Midterm #2, version A, given Spring 2002
Note question #50 is from Chapter 11, which students are not responsible for on Exam 2 - Summer 02.

Answers (if you think you see an error, please contact me ASAP).

1) d  6) d  11) d  16) a  21) b  26) d  31) b  36) c  41) a  46) a
2) a  7) b  12) c  17) c  22) a  27) d  32) a  37) d  42) d  47) b (F)
3) a  8) c  13) c  18) c  23) b  28) c  33) c  38) b  43) d  48) a (T)
4) c  9) c  14) b  19) d  24) b  29) b  34) d  39) a  44) b  49) a (T)
5) a  10) a  15) c  20) c  25) c  30) e  35) b  40) d  45) d  50) a (T)

Part I Multiple Choice

Use the diagram above to answer the following seven questions

1. The Keynesian equilibrium level of output is:
   a) 5.5
   b) .5
   c) 6
   d) 5

2. If national output (GDP) = 6, there will be:
   a) unplanned (unintended) increase in inventories of .5 per year.
   b) unplanned (unintended) decrease in inventories of .5 per year.
   c) .5 of planned invest equal to .5 actual investment, so there will be no unplanned inventory change.
   d) exports will exceed imports by .5 per year.

3. Assume I and G are constants (not functions of Y), then the marginal propensity to consume (MPC) is:
   a) .5
   b) 5.5
   c) 2
   d) can not be determined by the information above

4. If GDP = 6:
   a. automatic stabilizers will increase government spending, G.
   b. automatic stabilizers will decrease government spending, G.
   c. stores will order less from factories, reducing output and employment.
   d. stores will order more from factories, increasing output and employment.

5. The horizontal axis is labeled Y. This measures
   a) Gross Domestic Product (GDP) and National Income.
   b) GDP, but not National Income.
   c) National Income, but not GDP.
   d) Aggregate (planned) expenditures.
6) The 45 degree line measures where AE = Y. This indicates
   a) potential Keynesian equilibria.
   b) where planned aggregate expenditures equal output (and income) for an economy.
   c) where there are no unplanned changes in inventories.
   d) all of the above.

7) The AE curve shows how aggregate planned expenditures:
   a) always equal Y, by definition.
   b) are a function of Y, increasing as Y increases.
   c) are a function of the price level, increasing as price level decreases.
   d) are a function of the price level, decreasing as price level decreases.

8) In the Keynesian model, the primary difference between planned and actual investment is:
   a. net aggregate saving.
   b. planned consumption.
   c. unplanned changes in inventories.
   d. government spending on infrastructure.

9) Keynes said picking stocks which will increase in price was like judges at a beauty contest:
   a. choosing the most beautiful contestants.
   b. looking for inner beauty – and not “judging a book by its cover.”
   c. choosing the contestant who the other judges will pick as “most beautiful.”
   d. choosing the least beautiful contestants as the “winners.”

10) In the Keynesian model, an unplanned decrease in inventories will cause firms to:
   a. increase output.
   b. decrease output.
   c. decrease investment because of unfavorable future business prospects.
   d. “lay off” (or temporarily fire) workers.

11) If the level of income increases from $20,000 to $25,000 and consumption increases from $18,000 to $22,500, then the marginal propensity to consume is:
   a) .70
   b) .75
   c) .80
   d) .90

12) According to the Keynesian model, if the marginal propensity to consume were 0.75, an independent increase in investment expenditures of $20 billion would cause the Keynesian equilibrium level of aggregate income to rise by:
   a. $2 billion.
   b. $20 billion.
   c. $80 billion.
   d. $200 billion.

13) Under what conditions is the Keynesian aggregate expenditure model most relevant?
   a. when prices and wages are completely flexible.
   b. when inflation and unemployment occur simultaneously.
   c. when an economy has a large amount of unemployed resources of all types, (e.g., “excess capacity”).
   d. when an economy has no unemployed resources.

14) In the Keynesian model, which of the following will cause current consumption to increase?
   a. an increase in income taxes.
   b. an increase in the current disposable income.
   c. an increase in the interest rate.
   d. a decrease in government spending.
15) J.M. Keynes once said that investment behavior was determined by “animal spirits.” What does this imply about the “Keynesian Model” presented in this class?
   a. Investment is always equal to savings.
   b. Investment will increase when interest rates fall.
   c. Investment is autonomous, and not a stable function of anything else that is measurable.
   d. Investment is greater than savings.

16) In the Keynesian Aggregate Expenditures Model, the 45 degree line represent all possible equilibria because this line represents points where:
   a. Aggregate Planned Expenditures = Aggregate Output (and Income)
   b. Aggregate Output = Aggregate Income
   c. Aggregate Supply and Aggregate Demand are the same.
   d. The government budget is in balance.

17) Currently, American liberals (in comparison to American conservatives) tend to support:
   a) more defense spending and more social spending by government.
   b) more defense spending, but less social spending by government.
   c) more social spending, but less defense spending by government.
   d) less government spending in general – on both defense and social programs.

18) Keynes developed his economic theory during a period of:
   a) high unemployment and high inflation.
   b) low unemployment and low or negative inflation.
   c) high unemployment and low or negative inflation.
   d) low unemployment and high inflation.

19) Some economists believe a recession can benefit an economy by
   a) increasing inflation.
   b) reducing unemployment.
   c) increasing interest rates.
   d) causing inefficient firms to go bankrupt, allowing resources to move into more productive areas which may imply more rapid growth in output and income in the future (when the recession is over).

For the next two questions, consider a two good world, (x and y) where consumption and price changes between 2003 and 2004 are:

<table>
<thead>
<tr>
<th>Year</th>
<th>Consumption &amp; Production</th>
<th>Prices</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>x=2; y=2</td>
<td>P_x = 2, P_y = 2</td>
</tr>
<tr>
<td>2004</td>
<td>x=3; y=1</td>
<td>P_x = 2, P_y = 3</td>
</tr>
</tbody>
</table>

20) Using an old basket (calculating a Laspeyre price index) what is inflation between 2003 and 2004?
   a) 0%
   b) 12.5%
   c) 25%
   d) 30%

21) Using a new basket (calculating a Paasche price index) what is inflation between 2003 and 2004?
   a) 0%
   b) 12.5%
   c) 25%
   d) 30%

22) Disposable Income is
   a) income after tax is subtracted.
   b) income after saving is subtracted.
   c) income after saving and tax are subtracted.
   d) income after depreciation is subtracted.
For the following four questions, consider an economy with no government or foreign trade

23) If Consumption = 20 + .5Y and Planned Investment = 30, what is the Keynesian Equilibrium \( Y_E \)?
   a) $80  
   b) $100  
   c) $120  
   d) $200

24) What is the level of saving in equilibrium when Consumption = 20 + .5Y and Planned Investment = 30?
   a) $20  
   b) $30  
   c) $40  
   d) $50

25) If Consumption = 20 + .5Y and Planned Investment = 40 (an increase), what is the Keynesian Equilibrium \( Y_E \)?
   a) $80  
   b) $100  
   c) $120  
   d) $200

26) What is the Keynesian **Expenditure Multiplier** implied by your answers to the previous three questions?
   a) 120  
   b) 100  
   c) 20  
   d) 2

27) In a simple Keynesian model, the **balanced budget multiplier** is equal to:
   a) \( \frac{1}{1\text{-MPC}} \)  
   b) \( \frac{1}{1\text{-MPS}} \)  
   c) 0 (zero)  
   d) 1 (one)

28) The **paradox of thrift** states that if individuals try to save more it will:
   a) cause an economy to grow more quickly.  
   b) create future benefits, but will reduce current consumption.  
   c) cause Keynesian equilibrium income to fall, so the actual amount saved does not change.  
   d) cause Keynesian equilibrium income to rise by increasing investment.

29) Which of the following would be included in U.S. GDP but **not** U.S. GNP?
   a. indirect business taxes.  
   b. value of cars produced by Japanese firms in the U.S.  
   c. value of cars produced by U.S. firms in Mexico.  
   d. the depreciation (or capital consumption allowance) of capital owned by U.S. firms.

30) If the Fed wanted to use all three of its major monetary control tools to increase the money supply, it would
   a. sell bonds, reduce the discount rate, and reduce reserve requirements.  
   b. sell bonds, reduce the discount rate, and increase reserve requirements.  
   c. sell bonds, increase the discount rate, and increase reserve requirements.  
   d. buy bonds, increase the discount rate, and reduce reserve requirements.  
   e. buy bonds, reduce the discount rate, and reduce reserve requirements.
31) When an economy goes into recession, automatic stabilizers will tend to alter government spending and taxation so as to:
   a) reduce interest rates, thus stimulating aggregate demand.
   b) increase the budget deficit (or reduce the surplus).
   c) reduce the budget deficit (or increase the surplus).
   d) ensure that the budget will remain in balance.

32) Economists usually use the term “recession” to refer to
   a) a period of declining GDP.
   b) a period of unusually slow GDP growth.
   c) a period of declining exports.
   d) a period of declining unemployment.

33) Economists generally think that frictional unemployment:
   a) should be eliminated by appropriate macroeconomic (but not microeconomic) policies.
   b) should be eliminated by appropriate microeconomic (but not macroeconomic) policies.
   c) exists in a well-functioning economy.
   d) is the difference between the natural rate and actual rate of unemployment.

34) Which of the following is an example of an automatic stabilizer?
   a) unemployment compensation
   b) welfare programs that pay money to low income single parents (for example, TANF).
   c) income tax
   d) all of the above

35) If “THE” interest rate in the economy decreases from 20% to 10% today, the value of a previously issued (discount or “zero coupon”) bond paying $1000 in 1 year will:
   a) increase from $1000 to $1100
   b) increase from $833.33 to $909.09
   c) decrease from $909.09 to $833.33
   d) decrease from $1100 to $1000

36) The Federal Reserve earns most of its revenue because:
   a) it receives tax revenues from the Treasury Department.
   b) its primary liabilities pay interest, but not its primary assets.
   c) its primary assets pay interest, but not its primary liabilities.
   d) it receives insurance premiums from commercial banks

37) If the nominal interest rate is 12 percent and the inflation rate is expected to be 3 percent (by all economic agents) then the real interest rate is approximately:
   a. minus 9 percent.
   b. 4 percent.
   c. 15 percent.
   d. 9 percent.

38) The Fed’s assets include:
   a. currency in circulation and common stock in private firms.
   b. discount loans and treasury bonds.
   c. currency in circulation and commercial bank reserves.
   d. deposits of the Treasury Department with the Fed.

39) The Consumer Price Index (CPI) computes the increase in price of a fixed basket of goods from:
   a) the earlier period, and so measures inflation as higher (than if the basket from a later period were used).
   b) the earlier period, and so measures inflation as lower (than if the basket from a later period were used).
   c) the later period, and so measures inflation as higher (than if the basket from an earlier period were used).
   d) the later period, and so measures inflation as lower (than if the basket from an earlier period were used).
40) When individuals are unemployed because they do not have the qualifications and proper training necessary to fill available jobs, we say this is an example of:
   a. frictional unemployment.
   b. induced unemployment.
   c. cyclical unemployment.
   d. structural unemployment.

41) When individuals are unemployed while moving from one job to another this is a form of:
   a. frictional unemployment.
   b. natural unemployment.
   c. cyclical unemployment.
   d. structural unemployment.

42) Which of the following is not included in the “M1” measure of money?
   a. Checking deposits
   b. Travelers Checks
   c. Currency held by the non-bank public
   d. Treasury Bonds.

43) Which of the following individuals will most likely lose from an unanticipated increase in inflation?
   a. someone receiving Social Security benefits that are indexed so as to automatically increase with inflation.
   b. a person who recently purchased a large amount of real assets, such as land.
   c. a person who borrowed, with a fixed-interest rate loan, to purchase a home.
   d. a bank that previously made many long-term loans at fixed interest rates.

44) What would make it more difficult to use cigarettes as money?
   a. some people like to smoke cigarettes while others don’t.
   b. cigarettes that are all of different size and quality.
   c. a steady supply of new cigarettes sufficient to replace those smoked.
   d. cigarettes that are very durable and do not fall apart.

45) In a fractional reserve banking system, banks keep a fraction of:
   a. loans in the form of securities.
   b. currency in the form of reserves.
   c. assets in the form of reserves.
   d. deposits in the form of reserves.

46) If the Fed buys Treasury bonds from a private individual, the reserves of commercial banks:
   a. increase, leading to an increase in deposits and the money supply.
   b. decrease, leading to an increase in deposits and the money supply.
   c. increase, leading to a decrease in deposits and the money supply.
   d. decrease, leading to a decrease in deposits and the money supply.

Mark T or “a” if true;  or F “b” if false

47) An unexpected decrease in inflation will benefit those who borrowed at fixed interest rates in the past.

48) An example of debasement of currency is when base metals are added to coins, reducing their intrinsic value.

49) The Federal Open Market Committee includes the seven members of the Board of Governors.

50) The model presented in Chapter 11 assumes wealth can be held in the form of either (common) stocks or (Treasury) bonds.