Economics 330 Menzie D. Chinn
Fall 2005 Social Sciences 7418
University of Wisconsin-Madison

Final Examination

This exam is 120 minutes long, and is worth 120 points. Part I is multiple choice, Part II is a derivation/short answer, Part III is an essay. The points are allocated in proportion to the time you should spend on each problem. Place Parts I and II in Bluebook A, Part III in Bluebook B.

PART I: Multiple Choice [80 minutes total, 4 points each]. Do NOT explain.

1. The objectives of the Federal Reserve in its conduct of monetary policy include
a) economic growth.
b) price stability.
c) high employment.
d) all of the above.
e) None of the above

2. Which of the following is not a requirement in selecting an intermediate target?
a) Measurability
b) Controllability
c) Flexibility
d) Predictability

3. In practice, the Fed's policy of targeting money market conditions in the 1960s proved to be
a) countercyclical, helping to stabilize the economy.
b) procyclical, destabilizing the economy.
c) procyclical, helping to stabilize the economy.
d) countercyclical, destabilizing the economy.
e) none of the above.

4. Using Taylor's rule, when the equilibrium real federal funds rate is 2 percent, the output gap is negative 3 percent, the actual inflation rate is 1.5 percent, and the target inflation rate is 2 percent, the nominal federal funds rate should be
a) 1.25 percent.
b) 1.5 percent.
c) 1.75 percent.
d) 2.00 percent.
e) 2.25 percent

5. In the Keynesian theory of liquidity preference, velocity is equal to
a) MY/P.
b) VM/PY.
c) 1/f(i,Y).
d) Y/f(i,Y).
e) M/f(i,Y).

6. In the Baumol-Tobin analysis of the demand for money, either an increase in _____ or an increase in _____ increases money demand.
a) income; interest rates
b) the brokerage fee; interest rates
c) interest rates; the price level
d) the brokerage fee; income
e) expected inflation; income

7. Putting the Fed under control of the President, as part of the U.S. Treasury,
a) may place too much pressure on the Fed to Finance federal budget deficits.
b) impart an inflationary bias to monetary policy.
c) generate a political business cycle, in which just before an election contractionary policies are pursued to raise unemployment and interest rates.
d) cause all of the above.
e) cause only (a) and (b) above.

7. The marginal propensity to consume (mpc) can be defined as the fraction of
a) a change in income that is spent.
b) a change in income that is saved.
c) income that is spent.
d) income that is saved.
e) none of the above

8. When the Federal Reserve sells a government bond in the open market,
a) Federal Reserve liabilities remain unchanged.
b) reserves in the banking system increase.
c) reserves in the banking system decline.
d) both (a) and (b) occur.
e) none of the above.

9. The negative relation between investment spending and the interest rate is what gives the _____ curve its _____ slope.
a) IS; upward
b) IS; downward
c) LM; downward
d) LM; upward

10. A tax increase shifts the IS curve to the
a) left, causing output and interest rates to fall.
b) left, causing output and interest rates to increase.
c) right, causing output and interest rates to fall.
d) right, causing output and interest rates to rise.
e) left, causing output to fall and interest rates to increase.

11. An increase in spending that results from expansionary _____ policy causes the interest rate to _____.
a) fiscal; rise
b) fiscal; fall
c) incomes; rise
d) trade policy; fall
e) none of the above.

12. An expansionary monetary policy might increase net exports by
a) decreasing income and hence consumption of imported goods.
b) lowering real interest rates and increasing the value of the dollar.
c) raising nominal interest rates and increasing the value of the dollar.
d) raising real interest rates and increasing the value of the dollar.
e) lowering real interest rates and decreasing the value of the dollar.

13. The Fed's most commonly used means of changing the money supply is
a) changing reserve requirements.
b) changing the discount rate.
c) open market operations.
d) changes in the Regulation Q ceiling rate.
e) none of the above.

14. There are two types of open market operations: _____ open market operations are intended to change the level of reserve and the monetary base, and _____ open market operations are intended to offset movements in other factors that affect the monetary base.
a) defensive; dynamic
b) defensive; static
c) dynamic; defensive
d) dynamic; statics
e) offensive; defensive

15. The long-run aggregate supply curve is a vertical line passing through
(a) the natural rate of output.
(b) the natural-rate price level.
(c) the actual rate of unemployment.
(d) the expected rate of inflation.
(e) all of the above.

16. The Fed's use of the Fed Funds rate as an operating target in the 1970's
a) resulted in countercyclical monetary policy.
b) resulted in too slow growth in M1 throughout the decade.
c) resulted in procyclical monetary policy.
d) resulted in too rapid growth in M1 throughout the decade.
e) resulted in none of the above.

17. Which of the following is most likely to lead to inflationary monetary policy?
a) Declining oil prices
b) Resolution of conflict in the Middle East
c) The enactment of a free-trade agreement with Mexico
d) Rising government budget deficits
e) None of the above

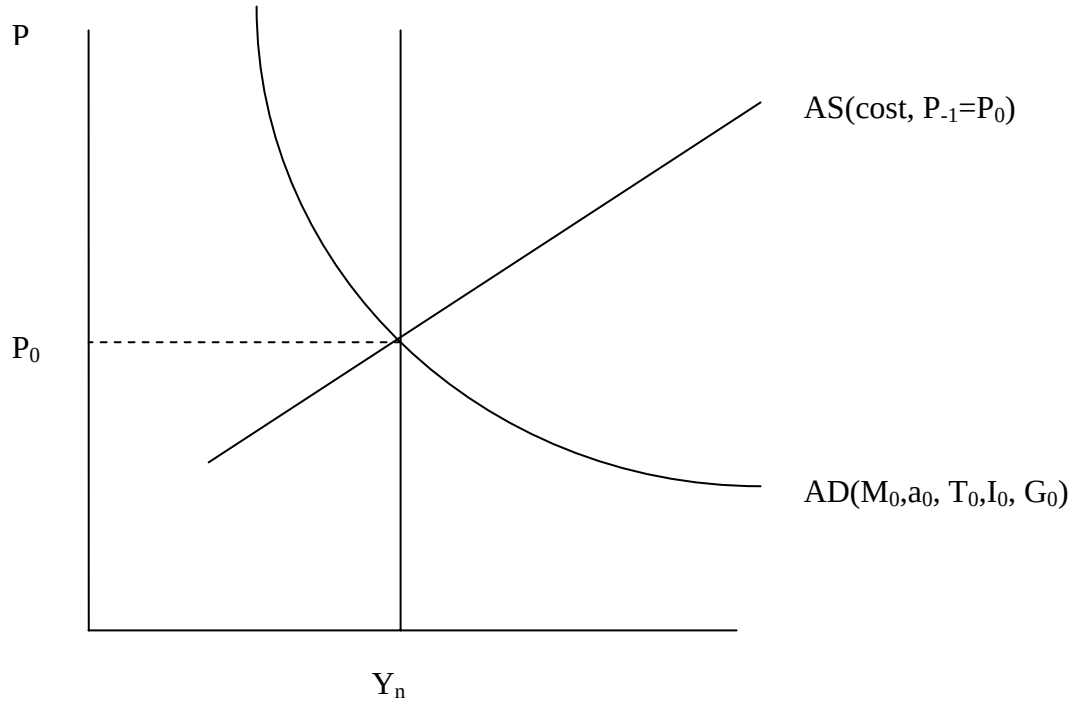
18. According to the traditional interest rate channel, expansionary monetary policy lowers the real interest rate, thereby raising expenditure on
a) business fixed investment.
b) residential housing.
c) consumer purchases of services.
d) all of the above.
e) only (a) and (b) of the above.

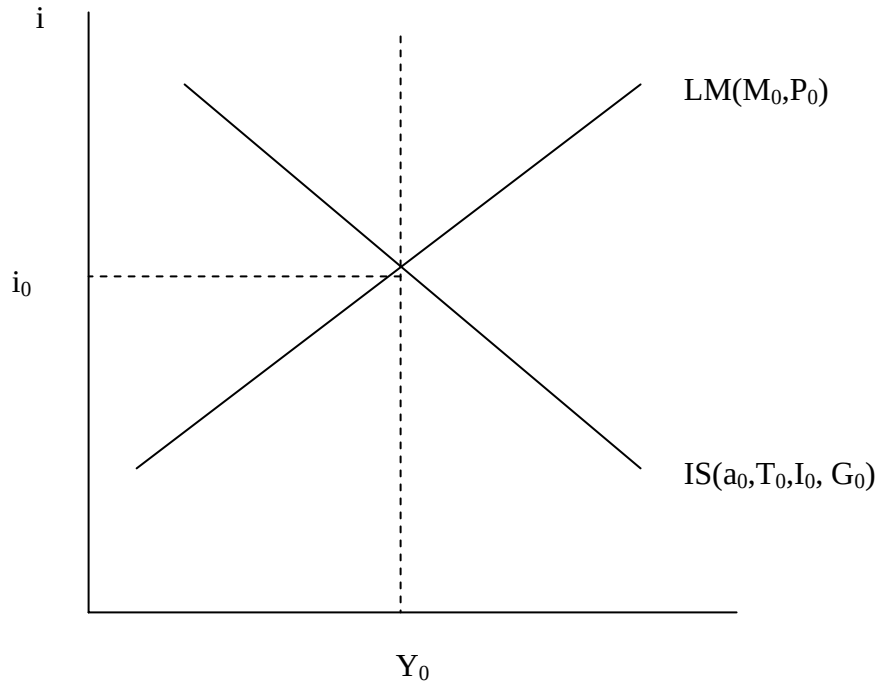
19. A decrease in the availability of raw materials that increases the price level is called a(n)
a) adverse demand shock.
b) beneficial demand shock.
c) adverse supply shock.
d) beneficial supply shock.
e) a positive monetary shock

20. According to the interest parity condition, if the domestic interest rate is
a) above the foreign interest rate, then there is a positive expected appreciation of the foreign currency.
b) above the foreign interest rate, then there is a negative expected appreciation of the foreign currency.
c) below the foreign interest rate, then there is a positive expected appreciation of the foreign currency.
d) not equal to the foreign interest rate, then the interest parity condition must be violated.
e) below the foreign interest rate, then the interest parity condition is violated.

PART II: Short Answer [20 minutes total]

Suppose the economy were described by an AD-AS model,





1. (5 minutes) Describe what happens (using a graph) if the increased price of oil causes the costs of production to rise.

2. (10 minutes) Assume that the Fed's goal is to have no change in prices (strict price stability).

What must the Fed do to monetary policy? Use a graph to show how this policy will affect output and the price level, clearly indicating all the curve shifts. Can you show using an IS-LM diagram what will happen to the interest rate?

3. (5 minutes) Once again using a graph, show what happens if the Fed does not change the money supply.

PART III. Short Answer/Policy [0 minutes]

1. (5 minutes) Write down the Taylor rule (defining the variables you use in your equation).

2. (5 minutes) Explain, using the Taylor rule, why knowing about trends in productivity growth is important for the conduct of monetary policy.

3. (10 minutes) Consider this excerpt from the *Business Telegraph* (11/16/2005):

> **Bernanke urges inflation targeting**
> **By David Litterick in New York** (Filed: 16/11/2005)
>
> Ben Bernanke, the man chosen by President Bush to succeed Alan Greenspan as chairman of the US Federal Reserve, raised the prospect of a new monetary regime in the US yesterday as he argued in favour of inflation targeting.
>
> "To the extent that naming a long-term inflation objective can help to stabilise expectations and keep inflation under control, I think it significantly advances our ability to meet mandates and increase employment growth," he said, as he began confirmation hearings before the US Senate.
>
> ...
>
> Mr Bernanke said any moves towards inflation targeting, which is used in the UK and in Europe, would have to be done through legislation. He also suggested the consumer price index - the most widely used measure of inflation - was not the best gauge and others would have to be considered.

If Bernanke and the FOMC were to follow an explicit inflation target rule, would it necessarily mean a change in the relationship embodied in the Taylor rule? Explain why or why not. Use equations if helpful.

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