Business Conditions Analysis **Prof. Yamin Ahmad**
ECON 736

Sample Final Exam

Name______________________________________ **Id #** ____________________________

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 35 questions for you to practice 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%.

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

1) Which of the following components of GDP is the largest for the United States?
A) imports
B) investment
C) exports
D) government spending
E) consumption

Answer: E

2) In the model of the goods market presented in lecture 4, which of the following variables is exogenous?
A) saving (S)
B) demand (Z)
C) consumption (C)
D) disposable income (Y_D)
E) none of the above

Answer: E

3) The marginal propensity to consume represents:
A) the change in consumption caused by a one–unit change in disposable income.
B) the level of consumption that occurs if disposable income is zero.
C) the ratio of total consumption to disposable income.
D) the change in output caused by a one–unit change in autonomous demand.
E) total income minus total taxes.

Answer: A

4) Suppose the consumption equation is represented by the following: $C = 500 + .8Y_D$. The multiplier in this economy is:

A) .2. B) .8. C) 1. D) 4. E) 5.

Answer: E

5) Equilibrium in the goods market requires that:

A) consumption equals income.
B) production equals demand.
C) government spending equals taxes minus transfers.
D) production equals income.
E) consumption equals saving.

Answer: B

Use the information below to answer questions (6) – (7):

$C = 1000 + .75Y_D$
$I = 850$
$G = 2500$
$T = 1000$

6) The equilibrium level of GDP for the above economy equals:

A) 3600.
B) 4350.
C) 13400.
D) 14400.
E) none of the above

Answer: D

Use the information below to answer the following questions:

$C = 1000 + .75Y_D$
$I = 850$
$G = 2500$
$T = 1000$

7) The multiplier for the above economy equals:

A) 2.
B) 3.
C) 4.
D) 5.
E) none of the above

Answer: C

8) Based on our understanding of consumption and saving, we know that the marginal propensity to consume and the marginal propensity to save must:

A) sum to exactly one.

B) be equal to the multiplier.

C) sum to less than one.

D) sum to more than one.

E) be equal to each other.

Answer: A

9) Which of the following equals demand in a closed economy?

A) C + I + G + X – IM B) C + I + G + IM – X C) C + I + G + X D) none of the above

Answer: D

10) Which of the following will cause a leftward shift in the money demand curve?

A) an increase in the interest rate

B) a reduction in income

C) an open market sale of bonds by the central bank

D) a reduction in the interest rate

E) none of the above

Answer: B

11) For this question, recall that Y is real GDP, $Y is nominal GDP, and M is the money supply. Which of the following ratios represents the velocity of money?

A) the ratio of M to high powered money (M/H)

B) $Y/M

C) M/Y

D) M/$Y

E) Y/M

Answer: B

12) Which of the following generally occurs when a central bank pursues expansionary monetary policy?

A) the central bank sells bonds and the interest rate increases

B) the central bank sells bonds and the interest rate decreases

C) the central bank purchases bonds and the interest rate increases

D) the central bank purchases bonds and the interest rate decreases

Answer: D

13) Which of the following is the correct definition of the IS curve?

A) The IS curve represents the combinations of output and the interest rate where the goods market is in equilibrium.

B) The IS curve represents the single level of output where financial markets are in equilibrium.

C) The IS curve represents the combinations of output and the interest rate where the money market is in equilibrium.

D) The IS curve represents the single level of output where the goods market is in equilibrium.

E) none of the above

Answer: A

14) Which of the following will cause a shift in the LM curve?

A) an increase in output

B) a reduction in taxes

C) an open market purchase of bonds

D) an increase in consumer confidence

E) all of the above

Answer: C

15) Suppose the economy is operating on the LM curve but not on the IS curve. Given this information, we know that:

A) the money market and bond markets are in equilibrium and the goods market is not in equilibrium.

B) the goods market is in equilibrium and the money market is not in equilibrium.

C) the money market and goods market are in equilibrium and the bond market is not in equilibrium.

D) neither the money, bond, nor goods markets are in equilibrium.

E) the money, bond and goods markets are all in equilibrium.

Answer: A

16) Which of the following will occur if there is an increase in taxes?

A) The IS curve shifts and the economy moves along the LM curve.

B) The LM curve shifts and the economy moves along the IS curve.

C) Both the IS and LM curves shift.

D) Output will change causing a change in money demand and a shift of the LM curve.

E) Neither the IS nor the LM curve shifts.

Answer: A

17) Suppose investment spending is NOT very sensitive to the interest rate. In our model we examined, this is equivalent to setting $b=0$. Given this information, we know that:

A) the LM curve should be relatively flat.

B) the IS curve should be relatively flat.

C) neither the IS nor the LM curve will be affected.

D) the IS curve should be relatively steep.

E) the LM curve should be relatively steep.

Answer: D

18) Suppose there is a simultaneous tax cut and open market purchase of bonds. Which of the following must occur as a result of this?

A) output decreases

B) the interest rate increases

C) both output and the interest rate increase

D) output increases

E) the interest rate decreases

Answer: D

19) Based on our understanding of the IS–LM model that takes into account dynamics, we know that a reduction in the money supply will cause:

A) an immediate drop in Y and immediate increase in i.

B) a gradual increase in i and gradual reduction in Y.

C) an immediate increase in i and no initial change in Y.

D) none of the above

Answer: C

20) The natural level of output is the level of output that occurs when:

A) the economy is operating at the unemployment rate consistent with achieving full employment.

B) the goods market and financial markets are in equilibrium.

C) the unemployment rate is zero.

D) the markup (m) is zero.

E) there are no discouraged workers in the economy.

Answer: A

21) In the aggregate supply relation, the current price level depends upon:

A) fiscal policy.

B) consumer confidence.

C) monetary policy.

D) expected price level.

E) all of the above

Answer: D

22) Suppose that the current price level is equal to the expected price level. Given this information, we know with certainty that:

A) the goods market and financial markets are in equilibrium.

B) the unemployment rate is equal to the natural rate of unemployment.

C) both the price level and the expected price level are equal to one.

D) the unemployment rate is zero.

E) none of the above

Answer: B

23) Which of the following will cause the aggregate demand curve will shift to the left?

A) a decrease in the price level

B) an increase in the money supply

C) a rise in the price level

D) an increase in taxes

E) an increase in consumer confidence

Answer: D

24) Which of the following events will NOT cause an increase in the aggregate price level?

A) an increase in P^e

B) a reduction in output

C) an increase in the markup

D) an increase in unemployment benefits

E) none of the above

Answer: B

25) An increase in the aggregate price level will cause:

A) a reduction in the interest rate and a rightward shift in the IS curve.

B) an ambiguous effect on investment.

C) an increase in investment and an increase in output.

D) an upward shift in the LM curve and an increase in the interest rate.

Answer: D

26) For this question, assume that the Phillips curve equation is represented by the following equation: $\pi_t - \pi_{t-1} = (\mu + z) - \alpha u_t$. An increase in the unemployment rate will cause:

A) a reduction in the markup over labor costs (i.e., a reduction in m).

B) an increase in the markup over labor costs.

C) a decrease in the inflation rate over time.

D) an increase in the inflation rate over time.

E) none of the above

Answer: C

27) Suppose the Phillips curve is represented by the following equation: $\pi_t - \pi_{t-1} = 20 - 2u_t$. Given this information, we know that the natural rate of unemployment in this economy is:

A) 10%.

B) 6.5%.

C) 20%.

D) 5%.

E) none of the above

Answer: A

28) If the nominal interest rate in year t is 10%, and the expected inflation rate for year t is 2%, then the expected real interest rate in year t is approximately:

A) 2%. B) 3%. C) 5%. D) 8%. E) 12%.

Answer: D

29) Assume a country is closed. Given this information, which of the following must occur?

A) Demand for domestic goods will be greater than the domestic demand for goods.

B) S = I

C) A budget surplus exists.

D) S + T = I + G

E) Demand for domestic goods will be less than the domestic demand for goods.

Answer: D

30) Suppose there is a reduction in the real exchange rate. Which of the following will occur as a result of this change in the real exchange rate?

A) an increase in imports

B) a decrease in government spending

C) an increase in net exports

D) a reduction in output

E) all of the above

Answer: C

31) Assume that the interest parity condition holds. Also assume that the U.S. interest rate is 6% while the U.K. interest rate is 8%. Given this information, financial markets expect the pound to:

A) depreciate by 2%.

B) appreciate by 2%.

C) appreciate by 6%.

D) depreciate by 14%.

E) appreciate by 4%.

Answer: A

32) Assume that the interest parity condition holds and that both the expected exchange rate and foreign interest rate are constant. Given this information, a reduction in the domestic interest rate will cause:

A) a reduction in the exchange rate expected in the future.

B) greater depreciation of the domestic currency expected in the future.

C) a reduction in the current exchange rate.

D) all of the above

E) none of the above

Answer: C

33) Assume the interest parity condition holds and that initially i = i*. A reduction in the domestic interest rate will cause:

A) a reduction in E.

B) an increase in the demand for the domestic currency.

C) an expected depreciation of the domestic currency.

D) all of the above

Answer: D

34) An increase in the money supply in a flexible exchange rate regime will cause:

A) a shift of the IP curve.

B) no change in E.

C) a depreciation of the domestic currency.

D) an increase in E.

Answer: C

35) For this question, assume that there is a simultaneous tax cut and monetary contraction. In a flexible exchange rate regime, we know with certainty that:

A) the exchange rate would decrease and output would increase.

B) the exchange rate would increase and output would decrease.

C) the exchange rate would increase.

D) the exchange rate and output would both increase.

E) none of the above

Answer: C

Part B: SHORT ANSWER QUESTIONS (40%)

Here are some short answer practice questions. **Answer any two of the following three questions.** Provide brief, clear answers along with your reasoning. 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 Note: The answers given here are not intended to be model answers. Rather, they are just a quick summary of the main points in the argument.

36. (20%) Suppose the US government cuts taxes in the budget later this year. Assuming that the money supply is left unchanged, what effect might this have on the exchange rate and output? (You should assume that international capital mobility is perfectly mobile).

Answer: Using the Twin Deficits identity: $S - I = G - T + NX$. A cut in taxes would increase the budget deficit. However, without a change in the money supply, there is pressure for the real interest rates to fall. This is pinned down by international capital mobility. Instead the real exchange rate appreciates. So even though we would normally expect output to increase from an increase in the budget deficit, the appreciation of the real exchange rate offsets this and output remains unchanged.

37. (20%) Can the expectation of lower inflation lead to a recession?

Answer: The answer is yes. Suppose that the government announces a future cut in the growth rate of money. Since velocity depends on expected inflation, $V(i)=V(r+\pi^e)$. The announcement of a fall in money growth will thus lower velocity. Thus from the Cambridge equation, $(M/P)=(1/V)Y$ without a change in real money balances, $(1/V)$ increases and so output falls to equate the demand for money to the supply of money. So a fall in expected inflation leads to a recession.

38. (20%) What is meant by the term "Classical Dichotomy"? Illustrate your answer using one of the models you have studied.

Answer:
The term "Classical Dichotomy" refers to the separation between nominal and real variables in the long run. Thus a real shock (originating in the goods market) has an impact on real variables in the long run. A nominal shock (originating in the money market) can only affect prices in the long run and not real variables like real interest rates:- see lecture notes for examples.