

Business Conditions Analysis

ECON 736

Final Exam

Professor Yamin Ahmad

Instructions:

There are two parts to this midterm. Part A consists of multiple choice questions. Please mark the answers to the multiple choice questions on the exam paper.

Part A has 30 questions and is worth 60%.

Part B is worth 40% and consists of short answer questions. Please answer any two of the three questions in the space provided. Answering more than two questions in part B will not gain you more than 40%. Please be **concise** in your answers. **Answer ONLY what the question asks**, as points are not awarded for verbosity! You should limit your answers to each question in section B to 1 side of a US letter sized paper.

In terms of a general hint to try and maximize points, *try to relate the context of the questions to any of the models that we have studied in lectures*. Where appropriate, use graphs and equations to help elucidate your answer! You may use your lecture notes and the textbook. Please sign the agreement below before turning in the exam.

Agreement: All of the work on this exam has been done independently, without consulting any other students in this class or faculty in other classes. As presented in class, the essays may be done with a referral to formulae, but all of the written material in the essay is original, "synthetic" independent work, with no copying of published or unpublished material. I attest that this exam has not been copied or distributed in any part or form.

Name (Please Print): _____

Student Id#: _____

Signature: _____

Date: _____

Final Exam

Name _____

Id # _____

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Part A: MULTIPLE CHOICE. Choose the one alternative that best completes the statement or answers the question.

- 1) Suppose the consumption equation is represented by the following: $C = 500 + .8Y_D$. Given this information, the marginal propensity to save is: 1) _____
- A) .2.
 - B) .8.
 - C) 1.
 - D) 5.
 - E) none of the above
- 2) An economy is in equilibrium when which of the following conditions is satisfied? 2) _____
- A) total saving equals investment
 - B) consumption equals saving
 - C) output equals consumption
 - D) total saving equals zero
 - E) all of the above

Use the information below to answer the following questions:

$$C = 4000 + .75Y_D$$

$$I = 2000$$

$$G = 1500$$

$$T = 1000$$

- 3) The equilibrium level of GDP for the above economy equals: 3) _____
- A) 7500.
 - B) 6750.
 - C) 27000.
 - D) 30000.
 - E) none of the above

- 4) Suppose government spending decreases by 200 for the above economy. Given the above information, we know that equilibrium output will decrease by: 4) _____
- A) 200.
 - B) 400.
 - C) 800.
 - D) 1000.
 - E) none of the above
- 5) **Autonomous** spending in a closed economy equals which of the following? 5) _____
- A) $c_0 + I + G + c_1T$
 - B) $C + I + G$
 - C) $c_0 + I + G - c_1T$
 - D) Z
- 6) Suppose the marginal propensity to consume equals .6 (i.e., $c_1 = .6$). Given this information, which of the following events will cause the largest reduction in output? 6) _____
- A) G decreases by 300
 - B) I decreases by 250
 - C) T increases by 300
 - D) both A and B
- 7) Consider the Quantity Theory as given by the Cambridge Equation: $MV = PY$. Recall that under the Quantity Theory, velocity, V , is assumed to be constant. Suppose that in 2005, the Fed increased money supply by 6%. In addition, you know that real GDP growth during 2005 was 2%. What was the inflation rate (approximately) in 2005? 7) _____
- A) 4%
 - B) 2%
 - C) -4%
 - D) 8%
 - E) There is insufficient information to be able to calculate the answer.
- 8) We know that the amount of money that individuals want to hold will: 8) _____
- A) increase as income decreases.
 - B) decrease as the interest rate increases.
 - C) increase as the interest rate increases.
 - D) none of the above
- 9) Which of the following generally occurs when a central bank pursues contractionary monetary policy? 9) _____
- A) the central bank sells bonds and the interest rate decreases
 - B) the central bank sells bonds and the interest rate increases
 - C) the central bank purchases bonds and the interest rate increases
 - D) the central bank purchases bonds and the interest rate decreases
- 10) Which of the following statements is consistent with a given (i.e., fixed) IS curve? 10) _____
- A) A reduction in the interest rate causes money demand to decrease.
 - B) An increase in government spending causes an increase in demand for goods.
 - C) A reduction in the interest rate causes investment spending to increase.
 - D) An increase in taxes causes a reduction in demand for goods.
 - E) A reduction in the interest rate causes an increase in the money supply.

- 11) Suppose the current level of output and the interest rate are such that the economy is operating on neither the IS nor LM curve. Which of the following is true for this economy? 11) _____
- A) Production does not equal demand.
 - B) The quantity supplied of bonds does not equal the quantity demanded of bonds.
 - C) Financial markets are not in equilibrium.
 - D) The money supply does not equal money demand.
 - E) all of the above
- 12) Suppose the central bank decides to conduct an open market purchase of bonds. Which of the following will occur as a result of this monetary policy action? 12) _____
- A) The LM curve shifts up.
 - B) The IS curve shifts rightward as the interest rate falls.
 - C) The IS curve shifts leftward as the interest rate increases.
 - D) The LM curve shifts down.
 - E) none of the above
- 13) Suppose the demand for money is NOT very sensitive to the interest rate (i.e. $h=0$ in our model). Given this information, we know that: 13) _____
- A) the IS curve should be relatively flat.
 - B) the LM curve should be relatively flat.
 - C) the IS curve should be relatively steep.
 - D) the LM curve should be relatively steep.
 - E) neither the IS nor the LM curve will be affected.
- 14) Suppose there is a simultaneous tax increase and open market purchase of bonds. Which of the following must occur as a result of this? 14) _____
- A) both output and the interest rate increase
 - B) the interest rate increases
 - C) output decreases
 - D) the interest rate decreases
 - E) output increases
- 15) Suppose there is a fiscal contraction. Which of the following is a complete list of the variables that **must** decrease? 15) _____
- A) consumption and investment
 - B) consumption
 - C) consumption and output
 - D) consumption, output and investment
 - E) consumption, output and the real interest rate
- 16) Suppose there is a Fed purchase of bonds and simultaneous tax cut. We know with certainty that this combination of policies must cause: 16) _____
- A) an increase in the interest rate (r).
 - B) a reduction in r .
 - C) an increase in output (Y).
 - D) a reduction in Y .

- 17) Consider a variant of the IS-LM model studied in class, where Investment, $I=I_0+b_1*Y-b_2*r$, and the demand for money, $L(r,Y)=m_0+k*Y-h*r$. We know **with certainty** that a tax increase must cause which of the following? 17) _____
- A) an increase in the interest rate and an upward shift in the LM curve
 - B) no change in output if the Fed simultaneously pursues expansionary monetary policy
 - C) a decrease in the interest rate and an increase in investment
 - D) an decrease in the interest rate and an ambiguous effect on investment
- 18) Suppose that people's marginal propensities to consume were such that the mpc, $c_1=1$. The IS curve in this case would have _____. 18) _____
- A) the usual downward slope
 - B) a negative slope
 - C) a positive slope
 - D) a slope equal to zero
- 19) Which of the following best defines the LM curve? 19) _____
- A) the combinations of i and Y that maintain equilibrium in financial markets
 - B) the combinations of i and Y that maintain equilibrium in the goods market
 - C) illustrates the effects of changes in i on investment
 - D) illustrates the effects of changes in i on desired money holdings by individuals
- 20) In the aggregate supply relation, a reduction in current output causes: 20) _____
- A) an increase in the expected price level and an upward shift of the AS curve.
 - B) a change in the expected price level this year.
 - C) an increase in the markup over labor costs.
 - D) a reduction in the current price level.
 - E) a shift of the aggregate supply curve.
- 21) Based on your understanding of the AS/AD model, which of the following is an INCORRECT statement about the short-run adjustment process for the macroeconomy? 21) _____
- A) An increase in output above the natural level will lead to higher nominal wages in transition to the long run.
 - B) An increase in demand increases output.
 - C) Output in excess of the natural level leads to higher prices.
 - D) A reduction in employment leads to lower prices.
 - E) none of the above
- 22) Suppose the economy is operating at a point where output is less than the natural level of output. Which of the following statements is correct given this information? 22) _____
- A) the price level is less than the expected price level
 - B) the price level will be higher next period than this period
 - C) the unemployment rate is less than the natural unemployment rate
 - D) all of the above
 - E) none of the above
- 23) Suppose the central bank implements contractionary monetary policy. Which of the following will occur in the short run? 23) _____
- A) an increase in the interest rate
 - B) a decrease in output
 - C) a decrease in the price level
 - D) all of the above
 - E) none of the above

- 24) If $Y > Y_n$, where Y_n represents potential GDP, we know with certainty that: 24) _____
 A) $P = P^e$. B) $P > P^e$. C) $u > u_n$. D) $P < P^e$.
- 25) Consider the Phillips curve presented in class: $\pi_t = \pi^e_t - \beta(u - u_n)$. Assume that expected inflation is based on the following: $\pi^e_t = \theta\pi_{t-1}$. An increase in θ will cause: 25) _____
 A) a reduction in the natural rate of unemployment.
 B) no change in the natural rate of unemployment.
 C) an increase in the natural rate of unemployment.
 D) inflation in period t to be more responsive to changes in unemployment in period t
- 26) Suppose the Phillips curve is represented by the following equation: $\pi_t - \pi_{t-1} = 20 - 2u_t$. Given this information, which of the following is most likely to occur if the actual unemployment in any period is equal to 6%? 26) _____
 A) The rate of inflation will tend to increase.
 B) The rate of inflation will tend to decrease.
 C) The rate of inflation will be constant.
 D) none of the above
- 27) Which of the following would cause an increase in exports? 27) _____
 A) a reduction in foreign output
 B) an increase in domestic output
 C) a reduction in the real exchange rate
 D) all of the above
 E) none of the above
- 28) In an open economy, net exports will be equal to which of the following? 28) _____
 A) AD
 B) Z
 C) $T - G$
 D) $S + T - G + I$
 E) $EX - IM$
- 29) Define the nominal exchange rate as the foreign price of domestic currency, e.g. the amount of Yen per dollar. When the interest parity condition holds, we know that the domestic interest rate must be equal to: 29) _____
 A) the foreign interest rate.
 B) the foreign interest rate minus the expected rate of appreciation of the domestic currency.
 C) the expected rate of appreciation of the domestic currency.
 D) the foreign interest rate minus the expected rate of appreciation of the foreign currency.
 E) the expected rate of depreciation of the domestic currency.
- 30) Suppose that the exchange rate is defined as the foreign price of domestic currency. In an open economy under flexible exchange rates, an increase in the domestic interest rate will cause a **decrease** in which of the following? 30) _____
 A) the exchange rate, E
 B) investment
 C) net exports
 D) all of the above
 E) only B and C above

Part B: SHORT ANSWER QUESTIONS (40%)

Answer any two of the following three questions. Provide **brief, clear** answers along with your reasoning, using diagrams to make your point effectively as needed. Make sure your arguments are logical. Use the models we have examined as a framework for answering the questions posed here. **You will not get points for verbosity here.** Rather, points will be awarded for the **clarity, consistency and conciseness of your answer.** Please limit your answers to the space provided.

31. (20%) Consider one of the four models of Aggregate Supply. Using one of these models, show how it is possible to obtain an upward sloping AS curve in the short run. Provide intuition for the relationship between the variables you consider.

32. (20%) For the IS-LM model, the equilibrium point E is given by the intersection of the IS and the LM curves? Show why this equilibrium point is unique, i.e. if we are not at point E , what would happen in this economy? Where would we end up? Provide intuition for the dynamics of any variables that you indicate would change in the economy.

33. (20%) Suppose that you are an economic advisor to policy makers in the country of Proklarush. The economy in Proklarush is mostly subject to shocks which hit its **good market**. Would you advise the central bank in Proklarush to target *interest rates* or *money supply* in order to stabilize the economy? Why?