Department of Economics

Iowa State University
Principles of Macroeconomics

Spring 2013, Midterm 2

Directions:
- Do not open this booklet until you are told to
- Fill in your name, birth date, ID, and exam version on the bubble sheet
    - This is version 1 of the exam

please write the version number across the top of your bubble sheet

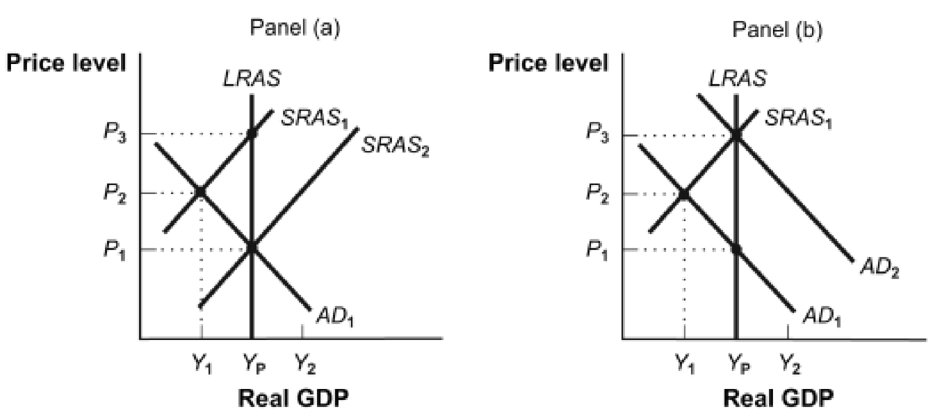
There are 40 questions total on the exam

1. Irving Fisher described debt deflation as a situation in which deflation:
   A) hurts lenders by reducing the value of their loans and lowering the interest rate on loan.
   B) increases aggregate demand and improves the economic downturn, leading to less deflation.
   C) reduces aggregate demand and worsens the economic downturn, leading to further deflation.
   D) reduces the debt obligation of the borrowers as they become better off under deflation.

2. If the economy is in a recessionary gap, then:
   A) nominal wages will fall and *SRAS* will shift to the right until the economy is at full employment.
   B) *AD* will shift to the right and prices of goods will rise until the economy goes back to producing potential output.
   C) nominal wages will rise and *SRAS* will shift to the left and the economy will eventually restore itself.
   D) the economy will remain in a recession forever without any kind of government intervention.

Use the following to answer question 3:

Figure: Policy Alternatives



3. (Figure: Policy Alternatives) If the economy is in equilibrium at Y_1 in panel (a) and the government decides to intervene, it would most likely
   A) decrease government spending.
   B) increase government spending.
   C) increase taxes.
   D) decrease the money supply.

4. The short-run Phillips curve:
   A) is vertical because there is no trade-off between inflation and unemployment rates in the short run.
   B) is horizontal because there is no trade-off between inflation and unemployment rates in the short run.
   C) is upward sloping because inflation and unemployment rates have a positive relationship in the short run.
   D) is downward sloping because there is a trade-off between inflation and unemployment rates in the short run.

5. The public debt–GDP ratio for the United States in 2011 was:
   A) the largest ratio in the world.
   B) less than 5%.
   C) over 200%.
   D) more or less the same as that of other wealthy countries.

6. Real GDP equals $200 billion, the government collects 20% of any increase in real GDP in the form of taxes, and the marginal propensity to consume is 0.8. What is the value of the expenditure multiplier? **(your answer should use information about both the taxes and the marginal propensity to consume)**
   A) 2.8
   B) 7.00
   C) 2.00
   D) 1.00

7. Suppose the government increases taxes by more than is necessary to close an inflationary gap. Which of the following would most likely result?
   A) This will not have any adverse effects on the economy, since inflation has been abated.
   B) The economy will generate a larger inflationary gap than anticipated.
   C) Equilibrium real GDP will be more than anticipated.
   D) The economy could move into a recession.

8. Transfer payments are payments that:
   A) are essentially tax refunds.
   B) erode the purchasing power of the economy.
   C) governments make to households even if the government did not receive a good or service from the household.
   D) governments make to households when the government receives a good or service.

9. If you transfer $1,000 from your savings account to your checking account:
   A) M1 increases by $1,000, and M2 decreases by $1,000.
   B) M1 and M2 don't change.
   C) M1 increases by $1,000, but M2 doesn't change.
   D) M1 decreases by $1,000, and M2 increases by $1,000.

10. If the economy is in an inflationary gap, the Federal Reserve should conduct ______ monetary policy to ______ aggregate demand.
    A) contractionary; increase
    B) expansionary; increase
    C) contractionary; decrease
    D) expansionary; decrease

11. If the economy is operating well below potential output, which of the following is likely?
    A) The cyclically adjusted budget balance deficit is larger than the actual budget balance.
    B) The cyclically adjusted budget balance and the actual budget balance are the same.
    C) The cyclically adjusted budget balance deficit is smaller than the actual budget balance.
    D) The cyclically adjusted budget balance and the actual budget balance are unrelated.

12. Suppose that consumer assets and wealth decrease in real value. How will this affect the aggregate demand curve?
    A) There will be a movement downward along the fixed aggregate demand curve.
    B) The aggregate demand curve shifts to the left.
    C) The aggregate demand curve shifts to the right.
    D) There will be a movement upward along the fixed aggregate demand curve.

13. An increase in the demand for money would result from:
    A) a decrease in the price level.
    B) a decrease in nominal GDP.
    C) an increase in the price level.
    D) a decrease in real GDP.

14. Which of the following statements is true?
    A) The demand for money curve is a vertical line.
    B) An increase in the money supply lowers the equilibrium rate of interest.
    C) A decrease in the money supply lowers the equilibrium rate of interest.
    D) The money supply curve is a horizontal line.

Use the following to answer question 15:

Scenario: Monetary Base and Money Supply

Assume that the reserve is 20% and the monetary aggregates are as follows:

Bank reserves at the Federal Reserve	$100 billion
Currency held by the public	$75 billion
Currency in the bank vaults	$50 billion
Checkable bank deposits	$250 billion
Traveler's checks	$5 billion

15. (Scenario: Monetary Base and Money Supply) How much is M1?
    A) $330 billion
    B) $380 billion
    C) $480 billion
    D) $325 billion

16. If inflation increases from 2% to 5%, the money demand curve will:
    A) remain constant, but the quantity of money demanded will decrease.
    B) shift to the left.
    C) shift to the right.
    D) remain constant.

17. The government budget balance equals:
    A) taxes plus government purchases minus government transfers.
    B) taxes plus government purchases plus government transfers.
    C) taxes minus government purchases minus government transfers.
    D) taxes minus government purchases plus government transfers.

18. Suppose the economy is operating in long-run equilibrium. If a positive demand shock hits the economy, we would expect:
    A) a short-run increase in real GDP and the price level, and a long-run increase in real GDP and a decrease in the price level.
    B) a short-run increase in real GDP and the price level, and a long-run decrease in real GDP and an increase in the price level.
    C) a short-run increase in real GDP and the price level, and a long-run increase in real GDP and an increase in the price level.
    D) a short-run increase in real GDP and the price level, and a long-run decrease in real GDP and a decrease in the price level.

19. Suppose a bank receives a $5,000 deposit and the reserve ratio is 25%. Based on this deposit **alone**, the bank can lend out:
    A) $3,500.
    B) $4,500.
    C) $4,000.
    D) $3,750.

20. Included in the M2 definition of money is(are):
    A) currency in circulation, money market funds, and travelers' checks.
    B) currency in circulation.
    C) money market funds.
    D) travelers' checks.

21. Stabilization policies have:
    A) been successful in reducing the economic fluctuations by neutralizing the effects of both supply and demand shocks.
    B) reduced the economic costs of supply shocks but have not been so successful against demand shocks.
    C) not reduced the effects of business cycles caused by either demand shocks or supply shocks.
    D) reduced the economic fluctuations caused by demand shocks but have not been effective against supply shocks.

22. The monetary base is:
    A) the sum of checkable bank deposits and currency in circulation.
    B) the sum of savings deposits and currency in circulation.
    C) the sum of reserves held by the banks and currency in circulation.
    D) the sum of checkable bank deposits and bank reserves.

23. If interest rates rise there will be a(n):
    A) increase in the money supply.
    B) increase in aggregate supply.
    C) decrease in aggregate demand.
    D) increase in aggregate demand.

24. The aggregate demand curve is negatively sloped in part because of the impact of interest rates on:
    A) net exports.
    B) consumption and investment.
    C) government purchases.
    D) potential output.

25. In the long run, the aggregate price level has:
   A) a positive effect on the quantity of aggregate output.
   B) a negative effect on the quantity of aggregate output.
   C) an impact on aggregate output but no impact on employment.
   D) no effect on the quantity of aggregate output.

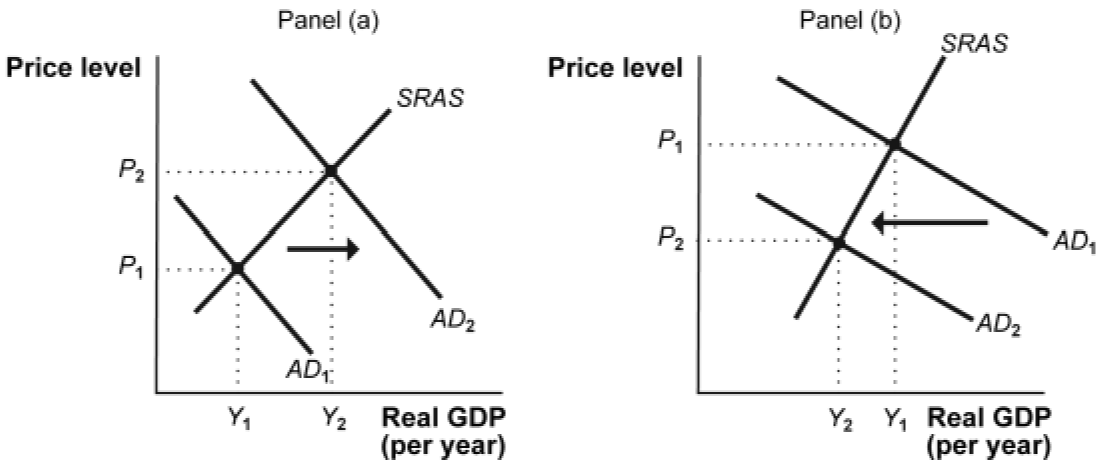
26. Assume that marginal propensity to consume is 0.8 and potential output is $800 billion. If the actual real GDP is $850 billion, which of the following policies would bring the economy to potential output?
   A) Increase taxes by $12.5 billion.
   B) Increase transfers by $12.5 billion.
   C) Increase taxes by $10 billion.
   D) Increase taxes by $50 billion.

27. Suppose a bank gets a new deposit of $100 cash and it has a 20% required reserve ratio. If the bank lends the maximum amount of money allowed, then the checkable deposits increase by:
   A) $100.
   B) $1,000.
   C) $20.
   D) $500.

28. When Fed officials worried about the possibility of “Japanification” in the United States, it meant that they were worried that the U.S. economy would:
   A) fall into a deflationary trap.
   B) fall into a period of hyperinflation.
   C) grow faster than the economy of Japan after World War II.
   D) accumulate large trade surpluses, like Japan.

Use the following to answer question 29:

Figure: The Money Supply and Aggregate Demand



29. (Figure: The Money Supply and Aggregate Demand) Refer to the figure The Money Supply and Aggregate Demand. If the economy is in an inflationary gap, the Federal Reserve will _______ government bonds, which will _______ the money supply and _______ interest rates. This is shown in panel _______.
    A) buy; decrease; raise; (b)
    B) buy; increase; lower; (a)
    C) sell; increase; raise; (b)
    D) sell; decrease; raise; (b)

30. There is a zero bound to which of the following economic variables?
    A) nominal interest rates
    B) potential output
    C) real money demand
    D) real money supply

31. When workers and firms become aware of a rise in the general price level:
    A) they will incorporate higher prices into their expectations of future prices.
    B) they will agree to renegotiate wage contracts downward.
    C) they will not do anything, because they know they are powerless to counter any economic changes.
    D) firms with sticky prices will ultimately adjust their prices downward.

32. The U.S. dollar is defined as:
    A) commodity-backed money, because it is convertible into gold.
    B) commodity money, because it is widely used to buy commodities.
    C) faith money, because we trust the government to defend its value.
    D) fiat money, because it was created by an act of law.

33. Suppose the Federal Reserve were to engage in open-market operations by buying $100 million of U.S. Treasury bills. Which of the following would be the end result of such an action?
    A) The money supply would increase by more than $100 million.
    B) The money supply would stay the same.
    C) The money supply would decrease by $100 million.
    D) The money supply would increase by $100 million.

34. Discretionary fiscal policy refers to:
    A) changes in taxes to account for externalities and control pollution.
    B) any change in interest rates.
    C) any change in money supply.
    D) changes in government spending or taxes to close a recessionary or inflationary gap.

35. If potential output growth is higher than actual output growth, then the:
   A) unemployment rate will remain constant.
   B) inflation rate will rise.
   C) unemployment rate will fall.
   D) unemployment rate will rise.

36. In the income-expenditure model, contractionary monetary policy leads to:
   A) higher interest rates, an increase in planned investment spending, and an increase in equilibrium GDP.
   B) higher interest rates, a decrease in planned investment spending, and a decrease in equilibrium GDP.
   C) lower interest rates, a decrease in planned investment spending, and a decrease in equilibrium GDP.
   D) lower interest rates, an increase in planned investment spending, and an increase in equilibrium GDP.

37. If the Federal Reserve uses expansionary monetary policy:
   A) there is a positive short-run effect on the price level, but the aggregate price level remains unchanged in the long run.
   B) there is a positive long-run effect on real GDP, but GDP remains unchanged at its potential level in the short run.
   C) there is a negative short-run effect on real GDP, but prices remain unchanged in the long run.
   D) there is a positive short-run effect on real GDP, but GDP remains equal to potential GDP in the long run.

38. An inflationary gap is automatically closed by _______ wages that shift the _______ .
   A) rising; *SRAS* curve rightward
   B) rising; *SRAS* curve leftward
   C) falling; *SRAS* curve leftward
   D) falling; *SRAS* curve rightward

39. The long-run Phillips curve shows the relationship between:
    A) expected inflation and actual inflation after the expectation becomes embedded in people's minds.
    B) the aggregate output and the aggregate price level in the economy at a given rate of expected inflation.
    C) unemployment and inflation after expectations of inflation have had time to adjust to experience.
    D) potential aggregate output and the natural rate of unemployment at a given rate of expected inflation.

40. A liquidity trap results from the:
    A) zero bound of the nominal interest rate.
    B) Fisher effect.
    C) inflation tax.
    D) expansionary fiscal policy.

Answer Key

1. C
2. A
3. B
4. D
5. D
6. A
7. D
8. C
9. C
10. C
11. C
12. B
13. C
14. B
15. A
16. C
17. C
18. B
19. D
20. A
21. D
22. C
23. C
24. B
25. D
26. A
27. D
28. A
29. D
30. A
31. A
32. D
33. A
34. D
35. D
36. B
37. D
38. B
39. C
40. A