy.

 * The marginal tax rate
 * Government spending
 * The Federal budget
 * The Federal Reserve system

That answer is incorrect.
Correct answer:
The Federal budget

The Federal budget is used to expand or contract government spending. Expansionary fiscal policy increases government spending and/or reduces tax revenues while contractionary fiscal policy reduces government spending and/or increases tax revenues. Government spending alone does not constitute fiscal policy. For example, if an increase in government spending is financed by an increase in taxes, there is no net increase in expenditures. Spending and tax policy must work in consort to effect fiscal policy.

As a result of the Fed's purchase of securities worth $300 million in the open market, the required reserves held by the banks has gone up by $270 million. Banks usually tend to hold about 2% excess reserves. The reserve ratio required by the Fed equals ________.

 * 21%
 * 23%
 * 18%
 * 14%

That answer is incorrect.
Correct answer:
18%

To solve this, remember the following two relationships:

change in required reserves = change in money supply * reserve ratio

potential deposit multiplier = 1/(reserve ratio + % of excess reserves)

If the reserve ratio required by the Fed equals R, then banks tend to have reserves of (R+2%) of the total money supply. The potential deposit multiplier is then equal to 1/(R+0.02).

When the Fed injects $300 million in the economy, the money supply increases by $300/(R+0.02) million. The required reserves increase by $300 * R/(R+0.02) million. This has been given to be $270 million. Therefore,

300* R/(R+0.02) = 270.
Solving, R = 0.02 * 270/30 = 18%

In passing, note that the actual reserves have gone up by $300 million. This is always the case. The amount of money issued by the Fed equals the amount held by the banks in reserves, as long as people do not hold currency at home (this is usually a negligible component of the total money supply anyway).

Which of the following is/are true about aggregate demand?

I. A decrease in the trade deficit accompanies an increase in domestic aggregate demand.

II. Forecasts of a recession are accompanied by an increase in aggregate demand.

III. An expansionary fiscal policy, which leads to inflation, is accompanied by increased current demand.

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

That answer is incorrect.
Correct answer:
III only

If people expect a recession to be on the horizon, they will tend to cut down on current consumption and save for the harder economic times ahead that are being signaled. If future inflation is expected to be high, then consumers want to buy goods in the current period, raising aggregate demand. Also, when aggregate demand rises, imports will rise, widening the trade deficit.

Rapid monetary growth leads to a continual rise in ________.

* full-employment capacity
* the price level
* unanticipated costs
* real GNP

That answer is incorrect.
Correct answer:

the price level

Rapid monetary growth infuses the economy with more money. The result is that each dollar possesses less purchasing power since there are so many dollars in the economy. This purchasing power devaluation is called inflation; that is a rise in the overall price level in the economy. (the overall price level in the economy is a broad representation of how much goods and services cost at a given time in an economy).

Which of the following will most likely accompany an unanticipated reduction in short-run aggregate supply?

* a reduction in the real rate of interest
* an increase in real GDP
* a decrease in unemployment
* an increase in prices

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

Any shock that causes resource prices to shift upward will contract the short run aggregate supply curve. This is because the real cost of production increases. A leftward shift of the aggregate supply curve increases prices.

According to the quantity theory of money, which one of the following economic variables would change in response to an increase in the money supply?

* velocity
* real income
* the demand for money
* employment
* prices

That answer is incorrect.
Correct answer:
prices

The quantity theory of money hypothesizes that a change in the money supply will cause a proportional change in the price level because velocity and real output are unaffected by the quantity of money.

If production were to suddenly decrease with no immediate change in the money supply, what would result?

* inflation
* an increase in income
* an interest rate cut by the Fed
* an interest rate hike by the Fed

* new demand for labor

That answer is correct!

Inflation would result from this situation because there would be too many dollars (i.e. the money supply) chasing too few goods (i.e. a drop in production). Note that the question eliminates any changes in Fed policy when it describes the money supply as static. The circumstances described are also called "stagflation."

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 sort of policy is the Central Bank probably perusing, and what economic problem is most likely occurring?

* contractionary monetary policy, unemployment
* contractionary monetary policy, high interest rates
* expansionary monetary policy, bear stock market
* expansionary monetary policy, high inflation
* expansionary monetary policy, slack resource utilization

That answer is incorrect.
Correct answer:
expansionary monetary policy, slack resource utilization

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.

Therefore the Central Bank is perusing an expansionary policy. This policy would typically be pursued during a period of poor capacity utilization and high unemployment.

If increased borrowing by the government drives up the real interest rate in the U.S., then

* U.S. exports will expand relative to imports.
* U.S. investors will increase their investments abroad.
* the dollar will depreciate in the foreign exchange market.
* the inflow of loanable funds from abroad will moderate the rise in the real rate of interest.

That answer is incorrect.
Correct answer:
the inflow of loanable funds from abroad will moderate the rise in the real rate of interest.

Increased borrowing by the government drives up the real interest rate in the U.S. As a result, foreign investors will want to invest more in the U.S. because they will receive a greater rate of return on their investment. Thus, the supply of loanable funds from abroad will increase and temper the increase in the real interest rate initiated by an increase in government borrowing.

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?

 * capital account deficit
 * higher borrowing cost
 * appreciating currency
 * increase in aggregate demand
 * rising price level

That answer is correct!

Borrowing to fund currency spending is essentially negative investment. Since net investment cannot be negative, nations with budget deficits often importing the investments they need. Such transactions go on the capital account, and hence such nations would have a capital account surplus.

The potential employment figure in a country has been reduced by the fact that in recent years, the country has experienced rapid technological growth which has rendered obsolete many of the skill sets previously valued highly. This component of unemployment is commonly referred to as:

 * Cyclical unemployment.
 * Technical unemployment.
 * Structural unemployment.
 * Frictional unemployment.

That answer is incorrect.
Correct answer:
Structural 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."

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

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

That answer is incorrect.
Correct answer:
disposable income.

Disposable income is by the far the major determinant of current consumption. If disposable income increases, consumers will increase their planned expenditures.

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
 * unemployed
 * a discouraged worker
 * employed

That answer is incorrect.
Correct answer:
unemployed

Persons are counted as unemployed only if they are available for and seeking work or awaiting recall from a layoff. An individual who refuses a job in order to find a better job is still "searching" for a job and therefore qualifies as unemployed.

The modern view of the Phillips curve suggests that

 * when inflation is less than anticipated, unemployment will fall below the natural rate.
 * when inflation is steady, actual unemployment will equal the natural unemployment.
 * there will be a trade-off between inflation and unemployment with both rational and adaptive expectations.
 * systematic demand stimulus policies will be unable to affect prices in the long run.

That answer is incorrect.
Correct answer:
when inflation is steady, actual unemployment will equal the natural unemployment.

If inflation is relatively constant over time, people come to anticipate that rate. As a result, this rate is reflected in both long-term contracts and the job search of workers. Once this happens, unemployment returns to its natural rate.

The ________ banking system permits banks to hold reserves of less than 100 percent of their deposits.

 * uninsured
 * fractional reserve
 * required reserve ratio
 * insured
 * credit reserve
 * none of these answers

That answer is incorrect.
Correct answer:
fractional reserve

The fractional reserve banking system requires that banks maintain only a fraction of their deposits in the form of cash and other reserves. Thus, banks do not have enough reserves to pay all their depositors simultaneously. The amount of cash and other reserves held is based on the required reserve ratio set by the Fed.

Independent of monetary expansion, the major empirical studies have failed to find a significant relationship between ________ and the rate of inflation.

* budget surpluses
* marginal tax rate increases
* budget deficits
* supply-side spending
* none of these answers

That answer is incorrect.
Correct answer:
budget deficits

Despite the continued popularity of the "budget-deficits cause inflation" view, macroeconomic analysis provides little support for the theory.

Other things constant, an increase in nominal GDP will generally

* increase the demand for money.
* increase the money supply.
* decrease the demand for money.
* reduce the nominal interest rate.

That answer is correct!

As GDP increases as the result of either the growth of real output or higher prices, the demand for money balances increases. Money is in greater demand because more transactions are occurring under a larger GDP. Additionally, if nominal GDP rose as a result of rising prices, for the same number of transactions, a greater amount of money is now necessary.

In an economy, part of the unemployment is caused by the fact that qualified workers are not aware of available jobs that they can seek. This is exacerbated by the fact that many employers are unaware of qualified candidates who can fill job openings at their firms.

This form of unemployment is known as ________.

* natural unemployment
* structural unemployment
* cyclical unemployment
* frictional unemployment

That answer is incorrect.
Correct answer:

frictional unemployment

Frictional employment arises due to a mismatch between what employers know and what job-seekers are looking for. Specifically, 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"

Which of the following factors will most likely dampen the multiplier effect of an increase in government spending financed by borrowing?

 * The increase in government spending may cause the money supply to expand, thereby setting off an inflationary spiral.
 * The increase in demand for loanable funds as the result of borrowing may cause interest rates to rise and private investment to fall.
 * The additional borrowing may cause the central bank to buy more bonds, which will reduce aggregate demand.
 * The budget deficit may cause business decision makers to become more optimistic.

That answer is incorrect.
Correct answer:
The increase in demand for loanable funds as the result of borrowing may cause interest rates to rise and private investment to fall.

The multiplier 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.

The view that erratic monetary policy is the primary source of both business instability and inflation is most closely associated with which group of economists?

 * Classical Economists
 * Keynesians
 * Virtually all economists have agreed with this view
 * Monetarists

That answer is incorrect.
Correct answer:
Monetarists

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.

"Monetary instability has been the major cause of economic instability in this country. Expansion in the money supply has been the source of every major inflation. Every major recession has been either caused or perpetuated by monetary contraction." Who among the following would most likely adhere to this view?

* Supply-side economists
* Keynesians
* Monetarists
* Early proponents of the quantity theory of money

That answer is incorrect.
Correct answer:
Monetarists

Monetarists believe that monetary instability is the major cause of fluctuations in real GDP and that rapid growth of the money supply is the major cause of inflation.

Potential GDP

* measures the output an economy could reasonably be expected to produce at full employment, under normal circumstances.
* is always less than actual GDP, except during a recession.
* minus actual GDP measures the loss of production as the result of inflation.
* is identical to actual GDP.

That answer is correct!

Potential output (or GDP) is the level of output that can be achieved and sustained into the future, given the size of the labor force, expected productivity of labor and natural rate of unemployment consistent with the efficient operation of the labor market. The actual output may differ from the economy's potential.

The relationship in which an expansionary fiscal policy leads to a reduced private investment due to its effect on interest rates is known as ________.

* the Laffer curve
* rational expectations
* the Phillips curve
* crowding-out effect

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

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.

Which of the following will decrease consumption (that is, cause the Keynesian consumption schedule to shift downward)?

* redistribution of income from older workers (age 45 and over) to younger workers (under age 35)
* the expectation that economic growth will accelerate
* the expectation that consumer prices will rise more rapidly during the next 12 months
* an increase in stock prices
* a reduction in disposable income

That answer is incorrect.
Correct answer:
a reduction in disposable income

The positive relationship between disposable income and consumption is reflected in the consumption function. Thus, if income falls, disposable income falls and consumption contracts.

According to the Keynesian view, which of the following will most likely occur as the result of an autonomous decrease of $10 billion in investment?

* an increase in aggregate output by some multiple of the $10 billion decrease in investment
* a $10 billion increase in consumption spending, which will exactly offset the reduction in investment spending
* a decrease of $10 billion in aggregate output
* a decrease in aggregate output by some multiple of the $10 billion decrease in investment

That answer is incorrect.
Correct answer:
a decrease in aggregate output by some multiple of the $10 billion decrease in investment

The amount of decrease in aggregate output as a result of the decline in investment is determined by the value of the expenditure multiplier (which will be greater than or equal to one). Thus, the $10 billion decrease in investment will be magnified by some amount as a decrease in aggregate output.

The Keynesian view of the business cycle suggests that

* the market economy is inherently stable.
* contractions will occur if investment proceeds too rapidly.
* the market economy is inherently unstable.
* downturns or upswings occur when actual saving and actual investment are not equal.

That answer is incorrect.
Correct answer:
the market economy is inherently unstable.

Keynesian economists believe that a market economy, if left to its own devices, is unstable and likely to experience prolonged periods of recession.

A commercial bank has $1,000,000 of outstanding demand deposits and actual reserves of $300,000. If the reserve ratio is 20 percent, what is the maximum amount of new loans the bank can extend?

* $500,000
* $100,000
* $300,000
* $1,000,000
* $150,000

That answer is incorrect.
Correct answer:
$100,000

The reserve requirement of 20 percent implies that the bank must hold 20 percent of its outstanding demand deposits as vault cash or deposits at the Federal Reserve. 20 percent of $1,000,000 implies that this bank must hold $200,000 as reserves. Current reserves of $300,000 are thus in excess of the requirement by $100,000. This amount, $100,000 may then be extended by the bank as loans.

Most modern economists agree that

* macroeconomic policy is the major source of economic stability.
* monetary and fiscal policy is necessary to guide and stimulate the macro economy.
* market economies possess stabilizing forces.
* market economies will usually create prolonged recessions.

That answer is incorrect.
Correct answer:
market economies possess stabilizing forces.

Many economists believe that there are market forces that will help stabilize an economy and cushion the effects of economic shocks. These are called self-correcting mechanisms.

If the inflation rate is 5%, how much will a basket of goods that currently costs $25 cost in 10 years?

* $57.33
* $28.91
* $37.50
* $50.00
* $40.72

That answer is incorrect.
Correct answer:
$40.72

The calculation is as follows: (1.05)^(10)*25=40.72

If the Fed is maintaining a constant growth in money supply of 5% when the inflation rate is 3% and the growth rate of real output is 8%, the growth rate of the velocity of money equals ________.

 * 0%
 * 8%
 * 6%
 * 10%

That answer is incorrect.
Correct answer:
6%

The velocity of money, V, satisfies the equation, MV = PY = GDP, where P is the average price level, Y is the quantity of produced goods and services and M is the money supply. This equation, when expressed in terms of percentage growth, can be shown to imply:

growth rate of M + growth rate of V = growth rate of real output + inflation

Hence, the growth rate of money velocity equals 8% + 3% - 5% = 6%.

If many people were to suddenly deposit into their checking accounts large sums of cash previously held in their homes and/or wallets and there are no offsetting actions by the Fed or change in institutional policies, this would

 * reduce the U.S. money supply.
 * lead to higher interest rates.
 * increase actual reserves of banks and tend to indirectly increase the money supply.
 * decrease M1 but increase M2.

That answer is incorrect.
Correct answer:
increase actual reserves of banks and tend to indirectly increase the money supply.

The actual reserves of banks would increase under such new deposits since banks are required to maintain a fraction of their total deposits as reserves. This scenario implies that the total value of deposits has increased; under a fractional reserve system then, the amount of actual reserves must then increase. The money supply is also affected through the deposit expansion multiplier: new deposits become new loans and new money is created.

Which of the following is most likely to be used in a fiscal policy as a variable in controlling the economy?

 * size of the budget.
 * reserve requirement.
 * marginal tax rates.
 * all of these answers.

That answer is correct!

The size of the governmental budget forms a large part of aggregate spending and constitutes a tool that can be used to control and direct an economy. Note that marginal tax rates is also an available tool, though changing tax rates is much harder than varying budget size. Reserve requirements is not a variable under governmental control, at least in the U.S . The reserve requirement is controlled by the Fed, which is largely independent and autonomous of the Federal government.

Congress passes a tax cut with no corresponding cut in government spending. In terms of fiscal policy-related effects, put the following in order of causation:

I. The quantity supplied increases
II. The aggregate demand curve shifts to the right
III. Disposable income increases
IV. Unemployment falls
V. The price level increases

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

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

The tax cut will effectively increase consumer income. A portion of this new income will be spent, therefore pushing the aggregate demand curve outward. The shift in aggregate demand creates a new equilibrium price level. Suppliers will respond to the new price level by increasing output. This will force suppliers to employ more labor, and therefore decreasing unemployment.

Highly variable inflation has which of the following effect?

* The information embedded in prices becomes more difficult to interpret.
* Lenders are unwilling to lend at long-term, fixed rates.
* All of these answers are correct.
* Individuals and firms will spend time devising ways of hedging against inflation rather than concentrating on productive activity.
* Contracts which delay delivery for long periods of time (such as construction of houses or other long-term projects) are difficult to negotiate.

That answer is incorrect.
Correct answer:
All of these answers are correct.

Highly variable inflation creates extra risk in any long-term contract, including loans, construction projects, etc. It also clouds the important signals sent by prices. In a highly variable price environment, it is impossible to distinguish from a real increase in the price of a given good and an inflationary increase. This uncertainty leads market participants to spend time hedging against inflation, perhaps by investing in commodities and precious metals, rather than in more productive activities.

Economic theory suggests that frictional unemployment would

 * decrease if unemployment benefits were increased.
 * decrease if methods of disseminating job information among unemployed workers were improved.
 * decrease if the legally established minimum wage were increased.
 * increase if methods of disseminating job information among unemployed workers were improved.

That answer is incorrect.
Correct answer:
decrease if methods of disseminating job information among unemployed workers were improved.

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. If job information were more easily accessible to unemployed workers, the match between compatible employers and employees would occur more quickly.

An increase in the real interest rate will

 * cause consumers to reduce their purchases of durable items like appliances and automobiles.
 * force the Fed to increase the money supply.
 * induce businesses to increase their level of investment.
 * increase the natural unemployment.

That answer is correct!

An increase in the real interest rate makes both consumers and investment goods more expensive so that both households and investors decrease their current expenditures in response.

An autoworkers union is negotiating a contract for a group of assembly plant workers. Management is willing to increase wages substantially, but wants cost-certainty over the next several years. Management proposes a ten-year contract where workers receive an initial 15% raise, and then 3% raises each year thereafter. Which of the following factors is most likely to prevent the union from accepting this offer?

I.   inflation may be greater than 3% annually over the next ten years

II. unions are typically more interested in worker safety and job
security than wages

III. the long-term nature of this contract would diminish the union's
power

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

That answer is incorrect.
Correct answer:

I only

Although this contract might be appealing to both workers and management, the unknown of inflation would make the union hesitant to lock in to such a long-contract. For example, if inflation averaged 7% for the contract term, workers would effectively be taking a pay cut in real terms each year. This highlights one of the major problems with inflation, that long-term contracts that would otherwise be beneficial to both parties are not entered into because of inflation.

In the planned aggregate expenditure model, imports will increase and net exports will decline when

* planned investment declines.
* government purchases increase.
* income rises.
* interest rates rise.

That answer is incorrect.
Correct answer:
income rises.

Because exports remain constant and imports increase as aggregate income expands, net exports will decline as income expands.

The currency of the nation of Economica (the EC) is very stable. The developing nation of Growmo decides to "peg" their currency (the GM) to the EC by offering to exchange GM's for EC's on demand. In order to back this exchange policy, the Growmo Central Bank acquires enough EC's to repurchase all outstanding GM's if necessary.

How does this impact the monetary base and the effective money supply for the nation of Economica?

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

That answer is correct!

The monetary base is made up of currency and bank reserves. In this case, Growmo has taken large amounts of currency out of circulation in Economica, but the currency is technically still part of the monetary base. Therefore the base has not changed, but the effective money in circulation has decreased.

Assume the reserve requirement is 10 percent. First National Bank has cash and deposits with the Fed of $35 million, loans and securities of $50 million and demand deposits of $300 million. First National is in a position to make

* no additional loans.
* $15 million of additional loans.
* $10 million of additional loans.
* $5 million of additional loans.

That answer is incorrect.
Correct answer:
$5 million of additional loans.

The reserve requirement of 10 percent implies that the Bank must maintain $30 million of vault cash or deposits with the Fed. Their current vault cash and Fed deposits of $35 million are in excess of the requirement of $5 million. Therefore, the Bank could extend $5 million more in loans and continue to comply with the reserve requirement mandated by the Fed.

According to monetarists, which of the following would most likely eliminate inflation?

* restrictive fiscal policy
* indexing of wages, taxes and pensions
* a steady 3 percent to 5 percent increase in federal expenditures
* a steady expansion in the money supply at a rate no greater than the long-run growth of real output

That answer is incorrect.
Correct answer:
a steady expansion in the money supply at a rate no greater than the long-run growth of real output

Monetarists believe that rapid growth of the money supply creates inflation. Therefore a steady minimal expansion of the money supply over time would not create inflation and would contribute to eliminating it.

Which of the following is a danger of inflation?

* Anticipated inflation may be greater than unanticipated inflation.
* High rates of inflation will reduce interest rates.
* Price changes can frustrate the intent of a long-term contract.
* Rapid price changes reduce uncertainty.

That answer is incorrect.
Correct answer:
Price changes can frustrate the intent of a long-term contract.

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. 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.

Which of the following factors determine whether or not an increase in the money supply will cause an increase in real GDP?

I. the level of capacity utilization
II. the degree to which the increase is anticipated by producers
III. whether the change in money supply causes inflation or not

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

That answer is incorrect.
Correct answer:
I, II

An increase in money supply may cause a temporary increase in real GDP if the economy has slack resources and the increase is unanticipated by producers. Regardless of these factors, the increase in the money supply will cause inflation and therefore this is not a determining factor.

Which of the following will most likely reduce the natural unemployment?

* an increase in the minimum wage
* an increase in the labor force participation rate of teen-agers
* an increase in the proportion of prime-age workers as a share of the labor force
* an increase in unemployment benefits

That answer is incorrect.
Correct answer:
an increase in the proportion of prime-age workers as a share of the labor force

The natural rate of unemployment is the long run average unemployment rate due to frictional and structural conditions of labor markets. Youthful workers experience more unemployment because they change jobs and move in and out of the labor force often. The natural rate of unemployment decreases when prime age workers compose a larger proportion of the work force because they experience as a group, less unemployment.

Use the table below to answer the following question.

Income (Dollars)	Consumption (Dollars)
60,000	58,000
66,000	62,000

What is the marginal propensity to consume?

* 1
* 0.33
* 1.50
* 0.67

That answer is incorrect.
Correct answer:
0.67

Since the MPC is determined according to the ratio: MPC = additional consumption divided by additional income, the MPC here equals: 4,000/6,000 = .66667 or .67.

In a given economy, an increase of 100 in income causes an increase in consumption of 64. By how much will aggregate output expand due to an initial expenditure of 1,000?

* 1,563
* 2,780
* 1,000
* 640

That answer is incorrect.
Correct answer:
2,780

The marginal propensity to consume (MPC) reflects the amount of each additional dollar in income that is spent on current consumption. In this case, MPC = 64/100 = 0.64. The ideal expenditure multiplier can be shown to be equal to 1/(1-MPC). Therefore, the expenditure multiplier equals 1/(1-0.64) = 2.78, so that an initial expenditure of 1000 will increase the output by 1000*2.78 = 2,780. Important: In Keynesian economics, equilibrium occurs when aggregate output equals aggregate expenditure. In the above example, you should be careful to distinguish between "initial expenditure" and "aggregate expenditure." The aggregate expenditure in the above example equals 2,780, which is the change in output. The "initial expenditure" which put the chain of expenditures in motion equals 1000.

When the Treasury issues bonds, the money supply ________.

* does not change
* decreases
* increases
* decreases or does not change

That answer is correct!

It should be remembered that the Treasury's sale of bonds is fundamentally different from the sale of bonds by the Fed. When the Treasury sells bonds, it is creating new national debt. However, it is not creating any new money since people who buy the bonds give up some of the money and this exact amount of money is re-circulated into the economy when the government spends it. On the other hand, when the Fed sells bonds, it is not creating new debt; it is simply reducing its holding of the bonds. In this process, it does end up taking money out of circulation since the proceeds from the sale end up in the Fed's vaults, not to be used till it decides to increase the monetary base.

An economy is currently in equilibrium at full employment. If there is an increase in aggregate demand, which of the following is/are true?

I. The price increase will be larger if the change is unanticipated than in the case where it is anticipated.

II. The supply curve moves to the left if the change is anticipated.

III. The demand curve moves to the left.

IV. Real GDP remains unaffected if the change is not anticipated.

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

That answer is correct!

The increase in demand is represented by a movement of the demand curve to the right. If resource owners accurately forecast the increased demand, they will appropriately increase their prices, making production costlier and moving the supply curve to the left. An equilibrium is reached at a higher price where real GDP and unemployment remain unaffected. Thus, the only effect is seen on nominal variables like inflation, leaving real variables unaffected if the change in demand is completely anticipated.
On the other hand, if the demand shift is not completely anticipated, then producers will be able to expand the output along the old supply curve in the short run. Real GDP increases, unemployment falls and an equilibrium is reached at a higher price which is lower than the price that prevails in the case of completely anticipated demand. Over time, resource owners adjust to the new information, moving the supply curve to the left and reaching an equilibrium where the real GDP is once again equal to potential GDP.

In a given economy, full employment occurs at a real GDP of 9,200. Planned aggregate expenditure equals 7,100. Planned consumption and government expenditures total 5,400 and planned exports equal 940. If the economy is in Keynesian equilibrium, real GDP equals ________.

 * 7,100
 * 6,340
 * 13,640
 * 9,200

That answer is correct!

In the Keynesian model, equilibrium is present when aggregate expenditure equals the value of current output. Hence, in the current example, equilibrium will occur when the real GDP equals the planned aggregate expenditure of 7,100.

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

I. Profit margins will decline.
II. Resource prices will stay relatively unchanged.
III. Prices will decrease.

IV. Employment will increase.

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

That answer is incorrect.
Correct answer:
III only

The decreased demand means the entire demand curve moves to the left. 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 fall in the aggregate demand. This will lead to a lower equilibrium price and decreased profit margins. Producers will cut back on production and lay off some of the workers, increasing the unemployment rate.
However, over a longer horizon, resource price contracts are renegotiated and resource prices decrease. This moves the supply curve to the right, till an equilibrium is restored at the maximum sustainable output of the economy. Profit margins rise back to their original levels, unemployment falls to the natural rate and the only lingering effect is seen in lower prices.

According to the Keynesian view, which of the following would most likely decrease aggregate demand?

 * an increase in the budget deficit
 * an increase in personal income tax rates
 * an increase in government expenditures
 * a decrease in corporate tax rates
 * an increase in transfer payments

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

An increase in personal income tax rates decreases aggregate demand by reducing the disposable income of consumers. Faced with a smaller amount of income to spend on goods and services, consumption will fall. Since consumption is a component of aggregate demand, aggregate demand also falls.

Which one of the following best explains why the crowding-out effect indicates that an increase in government spending financed by the sale of U.S. bonds to the public is unlikely to exert a strong expansionary impact on aggregate demand?

 * As government spending increases, income and taxes will also expand. The higher taxes will reduce both aggregate demand and output.
 * The sale of U.S. bonds to the public will drive up interest rates, thereby retarding private investment and aggregate demand.
 * The sale of bonds to the public reduces the money supply, which will offset the expansionary impact of the increased government spending.
 * The question is based on a false premise. The crowding-out effect indicates that the Treasury selling bonds to the public is very effective at stimulating demand.

That answer is incorrect.
Correct answer:
The sale of U.S. bonds to the public will drive up interest rates, thereby retarding private investment and aggregate demand.

The sale of U.S. bonds to the public reduces the supply of money in the economy. This is easily seen: the sale of U.S. bonds involves the exchange of a slip of paper with the words "U.S. Savings Bond" for U.S. currency. That is, money is exchanged for a slip of paper. This effectively reduces the money supply because individuals formerly holding money, now hold a slip of paper. The real interest rate represents the "price" of money. Therefore under a reduced supply of money, by the law of supply and demand, the real interest rate must rise. Under higher real interest rates private investment will fall, thus inhibiting the growth of aggregate demand.

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
* $5.2 trillion
* $6.76 trillion

That answer is correct!

Real GDP in 1990 in terms of 1982 prices is calculated as: $5.2 trillion / 1.30 or $4 trillion.

Which of the following is true?

* During a recession, cyclical unemployment will be zero.
* During a recession, an economy's output will exceed its long-run potential output.
* During a recession, the actual unemployment usually rises above the natural unemployment.
* During a recession, widespread unemployment will boost inflation.
* During a recession, the natural unemployment will exceed the actual unemployment.

That answer is incorrect.
Correct answer:
During a recession, the actual unemployment usually rises above the natural unemployment.

The actual rate of unemployment falls below the natural rate when the economy is in the midst of an economic boom and rises above the natural rate during a recession. This is because during an economic downturn, GDP grows less quickly and aggregate demand for labor declines.

Of the following, which would be considered unemployed?

* None of these answers.
* A secretary who has entered full-time graduate school to improve her skills.
* A 16-year old teenager who works 2 hours a day at the local bakery.

* A frustrated youth who has not been able to find a job for the past 6 months and is now in a state of depression, not looking for a job.(though he would accept one if it were offered to him).

That answer is correct!

A person is considered "unemployed" only if he or she is actively seeking a job but hasn't found one. Thus, to be considered "unemployed," you have to be part of the labor force (you must also be of 16 years age or more). The youth is a "discouraged worker," not a part of the labor force ("Discouraged workers" are those who are no longer seeking employment, though they would accept it if it were offered to them). Similarly, the secretary is no longer a part of the labor force. Finally, a worker working even one hour a week is considered "employed."

Calculate real output growth from period 1 to period 2 given the following information:

	Nominal GDP	GDP Deflator
Period 0	993	100
Period 1	1,000	106
Period 2	1,042	111

Assume period 0 is the base period.

* -0.8%
* 5.5%
* -6.0%
* -0.3%
* -0.5%

That answer is incorrect.
Correct answer:
-0.5%

To answer this question, first calculate the level of real GDP in period 1, which would be 1,000 * 100/106, or 943.4. Then calculate real GDP in period 2, which would be 1,042 * 100/111, or 938.7. The growth rate would then be 938.7 / 943.3 - 1, or 0.005. Note that since period 0 is the base period, real GDP would be based on the period 0 price level. Therefore you must use the period 0 deflator as the base.

Incorporation of expectations into economic decision making and the economic experience of recent decades indicate that in the long run

* high unemployment is a primary cause of inflation.
* there is no trade-off between inflation and unemployment.
* inflation relates directly to unemployment.
* inflation is inversely related to unemployment.

That answer is incorrect.
Correct answer:
there is no trade-off between inflation and unemployment.

The proposed tradeoff of the Phillips curve appears to not hold in the long run because unanticipated inflation eventually becomes anticipated inflation. As a result, increased inflation cannot reduce unemployment in the long run; in fact, the two will move together if the money supply is consistently increased.

Which of the following is/are objections to the use of discretionary fiscal policy to control the economy?

I. It is difficult to correctly time the fiscal policy.

II. Fiscal policy changes without a consistent monetary policy is destabilizing.

III. Implementation of fiscal policy changes takes much too long to be of use.

IV. There are automatic stabilizers built into the economy.

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

That answer is incorrect.
Correct answer:
I & III

While automatic stabilizers help in stabilizing the economy, their existence is not an argument against the use of discretionary fiscal policy. Rather, the reasons why fiscal policy is hard to use are timing and bureaucracy.

Which of the following variables is most important from a Supply-side Economist's viewpoint?

 * the marginal personal tax rates.
 * the elasticity of the aggregate resource supply curve.
 * direction and magnitude of change in the size of the budget.
 * supply of automatic stabilizers in the economy.

That answer is correct!

For the Supply-side economics, marginal personal tax rates are of crucial importance. A reduction in marginal tax rates increases the incentive to work and save more by increasing the disposable income.

Within the Keynesian aggregate expenditure model, what happens if the planned expenditures of consumers, investors, governments and foreigners are less than output?

 * Consumption expenditures will increase.
 * Wage rates will increase and unemployment will fall.
 * Inventories will fall and producers will increase output.
 * Producers will reduce output as their inventory levels rise.
 * Prices will increase and interest rates will rise.

That answer is incorrect.
Correct answer:
Producers will reduce output as their inventory levels rise.

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.

Taxation rates that produce revenues equal to government expenditures when an economy operates at its long-run capacity will

* lead to a budget deficit during a recession.
* lead to a budget surplus during a recession.
* also lead to a balanced budget during a recession.
* lead to a budget surplus during a recession unless Congress expands expenditures.

That answer is correct!

Tax rates implying a balanced budget when the economy is at full capacity will result in a budget deficit during a recession because total tax revenues will fall. Since income falls during a recession, even if the same tax rate is in place, total tax revenues will decline. Simultaneously, government expenditures will rise (as a result of an increased need for social services and transfer payments). Thus, the government deficit will rise.

In the Keynesian view of macroeconomics

* changes in prices rather than changes in output direct the economy to equilibrium.
* changes in output rather than changes in prices direct the economy to equilibrium.
* changes in both output and prices will restore equilibrium in the short run.
* the economy will continually be in equilibrium.

That answer is incorrect.
Correct answer:
changes in output rather than changes in prices direct the economy to equilibrium.

Keynesians believe that the supply of goods and services would serve as a signal to producers about the quantity to produce. Less spending would lead to increased inventories and firms would cut back on production.

How would an economist who believes in the crowding-out effect complete the following sentence? "The increase in the budget deficit causes the real interest rates to rise and therefore private spending and investment will

* decrease."
* stay the same."
* equal aggregate output."

* increase."

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).

If the supply of money is held constant, a decrease in the demand for money will ________ aggregate demand.

* not affect
* decrease
* increase
* insufficient information.

That answer is incorrect.
Correct answer:
increase

With a constant money supply, a decrease in the demand for money will lower real interest rates. The opportunity cost of current consumption is lowered, spurring aggregate demand.

Fed purchases of U.S. securities ________ the monetary base.

* none of these answers
* has no effect on
* increases
* decreases

That answer is incorrect.
Correct answer:
increases

The Fed purchase of securities increases the monetary base because it injects currency into the economy. Securities held by individuals are exchanged for currency provided by the Fed. Thus, the Fed has fewer liabilities (in the form of securities) but holds less cash. Individuals hold fewer securities but more currency. Thus, the monetary base has increased.

The money you take on a trip to pay for regular expenses such as gas and food is an example of

* the transactions demand for money.
* the velocity of money.
* the speculative demand for money.

* the precautionary demand for money.

That answer is correct!

This demand for money is a demand for conducting transactions. Transactions represent the purchase or sale of goods and services. This is not precautionary demand because these purchases are foreseen, they are not unexpected.

________ budget deficits reflect reduced tax revenues or increased spending due to a decline in economic activity during a recession.

* Active
* Passive
* Recessionary
* Discretionary
* None of these answers

That answer is incorrect.
Correct answer:
Passive

Tax revenues fall substantially during a recession as a result of reductions in personal income and business profits. Therefore, even if government expenditures are not increased or tax rates cut, an economic recession tends to increase the size o the budget deficit. Thus, in a sense, the deficit is "passive" since there was no action taken by policy makers to induce it.

The velocity of money refers to:

* the average number of times a unit of money is used to buy final goods or services during a given period.
* the number of times a unit of money exchanges hands during a given period.
* the rate at which the Central bank issues new money.
* the speed with which an average transaction can be conducted in an economy.

That answer is correct!

Note that only final goods and services are considered while defining velocity of money. All transactions involving intermediate goods are ignored. This also implies that the number of times a unit of money exchanges hands during a given period will be far in excess of the velocity of money.

If there is an increase in foreign financial investment in the U.S. as the result of large U.S. budget deficits, then

* the foreign exchange value of the dollar will depreciate, leading to an increase in both net exports and aggregate demand.
* fiscal policy will be more expansionary since there will be no crowding-out effect.
* the foreign exchange value of the dollar will appreciate, leading to a decline in aggregate demand.

 * fiscal policy will be more expansionary since U.S. residents will increase their saving so they can repay the foreigners in the future.

That answer is incorrect.
Correct answer:
the foreign exchange value of the dollar will appreciate, leading to a decline in aggregate demand.

As the U.S. budget deficit rises, the interest rate in the U.S. will rise. This higher interest rate attracts foreign investors-thus financial capital flows into the U.S. The higher rate of return on U.S. bonds etc elicits foreign investors-an increased demand for U.S. dollars is the result. Foreign investors require U.S. currency in order to invest in the U.S. market. Thus, under rising budget deficits the foreign exchange value of U.S. dollars rises as foreign investors compete for U.S. dollars. This increase in the foreign exchange value of the U.S. dollars drives down aggregate demand as foreign consumers are less able to afford U.S. exports.

Which of the following would be excluded from GDP calculations?

I. Your purchase of 1,000 Microsoft shares.
II. Brokerage charged on the purchase in (I).
III. The gift of $10,000 bequeathed to you by your grandfather.
IV. The fees charged by your lawyer to process your grandfather's gift.

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

That answer is correct!

The GDP counts only the final goods and services produced during a period. It excludes all financial transactions and income transfers. Hence, I & III are excluded while II and IV, which represent actual services, are not.

Which of the following best illustrates the difference between GDP and GNP?

 * GDP measures a country's output; GNP measures consumption.
 * GDP measures the output of final goods, while GNP measures both final and intermediate goods.
 * GDP measures the output produced domestically, while GNP measures the output produced by the "nationals" of a country.
 * GDP measures the productive output of a country, while GNP measures the material used to generate that output.

That answer is incorrect.
Correct answer:
GDP measures the output produced domestically, while GNP measures the output produced by the "nationals" of a country.

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.

Kelly receives a pay increase of 5%, but unbeknownst to her, this only compensates her for inflation over the next 12 months. What will the impact of inflation be on her spending habits?

 * She will spend a greater percentage of her income, believing that inflation will cause dollars today to be worth more than dollars tomorrow.
 * No impact.
 * Indeterminate, it depends on her marginal propensity to consume.
 * She will spend all of the 5% increase, as unanticipated inflation increases her daily costs.
 * She will be forced to save a greater percentage of her income to compensate for the loss of spending power over the next 12 months.

That answer is incorrect.
Correct answer:
No impact.

Whether individuals realize greater income due to inflation or not is irrelevant to how much they decide to spend. Kelly will spend a percentage of her total income based on her marginal propensity to consume. It is unfortunate for her that she will not realize any additional utility, because her increased income will only make up for the increase in prices, but this reiterates how inflation is a wash for consumers. Note that if the inflation was caused by an expansionary monetary policy, and if every consumer were like Kelly, the policy would have no real effect on consumer demand.

How would the Bureau of Labor Statistics count a person working part time who refuses a full-time job but who continues to look for a better paying full-time job?

 * not in the labor force
 * a fraction of an employed worker
 * a discouraged worker
 * employed
 * unemployed

That answer is incorrect.
Correct answer:
employed

Part-time workers who desire full time employment are classified as employed rather than unemployed if they work as much as a single hour per week. These people can be classified as underemployed but not unemployed.

Employment identifies the proportion of the population age 16 and over that is

 * either looking for work or on layoff waiting to be rehired.
 * out of the labor force.
 * either employed or seeking employment.
 * employed.
 * unemployed.

That answer is incorrect.
Correct answer:
employed.

The employment/population ratio is a more objective and meaningful measure of job availability than is the rate of unemployment. It is found as the ratio of the number of persons 16 years of age and over employed as civilians to the total civilian population 16 years of age and over.

Which of the following correctly states the relationship between gross domestic product and net domestic product?

* Net domestic product equals gross domestic product plus depreciation.
* Net domestic product equals gross domestic product minus government tax collections.
* Net domestic product equals gross domestic product minus depreciation.
* Net domestic product equals gross domestic product plus income received by citizens for factors of production supplied abroad minus income paid to foreigners for their contribution to domestic output.

That answer is incorrect.
Correct answer:
Net domestic product equals gross domestic product minus depreciation.

Net domestic product is gross domestic product minus a depreciation allowance for the wearing out of machines and buildings during the period.
As long as there is positive depreciation (which there must always be) then net domestic product will be less than gross domestic product.

If the money velocity is 5 and the nominal GDP is $100 million, then the stock of money in circulation is

* $100 million.
* $500 million.
* $20 million.
* $50 million.

That answer is incorrect.
Correct answer:
$20 million.

Velocity of money is defined as GDP divided by the stock of money. Thus, we need to solve for M if 5=$100 million/M. This implies that M=$20 million.

For a modern economy such as that of the U.S., full employment generally means

* everyone (excluding teen-agers) who wishes to work is employed.
* cyclical unemployment is present.
* between 94 percent and 95 percent of the labor force is employed.
* 100 percent of the labor force is either working or seeking work.

That answer is incorrect.
Correct answer:
between 94 percent and 95 percent of the labor force is employed.

Economists generally 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., most economists put this figure at 94 to 95 percent of the labor force.

The Fed can control money supply by which of the following methods?

I. Changing interest rates.
II. Changing the reserve ratio.
III. Changing the discount rate on its loans.
IV. Engaging in financial market transactions.

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

That answer is correct!

The Fed can increase the money supply by decreasing the reserve ratio, decreasing the discount rate on Fed-funds loan or buying securities on the market to inject new money in the economy (and vice versa).

Without money to serve as a medium of exchange,

* our standard of living probably would increase.
* self-sufficiency in production would still permit us to enjoy our level of economic activity.
* gains from trade would be severely limited.
* barter exchange methods would still permit us to enjoy our level of economic activity.

That answer is incorrect.
Correct answer:
gains from trade would be severely limited.

Money simplifies and reduces the costs of transactions. This reduction in transaction cost permits us to realize the enormous gain from specialization, division of labor and mass-production techniques that underlie our modern standard of living. Without money, exchange would be complicated, time-consuming and enormously costly.

In a given economy, an increase of 200 in income causes an increase in consumption of 123. By how much will aggregate output expand due to an increase in aggregate expenditure of 1,000?

* 2,600

* 615
* 1,626
* 1,000

That answer is incorrect.
Correct answer:
1,000

The Keynesian model equates output with expenditures, therefore if expenditures increase by 1,000, so will GDP. Be careful of the terminology used here. In this case, since the term "aggregate expenditure" was used, this indicates that the multiplier effect has already been accounted for. Had the term "initial expenditure" been used, then one would need to apply the expenditure multiplier. Remember that an initial expenditure is akin to a given individual spending additional funds, whereas changes in aggregate expenditures is the total change in spending. Initial Expenditure * Multiplier Effect = Change in Aggregate Expenditure.

Which of the following about the aggregate expenditure model is true?

* Actual output will equal potential output.
* Planned expenditures will equal potential output.
* The economy will not be in equilibrium at full employment.
* Planned expenditures need not equal actual expenditures.

That answer is incorrect.
Correct answer:
Planned expenditures need not equal actual expenditures.

Since producers must make production decisions in advance, they rely on anticipated demand for some future period. Consumption decisions are made in the current period. Therefore actual and planned expenditures will differ.

According to Say's law, there cannot be overproduction of goods and services because

* producing goods generates enough income to buy the total output.
* demand creates its own supply.
* overproduction will lead to higher unemployment, which will reduce production.
* less fortunate countries will always buy the excess output.

That answer is correct!

Say's Law states that production creates is own demand so that demand will always be sufficient OT purchase the goods produced because the income payments to the resource suppliers will equal the value of the goods produced.

An economy is currently in equilibrium at full employment. If there is a decrease in aggregate demand, which of the following is/are true?

I. The price decrease will be larger if the change is unanticipated than in the case where it is anticipated.

II. The supply curve moves to the left in the short run if the change is anticipated.

III. The unemployment falls below the natural rate.

IV. Real GDP remains unaffected if the change is not anticipated.

* II & IV
* I & III
* I & IV
* none of them.

That answer is incorrect.
Correct answer:
none of them.

The decrease in demand is represented by a movement of the demand curve to the left. If resource owners accurately forecast the decreased demand, they will appropriately decrease their prices, making production cheaper and moving the supply curve to the right. An equilibrium is reached at a lower price where real GDP and unemployment remain unaffected. Thus, the only effect is seen on nominal variables like inflation, leaving real variables unaffected if the change in demand is completely anticipated.
On the other hand, if the demand shift is not completely anticipated, then resource prices will not quickly adjust in the downward direction and producers will be able to cut the output only along the old supply curve in the short run. Therefore, real GDP will decrease and unemployment will rise above the natural rate. An equilibrium is reached at a lower price which is higher than the price that prevails in the case of completely anticipated demand. Over time, resource owners adjust to the new information, moving the supply curve to the right and reaching an equilibrium where the real GDP is once again equal to potential GDP.

If the full impact of an expansionary demand-stimulus policy is not completely anticipated, the policy will affect which of the following:

I. total output.
II. total employment.
III. inflation.
IV. real interest rates.

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

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

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. Real interest rates will rise as a result of increased demand for loanable funds and a decrease in savings, leading to reduced supply of loanable funds.

Which one of the following about expansionary monetary policy is true?

* Open market purchases lead to an excess money supply and an increase in interest rates.
* 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.
* Open market purchases lead to an excess money supply and a reduction in the interest rate.

That answer is incorrect.
Correct answer:
Open market purchases lead to an excess money supply and a reduction in the interest rate.

Expansionary monetary policy expands the money supply. One method to achieve this is for the Fed to purchase U.S. securities from the public. This injects currency into the economy and expands the money supply. An expanded money supply leads to a reduction in interest rates.

If an economy is operating below capacity, a monetary expansion will help move the economy toward ________.

* recession
* price deflation
* none of these answers
* full employment
* underemployment

That answer is incorrect.
Correct answer:
full employment

An economy operating below capacity will move toward full employment under a monetary expansion because aggregate demand will be stimulated. Individuals possess more money balances and thus consume more. This increased consumption shifts aggregate demand outward. Thus, the economy operates closer to the point of full employment.

Inflation

* indicates that there has been a general decline in the purchasing power of the dollar.
* occurs whenever any price in the economy rises.
* causes the purchasing power of a dollar to rise.
* almost always benefits creditors at the expense of debtors.
* is measured by changes in the cost of a typical market basket from one city to another.

That answer is correct!

Inflation is a continuing rise in the general level of prices, such that it costs more to purchase the typical bundle of goods and services that is produced and/or consumed.

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

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

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

During periods of weak resource demand, high unemployment and output less than the economy's potential GDP, real interest rates and real wages will decline and stimulate additional spending and a reduction in costs. This will eventually pull the economy out of the recession.

The largest component of GDP as measured by the expenditure approach is

* net profits of corporations.
* wages and salary earnings.
* investment.
* consumption.

That answer is incorrect.
Correct answer:
consumption.

Personal consumption expenditures are the largest component of GDP; in 1995 they amounted to $4,924 billion.

Under a fractional reserve banking system, commercial banks will increase the money supply if they

* sell government bonds to individuals and businesses.
* accept deposits in the form of cash.
* use the deposits of their customers to extend additional loans to individuals and businesses.
* increase their reserves held at a Federal Reserve bank.
* sell government bonds to foreigners.

That answer is incorrect.
Correct answer:
use the deposits of their customers to extend additional loans to individuals and businesses.

The fractional reserve banking system allows banks to hold only a fraction of their demand deposits at any time. Reserves in excess of this required amount are than loaned to borrowers at a positive interest rate. The money supply is increased when banks extend loans through the deposit expansion multiplier which is the reciprocal of the required reserve ratio.

A country's gross national product will most likely exceed its gross domestic product when the

* country has attracted a great deal of foreign investment.
* country has a large number of foreign workers.
* country has made substantial investments abroad.
* income of foreigners within the country exceeds the income of domestic citizens abroad.

That answer is incorrect.
Correct answer:
country has made substantial investments abroad.

These two output measures will differ significantly when there is a substantial difference between the income citizens earn abroad and the domestic income generated by foreigners. If significant investment is made abroad, that is, that is not generating output on American soil, the GNP will be greater than GDP. This is because only output generated on U.S. soil is counted in GDP while GNP includes output generated by any U.S. citizen, whether at home or abroad.

In year 0, $100 purchases a certain basket of goods. By year 3, $124 is required to purchase the same basket of identical goods. What has the average annual inflation rate been over this period?

* 24.0%
* 8.0%
* 7.4%
* 3.2%
* 11.6%

That answer is incorrect.
Correct answer:
7.4%

Calculate the average annual inflation rate by taking the cost in year 3 divided by the cost in year 0 all raised to the 1/3 power, or (124/100)^1/3 - 1.

The current M1 money supply of Economica is 10 billion. The nation of Islandia acquires 100 million of Economican Dollars and announces that one Islandian Bhat can now be exchanged for one Economican Dollar upon demand. The Economican Central Bank subsequently prints 100 million in Economican Dollars, which are held as currency.

Ignoring the velocity of money and assuming all other economic variables are constant, how much has the Economican M1 money supply increased and how much would the price level be expected to inflate?

* 100 million, 0%
* -100 million, -1%
* 0, 0%
* 100 million, 1%
* 0, 1%

That answer is correct!

In this case, the M1 money supply has increased by 100 million or 1%. Although this exact amount was essentially exported to Islandia, the currency is still outstanding and is therefore counted in M1. Under the basic price level equation P = M / Y (Price Level = Money Supply / Output, ignoring the velocity of money for the moment), a 1% increase in the money supply would result in a 1% increase in the price level.

However, the expatriated currency will not be used for domestic transactions, and therefore would not fuel price increases. We would expect zero inflation.

This illustrates one of the problems in using money aggregates to measure the real money supply.

The permanent income hypothesis implies that the consumption component of aggregate demand will

* be primarily determined by income rather than expected income in the long-term future.
* be relatively stable and therefore help stabilize aggregate demand over the business cycle.
* increase more rapidly than income during a business expansion.
* fluctuate substantially over the business cycle and thus be a major contributing factor to economic instability.
* be relatively unstable and will therefore contribute to interest rate instability over the business cycle.

That answer is incorrect.
Correct answer:
be relatively stable and therefore help stabilize aggregate demand over the business cycle.

The permanent income hypothesis suggests that individuals base their current consumption on their long-term expectation of their income. Thus, over recessions and expansions the consumption component of aggregate demand will be relatively constant and will help to adjust the economy toward its long run equilibrium levels.

In the short run, macroacceleration will tend to induce an expansion in output and employment because decision makers are

* unable to immediately differentiate between inflation and an increase in demand for their product or service.
* unable immediately to adjust previously negotiated long-term contracts in light of the new demand and price conditions.
* unsure whether the increase in demand is temporary or permanent.
* all of these answers.

That answer is incorrect.
Correct answer:
all of these answers.

A macroacceleration refers to an increase in the rate of money infusion in the economy. This type of policy results in higher than anticipated inflation. Thus, all of these answers are true under this scenario.

If heavy federal borrowing pushes up interest rates in the U.S., which of the following will most likely result?

* an inflow of financial capital from abroad and an appreciation in the foreign exchange value of the dollar.
* an outflow of financial capital as foreigners flee the U.S. capital market and an appreciation in the dollar's foreign exchange value.
* an outflow of financial capital as foreigners flee the U.S. capital market and a depreciation in the dollar's foreign exchange value.
* an inflow of financial capital from abroad and a depreciation in the dollar's foreign exchange value.

That answer is correct!

A high interest rate in the U.S. attracts foreign investors in search of a high return on their capital. Financial capital flows into the U.S. when interest rates rise. The increased demand for U.S. dollars (through which foreign investors "invest" in the U.S.) causes the foreign exchange value of the dollar to rise.

In the Keynesian view, equilibrium occurs when:

* total spending level equals total output.
* unemployment rate is equal to the long-run natural rate.
* all of these answers.
* total demand equals total supply.

That answer is correct!

According to the Keynesians, suppliers will produce only the quantities consistent with anticipated demand. 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.

When the marginal propensity to consume is 3/4 and an economy operates at its full-employment capacity, in the Keynesian model a $25 billion increase in government expenditures will

* increase real GDP $100 billion.
* increase real GDP $50 billion.
* increase real GDP $25 billion.
* increase real GDP $75 billion.
* leave real GDP unchanged.

That answer is incorrect.
Correct answer:
leave real GDP unchanged.

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 price; real output will stay the same.

According to the Keynesian view, if policy makers thought the economy was about to fall into a recession, which of the following would be most appropriate?

* a tax increase
* a planned increase in the budget deficit
* balancing the budget
* reducing government expenditures

That answer is incorrect.
Correct answer:
a planned increase in the budget deficit

A planned increase in the budget deficit will stimulate aggregate demand: reduced tax revenues and higher government expenditures will expand the government deficit but at the same time, will increase aggregate demand.

Which one of the following is incorrect regarding money?

* The value of money is related to the quantity of money in circulation.
* The value of money is dependent on the quantity of gold held by the Federal Reserve.
* Money is a medium of exchange.
* Money serves as a unit of account.
* Money is a store of wealth.

That answer is incorrect.
Correct answer:
The value of money is dependent on the quantity of gold held by the Federal Reserve.

The value of money is currently dependent on the supply of money in the economy. Although this supply is controlled by the Federal Reserve it is no longer fixed by the gold standard.

Which of the following will most likely result from an unanticipated decrease in aggregate supply due to unfavorable weather conditions in agricultural areas?

* a decrease in prices
* an increase in prices
* a decrease in inflation
* a decrease in unemployment
* an increase in the natural unemployment

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

A supply shock to resources causes resource prices to increase and therefore, the costs of production to also increase. This will cause the short run aggregate supply curve to shift leftward which has the effect of raising prices.

The Central Bank decides to have the money supply increase by exactly 5% each year. Which of the following statements would be false?

 * This policy is considered non-activist monetary policy.
 * This policy may spur growth in the short-term, but will have no impact on real income in the long-run.
 * The 5% increase is known as a policy rule.
 * None of these answers is correct.
 * Following this policy will require the Central Bank to adjust the amount of new currency injected into the economy based on feedback data.
 * Assuming production remains constant, inflation will be about 5% each year.

That answer is incorrect.
Correct answer:
This policy may spur growth in the short-term, but will have no impact on real income in the long-run.

This type of policy is known as non-activist monetary policy, and the 5% increase is called the policy rule. Remember that new currency issued does not have a one-to-one relationship with the money supply. Depending on how the money multiplier changes, the Central Bank may need to issue more or less new currency.

One of the key advantages to this type of policy is that it takes the variability out of inflation. Although there could be short-term fluctuations, long-run inflation will be about 5%. In fact, we know that if production remained constant inflation would be 5% each and every year. This suggests that economic participants will be very well informed about future inflation.

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.

If the inflation rate is 3.5%, how much will a basket of goods that currently costs $25 cost in 50 years?

 * $98.23
 * $111.39
 * $139.62
 * $225.00
 * $43.75

That answer is incorrect.
Correct answer:
$139.62

The calculation is as follows: (1.035)^(50)*25=139.62

If a recession is about to begin, the Keynesian view indicates that policy makers should

* decrease government spending while holding taxes constant.
* increase government spending not increase taxes.
* balance the budget.
* hold government spending constant and increase taxes.

That answer is incorrect.
Correct answer:
increase government spending not increase taxes.

Increasing government spending will stimulate aggregate demand in the economy and most likely will reduce the problem of recession (which is a contraction of economic activity). Similarly, reducing taxes will result in an increase in aggregate demand as consumer disposable income will rise. Under increases disposable incomes, consumers will buy more goods and services and will thus stimulate aggregate demand and reduce the likelihood of a recession.

A nation has recently emerged from several years of war, in which the government used debt to support the war effort without raising taxes. Which of the following economic problems is this nation most likely facing?

* stagflation
* deflation
* unemployment
* inflation
* over regulation

That answer is incorrect.
Correct answer:
inflation

A debt-financed war is effectively expansionary fiscal policy. Therefore a nation emerging from war time is likely to be dealing with substantial inflation. This is consistent with the U.S. economy after World War I, World War II, Korea and Vietnam.

"Inflation gives a stimulus only when it is unanticipated. But when people get adjusted to it, the mere occurrence of what was expected is no longer stimulating." This statement is

* essentially correct.
* false; inflation will always catch decision makers by surprise.
* false; inflation stimulates output and employment regardless of whether it is anticipated.
* false; inflation will not stimulate output and employment even when the effects are unanticipated.

That answer is correct!

This statement is correct because only unanticipated inflation will result in a decrease in the real wage and ultimately, an increase in employment. This increase in employment increases real output.

Which of the following is/are accomplished by automatic stabilizers?

I. In a recession, they cause a greater budget deficit than would prevail in their absence.

II. In a recession, they cause a greater budget surplus than would prevail in their absence.

III. In a boom, they cause a greater budget deficit than would prevail in their absence.

IV. In a boom, they cause a greater budget surplus than would prevail in their absence.

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

That answer is incorrect.
Correct answer:
I & IV

Automatic stabilizers work in a way that reduces government spending during booms and increases it during sluggish times. When government spending increases, the budget deficit increases (or the surplus decreases) and vice versa. From this, I & IV follow.

Which of the following will most likely occur during the expansionary phase of a business cycle?

* Interest rates rise and the number of housing starts declines.
* GDP rises sharply and unemployment falls.
* Real GDP declines and inflation rises sharply.
* inflation rises and employment falls.

That answer is incorrect.
Correct answer:
GDP rises sharply and unemployment falls.

During an expansionary phase of the business cycle business sales rise, GDP grows rapidly and the rate of unemployment declines.

Which of the following will lead to an increase in aggregate demand in the U.S. ?

* a decrease in wealth due to a stock market crash
* a decrease in the real interest rate
* an increase in the probability of a recession
* an increase in the real interest rate
* a decline in real income in Japan and Western Europe

That answer is incorrect.
Correct answer:
a decrease in the real interest rate

An decrease in the real interest rate makes both consumers and investment goods less expensive so that both households and investors increase their current expenditures in response.

In year 0, $10 could purchase a certain basket of goods. In year 5, the identical basket of goods cost $13. What was the average annualized inflation rate during this period?

 * 11%
 * 30%
 * 5%
 * 6%
 * 8%

That answer is incorrect.
Correct answer:
5%

The calculation is as follows: (13/10)^(1/5)-1=0.0539

Which of the following would increase both GDP and GNP?

 * the sale of a good produced by a foreign 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 the U.S.
 * the sale of a good produced by a domestic 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 the U.S.

Since GNP is the total market value of all final goods and services produced by the citizens of a country a good that is produced by a domestic citizen is included in GNP calculation. GDP inclusion requires that the good be sold domestically; thus, it will also contribute to GDP.

Which of the following will most likely occur during the contraction phase of a business cycle?

 * Real GDP declines and unemployment rises.
 * GDP rises sharply and unemployment falls.
 * Inflation rises and employment falls.
 * Real GDP increases and inflation rises sharply.
 * Interest rates rise and the number of housing starts declines.

That answer is correct!

As aggregate business conditions slow, the economy begins the contraction or recessionary phase of a business cycle. Real GDP grows at a slower rate or even declines and unemployment increases.

Which one of the following would add to this year's GDP?

* a professor's $1,000 tax-deductible gift to her college
* your purchase of 100 shares of IBM stock
* rent you fail to make to Budget Rent-A-Car because you filed for bankruptcy
* your purchase of a five-year-old house from its original owner
* the value of lawn services a 16-year-old reports as income to the government

That answer is incorrect.
Correct answer:
the value of lawn services a 16-year-old reports as income to the government

GDP comprises the total market value of all final goods and services produced domestically during a specific period. Therefore, the services provided by the teenager are domestically produced and therefore contribute positively to the GDP.

Which of the following items is NOT used in calculating the GDP using the Resources Cost-income approach?

* Income payments to resources.
* Compensation of employees.
* Government gross investment.
* Rents, interest income and profits.

That answer is incorrect.
Correct answer:
Government gross investment.

The Resource cost-income approach can be summarized as "GDP = Cost of human resources + cost of capital resources + costs imposed by the government + GNP-GDP adjustment"

Cost of capital resources includes items like corporate profits, interest income and depreciation. Costs imposed by the government which increase the sale prices of goods, such as sales, use tax and other indirect business taxes also add to GDP in this approach. The GNP-GDP adjustment rectifies the fact that some of the payments and incomes are made to foreigners and citizens living outside the country.

Gross investment by the government appears in the "Expenditure approach" to measuring GDP, not the Resource cost-income approach.

"The velocity of money is not affected by money supply." This view is held by:

* Keynesians.
* Classical economists.
* Monetarists.
* Neoclassical economists.

That answer is incorrect.
Correct answer:
Classical economists.

The quantity theory of money maintained by classical economists postulates that the velocity of money depends on institutional factors like the communication systems, banking and credit arrangements, etc. and is not affected by changes in money supply.

Commercial depository institutions and the federal government are the only customers of ________.

* Federal Reserve Banks
* credit unions
* the FDIC
* savings and loans
* commercial banks

That answer is correct!

The Federal Reserve is the central bank of the U.S. It is essentially the bank's bank. It carries out banking regulatory policies and is responsible for the conduct of monetary policy.

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

I. The government percentage of GDP is unusually high

II. The spending increases are offset by tax hikes

III. The legislation can be enacted and implemented well in advance of problematic unemployment

IV. GDP is currently below potential GDP

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

That answer is incorrect.
Correct answer:
III only

Government percentage of national income is not an issue in terms of fiscal policy. If spending increases are offset by tax hikes, 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.

The government budget deficit is currently at 600 billion dollars. The government is following:

* a restrictive fiscal policy.
* a discretionary fiscal policy.

* cannot be determined.
* an expansionary fiscal policy.

That answer is incorrect.
Correct answer:
cannot be determined.

Economists consider a budget to be restrictive or expansionary based on the change in the size of the budget, not the level of the budget. Hence, a knowledge of the budget deficit or surplus, in itself, does not indicate the type of fiscal policy being implemented.

The fact that consumption demand is stable over the business cycle and that changes in real interest rates help redirect economic fluctuations can both be cited as evidence that

* price adjustments in the resource market will destabilize the economy.
* market forces tend to cushion the effects of an economic shock.
* discretionary fiscal policy will improve the performance of the economy.
* market economies are inherently unstable.

That answer is incorrect.
Correct answer:
market forces tend to cushion the effects of an economic shock.

During periods of weak resource demand, high unemployment and output less than the economy's potential GDP, real interest rates and real wages will decline and stimulate additional spending and a reduction in costs. This will eventually pull the economy out of the recession. Similarly 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.

Some households and firms hold money balances so they can respond quickly to profit-making opportunities. This reason for holding money is known as

* investment demand.
* precautionary demand.
* transaction demand.
* speculative demand.

That answer is incorrect.
Correct answer:
speculative demand.

Individuals and businesses may want to maintain part of their wealth in the form of money so they will be in a position to take ready advantage of opportunities to purchase desired items at low prices. Holding money for this reason is termed speculative demand for money.

Which of the following would be officially classified as unemployed?

* a mathematician who returned to graduate school after failing to find a job the last four months
* a 60-year-old former steel worker who would like to work but has given up actively seeking employment
* none of these answers would be officially classified as unemployed
* a school administrator who has been working as a substitute teacher one day per week while looking for a full-time job in administration

That answer is incorrect.
Correct answer:
none of these answers would be officially classified as unemployed

The term unemployed is used to describe a person not currently employed who is either (1) actively seeking employment or (2) waiting to begin or return to a job. The school administrator is considered employed while the other two examples are not considered in the labor force.

If an economy's stock of privately owned capital goods is greater at the end of the year than at the beginning of the year, then over this period

* net private domestic investment has exceeded gross private domestic investment.
* net private domestic investment has been positive.
* depreciation has exceeded gross private domestic investment.
* depreciation has exceeded net private domestic investment.

That answer is incorrect.
Correct answer:
net private domestic investment has been positive.

Net private domestic investment is the difference between private domestic investment and depreciation. If the stock of capital is greater at the end of the year, then the firm has bought new capital at a faster rate than old capital has worn out. Therefore, net private domestic investment was positive.

Which of the following is/are true about the "permanent income hypothesis?"

I. It implies that there is a permanent one-to-one increase in consumption for a given change in income.

II. It maintains that the consumption of households is largely determined by their long-range expected income.

III. It implies that changes in business cycle do not exert a large impact on current consumption.

IV. Consumption instability destabilizes aggregate demand over a business cycle.

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

That answer is incorrect.

Correct answer:
II & III

According to the Permanent Income Hypothesis, the consumption of households is largely determined by their long-term expected income. This follows from the desire of households to maintain a smooth level of consumption. Hence, an increase in income causes people to spend part of it on higher consumption and save the rest. Similarly, a decrease in income causes them to dip into their savings and not cut back on current consumption as much. This stability in consumption actually serves to reduce the instabilities in a business cycle.

Within the framework of Keynesian analysis, if the federal government increased its spending without increasing its tax revenues during a period of full employment,

* interest rates would fall.
* inflation would ensue.
* the national debt would decline.
* a recession would develop.

That answer is incorrect.
Correct answer:
inflation would ensue.

Inflation would result if the government increased spending without increasing tax revenues during a period of full employment since aggregate demand would rise. Increased government spending in such an environment would lead to inflation since aggregate demand would rise: as aggregate demand rises (and aggregate supply cannot rise since the economy is already at full employment) prices rise since more demand is competing for the same number of goods. Thus, an increase in government expenditures must be coupled with an increase in taxation designed to reduce consumer disposable incomes (and thus private aggregate demand).

Assume the Fed purchases $20,000 worth of U.S. Treasury bonds from Donald Trunk, who deposits the money with First National Bank. If the required reserve ratio is 20 percent, the immediate effect of this transaction (before the deposit expansion multiplier) will be to

* increase the money supply $20,000 and increase the required reserves of First National Bank $16,000.
* increase the money supply $20,000 and increase the excess reserves of First National Bank $16,000.
* increase the money supply $20,000 and increase the excess reserve of First National Bank $20,000.
* exert no impact on either the money supply or the excess reserves of banks.

That answer is incorrect.
Correct answer:
increase the money supply $20,000 and increase the excess reserves of First National Bank $16,000.

The money supply increases by $20,000 because Donald Trunk, who formerly held a bond note worth $20,000, now holds $20,000 in actual money. So where there used to be a piece of paper, there is now actual money. The excess reserves of the bank will increase by $16,000 since they bank is required to hold only 20 percent of its total deposits: since its total deposits have increased by $20,000 this implies that it must hold 20 percent of $20,000 which is $16,000.

Both the U.S. experience and international comparisons strongly indicate that persistent, rapid growth in the money supply is linked with ________.

 * none of these answers
 * declining interest rates
 * price deflation
 * price inflation
 * unemployment

That answer is incorrect.
Correct answer:
price inflation

U.S. data indicates that shifts to rapid monetary growth for an extended period of time are generally followed by an acceleration in the inflation rate. International data show that countries with low rates of growth in the money supply tend to experience low rates of inflation.

An unanticipated ________ will temporarily stimulate output and employment.

 * none of these answers
 * monetary contraction
 * all of these answers
 * fiscal contraction
 * monetary expansion

That answer is incorrect.
Correct answer:
monetary expansion

The increase in aggregate demand emanating from an unanticipated increase in the money supply will lead to a short-run expansion in real output and employment.

Given:

Population	50 million
Number in the labor force	30 million
Number employed full time	20 million
Number employed part time	8 million
Number unemployed	2 million

What is the labor force participation rate of the economy?

 * 60 percent
 * 66.7 percent
 * 93.3 percent
 * 56 percent

That answer is correct!

Labor force participation rate is the number of persons in the civilian labor force 16 years of age or over who are either employed or actively seeking employment as a percentage o the total civilian population 16 years of age and over. This can be expressed as: 30/50 or 60 percent.

An economist who calls for reducing marginal tax rates to pull an economy out of a recession is:

* A Neo-Classicist.
* A Supply-side Economist.
* A Keynesian.
* A Monetarist.

That answer is incorrect.
Correct answer:
A Supply-side Economist.

For the Supply-side economics, marginal personal tax rates are of vital importance. 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 they are utilized.

If both monetary and fiscal policy became much more expansionary, Keynesians and monetarists would agree that

* the policy would temporarily stimulate output and employment if people did not anticipate the effects of the policy.
* the change in fiscal policy would control primarily unemployment, whereas the change in monetary policy would primarily affect prices.
* the natural unemployment rate would decline.
* real growth would continue as before but inflation would decline.

That answer is correct!

Unanticipated expansionary policies stimulate output and employment because the real cost of labor declines.

The four components of planned aggregate expenditures are

* consumption, investment, inventories and government purchases.
* consumption, planned investment, unplanned changes in inventory and exports.
* consumption, investment, exports and imports.
* consumption, investment, government purchases and net exports.

That answer is incorrect.
Correct answer:
consumption, investment, government purchases and net exports.

Aggregate expenditures is comprised of planned consumption, investment government purchases and the difference between exports and imports.

The crowding-out effect suggests that

 * budget deficits that lead to higher interest rates reduce private investment spending.
 * 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.
 * expansionary fiscal policy causes inflation.
 * an increase in private spending resulting from an expansion in the budget deficit and higher real interest rates will reinforce the expansionary impact of a pure fiscal action.

That answer is correct!

The crowding out effect suggests that government budget deficits increase real interest rates as the government competes in the market for loanable funds. Since the real interest rate reflects the "price" of investment, private investment will fall.

Which of the following would not be an expected impact of a cut in taxes with no corresponding decrease in government spending?

 * a outward shift in the aggregate supply curve
 * an increase in aggregate demand
 * an increase in the price level
 * an increase in interest rates
 * a decrease in unemployment

That answer is correct!

Theoretically, fiscal policy should cause a shift in the aggregate demand curve, which will cause movement along the supply curve. There is little reason to expect government spending to shift the supply curve.

If depreciation and indirect business taxes (including business transfers) were added to national income, the result would be

 * less than net product.
 * equal to net product.
 * equal to GDP.
 * less than personal income.

That answer is incorrect.
Correct answer:
equal to GDP.

National income is equal to GDP minus depreciation and indirect business taxes and represents the total income payments to owners of human and physical capital during a period. It includes both the domestic and foreign income earned by the nationals.

Which one of the following persons would be considered unemployed?

* a retired construction worker
* a northern construction worker laid off due to cold weather
* a full-time college student who is not a member of the labor force
* a part-time worker looking for a full-time job

That answer is incorrect.
Correct answer:
a northern construction worker laid off due to cold weather

In order to be unemployed, an individual must be a member of the labor force and be unemployed. The construction worker is the only such person; he suffers cyclical unemployment.

If an economy operates on the Keynesian range of its SRAS curve and the marginal propensity to consume is 2/3, a $100 billion increase in investment will cause real output to increase approximately ________.

* zero; only inflation will result
* $667 billion
* $300 billion
* $100 billion
* $66 billion

That answer is incorrect.
Correct answer:
$300 billion

The expenditure multiplier is found by M = 1/(1-MPC). Here M = 1/(1-2/3) = 3. Therefore a $100 billion is magnified three time to equal $300 billion.

"On the whole, statistics show that the velocity of money is high when the nominal interest rate is high." This statement is most consistent with the idea that

* the Fed fixes the velocity of money.
* the velocity of money is inversely related to the expected inflation rate.
* real GDP grows rapidly when the velocity of money is high.
* the velocity of money relates directly to the opportunity cost of holding money balances.

That answer is incorrect.
Correct answer:
the velocity of money relates directly to the opportunity cost of holding money balances.

A high nominal interest rate increases the "cost" of holding money balances. Thus, under a higher nominal interest rate, individuals will hold fewer money balances. As a result, the smaller amount of money in circulation must conduct the same number of transactions which implies that the average number of times that a given dollar is used in the purchase of final goods and services must rise.

The economy has had unusually high inflation over the last 4 years due in part to an oil shock. However, the Central Bank has been aggressively raising interest rates recently. According to the adaptive expectations hypothesis, which of the following is most likely for the upcoming year?

* none of these answers is correct
* the Central Bank's initiatives will be unsuccessful
* most economic participants will adapt their inflation estimates to the Central Bank's new policy
* short term rates may fall despite Central Bank efforts
* most economic participants will overestimate inflation

That answer is incorrect.
Correct answer:
most economic participants will overestimate inflation

This scenario suggests that inflation will be lower in the upcoming year than years past because of Central Bank maneuvers. Adaptive expectations, however, suggests that new information, such as monetary policy, will not be incorporated into inflation expectations. Therefore one would expect inflation to be overestimated in the upcoming year.

Which of the following describes the historical record of the business cycle in the U.S. ?

* The economy experiences a boom about once every 20 years.
* Both the length and magnitude of the business cycle have been irregular and unpredictable.
* Depressions have occurred every 25 years and are followed by two years of expansion.
* Expansionary phases are almost always of the same length and magnitude.

That answer is incorrect.
Correct answer:
Both the length and magnitude of the business cycle have been irregular and unpredictable.

During the period from 1960 to 1995, the annual fluctuations in real GDP have fallen within the range of minus 2 percent to plus 6 percent. Economic ups and downs were thus present during this period.

How would a domestic citizen's purchase of a foreign-produced good change GDP?

* It would increase GDP.
* It would decrease GDP.
* It would leave GDP unchanged.
* It is unclear whether it would increase or decrease GDP.

That answer is incorrect.
Correct answer:

It would leave GDP unchanged.

GDP is the total market value of all final goods and services produced domestically during a specific period. The output generated by a foreign country but purchased by a domestic citizen has no effect on GDP because the output was not produced on domestic soil.

The demand for money is inversely related to ________.

 * the speculative demand for money
 * the supply of money
 * the money interest rate
 * the required reserve ratio
 * the cost of goods and services

That answer is incorrect.
Correct answer:
the money interest rate

A high interest rate induces individuals to save their money rather than consume. The demand for money is positively related to consumption; thus as consumption falls (as individuals shift their money into saving to take advantage of the high interest rate), the demand for money falls.

If you anticipate that inflation will accelerate next year, which of the following will be the best protective action?

 * buying needed consumer durables, such as new tires and a dishwasher, now, rather than postponing these purchases
 * converting your stocks and bonds into cash
 * purchasing a life insurance policy or other assets that will guarantee a fixed money income stream as inflation accelerates
 * financing your new home with a variable-interest 30-year mortgage
 * purchasing an asset such as a government bond that will maintain its nominal value as inflation increases

That answer is correct!

Since inflation implies a rise in the general price level, it would be wise to make large consumer purchases before the inflation hits. This advice should be tempered however by realized that while prices increase under inflation, so do incomes. Thus, the real purchasing power decline under inflation is mitigated by rising incomes.

The economy has had unusually high inflation over the last 4 years due in part to an oil shock. However, the Central Bank has been aggressively raising interest rates recently. According to the rational expectations hypothesis, which of the following is most likely for the upcoming year?

 * none of these answers is correct
 * most economic participants will adapt their inflation estimates to the Central Bank's new policy
 * short term rates may fall despite Central Bank efforts

* most economic participants will overestimate inflation
* the Central Bank's initiatives will be unsuccessful

That answer is incorrect.
Correct answer:
most economic participants will adapt their inflation estimates to the Central Bank's new policy

This scenario suggests that inflation will be lower in the upcoming year than years past because of Central Bank maneuvers. Rational expectations, suggests that any new information, such as monetary policy, will be incorporated into inflation expectations.

Under adaptive expectations, an unanticipated shift to a more expansionary monetary policy will

* temporarily reduce unemployment.
* temporarily reduce the natural unemployment.
* place downward pressure on prices.
* temporarily reduce output.

That answer is correct!

The time lag and systematic error associated with adaptive expectations implies that in the short-term, an unanticipated shift toward expansionary monetary policy will reduce unemployment by reducing the real wage.

The impact of expansionary anticipated monetary policy in the short run will be to ________ the real interest rate.

* impossible to determine with information given
* decrease
* have not effect on
* increase

That answer is incorrect.
Correct answer:
decrease

Anticipated expansions in the money supply will decrease the real interest rate as individuals save more, thus increasing the supply of loanable funds. Since the real interest rate is the "cost" of borrowing money, this cost falls as the supply of the funds increases.

A nation has a government program by which workers who are laid-off are paid their previous salary for one month. Which of the following terms most accurately describes this program?

* Keynesian
* supply-side
* monetary policy
* automatic stabilizer

* socialism

That answer is incorrect.
Correct answer:
automatic stabilizer

An automatic stabilizer is anything that would decrease the government budget surplus during slow economies and increase the surplus during strong economic periods. The described program would qualify as an automatic stabilizer as weak periods are characterized by large numbers of lay-offs.

Which of the following is NOT an automatic stabilizer?

* Corporate income tax.
* Progressive income taxes.
* Government construction projects.
* Unemployment compensation.

That answer is incorrect.
Correct answer:
Government construction projects.

An automatic stabilizer is anything which serves to cushion the economy without the need for a decision by policy makers. For example, if unemployment is high, then unemployment programs will automatically increase outlays, pumping funds into the economy exactly when the economy is weak. Taxes are an expense item that falls when income falls, and if governments keep spending static, then the lower taxes will have a positive impact on income. A construction project is an example of a discretionary policy move, not an automatic stabilizer.

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

I. The real GDP is not affected by money supply.
II. The velocity of money is not affected by money supply.
III. Prices are not affected by money supply.

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

That answer is incorrect.
Correct answer:
I & II

The equation of exchange, in standard notation, says, MV = PY = GDP. The quantity theory of money maintained by classical economists postulates that Y and V are determined by factors other than the amount of money in circulation. The real output, Y, is affected by factors like the resource base available, current technological level, available skill sets and the regulatory environment. Similarly, the velocity of money depends on institutional factors like the communication systems, banking and credit arrangements, etc. Thus, Classical economists believed that any change in the money supply leads to a proportional change in prices, leaving the real GDP unaffected.

Inflation has been about 5% for the last several years. Many economists have recently been arguing that consumers may soon begin saving more and spending less.

If inflation were actually 4% next year, and this causes a small increase in real GDP, which of the following must have been true?

I. producers generally were forming inflation forecasts based on the rational expectations theory

II. there were slack resources in the economy

III. the Central Bank increased the money supply

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

That answer is incorrect.
Correct answer:
I, II

If actual inflation were 4%, and this caused an increase in real GDP, two things must have been true. First, there must have been slack resources in the economy that were utilized to increase production. Second, inflation expectations must have been less than 4%. If producers were acting according to the adaptive expectations hypothesis, they would have collectively expected 5% inflation. By the rational expectations hypothesis, they would have expected something less than 5%, because an increase in the savings rate would effectively decrease the money supply.

We cannot say why inflation was 4%. The money supply may have increased independently of the Central Bank.

If you anticipate that inflation will accelerate next year, which of the following would be the best protective action to take?

 * financing your new home with a fixed-rate mortgage
 * purchasing an asset such as a government bond that will maintain its nominal value as inflation increases
 * converting your stocks and bonds to cash
 * purchasing a life insurance policy or other asset that will guarantee a fixed money income stream as inflation accelerates

That answer is correct!

If inflation accelerates next year, you will be paying a lower real interest rate if next year. This is because the real interest rate equals the nominal interest rate divided by the price level. Under inflation the price level rises and therefore erodes the real interest rate.

When an expansionary demand-stimulus policy is unanticipated, profit margins will ________ and employment will ________ in the short run.

* increase, decrease.
* decrease, also decrease
* decrease, increase
* increase, also increase

That answer is incorrect.
Correct answer:
increase, also increase

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. So goods prices will increase as a result of increased demand. However, resource prices are more inflexible and will take time to increase. Thus, profit margins will increase. Producers will increase the resource utilization to expand the output to meet increased demand, leading to a fall in the unemployment rate.

"Recession" in an economy is characterized by which of the following?

I. Falling sales.
II. Fall in the level of real GDP.
III. Increased unemployment.
IV. Prolonged and severe economic hardship.

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

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

IV is considered to be a depression. A recession is a more regular feature of an economy as it cycles through booms and contractions. However, at times, an economy gets stuck in a prolonged and particularly severe business conditions. This state is referred to as "depression."

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

* an increase in unemployment
* an increase in real GDP
* an increase in nominal GDP
* an increase in prices
* an increase in the employment rate

That answer is correct!

The impact of an unanticipated reduction in aggregate demand is that there is a decline in output and prices. As output falls unemployment also falls due to weak demand.

Which of the following would be included in this year's GDP?

 * the value of a new domestic automobile, at its sale price
 * a sale of IBM stock from one individual to another
 * the face value of a life insurance policy paid to a woman on the death of her husband
 * the value of a used car, at its sale price

That answer is correct!

GDP is the total market value of all final goods and services produced domestically during a specific period. Thus, an automobile that is domestically produced will contribute positively to the calculation of GDP. The amount of positive contribution is based on the final sale price of the good; the intermediate cost of the components to the automobile are not counted since this would lead to double counting.

If people decide to hold more money as currency and less as checking deposits, this will most likely cause a(n)

 * increase in required reserves.
 * decrease in the federal funds rate.
 * increase in bank reserves.
 * decrease in the money supply.

That answer is incorrect.
Correct answer:
decrease in the money supply.

Since banks are allowed to make loans equal to their excess reserves, the money supply will contract under this scenario. This is because when individuals transfer their holdings from checking deposits to cash the actual reserves of banks declines. Since excess reserves equals actual reserves minus the required reserves, excess reserves have fallen and therefore the money supply will contract. If this continues to confuse you, set up an example whereby a banks has deposits equal to $1,000 and a reserve requirement of 10 percent. A $50 withdrawal is made. How have excess reserves changed? How does this affect the money supply through the deposit expansion multiplier?

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

 * Falling wages eventually lead the economy back to full employment.
 * Equilibrium is a state of full employment without inflation.
 * Supply creates its own demand.
 * Changes in private investment are a major source of economic instability.

That answer is incorrect.
Correct answer:
Changes in private investment are a major source of economic instability.

Keynesian economists believe that wide fluctuation in private investment is the villain of the business cycle. An economic expansion accelerates into a boom because investment is amplified by the multiplier and stimulates other parts of the economy. At the first sign of the slowdown though, investment plans are sharply curtailed and intensify a recessionary phase.

If the prices of TVs were to rise, which of the following effects would occur?

 * The demand curve for TVs will not be affected. The demand curve for cable service would shift to the left.
 * The supply curve for TV cable services will move to the left, causing a price decline.
 * The supply curve will not be affected, though the quantity of cable service supplied will increase, causing a price decline.
 * The entire demand curve for TV cable services would shift to the left.

That answer is correct!

TVs and TV cable services are complementary goods. Although a shift in the price of TVs only causes the quantity demanded to change for TVs (not the demand curve itself), the price of compliments is a factor in determining the demand curve for cable service. Therefore, the change in this factor causes a shift in the demand curve, in this case, to the left.

During a period of rapid growth in output

 * employment generally decreases, while unemployment increases.
 * both employment and unemployment generally fall.
 * both employment and unemployment generally rise.
 * employment generally increases and unemployment declines.

That answer is incorrect.
Correct answer:
employment generally increases and unemployment declines.

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

Net domestic product equals gross domestic product

 * plus net income earned abroad.
 * plus rents.
 * minus imports.
 * minus depreciation.

That answer is incorrect.
Correct answer:
minus depreciation.

Net domestic product is gross domestic product minus a depreciation allowance for the wearing out of machines and buildings during the period.

Congress passes a law that requires government spending rise each year by exactly the inflation rate. The year the law was passed the budget was balanced, inflation was moderate, and unemployment was at the natural rate. If national income declines, which of the following will probably be true?

I. the government's percentage of GDP will increase
II. tax receipts will decline
III. government debt will increase

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

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

During a recession, tax receipts would decline, but unless there is deflation government spending would not decline. Therefore the government would be in a deficit, causing debt to increase. Since the government is running a deficit, its demand has increased. Since national income has fallen, we can surmise that demand from consumers, foreigners, and investors has fallen. Therefore the government percentage of GDP will increase. Laws that automatically cause the government to be in a deficit stance during recessions are called non-activist fiscal policy.

The nation is currently in recession. During a presidential election, one candidate proposes that the recession is being caused by wasteful government spending. The candidate proposes a proportional decrease in spending and taxes. Using a fiscal policy framework, how would this proposal effect the economy?

* A balanced budget would eventually cause debt to be paid off, resulting in lower interest rates, and spurring economic growth.
* The decrease in government spending would cause a negative shift in the aggregate demand curve, creating a negative impact on the economy.
* Since the consumer sector is more efficient than the government sector, this would cause resources to be used more efficiently, increasing output.
* Government layoffs caused by the decrease in spending will increase unemployment.
* This proposal would be neutral from a fiscal policy perspective.

That answer is incorrect.
Correct answer:
This proposal would be neutral from a fiscal policy perspective.

Fiscal policy will only have an impact on aggregate demand/supply when there is a net change in government demand, i.e. government spending less taxes. Since this proposal involves proportional changes in taxation and spending, this will have no immediate impact from a fiscal policy standpoint.

Which of the following groups of people will most likely benefit from a period of unanticipated inflation, assuming the composition of their assets and liabilities remains unchanged?

* those whose assets include a government bond and a life insurance policy
* those who have no liabilities and whose assets include a savings account, long-term government bonds and a paid-up life insurance policy
* those whose assets include a house and a car and whose liabilities include a fixed-rate mortgage and an automobile loan
* those whose assets include corporate bonds, a savings account and a house with a variable-rate mortgage

That answer is incorrect.
Correct answer:
those whose assets include a house and a car and whose liabilities include a fixed-rate mortgage and an automobile loan

Under a fixed rate mortgage and automobile loan the real interest rate paid will decline if inflation occurs. This is because the real purchasing power of money declines and thus, the loan is repaid with dollars that are worth less in real terms.

If increased government borrowing drives up real interest rates in the U.S., then

* U.S. exports will tend to contract relative to imports.
* the inflow of loanable funds from abroad will dampen the increase in real interest rates, but it will also cause the dollar to appreciate.
* private investment will tend to decline.
* U.S. investors will increase their investments abroad.
* none of these answers.

That answer is correct!

An increase in U.S. government borrowing will drive real interest rates up in the U.S. As a result, foreign investors will want to increase their investment in the U.S. to take advantage of the higher rate of return offered there. Increased demand for U.S. dollars (the result of increased investment demand) will drive up the exchange rate for U.S. dollars. Consequently U.S. exports will be less affordable abroad and aggregate demand will fall.

Which of the following would cause the U.S. money supply to expand?

* an increase in the discount rate.
* a commercial bank using excess reserves to extend a loan to a customer.
* an increase in the reserve requirement.
* a commercial bank purchasing U.S. securities from the Fed as an investment.

That answer is incorrect.
Correct answer:
a commercial bank using excess reserves to extend a loan to a customer.

The U.S. money supply expands when banks extend loans. The process is as follows: a bank extends a loan to an individual. This first individual spends the amount of the loan; thus the amount of the loan becomes the income of a second individual. This second individual then deposits this income into a banking institution. The fraction of this deposit representing excess reserves is then lent to a third individual. Once the third individual spends the loan, it represents income to a fourth individual who deposits the amount in a banking institution which lends the excess reserves to a fifth individual. This process continues. The process is constrained by the reserve requirement which limits the amount of each subsequent loan. However, it is clear that the money supply expands under this scenario.

An economy experiencing substantial inflation, high unemployment and slow (or negative) output growth is said to be in a period of

* deflation.
* economic boom.
* depression.
* stagflation.

That answer is incorrect.
Correct answer:
stagflation.

Stagflation refers to the phenomenon of rapid inflation and sluggish economic growth.

According to the permanent income hypothesis, consumption by a family depends primarily on the family's

* interest income relative to earnings derived from labor services.
* expected long-term income.
* level of taxes.
* income.

That answer is incorrect.
Correct answer:
expected long-term income.

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.

Which of the following assets is most liquid?

* 10 acres of land
* funds in a savings account
* a television set
* a car

That answer is incorrect.
Correct answer:
funds in a savings account

Funds in a saving account are more liquid than a car because it takes time to exchange a car for money. The same is true for land or a television set. Physical objects will always be more illiquid than financial assets.

Over the last 5 years, inflation rates have been 4%, 11%, 16%, 6%, and 9%. If the real interest rate for the average 30-year, fixed-rate home loan is 5%, what should nominal fixed-rate should a lender charge on the average 30-year home loan?

* 14.2%
* 14%
* 15.3%
* 5%
* Unknown

That answer is incorrect.
Correct answer:
Unknown

Inflation has been highly variable over the last several years, and therefore making this decision is extremely difficult for the lender. If the lender picks a rate too low, inflation may destroy the lender's profits. Conversely, if the lender picked a rate too high, the rate would not be competitive in the near future, causing the borrower to re-finance. Hence, the lender may be unwilling to lend at all, at least not at fixed rates. This is one of the primary consequences of variable inflation.

A business spends $10 million on new capital equipment and during the same year $3 million of its existing capital wears out. Which of the following is correct?

* The firm's gross investment is $3 million and its net investment $7 million.
* The firm's gross investment is $7 million and its net investment $3 million.
* The firm's gross investment is $10 million and its net investment $7 million.
* The firm's gross investment is $7 million and its net investment $10 million.

That answer is incorrect.
Correct answer:
The firm's gross investment is $10 million and its net investment $7 million.

Net domestic product is gross domestic product minus a depreciation allowance for the wearing out of machines and buildings during the period.
So during the period considered, the total amount of new investment was $10 million but $3 million worth of capital wore out during the period. Therefore, the investment minus the amount that wore out is the net investment addition made to the firm during the period.

The expenditure multiplier is defined as the ratio of:

* change in employment for a given change in aggregate expenditure.
* change in expenditure for a given change in income.
* change in aggregate output for a given change in aggregate expenditure.

 * change in demand for a given change in prices.

That answer is incorrect.
Correct answer:
change in aggregate output for a given change in aggregate expenditure.

The basic idea behind the expenditure multiplier is the fact that one person's spending becomes another person's income. Hence, income-driven demand tends to multiply with aggregate expenditure, which fuels higher production in the Keynesian model. The total change in output caused by the first expenditure that sets the chain in motion is defined as the expenditure multiplier. For e.g., if you spend $100 on a good and follow all the resulting expenditures and increase in output arising from this act, you will have calculated the expenditure multiplier for the economy. The expenditure multiplier is directly linked to a quantity called "marginal propensity to consume" (MPC), which reflects the amount of each additional dollar in income that is spent on current consumption. Specifically, the ideal expenditure multiplier equals 1/(1-MPC).

Which of the following will most likely increase the natural unemployment?

 * an increase in the number of prime-age (30-55) workers as a share of the labor force
 * an increase in the number of retired workers collecting Social Security
 * an increase in the number of youthful (under age 25) workers as a share of the labor force
 * a decrease in the minimum wage
 * a decrease in unemployment compensation benefits relative to market wage rates

That answer is incorrect.
Correct answer:
an increase in the number of youthful (under age 25) workers as a share of the labor force

Youthful workers experience more unemployment because they change jobs and move in and out of the labor force often. Therefore, as the number of youthful workers increases in the labor force, the natural rate of unemployment is likely to increase also.

The theory which calls for reduction in marginal tax rates to stimulate the economy is known as:

 * Fringe Taxation.
 * Supply-side Economics.
 * Budgetary Economics.
 * Keynesian Theory.

That answer is incorrect.
Correct answer:
Supply-side Economics.

For the Supply-side economics, marginal personal tax rates are of vital importance. 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 they are utilized.

Within the AD/AS model, increased consumer and investor optimism concerning the future will lead to a(n)

 * reduction in the natural unemployment.
 * increase in the natural unemployment.
 * increase in long-run aggregate supply (LRAS shifts to the right).
 * decrease in aggregate demand (AD shifts to the left).
 * increase in aggregate demand (AD shifts to the right).

That answer is incorrect.
Correct answer:
increase in aggregate demand (AD shifts to the right).

Consumer and investor optimism concerning the future direction of the economy stimulates current investment consumption. Investment today may be necessary if business firms are gong to benefit fully from these opportunities. Similarly, consumers are more likely to buy big ticket items when they expect an expanding economy to provide them with both job security and rising income in the future. So increased optimism encourages additional current expenditures by both investors and consumers, increasing aggregate demand.

When buyers and sellers in the resource market fully anticipate and quickly adjust to the effects of demand stimulus policies, expansionary macroeconomic policies will

 * lead to higher prices while leaving real output unchanged.
 * increase both real output and the real rate of interest.
 * reduce unemployment.
 * reduce real wage rates and improve profit margins.

That answer is correct!

Prices will rise as economic agents full account for rising prices in their contracts. Real output will be unchanged since the real wage will remain constant due to fully anticipated increases in prices by workers.

Suppose most individuals expect inflation to increase substantially next year. Which of the following will most likely occur?

 * actual inflation will decline since everyone will be preparing for higher prices.
 * the national government will decline as individuals take jobs to prepare for the higher prices.
 * the short-run Phillips curve will shift outward (to the right), resulting in higher unemployment for any specific inflation rate.
 * unemployment will decline as inflation increases.

That answer is incorrect.
Correct answer:
the short-run Phillips curve will shift outward (to the right), resulting in higher unemployment for any specific inflation rate.

Higher expected inflation shifts the Phillips curve to the right because inflation will occur and unemployment will not fall.

Which one of the following would count as an investment as the term is used by national income accountants?

* a freight-hauling firm buying a new domestically produced truck
* buying an existing house
* buying a U.S. government bond
* buying 100 shares of Exxon stock

That answer is correct!

Investment refers to the flow of private sector expenditures on durable assets. A truck is considered a durable asset and therefore its purchase represents investment.

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

* 25
* 10
* 100
* 4
* 5
* 75
* 20
* 50

That answer is incorrect.
Correct answer:
4

The potential money deposit multiplier is inversely related to the reserve requirement ratio (i.e., money deposit multiplier = (1/.25)=4.

In an economy, the reserve requirement is 15%. If a bank has deposits of $400 million, loans of $364 million and reserves of $84 million, the excess reserves equal:

* $56 million
* $29 million
* $24 million
* $52 million
* $84 million

That answer is incorrect.
Correct answer:
$24 million

The reserves required equal 400 * 0.15 = $60 million. The excess reserves then equal 84 - 60 = $24 million

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A budget is judged to be expansionary or restrictive based on:

 * the size of the budget deficit.
 * its effect on unemployment rate.
 * the change in the size of the budget deficit.
 * whether it increases or decreases the size of the government.

That answer is incorrect.
Correct answer:
the change in the size of the budget deficit.

The level of budget deficit or surplus is already known. It is the change in this level that determines whether the government expenditure increases or decreases. Economists consider a budget to be restrictive or expansionary based on the change in the size of the budget.

Frictional unemployment

 * would be eliminated if monetary policy were more stable.
 * would be eliminated if fiscal policy were more stable.
 * is the result of workers quitting their jobs because they can not get along with their supervisors.
 * is inevitable even when labor markets are working well.

That answer is incorrect.
Correct answer:
is inevitable even when labor markets are working well.

Frictional unemployment will always be present because persons seeking jobs and firms hiring employees with the qualifications of the job seekers do not know about each other. This "job search" will eventually lead to efficiency and higher real income for employees.

The nation commences a project called "The Better Society" by which the government will use deficit spending to try to eradicate poverty. Which of the following economic variables is most likely to increase consistently for the duration of this policy?

 * Unemployment
 * Real interest rates
 * Fiscal surplus
 * Productivity
 * Inflation

That answer is incorrect.
Correct answer:
Real interest rates

Deficit spending tends to cause interest rates to rise as government demand for loans drives the price of money up. Note that "inflation" is incorrect because the price level would increase, but the inflation level would not necessarily increase.

Congress recently passed a retro-active tax-cut, causing all tax payers to receive $100 checks from the Treasury. Susan receives her check, but believes that the tax cut will be repealed next year and anticipates owing the $100 back to the government next April. How will this most likely impact Susan's spending?

 * Indeterminate, this depends on her marginal propensity to consume.
 * She will save $200 to pay for taxes next year.
 * No changes.
 * She will spend the $100 now, because consumers are not forward thinking.
 * She will spend some portion of the $100 now, and save the rest for taxes later.
 * Indeterminate, this depends on her marginal propensity to save.

That answer is incorrect.
Correct answer:
No changes.

Susan is unlikely to spend any of the $100 because she anticipates owing this back shortly. Had this tax cut been part of an expansionary fiscal policy, and the entire economy thought as Susan did, then the policy would have no effect.

If the marginal propensity to consume (MPC) is .6, what is the expenditure multiplier?

 * 2.5
 * 1.4
 * 0.6
 * 6.0
 * 0.4

That answer is correct!

The expenditure multiplier is found by M = 1/(1-MPC). Here, M = 1/(1-.6) = 2.5.

Which of the following events will increase GDP?

 * selling an antique writing desk for $500 cash
 * losing $500 playing blackjack in your dorm
 * the police department hiring an extra detective to track down the burglar who stole your stereo
 * a burglar stealing your stereo

That answer is incorrect.
Correct answer:
the police department hiring an extra detective to track down the burglar who stole your stereo

GDP is the total market value of all final goods and services produced domestically during a specific period. The police officer provides a service that is domestically generated and therefore contributes positively to the calculation of GDP.

Which of the following provides the best explanation of why money is valuable?

* Money is valuable because it is scarce relative to the demand for the services it provides.
* Money is valuable because it is declared legal tender by the government issuing it.
* Money is valuable because it is backed by precious metals, primarily gold and silver.
* Money is valuable because it has intrinsic value, independent of its use as a means of exchange.

That answer is correct!

Money's main source of value is the same as for other commodities, it is determined by demand relative to supply. People demand money because it reduces the cost of exchange. When the supply of money is limited relative to the demand, money will be valuable.

When people speak of the labor force participation rate, they are actually talking about the percentage of

* people actively participating in meaningful economic activity.
* people not working but actively seeking work.
* working-age people who are either working or seeking work.
* new entrants into the labor force.

That answer is incorrect.
Correct answer:
working-age people who are either working or seeking 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 employed or actively seeking employment as a percentage of the total civilian population 16 years of age and over. A person is in the labor force if they are employed or are actively searching for work.

Which of the following is/are components of M2 money supply?

I. Traveler's checks
II. Small money market deposits
III. Currency
IV. Small denomination CDs

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

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

Note that I and III are included in M1 money supply and M2 money supply consist of M1 supply plus savings deposits, including money market deposits, time deposits of less than $100,000 and small denomination money market mutual fund shares.

Frictional unemployment refers to the unemployment due to:

* none of these answers.
* structural characteristics of the economy.
* business downturn and falling profits.
* constant changes in the economy.
* strikes caused by unionization.

That answer is incorrect.
Correct answer:
constant changes in the economy.

Frictional employment arises due to a mismatch between what employers know and what job-seekers are looking for. Specifically, 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" and changes in the economy are the primary cause of it.

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

I. government debt high enough to be negatively impacting interest rates
II. tax hikes are concentrated among the wealthy
III. the legislation can be enacted and implemented well in advance of particularly high inflation.
IV. inflation is currently abnormally high

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

That answer is incorrect.
Correct answer:
III only

Although government debt can negatively impact interest rates, lower rates would eventually stimulate the economy, and a tax hike implies inflation is the problem. Which class of taxpayers are impacted by the tax hike is not a matter of fiscal policy. If inflation is currently abnormally high, this does not indicate whether fiscal contraction is currently needed, the economy might slow down before the policy can take effect. In order for fiscal policy to be effective, legislation must be past in advance of the actual economic problem.

Consider an economy for which the government budget is in balance when the economy operates at long-run capacity. If policy makers do not alter either tax rates or expenditure programs, during a recession

* a budget surplus will probably occur.
* a budget deficit will probably occur.
* the recession will continue indefinitely.
* the budget will probably remain in balance.

That answer is incorrect.
Correct answer:
a budget deficit will probably occur.

If expenditure programs and tax rates do not change during a recession, a budget deficit will occur since total tax revenues will fall (the consequence of smaller incomes) and total expenditures will rise (the consequence of a greater need for social services and transfer payments). The government's tax and social service regime is the same but the economy is different.

Credit card balances are part of which of the following?

* M2 money supply.
* M3 money supply.
* None of these answers.
* M1 money supply.

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

Credit card balances are not considered part of the money supply, since they are simply short-term loans.

Use the table below to choose the correct answer.

Income (Dollars)	Consumption (Dollars)
1,000	800
1,200	960
1,400	1,120

The marginal propensity to consume for this hypothetical economy is ________.

* 0.75
* 0.80
* 1
* 0.67

That answer is incorrect.

Correct answer:
0.80

Since the MPC is determined according to the ratio: MPC = additional consumption divided by additional income, the MPC here equals: 160/200 = .80.

A decrease in nominal GDP at a constant money supply will ________ money interest rate.

 * not be affected
 * decrease
 * insufficient information
 * increase

That answer is incorrect.
Correct answer:
decrease

As the nominal GDP decreases, the demand for money balances decreases, too. This is because either the real output has fallen or because prices have decreased. In either case, a lower amount of money is flowing in transactions. As the demand for money falls, the interest rate falls. Remember that money is like any other good; the lower its demand, the lower its "price."

Which of the following can distort the meaning of aggregate money supply measurements, such as M1 or M2?

 * all of these of these answers are correct
 * none of these answers is correct
 * currency held as reserve by foreign governments
 * increased usage of debit cards
 * increased usage of mutual funds over time deposits

That answer is correct!

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.

Increased use of debit cards has changed the demand for currency. Consumers may be carrying less cash in their wallets, rather leaving this cash in bank accounts and accessing it through a debit card. This increases bank reserve requirements and directly increases the monetary base with no real change in the way money was used.

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

I. Number of consumers.
II. Total money supply flowing in the economy.
III. Production capacity available in the economy.
IV. Prices of related goods.

* I, II & IV
* I & II
* III and IV.
* I & IV

That answer is correct!

Note that production capacity does not determine the demand curve but contributes to the supply curve. Also, the total money supply in the economy determines the values plotted on the price-axis of a demand curve. For a constant production capacity, an increase in money supply leads to inflation, thus re-labeling all the prices used in a demand curve.

Which of the following will most likely decrease the natural unemployment?

* an increase in unemployment compensation benefits relative to market wage rates
* an increase in the minimum wage
* an increase in the number of youthful (under age 25) workers as a share of the labor force
* an increase in the number of prime-age (30-55) workers as a share of the labor force

That answer is incorrect.
Correct answer:
an increase in the number of prime-age (30-55) workers as a share of the labor force

The natural rate of unemployment is the long run average unemployment rate due to frictional and structural conditions of labor markets. Youthful workers experience more unemployment because they change jobs and move in and out of the labor force often. The natural rate of unemployment increases when youthful workers compose a larger proportion of the work force.

In the basic Keynesian model of income determination, aggregate expenditures refer to

* consumer spending measured in constant prices.
* combined expenditures of consumers, businesses, governments and foreigners (net exports).
* the amount of demand for consumer goods that would arise if all citizens had all the income they wanted.
* the amount of GDP that could be produced if unemployment were zero.

That answer is incorrect.
Correct answer:
combined expenditures of consumers, businesses, governments and foreigners (net exports).

Aggregate expenditure is comprised of planned consumption expenditures, planned investment expenditures, planned government expenditures and planned net exports.

Starting with initial long-run equilibrium in the goods and services market (the AD/AS diagram), the short-run effect of a sudden decrease in optimism about future business conditions will be a(n)

 * reduction in output and an increase in prices.
 * reduction in both output and prices.
 * increase in both output and prices.
 * increase in output and a reduction in prices.

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

Pessimism about the future business conditions will cause investors and consumers to cut back on current expenditures for fear that they will be overextended when the economy contracts. This pessimism leads to a decline in aggregate demand. In response to weaker demand, business owners will cut back production and simultaneously lower prices.

Starting from an initial long-run equilibrium at full employment, an unanticipated shift to more expansionary fiscal or monetary policy would tend to increase

 * prices and unemployment in the long run.
 * nominal GDP in the long run but not the short run.
 * real output in both the long run and the short run.
 * real output in the short run but not the long run.

That answer is incorrect.
Correct answer:
real output in the short run but not the long run.

In the short run an unanticipated shift to more expansionary policies will increase real output but in the long run will only create inflation if output is initially at full employment.

If the central bank wishes to increase output, it would attempt to ________ the money supply by ________ short-term interest rates.

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

That answer is incorrect.
Correct answer:
increase, decreasing

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

Which of the following is the best definition of money?

 * coins and currency in the hands of the public
 * anything generally accepted as a payment for goods or repayment of debt
 * anything that is a liability of the federal government
 * anything that is a liability of a commercial bank
 * anything that is a store of value

That answer is incorrect.
Correct answer:
anything generally accepted as a payment for goods or repayment of debt

Money can be defined as that which allows individuals to determine the current value of all goods and services.

If a budget deficit leads to an increase in U.S. real interest rates, the higher rates will tend to cause

 * the dollar to depreciate.
 * the dollar to appreciate.
 * an increase in private investment.
 * an increase in net exports.

That answer is incorrect.
Correct answer:
the dollar to appreciate.

The U.S. dollar will appreciate under an increase in real interest rates since foreign investors will demand more U.S. dollars. The increase in the real interest rate attracts foreign investors because they will receive a higher real rate of return on their investment. The increased demand for U.S. dollars will cause the currency to appreciate due to the usual law of supply and demand: as the demand for a good or service increases, the price of that good or service increases. Effectively, the exchange value of the U.S. dollar represents its "price."

Which of the following statements is true?

I. During periods of inflation, decision makers with adaptive expectations will systematically underestimate future inflation.

II. During periods of dysinflation, decision makers with rational expectations will systematically underestimate future inflation.

 * I is true, II is false.
 * both are true.
 * II is true, I is false.
 * both are false.

That answer is correct!

I is true because adaptive expectations implies systematic error. During periods of inflation, individuals systematically underestimate the future inflation rate. However, under rational expectations, decision makers weigh all available evidence when they form their expectations about future economic events and thus avoid systematic errors.

A change in which of the following would cause the long-run aggregate supply curve to shift?

I. Quantity of resources.
II. Level of technology.
III. Level of demand in the economy.
IV. Public policy toward the supply industry.

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

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

The level of demand in the economy has only a second or third order effect on the long-run supply curve (through its effect on aggregate income and the resultant change in people's preference for work against leisure). The supply curve is primarily determined by resource constraints like aggregate available resources, technological level and governmental policies.

Which of the following will lead to a reduction in aggregate demand in the U.S. ?

* a reduction in the real interest rate
* a higher price level
* the rapid growth of real income in Japan and Western Europe
* an increase in real interest rates
* a decrease in recession fears

That answer is incorrect.
Correct answer:
an increase in real interest rates

An increase in the real interest rate makes both consumers and investment goods more expensive so that both households and investors decrease their current expenditures in response.

Within the AD/AS model, increased consumer and investor optimism concerning the future will lead to a(n)

* increase in long-run aggregate supply (LRAS shifts to the right).
* reduction in the natural unemployment.
* increase in aggregate demand (AD shifts to the right).
* decrease in aggregate demand (AD shifts to the left).

That answer is incorrect.
Correct answer:
increase in aggregate demand (AD shifts to the right).

Consumer and investor optimism implies that business decision makers will invest more in order to take advantage of the expanding future economy; consumers are more likely to buy big ticket items when they expect an expanding economy to provide them with both job security and rising income in the future. Thus, increased optimism encourages additional current expenditures by both investors and consumers spurring aggregate demand.

Which of the following is most indicative of a recession?

* an increase in the interest rate
* a decline in real GDP
* a decline in unemployment
* a rise in inflation

That answer is incorrect.
Correct answer:
a decline in real GDP

A recession refers to a downturn in economic activity characterized by declining real GDP and rising unemployment. Thus, a decline in real GDP is a good indicator of a recession.

If policy makers wished to increase aggregate demand, which of the following policies might be undertaken?

* simplify the tax code
* reduce government debt
* borrow to fund public works projects
* increase target interest rates
* decrease the money supply

That answer is incorrect.
Correct answer:
borrow to fund public works projects

In order to increase aggregate demand, policy makers might engage in expansionary fiscal policy. This requires the government to spend more than it collects in taxes. Increasing target interest rates, decreasing the money supply, and paying down debt would all result in lower aggregate demand. Simplifying the tax code would cause an increase in aggregate supply.

Excess reserves of banks equal

 * asset minus the liabilities of the banks.
 * actual reserves minus demand deposits.
 * required reserves minus demand deposits.
 * actual reserves minus required reserves.

That answer is incorrect.
Correct answer:
actual reserves minus required reserves.

Excess reserves of banks are those reserves held by banks in excess of the reserve requirement. Thus, excess reserves equal actual reserves minus reserves held to satisfy the reserve requirement.

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. If the Central Bank provides this loan, the money supply will ________. If another bank supplies this loan, the money supply will ________.

 * not change, expand
 * not change, contract
 * not change, not change
 * expand, not change
 * expand, expand
 * expand, contract
 * contract, contract

That answer is incorrect.
Correct answer:
expand, not change

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. 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.

The nation of Economica nominal GDP has increased from 100 to 104 units over the last 12 months. Foreigners within Economica have earned income of 1.1 units. Which of the following conclusions are valid?

 * GNP has increased by 5.1%
 * GNP has increased by 2.9%
 * inflation has been positive
 * none of these answers is correct
 * output has increased 4%

That answer is incorrect.
Correct answer:

none of these answers is correct

Nominal GDP states only that the value of total output has increased 4% over the period. Since it is not known whether the increase in the value of output was real or inflationary, no conclusions can be made about output. Although we know that foreigners have earned 1.1, we do not know how much domestic citizens have earned abroad, and therefore we cannot make a statement about GNP.

The nation of Economica has increased their M1 money supply by 10% over the last year by printing currency. This policy causes no price inflation. Which of the following could explain this phenomenon?

I. The nation of Islandia begins using the Economican currency as a reserve.
II. Aggregate output increases in Economica.
III. The Central Bank begins a government debt buy-back program.

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

That answer is incorrect.
Correct answer:
I, II

Under the basic price level equation P = M / Y (Price Level = Money Supply / Output, ignoring the velocity of money for the moment), a 10% increase in the money supply would result in an increase in the price level. One obvious thing that could prevent price inflation would be a corresponding increase in output. Another possibility would be some reduction in the money available for purchase of goods, such as a foreign nation holding domestic currency as reserve.

When Central Banks buy government debt, they usually do so with newly printed cash, and even if not, a debt buy-back would serve to decrease interest rates, which would result in an expansion of the money supply.

According to the Keynesians,

* Automatic stabilizers effectively direct the economy to equilibrium.
* aggregate demand is the major source of economic disturbance.
* consumption remains relatively stable over the ordinary business cycle.
* all of these answers.

That answer is incorrect.
Correct answer:
aggregate demand is the major source of economic disturbance.

In Keynesian economics, fluctuations in aggregate demand are a major source of movements in the economy. Suppliers try to anticipate demand for goods before producing them so that rapid variation in demand leads to instabilities in the economy.

Which of the following best expresses the central idea of counter-cyclical fiscal policy?

 * the balanced-budget approach is the proper criterion for determining annual budget policy.
 * budget deficits are planned during economic recessions and budget surpluses are planned during economic booms.
 * actual budget deficits should equal actual budget surpluses during a period of deflation.
 * none of these answers.
 * budget deficits are planned during economic booms and budget surpluses are utilized to fight economic recessions.

That answer is incorrect.
Correct answer:
budget deficits are planned during economic booms and budget surpluses are utilized to fight economic recessions.

Counter-cyclical fiscal policy refers to manipulating aggregate demand through government policies of expenditure and taxation to stabilize the macroeconomy. Thus, during economic booms, government expenditures should fall and taxation should rise (to diminish aggregate demand). During economic recessions, government expenditure should rise and tax rates should fall to stimulate aggregate demand and move the economy out of recession.

In the aggregate demand/aggregate supply model, when the intersection of AD and SRAS is to the left of LRAS, the economy

 * will experience increasing taxes.
 * is experiencing abnormally high unemployment.
 * will experience an increase in prices.
 * will experience rising resource prices.
 * will experience rising money interest rates.

That answer is incorrect.
Correct answer:
is experiencing abnormally high unemployment.

An intersection of the AD and SRAS to the left of the LRAS implies that the economy is operating below full employment. This suggests that business firms will reduce output and cut prices. The actual rate of unemployment will increase above the economy's natural rate.

The velocity of money ________ if the money demand declines but the same amount of business is being conducted in the economy.

 * need more information to answer the question
 * increases
 * decreases
 * stays the same

That answer is incorrect.
Correct answer:
increases

The velocity of money is a rough measure of the number of times that each dollar is used to purchase final goods and services during one year. 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. So the velocity of money is increasing.

In the aggregate demand/aggregate supply model, when output exceeds an economy's long-run potential capacity, the economy will experience

* rising real wages and resource prices that will direct the economy toward full employment at a higher price level.
* falling resource prices that will restore equilibrium at a lower price level.
* a budget deficit that will cause policy makers to increase taxes that will help restore full employment.
* rising interest rates that will stimulate aggregate demand and restore full employment.
* falling real wages and resource prices that will stimulate employment and real output.

That answer is correct!

The AD/AS model suggests that an economy operating higher than potential will experience rising resource prices since demand is high for these resources. An increase in these prices will discourage their use and aggregate supply will contract toward its equilibrium at full employment. There is no time frame for this adjustment.

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

* expansionary phase.
* contractionary phase.
* boom.
* periodic phase.

That answer is incorrect.
Correct answer:
contractionary phase.

As aggregate business conditions slow, the economy begins a contraction or recessionary phase of a business cycle. During the contraction the sales of most businesses fall, real GDP grows at a slow rate or perhaps declines and unemployment in the aggregate labor market increases.

Since 1993, the GDP deflator of an economy has gone up by 14%. The nominal GDP has grown by 31%. Then, the growth in the real GDP equals ________.

* -13%
* +14.9%
* +31%
* +17.2%

That answer is incorrect.

Correct answer:
+14.9%

The fact that the GDP deflator has increased implies that prices have risen since the base year. If the base year GDP is denoted G, then the current nominal GDP equals 1.31*G. The current GDP deflator equals 100*1.14 = 114. Therefore, the current GDP expressed in base year prices equals 1.31*100/114*G = 1.149G. Thus, the real GDP has grown by (1.149 - 1) = 14.9%.

The Keynesian analysis implies that maximum potential output, full employment and price stability can be achieved if

* marginal tax rates are kept low so the incentive to produce will not be damaged.
* aggregate expenditures are maintained at the proper level.
* the federal budget is balanced annually.
* households save a large enough proportion of their income.

That answer is incorrect.
Correct answer:
aggregate expenditures are maintained at the proper level.

The Keynesian model implies that regulation of aggregate expenditures is the crux of sound macroeconomic policy. If aggregate expenditures can be made large enough to achieve capacity output, but not so large as to result in inflation, the Keynesian view implies that maximum output, full employment and price stability could be attained.

According to the permanent income hypothesis, a family's consumption is primarily dependent on its

* sense of what phase of the business cycle the economy is going through.
* expected long-term income.
* interest income relative to income from labor services.
* disposable income.

That answer is incorrect.
Correct answer:
expected long-term income.

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.

Inflation creates an incentive to spend now because

* inflation masks the true return on investments
* the same money will be worth less in the future
* of the time value of money
* of the marginal propensity to consume
* consumers know future Federal Reserve action will increase interest rates

That answer is incorrect.
Correct answer:
the same money will be worth less in the future

Inflation causes the value of money to deteriorate over time. Therefore consumers have an incentive to make purchases now. Although the time value of money is another incentive to make purchases now, time value of money and inflation are separate concepts. The expectations hypothesis states that consumers may react to expected future monetary policy decisions, but this case, it is an indirect effect at best.

When additional reserves are injected into the banking system, they can potentially increase the money supply by an amount equal to the additional (excess) reserves multiplied by the

* required reserve ratio.
* reciprocal of the required reserve ratio.
* reciprocal of 1 plus the required reserve ratio.
* reciprocal of 1 minus the required reserve ratio.

That answer is incorrect.
Correct answer:
reciprocal of the required reserve ratio.

The deposit expansion multiplier is calculated as the reciprocal (or inverse) of the required reserve ratio. If the required reserve ratio is 10 percent, the deposit expansion multiplier is 10. Thus, each dollar deposited in a bank expands the money supply by 10 dollars.

If people anticipate that expansionary macroeconomic policy will lead to higher prices than actually occur (they overestimate inflation), then the expansionary policy will

* leave unemployment unchanged.
* temporarily decrease unemployment.
* reduce the natural unemployment rate.
* increase the natural unemployment rate.
* temporarily increase unemployment.

That answer is incorrect.
Correct answer:
temporarily increase unemployment.

The overestimation of inflation results in an increase in the actual rate of unemployment because wage and other contracts will account for price increases in excess of actual price increases. Thus, the rise in nominal wages and other prices will be too high to maintain a constant real wage or real price level. Under higher real wages and prices, output is contracted and unemployment will temporarily rise until agents realize their error of overestimation and revise their contracts.

For a modern economy such as that of the U.S., full employment generally means that

* everyone excluding teen-agers who wishes to work is employed.
* the economy operates at the natural unemployment.
* between 94 percent and 95 percent of the population is employed.
* 100 percent of the labor force is either working or looking for a job.
* cyclical unemployment is large.

That answer is incorrect.
Correct answer:
the economy operates at the natural unemployment.

Full employment is often defined as the level of employment that results when the rate of unemployment is normal, considering both frictional and structural factors. In the U.S., most economists put this future at 94 to 95% of the labor force. This would imply a natural rate of unemployment of 5 to 6% of the labor force.

A discouraged worker is a worker who

* continues to look for work even though she believes her prospects are slim.
* is working at a job that she does not have the skills for.
* would be willing to accept a job but who has stopped looking for work.
* would like to work full time but who has been forced to work part time.

That answer is incorrect.
Correct answer:
would be willing to accept a job but who has stopped looking for work.

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.

According to Keynesian theory,

* short-run economic disturbances may lead to long periods of disequilibrium conditions.
* markets will quickly adjust to restore equilibrium.
* real wages will quickly tend to fall during a recession.
* misguided economic policy contributed to the severity of the Great Depression.

That answer is correct!

Keynesian economists believe that the market economy is likely to experience prolonged periods of recession. This view emphasizes the destabilizing potential of autonomous changes in expenditures powers by the multiplier and changes in optimism.

An individual should continue to spend time searching for a job as long as

* information is available that the individual has not yet collected.
* job openings are available in the individual's field.

* the marginal gain from additional search exceeds the marginal cost.
* the expected salary exceeds all salary offers.

That answer is incorrect.
Correct answer:
the marginal gain from additional search exceeds the marginal cost.

The marginal benefit derived from job search declines with time spent searching for a job because it becomes less likely that additional search will lead to a better position. The primary cost of job search is generally the opportunity cost of wages forgone as a result of failure to accept one's best current alternative. Thus, the marginal cost of job search rises with the length of one's job search time. The job seeker is wise to terminate job search once the marginal cost equals the marginal benefit of continued search.

Rudy owns a bagel shop. He knows nothing about economics, and pays little attention to monetary or fiscal policy. If monetary policy causes long-run 5% inflation, how will this impact Rudy's production decisions in the long-run?

* Rudy will probably decrease his production as the price of inputs and wages increase.
* Rudy will choose not to finance his business with debt due to higher inflation.
* Rudy will increase production in response to higher prices, unaware that the price increase was really inflationary.
* Indeterminate, it depends on the price elasticity of bagels.
* No changes.

That answer is incorrect.
Correct answer:
No changes.

In the long-run, inflation is a wash regardless of whether economic participants are aware of it or not. In Rudy's case, he would experience a 5% increase in the price he can charge for bagels, but also suffer a 5% increase in his costs. The demand curve for his bagels and his supply curve would both shift upward in proportion to inflation, leaving him with the same production level. Note that this explains why monetary policy cannot expand real GDP in the long-run.

A person is considered unemployed if she is

* not working but is actively looking for work.
* working at a part-time job.
* taking a vacation from a job.
* not working for pay.
* working at a full-time job in a foreign country.

That answer is correct!

Persons are counted as unemployed only if they are available for and seeking work or awaiting recall from a layoff.

If Federal Reserve policy increases the excess reserves of banks, why will banks want to expand their loans and investments?

* Excess reserves are a non-interest-bearing asset for banks.
* Banks are legally required to expand loans when the Fed creates excess reserves.
* Maintaining reserves in excess of demand deposits is against the law.
* Banks fear the Fed will remove the excess revenues.

That answer is correct!

Banks consider reserves to be excess when they exceed the amount required by the reserve requirement ratio as set by the Fed. Thus, excess reserves are used by banks to make loans and investments because they are not required by the Fed to hold such reserves as vault cash or as deposits with the Fed. Banks generate profits through making loans and investments and since banks are profit seeking entities, they increase their loans and investments if their excess reserves are increased though Federal Reserve policy.

If the money velocity (V) and real output (Q) were increasing at approximately the same rate, then

* monetary acceleration would not lead to inflation.
* inflation, if present, would be of the cost-push variety.
* it would be impossible for monetary authorities to control inflation.
* inflation would be closely related to the long-run rate of monetary expansion.

That answer is incorrect.
Correct answer:
inflation would be closely related to the long-run rate of monetary expansion.

This statement is derived from the quantity theory of money which hypothesizes that a change in the money supply will cause a proportional change in the price level because velocity and real output are unaffected by the quantity of money.

The equation of exchange is ________.

* MY = PY
* MY = PQ
* MY = PV
* MV = PV
* MV = PY

That answer is incorrect.
Correct answer:
MV = PY

The equation of exchange reflects both the monetary and real sides of each final-product exchange. M is the money supply, V is the velocity of money, P is the price level and Y is the output of goods and services produced.

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 adaptive expectations hypothesis, how will her estimation differ from Jenna's?

* Colleen will expect less inflation that Jenna.
* Colleen will expect exactly the same inflation rate as Jenna.
* This cannot be determined because the money supply does not impact the price of clothes.
* Colleen will expect greater inflation than Jenna.
* This cannot be determined without knowing Jenna's expectations of Fed maneuvers.

That answer is incorrect.
Correct answer:
Colleen will expect exactly the same inflation rate as Jenna.

Jenna has arrived at her inflation expectation based on the adaptive expectations hypothesis as well. Therefore their expectation will be exactly the same.

The marginal propensity to consume is defined as the

* fraction of total income spent on consumption.
* fraction of total income not spent on consumption.
* fraction of a change in income that is saved.
* proportion of a given change in income that is spent on consumption.

That answer is incorrect.
Correct answer:
proportion of a given change in income that is spent on consumption.

The MPC is determined according to the ratio: MPC = additional consumption divided by additional income.

How would buying a good produced in a foreign country by a domestic citizen change GDP and GNP?

* It would increase GNP and leave GDP unchanged.
* It would increase GDP and leave GNP unchanged.
* It would leave both GDP and GNP unchanged.
* It would increase GNP and GDP.

That answer is correct!

Since GNP is the total market value of all final goods and services produced by the citizens of a country, a good that is produced by a domestic citizen is included in GNP calculation even if it is sold abroad. GDP inclusion requires that the good be sold domestically; thus, this transaction would not contribute to GDP.

Which of the following about inflation is true?

* High rates of inflation are usually associated with wide year-to-year swings in inflation.
* High rates of inflation are usually associated only with smaller countries such as Turkey.
* High rates of inflation imply that a country is likely to experience stable price level increases from year to year.
* High rates of inflation are usually associated only with very large countries such as the U.S.

That answer is correct!

High rates of inflation are almost always associated with wide year to year swings in the inflation rate. this trend is observable across the U.S. and Brazil: in the U.S., inflation has been low and the rate has seldom changed by more than 1 or 2 percent from one year to the next. In Brazil, inflation has been very high and has varied substantially more from one year to another.

According to the Keynesian model, if the marginal propensity to consume were 0.8, an independent increase in investment expenditures of $25 billion would cause the equilibrium aggregate income to rise

* $20 billion.
* $50 billion.
* $100 billion.
* $125 billion.

That answer is incorrect.
Correct answer:
$125 billion.

The expenditure multiplier is found by M = 1/(1-MPC). Thus, here M = 1/(1-.8) = 5. Therefore the $25 billion increase in aggregate expenditures is magnified five times to $125 billion.

The legal requirement that commercial banks hold reserves equal to some fraction of their deposits

* limits the ability of banks to expand the money supply by extending additional loans.
* prevents runs on banks by depositors who fear that banks have insufficient assets to meet the claims of their depositors.
* limits the ability of the Treasury to expand the national debt.
* prevents the Fed from controlling the money supply since commercial banks can always offset the actions of the Fed.

That answer is correct!

The legal requirement that commercial banks hold reserves equal to some fraction of their deposits (the required reserve ratio) implies that banks must limit the number of loans they extend (i.e., they cannot loan 100 percent of the value of their deposits). Banks must maintain a fraction of their total deposits at any given time and therefore cannot make unlimited loans.

The demand for money to provide instant purchasing power is known as

* precautionary demand.
* transaction demand.
* speculative demand.
* consumption demand.

That answer is incorrect.
Correct answer:
transaction demand.

At the most basic level money is held in order to conduct transactions. Money provides purchasing power to its holder because it can be used to purchase almost any commodity quickly and easily with numerous people.

To pull an economy out of a recession, a supply side economist would suggest:

* a reduction in the marginal tax rates.
* an increase in budget deficit.
* a reduction in corporate tax rates.
* a reduction in the costs of supply-side resources.

That answer is correct!

For the Supply-side economics, marginal personal tax rates are of vital importance. 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.

For an oil-importing country such as the U.S., the immediate effect of a supply shock caused by an increase in the price of imported oil would tend to be a(n)

* increase in prices, real output and unemployment.
* decrease in prices, real output and employment.
* decrease in real output and employment and an increase in prices.
* increase in real output and a decrease in prices.

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

A reduction in the supply of resources (or a supply shock) such as oil causes resource prices to shift upward. The reduction in the availability of oil contracts the short run aggregate supply curve which increases prices and leads to a lower level of real output. This lower level of real output in turn results in higher unemployment since there is less labor demand.

A higher real interest rate resulting from expansionary fiscal policy crowds out ________ and thereby dampens the stimulus effects of the fiscal policy.

* private investment
* the purchase of bonds
* public investment
* consumer spending

That answer is correct!

The crowding out effect of deficit spending involves the government borrowing to finance government expenditures in excess of government revenue. The government's large amount of borrowing drives up the interest rate as the demand for loanable funds rises. Increased demand for loanable funds necessarily drives up the interest rate.

Which one of the following factors will most likely cause an increase in aggregate demand?

* an increase in the expected inflation rate
* a technology development that reduces the cost of producing computer chips
* an increase in the real interest rate
* a decline in net exports due to falling incomes abroad

That answer is correct!

An increase in the expected inflation rate causes consumers and investors to spend more during the current period. "Buy now before prices go higher" becomes the order of the day. This stimulates current aggregate demand.

If a country has attracted a relatively large number of foreign workers and a large amount of foreign investment, then

* national income will generally exceed gross national product.
* net domestic product will generally exceed gross domestic product.
* gross national product will generally exceed gross domestic product.
* gross domestic product will generally exceed gross national product.

That answer is incorrect.
Correct answer:
gross domestic product will generally exceed gross national product.

These two output measures will differ significantly when there is a substantial difference between the income citizens earn abroad and the domestic income generated by foreigners. A high number of foreign workers and a large amount of foreign investment in the home country implies that the level of output generated within the country will be greater than the amount of output generated by the country's citizens.

Other things being equal, the slope of the Keynesian aggregate expenditure schedule will increase as the result of a(n)

* increase in the marginal propensity to save.
* increase in the general price level.
* increase in the marginal propensity to consume.
* decline in the inflationary gap.
* decline in the value of the multiplier.

That answer is incorrect.
Correct answer:
increase in the marginal propensity to consume.

An increase in the MPC results in an increase in the expenditure multiplier which is defined as 1/(1-MPC). An increase in the expenditure multiplier will result in an increase in expenditures.

Monetary policy involves manipulation of ________. This is most often accomplished by changing ________.

* the foreign currency rate, national debt
* interest rates, target rates
* unemployment rate, interest rates
* the inflation rate, government spending
* the money supply, interest rates

That answer is incorrect.
Correct answer:
the money supply, interest rates

Monetary policy deals strictly with manipulation of the money supply. The primary means of executing monetary supply is changing interest rates.

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

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

That answer is incorrect.
Correct answer:
cyclical unemployment.

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

A country has a total civilian population of 91 million, of which 72 million are over the age of 16, all of whom are ready to accept work. 52 million people have full-time jobs and 11 million have part-time jobs. The unemployment rate and the employment/population ratio equal:

* 12.5%; 69.23%
* 87.5%; 69.23%
* 12.5%; 30.77%
* 27.8%; 57.14%

That answer is correct!

Even people who are employed part-time are considered fully employed. Hence, the total employment equals 51+11 = 63 million people. The labor force equals 72 million. Thus, the unemployment rate equals (72 - 63)/72 = 12.5%. The employment to population ratio, on the other hand, equals 63/91 = 69.23%.

If inflation is higher than expected this will benefit ________ while harming ________.

* tax-payers; government
* consumers; producers
* wealthy; poor
* debtors; lenders
* retailers; wholesalers/producers

That answer is incorrect.
Correct answer:
debtors; lenders

Debtors benefit from higher than expected inflation, as the dollars borrowed initially can be paid back with less valuable dollars in the future. It follows therefore that lenders are harmed. Since the interest rate paid on a loan includes some inflation premium, if inflation is as expected, this inflation premium will compensate the lender for the deterioration in money value.

Which of the following will most likely cause an increase (shift to the right) in a nation's long-run aggregate supply curve?

* an increase in the labor force
* a decreasing rate of capital formation
* an increase in the national debt
* an increase in aggregate demand
* a decrease in the labor force participation rate

That answer is correct!

Increases in the economy's resource base make it possible to produce and sustain a larger rate of output. An increase in the labor force will increase both LRAS and SRAS.

The permanent income hypothesis implies that the consumption component of aggregate demand will

* increase more rapidly than income during a business expansion.
* be relatively stable and thereby help stabilize aggregate demand over the business cycle.
* be primarily determined by income rather than expected income in the long-term future.
* fluctuate substantially over the business cycle and thereby be a major contributing factor to economic instability.

That answer is incorrect.
Correct answer:
be relatively stable and thereby help stabilize aggregate demand over the business cycle.

The permanent income hypothesis suggests that individuals will smooth their consumption according to their long-term expectations of their income. Thus, consumption will be relatively constant over periods of higher or lower income. This will work to stabilize aggregate demand during economic booms and recessions.

Within the AD/AS model, how does an economy adjust to an output beyond the economy's long-run capacity (such as would result from an unanticipated increase in aggregate demand)?

* Increasing wage rates and resource prices reduce aggregate demand and restore equilibrium at a higher price level.
* Long-run aggregate supply increases, leading to a new equilibrium at a lower price level.
* Wage rates and resource prices rise, causing a decline in SRAS 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.

That answer is incorrect.
Correct answer:
Wage rates and resource prices rise, causing a decline in SRAS and the restoration of equilibrium at a higher price level.

If output is above potential output, competition for resources (including labor) will drive prices (and wages) higher. In turn, higher resource prices will result in lower profits for firms, discouraging production and decreasing aggregate output.

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

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

That answer is incorrect.
Correct answer:
aggregate measures of economic output and real income.

The business cycle is the observable swings in the rate of output produced. The business cycle is generally measured by variables such as the rate of unemployment and changes in real GDP.

The natural unemployment exceeds zero because

 * the economy is characterized by dynamic change and imperfect information.
 * not every member of society is capable of participating in the labor force.
 * unemployment will always rise during the recessionary phase of the business cycle.
 * some workers will always have few skills.

That answer is correct!

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.

Inflation tends to be self-perpetuating because of tendencies of consumers to __________ and producers to _________.

 * spend more as income rises, produce more for sale
 * bid up prices irrationally, produce more at higher prices
 * spend more now, store goods in inventories rather than sell them
 * save more, invest more
 * spend less, lay off workers

That answer is incorrect.
Correct answer:
spend more now, store goods in inventories rather than sell them

Consumers tend to spend more now in anticipation of inflation, while producers tend to store goods in inventories in anticipation of higher future prices. Consumers therefore exacerbate the "too many dollars" side of inflation by spending more, and producers perpetuate the "too few goods" side of inflation by selling fewer goods.

Large denomination money market mutual funds are part of the _________ money supply.

 * M1
 * M4
 * M2
 * M3

That answer is incorrect.
Correct answer:
M3

Small denomination money market funds are part of M2 while the large denomination ones (minimum $50,000 deposits) are part of M3. There is no M4 definition of money supply; M3 is the broadest definition.

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

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

That answer is incorrect.
Correct answer:
an increase in real GDP

In response to an unanticipated increase in aggregate demand for goods and services, prices will rise in the short run and output will temporarily increase.

Fiscal policy involves:

 * none of these answers.
 * the use of a government's taxing and spending authority.
 * discretionary actions by the Fed to control inflation.
 * the actions by the Treasury to control budgetary spending.

That answer is incorrect.
Correct answer:
the use of a government's taxing and spending authority.

Fiscal policy refers to the use of governmental authority in determining taxation and spending schedules to achieve macroeconomic goals.

A business produced $10 million of goods in 1990 but sold only $9 million. Is the $1 million increase in inventory counted as part of the 1990 gross domestic product?

 * Yes, because these inventories are part of the output of the economy in 1990.
 * Yes, but they will be added to the 1990 GDP only if they are sold in 1991.
 * No, because inventories are intermediate goods.
 * No, because if these inventories were sold in 1991, they would be counted twice.

That answer is correct!

GDP is designed to measure current production and therefore has an allowance for goods produced that were not sold during the year. This is called inventory investment.

If the increase in nominal GDP equals 6% and the increase in the real GDP equals 4%, the GDP deflator has:

 * not changed.

* decreased by 1.92%.
* increased by 1.92%.
* decreased by 2%.
* increased by 2%.

That answer is incorrect.
Correct answer:
increased by 1.92%.

The increase in real GDP equals increase in nominal GDP divided by increase in GDP deflator. Hence, the GDP deflator has increased by 1.06/1.04 = 1.92%.

An increase in the short term interest rates will ________ the velocity of money.

* increase
* not change
* insufficient information.
* decrease

That answer is correct!

An increase in the short term interest rates increases the opportunity cost of holding money balances. Hence, households and businesses will conduct the regular business with lower amounts of currency, increasing the velocity of money. Note that this contradicts the quantity theory of money, wherein classical economists believed that the velocity of money depended on institutional arrangements and not on the changes in money supply.

To stimulate a sluggish economy, which of the following would be advocated by a Keynesian?

I. Cutting taxes.
II. Increasing budgetary spending.
III. Increasing money supply.
IV. Lowering interest rates.

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

That answer is incorrect.
Correct answer:
I & II

If demand from the private economy is weak, Keynesian economists would advocate using government spending to increase demand directly, and cutting taxes to increase disposable income, thereby increasing consumer and investment demand indirectly.

Congress passes a law stating that the government will pay up to $1,500 each month to any laid-off worker for up to one year or until s/he finds a new job. Assume all other government spending programs remain constant and tax policy does not change. How would economists categorize such a law?

 * fiscal policy rule
 * passive monetary policy
 * pork politics
 * non-activist fiscal policy
 * deficit spending
 * expansionary fiscal policy

That answer is incorrect.
Correct answer:
non-activist fiscal policy

Fiscal policy involves the use of the government budget to impact aggregate demand. In this case, government spending will increase during times when unemployment is high, effectively increasing aggregate demand at times then other market sectors are lagging. Such a policy is called non-activist fiscal policy.

Which of the following is the most common method used by central banks to enact monetary policy?

 * targeting the price of gold
 * setting short-term interest rates by decree
 * printing currency
 * purchase and sale of short-term securities
 * manipulation of currency value

That answer is incorrect.
Correct answer:
purchase and sale of short-term securities

Most major industrialized nations enact monetary policy by "open-market activity," by which the central bank purchases or sells short-term securities in an attempt to maintain short-term rates at a certain level. In the U.S., the Federal Reserve announces target rate for over-night bank loans, and then will purchase or sell such loans in the open market to maintain that rate. The press often announces that the Fed "sets" interest rates, but this is not the case.

You have been given the following macroeconomic information for a given year:
Personal consumption = 3,000; Indirect business taxes = 425
Depreciation = 120; Gross private investment = 2,200
Government expenditures = 1,300; Imports = 2,300
Exports = 2,600; Employee income = 225
Corporate profits = 700; Government investments = 900

The GDP, calculated using the Expenditure approach, equals ________.

 * 7,400
 * 7,700
 * 9,950
 * 8,925

* 13,770

That answer is incorrect.
Correct answer:
7,700

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.

In this case, the GDP equals 3000 + 2200 + 1300 + 900 + 2600 - 2300 = 7,700.

Which of the following would not be an expected impact of debt-financed new government spending?

* a decrease in unemployment
* an increase in capital utilization
* a outward shift in the aggregate supply curve
* an increase in aggregate demand
* an increase in the price level

That answer is incorrect.
Correct answer:
a outward shift in the aggregate supply curve

Theoretically, fiscal policy should cause a shift in the aggregate demand curve, which will cause movement along the supply curve. There is little reason to expect government spending to shift the supply curve.

Suppose the government borrowed 140 billion dollars and cut taxes in an equivalent amount. According to the Rational Expectations theory:

* resource prices will fall, leading to lower unemployment.
* there will be no systematic effect on aggregate demand or interest rates.
* the economy will experience an inflation due to increased consumption.
* the domestic currency will depreciate, causing an increase in exports.

That answer is incorrect.
Correct answer:
there will be no systematic effect on aggregate demand or interest rates.

If the people behaved according to the Rational Expectations Theory, they would recognize that the current tax cuts financed with debt would lead to an equivalent amount of higher future taxes. This would induce them to save all of the money they receive in tax cuts in anticipation of higher tax liability in the future. This is the basis of Rational Expectations Theory's claim that discretionary fiscal policy will not affect the economy in any systematic way. This means that aggregate demand, real GDP and real interest rates will all remain unaffected.

Congress passes a law that requires government spending rise each year by exactly the inflation rate. The year the law was passed the budget was balanced, inflation was moderate, and unemployment was at the natural rate. What could be said about the government's budgetary position if national income declines?

* this cannot be determined without knowing degree national income declined
* the government would be in a deficit position because tax receipts would rise
* the budget would remain balanced
* the government would enjoy a surplus because spending would fall
* this cannot be determined without knowing the exact inflation rate

That answer is incorrect.
Correct answer:
the government would be in a deficit position because tax receipts would rise

During a recession, tax receipts would decline, but unless there is deflation government spending would not decline. Therefore the government would be in a deficit. Laws that automatically cause the government to be in a deficit stance during recessions are called non-activist fiscal policy.

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 fall.
* Output will increase and prices rise.
* Output will decrease and prices rise.
* Output will increase and prices decline.

That answer is incorrect.
Correct answer:
Output will increase and prices rise.

Consumer and investor optimism concerning the future direction of the economy stimulates current investment consumption. Investment today may be necessary if business firms are gong to benefit fully from these opportunities. Similarly, consumers are more likely to buy big ticket items when they expect an expanding economy to provide them with both job security and rising income in the future. So increased optimism encourages additional current expenditures by both investors and consumers, increasing aggregate demand. This increase in aggregate demand will stimulate output and place upward pressure on prices.

Since 1960, the federal budget deficit as a percent of GNP has generally ________ during recessions and ________ during periods of economic expansion.

* declined; increased
* remained stable; declined
* increased; declined
* increased; remained stable

That answer is incorrect.

Correct answer:
increased; declined

This is an example of counter-cyclical policy: during recessions, government revenue falls and government expenditures rise.

Within the AD/AS model, if consumers suddenly increase their saving and cut back on spending, then the

 * real interest rate will decline.
 * real interest rate will fall as the result of an increase in prices.
 * long-run aggregate supply will decline to restore equilibrium.
 * natural unemployment will rise.

That answer is correct!

Increased savings expands the supply of loanable funds and decreases the interest rate. This will stimulate investment and consumption spending and will work to correct the decline in consumption due to increased savings.

The consumption function shows the relationship between consumption and:

 * total wealth.
 * expected inflation.
 * disposable income.
 * permanent income.

That answer is incorrect.
Correct answer:
disposable income.

Disposable income is the income available to consumers after taxes. This income can either be spent on current consumption or invested in assets for future use. The consumption function shows the relationship between this disposable income and consumption. Remember that this function is almost certainly not linear, although it is often illustrated as such.

If income of a family increases from $20,000 to $25,000 and consumption from $18,000 to $22,500, then the family's marginal propensity to consume is ________.

 * 0.72
 * 0.80
 * 0.20
 * 0.88
 * 0.90

That answer is incorrect.
Correct answer:

0.90

Since the MPC is determined according to the ratio: MPC = additional consumption divided by additional income, the MPC here equals: 4,500/5,000 = 0.90.

Which of the following are reasons why inflation is problematic for lenders

I. Lenders will not be compensated for inflation levels higher than expectations

II. Inflation lower than expectations impacts lenders' profits

III. Inflation causes nominal interest rates to be higher

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

That answer is incorrect.
Correct answer:
I only

Some inflation expectation is priced into any loan interest rate. If actual inflation is higher than this over the loan period, then lenders will not receive adequate compensation for the decrease in purchasing power of the loaned principal.

Which of the following will most likely cause an increase (shift to the right) in the long-run aggregate supply curve?

 * an increase in the price of imported oil
 * a new regulation that substantially increases the cost of producing computers and computer-directed products
 * an increase in the economy's rate of capital formation
 * an increase in marginal tax rates
 * an increase in the national debt

That answer is incorrect.
Correct answer:
an increase in the economy's rate of capital formation

An increase in the economy's rate of capital formation improves the efficiency of resource use and allow higher sustainable levels of long run output. This is because capital investment expands the supply of physical capital and allows more production to occur (permanently).

The GDP deflator equals

 * the consumer price index.
 * the standard price index.
 * none of these answers.
 * the economic inflation index.

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

The GDP deflator is used to calculate real GDP from nominal GDP by adjusting appropriately for inflation. For this, an inflation index is created, called the "GDP deflator." However, the GDP deflator is broader than the Consumer Price Index. The CPI is an inflation index for a broad basket of standard consumption goods and services. On the other hand, the GDP deflator is an inflation index for the entire basket of goods and services which are part of the GDP.

According to the Keynesian view, which of the following will most likely occur as the result of an autonomous decrease of $10 billion in investment?

 * a decrease in aggregate output by an amount greater than the $10 billion decrease in investment
 * a decrease of $10 billion in aggregate output
 * an increase in aggregate output by some multiple of the $10 billion decrease in investment
 * a $10 billion increase in consumption spending, which will exactly offset the reduction in investment spending
 * a decrease in aggregate output by some amount less than the $10 billion decrease in investment

That answer is correct!

The expenditure multiplier suggests that decrease in aggregate expenditures will magnify into larger decreases in aggregate output. The expenditure multiplier is a function of the MPC in that a larger MPC implies larger magnification of decreases in aggregate expenditures.

According to Keynesians, an expansionary fiscal policy increases aggregate demand and employment because:

 * a multiplier demand effect occurs in the economy.
 * people fail to anticipate higher future taxes and increase current spending.
 * a lowering of interest rates reduces the incentive to defer spending.
 * people rationally anticipate higher future inflation and raise current expenditure.

That answer is correct!

Keynesians postulate a domino effect that occurs when the government increases its spending. Specifically, when the government spends, incomes of some people are raised, who go and spend a part of it. Their expenditures, in turn, increase the incomes of some other people and so on. This triggered chain reaction leads to a total increase in demand far in excess of the original expenditure incurred by the government.

If prices and wages quickly adjust to bring the macro economy back to equilibrium at full employment, we can conclude that

* the market's self-correcting mechanism works reasonably well.
* policy rules will tend to destabilize the economy.
* prolonged periods of abnormally high unemployment will be a persistent problem.
* discretionary monetary and fiscal policy will help stabilize the economy.

That answer is correct!

Flexible prices and wages allow the economy's self-correcting mechanism to adjust the economic shocks. The time frame for this adjustment process is under debate among many economists.

If an economy is operating in a range where its aggregate supply curve is vertical, then

* the economy must be well below its full-employment output.
* an increase in aggregate demand will expand nominal GDP but not real GDP.
* a reduction in aggregate demand will lead to both a higher price level and more real output.
* the actual inflation rate and the expected inflation rate must be equal.
* an increase in aggregate demand will lead to an increase in real GDP without any increase in prices.

That answer is incorrect.
Correct answer:
an increase in aggregate demand will expand nominal GDP but not real GDP.

Once the economy's full employment capacity is achieve, additional demand merely leads to higher prices rather than to more real output. Nominal gains in output may occur but real increases are negated since the price level increases along with output.

Suppose the Fed purchases $100 million worth of Treasury bonds in the open market. This will cause loanable funds to ________. In the short run, the real interest rate will ________.

* increase; rise
* increase; fall
* decrease; fall
* decrease; rise

That answer is incorrect.
Correct answer:
increase; fall

The purchase of bonds releases additional money in the market, increasing the monetary base and the total money supply. In the short run, this reduces the real rate of interest.

Which of the following are reasons why budget deficits may lead to increase in the published cost of borrowing?

I. increased demand for loanable funds
II. rational expectation of future tax increases or spending cuts
III. inflation

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

That answer is incorrect.
Correct answer:
I, III

The published cost of borrowing is another way of saying the nominal interest rate. Since the government must finance the budget deficit with debt, this increases the demand for loanable funds, and hence increases real interest rates. Deficit spending also causes inflation, since the shift in aggregate demand results in a higher equilibrium price level. This would also increase nominal interest rates.

When an economy is temporarily operating at a less than full-employment output, the AD/AS model indicates that

* lower wage rates and resource prices will increase SRAS and restore equilibrium, but the model does not indicate how rapidly this will occur.
* abnormally high unemployment and excess supply will fail to restore full - employment equilibrium.
* flexible wages and prices will restore full-employment equilibrium quickly.
* only an increase in aggregate demand could restore full-employment equilibrium.

That answer is correct!

The AD/AS model suggests that an economy operating at less than potential will experience falling resource prices since demand is low for these resources. A decline in these prices will stimulate their usage and aggregate supply will pick up. Equilibrium at full employment will follow. There is no time frame for this adjustment.

The equation of exchange states that

* money supply multiplied by nominal GDP equals velocity.
* velocity multiplied by money supply equals nominal GDP.
* money supply divided by velocity equals real GDP.
* money supply divided by velocity equals nominal GDP.

That answer is incorrect.
Correct answer:
velocity multiplied by money supply equals nominal GDP.

The equation of exchange implies that when the existing money stock M is multiplied by the umber of times V that money is used to buy final products, this yields the economy's nominal GDP (or output times the price level).

The Department of Commerce sums the payments made to resources wages, self-employment income, rents, interest, profits, indirect taxes and depreciation to arrive at GDP. This method of deriving GDP is called the

* resource cost-income approach.
* opportunity cost approach.
* monetarist approach.
* expenditure approach.

That answer is correct!

The Resource Cost-Income approach to GDP calculates the sum of income payments to resource owners (at factor cost) plus non-income cost items plus GNP-GDP adjustment.

Gretchen represents a union of teachers attempting to negotiate a new collective bargaining agreement. She makes an estimation that inflation will be 5% going forward based on the average of the last five years. She intends to have corresponding pay increases included in the union contract. Which of the following economic terms describes her methodology?

* rational expectations
* historical reference theory
* public choice
* collusion
* adaptive expectations

That answer is incorrect.
Correct answer:
adaptive expectations

Adaptive expectations hypothesis suggests that individuals will base their views of the future on their experience. Gretchen has made her estimation according to this theory.

In the Keynesian aggregate expenditure model, business decision makers will respond to an unplanned reduction in inventories by

* reducing output.
* cutting prices.
* lowering wage rates.
* expanding output.
* decreasing employment.

That answer is incorrect.
Correct answer:
expanding output.

If actual inventory investment is less than planned inventory investment, decision makers increase output in order to restore inventories to the desired level. Such reductions in inventories suggest that aggregate expenditures were in excess of the level expected.

Drawing on her account at First Guarantee Bank, Susan writes a check to Valerie, who deposits the check in her account at Citizens First Bank. Once the check has cleared, which of the following would have occurred to bank reserves and the M1 money supply?

	Bank Reserves	M1
I.	increased	increased
II.	increased	no change
III.	no change	increased
IV.	no change	no change

* III.
* IV.
* I.
* II.

That answer is incorrect.
Correct answer:
IV.

There is no change in either bank reserves or M1 for the following reasons. Total bank reserves are constant because there is simply a transferal of money across banks: each bank is subject to the same reserve requirement and therefore each maintains identical reserves. M1 is constant because the total amount of deposits in the economy is the same: the money supply is affected only by new deposits.

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

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

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

The difference between the actual and expected inflation rate (higher than expected) causes an erosion in the real wage, thus stimulating employment. The real interest rate declines as the money supply increases.

Sean owns a factory that produces paper cups. Sean had expected the price of paper cups to remain fairly stable. However, he suddenly finds demand for his paper cups are exceeding his current production level, and he decides to raise prices. This increases his profits to the point that he is considering adding a third shift. Sean is unaware that the Central Bank has been expanding the money supply recently.

Which of the following statement is NOT true about the situation described above?

* Adding a third shift will probably cost Sean more than he expects.
* Sean is acting in a profit maximizing manner.
* All of these answers are correct.
* Sean's lack of understanding of economics hindered the Central Bank's ability to influence his decision making.
* The price of raw materials used by Sean may soon increase.
* None of these answers is correct.

That answer is incorrect.
Correct answer:
Sean's lack of understanding of economics hindered the Central Bank's ability to influence his decision making.

In this case, Sean reacted according to the Law of Supply, one of the basic foundations of economics. The price of his product went up, and therefore he may decide to produce more. Because we are told his profits rose, we can assume that his costs did not increase by as much as the price increase. Because Sean is unaware that inflation may be the real reason why prices for his products rose, he will not plan for likely future cost increases.

In this scenario, the Central Bank is expanding the money supply, presumably to decrease unemployment and increase production. If Sean were to expand his production, he would be doing precisely as the Central Bank had hoped. Had Sean been more cognizant of macroeconomic activity, he would be less likely to expand and more likely to brace for cost increases. It is precisely his lack of economic knowledge that allowed the Central bank to influence his decision making.
