

Economics 402

**Final Exam Practice Questions**

The exam will cover material in Chapters 1-14, 16, 19 of the Mankiw textbook (with an emphasis on material since the second midterm) and anything additional covered in class.

The following are examples of the types of questions that will be asked on the final. There will be multiple choice and short answer questions on the exam. I may use some of these questions on the final, so I will not post answers to them. However, you should be able to determine answers to these questions based on the textbook and class notes.

1. The  $LM$  curve is steeper the \_\_\_\_\_ the interest sensitivity of money demand and the \_\_\_\_\_ the effect of income on money demand.
  - A) greater; greater
  - B) greater; smaller
  - C) smaller; smaller
  - D) smaller; greater
2. In a small open economy, net exports depend \_\_\_\_\_ on the exchange rate, where the exchange rate is defined as the amount of \_\_\_\_\_ currency per unit of \_\_\_\_\_ currency.
  - A) negatively; foreign; domestic
  - B) negatively; domestic; foreign
  - C) positively; domestic; foreign
  - D) positively; foreign; domestic
3. The imperfect-information model assumes that producers find it difficult to distinguish between changes in:
  - A) real wages and nominal wages.
  - B) the overall level of prices and relative prices.
  - C) the overall level of prices and the expected level of prices.
  - D) cost-push inflation and demand-pull inflation.
4. According to the imperfect-information model, in countries in which there is a great deal of variability of prices:
  - A) the response of output to unexpected changes in prices will be relatively large.
  - B) the response of output to unexpected changes in prices will be relatively small.
  - C) output will respond negatively to an unexpected rise in prices.
  - D) output will not respond to an unexpected change in prices.

5. According to the sticky-wage model, when the price level is less than the expected price level, workers get a \_\_\_\_\_ real wage than expected, and \_\_\_\_\_ workers are hired than expected.
- A) lower; more
  - B) lower; fewer
  - C) higher; more
  - D) higher; fewer
6. To illustrate inflation inertia in an aggregate demand–aggregate supply model, the short-run aggregate supply curve shifts upward because of increases in \_\_\_\_\_, and the aggregate demand curve shifts upward because of increases in \_\_\_\_\_.
- A) the expected price level; the money supply
  - B) the money supply; the expected price level
  - C) output; the price level
  - D) the price level; output
7. If the Fed has discretion to choose its own policy and announces a policy of low inflation, then:
- A) the policymaker is required to make the money supply grow at a low rate.
  - B) private economic agents are sure to believe the announcement because it is credible.
  - C) private economic actors are likely to discount the policy because the Fed has an incentive to renege on its policy once expectations are formed.
  - D) the Fed is certain to renege on its policy once expectations are formed because then it can lower unemployment with minimum inflation.
8. If people's expectations of inflation are formed rationally rather than based on adaptive expectations and if policymakers make a credible policy move to reduce inflation, then the costs of reducing inflation will be \_\_\_\_\_ traditional estimates of the sacrifice ratio.
- A) much higher than
  - B) much lower than
  - C) exactly equal to
  - D) approximately two percent greater than
9. The average propensity to consume is the:
- A) ratio of consumption to income.
  - B) amount consumed out of an additional dollar of income.
  - C) amount available for consumption after precautionary saving.
  - D) ratio of consumption to wealth.

10. According to Friedman's permanent-income hypothesis, if the marginal propensity to consume out of permanent income equals 0.9 and current income equals \$55,000 (of which \$5,000 is transitory income), then consumption should equal:
- \$5,000.
  - \$45,000.
  - \$49,500.
  - \$55,000.
11. Milton Friedman argued that, although household studies showed that high-income households generally have lower average propensities to consume, this phenomenon is due to the fact that these households have, on average:
- positive transitory income.
  - negative transitory income.
  - higher permanent income.
  - lower permanent income.
12. According to the real business cycle theory, a temporary increase in the current interest rate will make people want to work:
- more.
  - less.
  - the same amount.
  - not at all.
13. Policymakers are contemplating undertaking either an increase in government spending or an increase in the money supply. Either policy is forecast to have the same impact on income in the short run. Use the *IS-LM* model to compare the impact on consumption and investment of the two policy alternatives.
14. a. An economy is initially at the natural level of output. There is an increase in government spending. Use the *IS-LM* model to illustrate both the short-run and long-run impact of this policy change. Be sure to label: i. the axes; ii. the curves; iii. the initial equilibrium, iv. the short-run equilibrium, and v. the terminal equilibrium.  
 b. Explain in words the short-run and long-run impact of the change in government spending on output and interest rates.
15. Assume that the *LM* curve for a small open economy with a floating exchange rate is given by  $Y = 200r - 200 + 2(M/P)$ , while the *IS* curve is  $Y = 400 + 3G - 2T + 3NX - 200r$ . The function for *NX* is  $NX = 200 - 100e$ , where  $e$  is the exchange rate. The price level ( $P$ ) is fixed at 1.0. The international interest rate is  $r^* = 2.5$  percent.
- Using the *LM* curve, find the equilibrium level of  $Y$  in the small open economy, if  $M = 100$ .
  - Given this value of  $Y$ , if  $G = 100$  and  $T = 100$ , what must be the equilibrium value of  $NX$ ?
  - If this value of  $NX$  is to be achieved, what must be the equilibrium exchange rate,  $e$ ?

16. a. You are the chief economic adviser in a small open economy with a floating-exchange-rate system. Your boss, the president of the country, wishes to increase the level of output in the short run in order to win reelection. Do you recommend using expansionary or contractionary, monetary or fiscal policy?
- b. Use the Mundell-Fleming model to illustrate graphically your proposed policy. Be sure to label: i. the axes; ii. the curves; iii. the initial equilibrium levels; iv. the direction the curves shift; and v. the new short-run equilibrium.
17. The firms and workers in Alpha form expectations adaptively. The firms and workers in Omega form expectations rationally. Their otherwise identical economies are initially in equilibrium at the natural level of output with 10 percent inflation. The central banks of both Alpha and Omega make credible commitments to reduce the growth rates of money until they achieve 2 percent inflation. Compare and contrast the adjustment process to the new equilibrium at the lower rate of inflation in both countries.
18. For each of the following policies indicate whether the policy is i) a monetary or a fiscal policy, ii) an active or a passive policy, and iii) a policy by rules or with discretion:
- the central bank follows a policy of allowing the money supply to grow at a constant 4 percent per year;
  - a government follows a policy of keeping government spending over a calendar year equal to government revenue over the calendar year;
  - the central bank uses judgment to adjust the growth of the money supply based on expectations of what will happen to output and inflation over the next five years.
  - the government keeps tax laws unchanging and allows government spending to change, depending on which spending bills are passed by the legislature.
19. Assume that the typical household behaves according to Irving Fisher's two-period model, that consumption in both periods is a normal good and that households are initially savers. Illustrate graphically how a tax cut in period one affects consumption in both periods. Assume that the average consumer does not believe that he or she or any one in the family will ever have to pay higher taxes in the future to offset the current cuts.
20. Assume that aggregate labor supply is given by  $L^s = 1,000(1 + r)(W_1/W_2)$ , where  $r$  is the real interest rate expressed as a fraction,  $W_1$  is the current wage, and  $W_2$  is the future wage.
- What is  $L^s$  if  $r$  is 0.03,  $W_1$  is 20, and  $W_2$  is 20?
  - If the real interest rate rises to 0.04, what is  $L^s$ ?
  - If the real interest rate is 0.03 and  $W_1$  is 20, what is  $L^s$  if  $W_2$  is 20?