Economics 102

Additional Practice Questions

Summer 2014

1. Holding everything else constant, in the simple Keynesian Model presented in class, when aggregate expenditure is greater than production, this reduces the level of inventories and in the short-run results in an increase in the aggregate price level.

a. True

b. False

2. Which of the following statements best describes the differences between the Classical and Keynesian models presented in class?

a. When the economy is in the midst of an economic recession, the Keynesian economist typically will advocate governmental intervention while the Classical economist will advocate patience.

b. According to the Classical Model, economic fluctuations are due to a disequilibrium in the labor market; in the simple Keynesian Model, when aggregate expenditure is greater than actual production, prices rise to eliminate this disequilibrium.

3. Deliberate actions by policy makers that cause fiscal policy to be expansionary when the economy contracts are called automatic stabilizers.

1. True
2. False

4. Consider an economy using the Keynesian model as presented in class. The value of the autonomous expenditure multiplier [1/(1-b)] in this economy is 2. If government spending increases by $50 while taxes simultaneously increase by $50, what will happen to the equilibrium level of GDP?

a. It will not effectively change the level of output since the increase in government spending which stimulates spending is exactly offset by the increase in taxes which contracts spending.

b. It will cause the equilibrium level of GDP to increase by less than $50 because of the multiplier effect.

c. It will cause the equilibrium level of GDP to increase by more than $50 because of the multiplier effect.

d. It will cause the equilibrium level of GDP to increase by exactly $50 due to the multiplier effect.

Use the Loanable Funds Model to answer the next **two** questions:

Y = C + SP + T – TR

SG = T – TR – G

NS = SP + SG

NS = Y – C – G

KI = M – X

Y = C + I + G + (X – M)

In equilibrium, leakages = injections

Furthermore, suppose the government runs a balanced budget (that is, G – T + TR = 0) and collects $300 in tax revenue. Firms spend $55 on new capital and capital inflow equals $15. Income equals $450 and $220 of that income is spent on consumption. Furthermore, leakages equal injections in this economy.

5. What is the level of private saving in this economy?

a. $55 since private saving must equal investment in order for the loanable funds market to be in equilibrium.

b. $70 since businesses are spending $55 of their own money plus $15 provided via the foreign sector (i.e., the capital inflow).

c. $40 since businesses are demanding $55 worth of loanable funds and the foreign sector is supplying only $15 worth of loanable funds.

d. $25 since the total demand for loanable funds is $40 and there are $15 of loanable funds being supplied through the capital inflow.

6. What is the level of government transfers in this economy?

1. $0
2. $90
3. $110
4. $125

7. According to the Loanable Funds Model, which of the following will most likely contribute to long-run growth?

1. An increase in payments to the unemployed.
2. Increased restrictions on immigration.
3. Improved birth control methods.
4. A reduction in the capital gains tax.

8. Answer this question according to the Classical Model. The US runs a trade deficit with China. Holding everything else constant, if the US narrows this gap by increasing exports, what will happen to the level of investment in the United States?

1. Investment in the U.S. will increase relative to its initial level.
2. Investment in the U.S. will decrease relative to its initial level.
3. Investment in the U.S. could either increase or decrease relative to its initial level.
4. There will be no effect on investment in the U.S.

9. The full employment level of output in an economy refers to the level of output produced when:

1. Everyone above age 16 is working.
2. Everyone above age 16 who wants a job is working.
3. There is no unemployment due to the business cycle.
4. There is no cyclical or structural unemployment.

Use the following information for the next **two** problems.

Consider a closed economy whose price levels in 2004 and 2005 are the same. The GDPs in 2004 and 2005 are $4,000 and $5,000, respectively. Household consumption was $3,000 and private saving was $500 in 2004. In 2005, the government deficit increased by $500. Private saving was $1,500 in 2005. Analyze this economy using the Classical model given below:

Y = C + SP + T – TR

SG = T – TR – G

Y = C + I + G

NS = SP + SG

NS = Y – C – G

In equilibrium, leakages = injections

10. The increase in private investment in 2005 is:

1. $500
2. $1,000
3. $1,500
4. $2,000

11. Calculate the leakages in 2004.

1. $500
2. $1,000
3. $3,500
4. There is not enough information to answer this question.

12. Consider an economy using a Keynesian model. The economy is initially in equilibrium at Y1. Holding everything else constant, if there is an increase in the level of autonomous consumption this will

a. Cause the equilibrium level of real GDP to increase.

b. Cause inventories to decrease if the economy continues to produce at its initial level of output.

c. Cause output to be expanded via the multiplier process.

d. (a), (b) and (c) are all true statements.

Use the following information about a closed economy to answer the next **two** questions.

C=100+0.5(Y-T)

I=100

G=70

T=0.2Y

13. What is the value of disposable income for this economy?

a. 0.5(Y–T)

b. 100 + 0.4(Y-T)

c. 0.8(Y-T)

d. 0.8Y

14. What is the equilibrium level of income for this economy?

a. $190

b. $270

c. $450

d. $900

15. BiCi Credit is a bank operating in the country of Moneyland. The reserves that BiCi credit holds in an account with Moneyland Central Bank are considered:

1. Liabilities in the balance sheet of BiCi Credit.
2. Assets in the balance sheet of Moneyland Central Bank.
3. Liabilities in the balance sheet of Moneyland Central Bank.
4. They are not accounted for in the balance sheets of either BiCi Credit or Moneyland Central Bank.

16. Suppose the demand and supply of money are given by the following equations:

Demand: 

Supply: 

In the above equations, r is the interest rate, MD is money demand, and MS is money supply. Furthermore, suppose that the interest rate is currently 4% (r = 4 in the above equation). Which of the following is **TRUE**?

1. People will want to hold money since banks are paying relatively high interest rates.
2. People will want to buy bonds and thus, the interest rate will rise.
3. People will want to buy bonds and this increased demand for bonds will lead to lower interest rates.
4. People will want to sell bonds, and this decreased demand for bonds will lead to higher interest rates.

17. Which of the following is most likely to be a consequence of an open market purchase of bonds by the Federal Reserve?

1. The money supply will increase, the price of bonds will fall, the interest rate will fall, and output will increase.
2. The money supply will increase, the price of bonds will increase, the interest rate will fall, and output will increase.
3. The money supply will decrease, the price of bonds will fall, the interest rate will increase, and output will decrease.
4. The money supply will decrease, the price of bonds will increase, the interest rate will rise, and output will fall.

18. Suppose the Fed increases the level of reserves in an economy by $500 through an open market purchase. In which of the following situations will this $500 increase in reserves have the largest short run effect on the money supply?

1. People hold all of the new reserves as currency.
2. People hold the new reserves as equal amounts of currency and demand deposits and banks maintain a reserve ratio of 10 percent.
3. People hold the new reserves as demand deposits, and banks maintain a reserve ratio of 50 percent.
4. People hold the new reserves as demand deposits, and banks maintain a reserve ratio of 10 percent.

19. According to the aggregate supply and demand model, holding everything else constant, a decrease in the aggregate price level leads to which of the following sequences?

1. The money demand curve will shift to the right, the interest rate will increase, the aggregate expenditure line will shift downward, and there will be movement upward along the aggregate demand curve.
2. The money demand curve will shift to the left, the interest rate will fall, the aggregate expenditure line will shift upward, and there will be movement downward along the aggregate demand curve.
3. The money demand curve will shift to the left, the interest rate will fall, the aggregate expenditure line will shift downward, and there will be movement upward along the aggregate demand curve.
4. The money demand curve will shift to the right, the interest rate will fall, the aggregate expenditure line will shift upward, and there will be movement downward along the aggregate demand curve.

Answer the next **two** questions using the following information.

Money Supply: 

Money Demand:  (e.g. 5% would mean that r = 0.05)











Aggregate Demand (AD): 

Aggregate Supply (AS): 

20. What is the equilibrium level of output (Y) and the equilibrium level of investment (I)?

1. 70,000; 4,400.
2. 120,000; 4,400
3. 80,000; 6,000.
4. 110,000; 6,000.

21. Think about the aggregate demand and aggregate supply model when answering this question. Suppose the economy is in equilibrium but operating below full-employment output. What will happen in the long run in this economy?

1. Nothing will happen. There is no need for adjustment in this market.
2. Adjustment in the labor market will cause an outward shift in the short-run aggregate supply curve, bringing us back to equilibrium with the long-run aggregate supply curve at the full employment output.
3. Adjustment in the money market will cause an inward shift in the short-run aggregate supply curve, bringing us to equilibrium with the long-run aggregate supply curve at the full employment output.
4. Adjustment in the output market will cause an outward shift in the short-run aggregate supply curve to bring us back to equilibrium with the long-run aggregate supply curve at the full employment output.

Use the following Keynesian Model of a closed economy to answer the next **two** questions.





 in equilibrium



The aggregate consumption function of Badgerland is linear in disposable income (Y - T). Assume that the economy is in equilibrium each year.

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| Year | Y | T | C | I | G | S |
| 2004 | 1000 | 100 | 830 | 70 |  |  |
| 2005 | 1200 | 150 |  |  | 200 | 115 |
| 2006 | 1500 | 200 |  | 100 |  |  |

22. The consumption in 2005 is \_\_\_; the consumption in 2006 is \_\_\_.

* 1. 935; 1000.
  2. 900; 1100.
  3. 900; 1000.
  4. 935; 1110.

23. What is the nominal growth rate of government spending (G) between 2004 and 2006?

1. 190%
2. 150%
3. 90%
4. 50%

24. If the Federal Open Market Committee decides to expand the money supply, then it will

a. raise the discount rate to member banks.

b. issue directions to purchase government securities, thus putting more reserves in member banks.

c. issue directions to sell government securities, thus taking reserves from member banks.

d. order new Federal Reserve notes delivered to member banks.

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26. The aggregate demand curve

a. represents the relationship between prices and quantities of all goods produced in an economy.

b. is derived from equilibrium conditions in the labor and money markets.

c. gives the equilibrium level of real GDP corresponding to a given price level.

d. plots the interest rate as a function of output.

27. Which of the following would lead to a downward movement along the aggregate demand curve?

a. a decrease in government purchases.

b. an increase in the money supply.

c. a decrease in the price level.

d. a decrease in taxes.

28. Which of the following would shift the aggregate demand curve to the right?

a. increase in government purchases, investment spending, autonomous consumption, taxes, or the money supply.

b. increase in government purchases, investment spending, autonomous consumption, or the money supply.

c. increase in government purchases, investment spending, autonomous consumption or taxes.

d. decrease in government purchases or investment spending, and increases in autonomous consumption, taxes, or the money supply.

29. The aggregate supply curve would shift downward if

1. unit costs increase due to an increase in output.
2. the wage rate increases.
3. good weather increases crop yields.
4. an increase in real GDP causes the price level to decrease.

30. If a demand shock causes an economy to operate at a point above potential GDP, then

1. the aggregate supply curve will shift to return the economy to the original point of equilibrium.
2. the economy will correct itself through rising wages and prices.
3. this short run equilibrium point will become the new long run equilibrium GDP.
4. the economy will correct itself through falling wage rates and prices.

31. In the long run AS-AD model,

1. the position of the AD curve determines output.
2. the self-correcting mechanism of the economy is irrelevant.
3. the AS curve shifts leftward whenever the economy is growing.
4. the position of the AD curve determines the price level.

32. If the price level is increasing and output is falling, which of the following could be the reason?

1. A positive supply shock.
2. A positive supply shock combined with a positive demand shock.
3. A negative supply shock.
4. A positive demand shock.

33. If the Fed is maintaining an interest rate target and notices a drop in the interest rate, which of the following would be its likely interpretation and response?

1. Money demand has increased; sell government bonds.
2. Money supply has decreased; buy government bonds.
3. Money demand has decreased; sell government bonds.
4. Money demand has increased; buy government bonds.