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Economics 202

## Old Midterm #2

### **Part 1. Multiple Choice Questions (2 points each question)**

1. According to how economists define investment, which one of the following statements about investment is **false**?
  - a. investment includes changes in inventories
  - b. investment includes the exchange of all stocks and bonds
  - c. investment decreases when inventories fall
  - d. investment includes the purchase of new capital equipment
  - e. investment is an expenditure that affects aggregate demand
  
2. What does the term "autonomous" mean?
  - a. the term refers to the use of computers in production
  - b. the term refers to how much we consume of certain goods
  - c. the term refers to expenditures that do not change with changes in income
  - d. the term refers to a type of transportation expenditure discussed in class
  
3. How does the Labor market relate to the Goods and Services market?
  - a. the demand for labor is derived from the level of output in the Goods and Services market
  - b. decreases in the output of goods and services create an increase in just voluntary unemployment if labor market wages decrease
  - c. decreases in the output of goods and services create an increase in just involuntary unemployment if labor market wages do not decrease
  - d. all of the above

*Questions #4-5 relate to the US Foreign Exchange market for Japanese currency (the yen).*

4. If there is an increase in US capital inflow from Japan, then how is this market affected?
  - a. increase in the price of foreign exchange and an increase in the quantity of foreign exchange
  - b. decrease in the price of foreign exchange and a decrease in the quantity of foreign exchange
  - c. decrease in the price of foreign exchange and an increase in the quantity of foreign exchange
  - d. increase in the price of foreign exchange and a decrease in the quantity of foreign exchange
  
5. If the price of foreign exchange is dollars divided by yen, then how does an increase in the demand for foreign exchange affect this market?
  - a. the dollar depreciates relative to the yen
  - b. the dollar appreciates relative to the yen
  - c. Japanese goods are less expensive for US citizens
  - d. the yen depreciates relative to the dollar

6. Based on how we model the Loanable funds market in class (and the textbook), what do we know about the Domestic Savings curve that's included on the graph?

- a. capital inflow causes the quantity of domestic savings to increase
- b. capital outflow causes the quantity of domestic savings to increase
- c. increases in the interest rate causes the quantity of domestic savings to increase
- d. decreases in the interest rate causes the quantity of domestic savings to increase
- e. both a and b

7. Where does "equilibrium" occur in the AE model:

- a. where the aggregate demand curve intersects the aggregate supply curve
- b. where aggregate demand curve intersects the aggregate expenditure curve
- c. where income and real GDP are equal
- d. where aggregate expenditure and real GDP are equal

8. What makes the government expenditure multiplier smaller in absolute value?

- a. the marginal propensity to consume (MPC) decreases
- b. Government spending decreases
- c. Investment decreases
- d. Taxes are decreased
- e. both a and b are correct

9. Which statement about the marginal propensity to save (MPS) is true:

- a. MPS is the change in Savings divided by the change in Consumption
- b.  $MPS = 1 - MPC$
- c. the government expenditure multiplier increase in size as the MPS increases
- d. the MPS increases whenever consumer Savings increases

10. Which statement about the MPC is true:

- a. the MPC determines the rate at which autonomous consumption changes
- b. the MPC can be greater in value than one
- c. the MPC equals consumption expenditure divided by disposable income
- d. the MPC increases whenever Consumption increases
- e. the MPC shows how consumption changes with any change in disposable income

11. How does an increase in the MPC affect the economy?

- a. the tax multiplier will become a positive value
- b. more output will be produced
- c. an inflationary gap will occur
- d. a recessionary gap will occur

12. If  $MPC = 0.5$ , then what change in DI would bring a \$70 increase in Consumption?

- a. Consumption would increase by \$70 if DI increased by \$70
- b. Consumption would increase by \$70 if DI increased by \$35
- c. Consumption would increase by \$70 if DI increased by \$140
- d. Consumption would increase by \$70 if DI increased by \$100
- e. not enough information is given to calculate an answer

The information below corresponds with questions #13-17.

Assume that a certain country has the following equations describing its macroeconomy:

$C = 0.6(DI) + 1100$	C = consumption, DI = disposable income
$I = 1000$	I = investment
$G = 1000$	G = government spending
$T = 500$	T = tax revenue
$X = 2000$	X = exports
$M = 2000$	M = imports
$DI = Y - T$	Y = real GDP
$Y_p = 10,000$	$Y_p$ = Potential real GDP

13. The value associated with this country's (simple) government expenditure multiplier is:

- a. 2.5
- b. 1.5
- c. 0.6
- d. 5
- e. none of the above

14. The value associated with this country's (simple) tax multiplier is:

- a. - 0.6
- b. - 1.5
- c. - 2.5
- d. - 5
- e. none of the above

15. When this economy produces at equilibrium GDP, what will be overall savings?

- a.  $S = 2250$
- b.  $S = 2000$
- c.  $S = 1500$
- d.  $S = 2500$
- e. none of the above

16. Which of the following is a true statement about this country's government budget:

- a. the government's budget is in a deficit
- b. the government's budget is in a surplus
- c. the government's budget is balanced
- d. none of the above

17. Which of the following is a true statement about this country's trade balance:

- a. this economy has a trade deficit
- b. this economy has a trade surplus
- c. this economy has net exports of 0
- d. none of the above

Use the table below to answer Questions #18-21. Assume that this table provides consumption and savings for a society at different levels of disposable income. Assume further that the marginal propensity to consume in this economy is 0.8 (i.e.  $MPC = 0.8$ ).

Row	C	S	DI
1	8,400		8,000
2	9,200		9,000
3			10,000

C = Consumption  
 S = Savings  
 DI = Disposable Income

18. What is the value of savings (S) in row 2?
- 200
  - 400
  - 600
  - 800
  - none of the above
19. What is the value of consumption (C) in row 3?
- 8,000
  - 8,800
  - 9,400
  - 10,000
  - none of the above
20. Which of the following is a true statement about the economy depicted in the table above:
- this economy experiences dissaving when disposable income is \$8000
  - this economy experiences dissaving when disposable income is \$9000
  - this economy is at the break even point when disposable income is \$10000
  - all of the above
  - none of the above
21. In the economy depicted in the table above, which of the following statements is true about the average propensity to consume (APC) and MPC in this economy for rows 1-3:
- as disposable income increases, the APC remains equal to the MPC
  - as disposable income increases, the APC increases and get steadily larger than the MPC
  - as disposable income increases, the APC decreases, but is greater than the MPC in rows 1-3
  - as disposable income increases, the APC decreases, but is less than the MPC in rows 1-3
22. Which statement about multipliers is true:
- government spending multiplier is greater than zero
  - government spending multiplier is greater in absolute value than the tax multiplier
  - tax multiplier is only greater than one in absolute value when the MPC is greater than 0.5
  - all of the above

23. In the AE model, if the government decides to increase both government spending and taxes by \$1000, then what effect does this have on the economy?

- a. real GDP will increase by \$1000
- b. real GDP will remain unchanged
- c. real GDP will increase by more than \$1000
- d. real GDP will increase by less than \$1000

24. In the AE model, if the government decides to increase government spending by \$1000, then what effect does this have on the economy?

- a. real GDP will increase by \$1000
- b. real GDP will remain unchanged
- c. real GDP will increase by more than \$1000
- d. real GDP will increase by less than \$1000

25. Which of the following is **not** a belief of Supply Side economists:

- a. deregulation of specific industries
- b. lowering (marginal) income tax rates
- c. lowering corporation tax rates
- d. raising (marginal) tax rates during inflationary gaps
- e. none of the above (all are beliefs of Supply Side economists)

26. Which of the following is not an example of fiscal policy:

- a. reducing the expenditure on national parks
- b. increasing taxes on junk food
- c. paying off part of the national debt by printing more (new) money
- d. eliminating loop holes in the tax code

27. What problems exist with fiscal policy?

- a. fiscal policy leads to crowding in
- b. due to the political process, it may be difficult to quickly pass certain kinds of fiscal policy through Congress
- c. it too frequently uses changes in interest rates
- d. all of the above

28. As discussed in class, what is the basic problem associated with "pork barrel spending"?

- a. the political incentives of politicians are not necessarily compatible with the economic goals of society as a whole
- b. increasing spending tends to be inflationary
- c. this type of spending tends to raise interest rates
- d. this type of spending tends to occur more during inflationary gaps

29. During an inflationary gap, which example of fiscal policy would work best?

- a. increasing the money supply
- b. increasing government expenditure
- c. increasing taxes
- d. increasing government expenditure and taxes by the same amount

30. Which of the following is the most accurate statement about the term “inside lag”:
- a. the inside lag refers to a period of time between when an economic problem is recognized and a policy is implemented to solve the economic problem
  - b. the inside lag refers to a period of time between when a policy is implemented to solve an economic problem and the point where the problem is solved domestically
  - c. the inside lag refers to a period of time when higher rates of consumption are lowering investment spending within the economy
  - d. the inside lag refers to a period of time when investment expenditure is reacting to changes in domestic savings
31. As discussed in class, which of the following is the best description of the "National Debt"?
- a. the difference between each consumer's income and their expenditure
  - b. the difference between the amount our country owes other countries and what other countries owe us
  - c. the sum of all government budget deficits (i.e. over time)
  - d. the difference between government spending and tax revenues in a specific year
32. Which of the statements below is the best explanation as to why the following comment is a bad analogy: "If U.S. citizens must balance their checkbook, then so should the U.S. government!"
- a. the U.S. government has fewer constraints on its ability raise finances for expenditure than do U.S. citizens
  - b. the U.S. government's budget is much larger than that of the typical U.S. citizen
  - c. the U.S. government is involved in exporting and importing goods, but the typical U.S. citizen is not
  - d. the U.S. government has a larger debt to income ratio than typical U.S. citizens
33. Why is it misleading to use a country's total debt when determining whether that country has *borrowed too much money*?
- a. total debt is measured as the accumulated budget deficits of the government
  - b. the level of a country's debt tells us nothing about the country's ability to pay off that debt
  - c. because debt is positively related to a country's GDP
  - d. because debt is negatively related to a country's GDP
  - e. because debt increases whenever a country runs budget deficits
34. When the number of government bonds increases, what is the most likely general result?
- a. bond prices will rise, interest rates will fall
  - b. bond prices will fall, interest rates will rise
  - c. both bond prices and interest rates will rise
  - d. both bond prices and interest rates will fall
35. When the number of government bonds increases, what is the most likely cause (below)?
- a. the government is trying to correct an inflationary gap
  - b. the government is experiencing a budget surplus
  - c. the government is trying to correct a situation where the economy is producing at an output level greater than Potential GDP
  - d. the government is trying to correct a situation where the economy is operating within a recessionary gap

36. As discussed in class, what is crowding out?

- a. where higher taxes lead to lower consumption expenditure
- b. where higher taxes lead to lower savings
- c. where government borrowing tends to lower (private) investment expenditure
- d. where increases in nominal wages lead to firms laying off more employees

37. As discussed in class, which of the following is the best description of the purpose of the trend line on a business cycle graph:

- a. points above the trend line show us future rates of growth, points below the trend line show us prior rates of growth
- b. points above the trend line are positive values, points below the trend line are negative values
- c. the trend line shows us the rate of increase in job growth
- d. the trend line reveals the depth of any recessionary or inflationary gap
- e. the trend line reveals the average rate of growth in GDP over time

38. In its effort to balance the budget over time, government has decided to lower taxes during recessionary gaps and raise taxes during inflationary gaps. Which budget balancing philosophy is closest to what they've adopted:

- a. the balance annually approach
- b. the balance over the business cycle approach
- c. the demand management approach
- d. all of the above

39. Which budget balancing philosophy creates an incentive for smaller government budgets:

- a. the balance annually approach
- b. the balance over the business cycle approach
- c. the demand management approach
- d. all of the above

40. Assume that government changes their budget balancing philosophy from balancing annually to the functional finance approach. Soon after, the economy goes into recession. With this in mind, fill in the appropriate words in the sentence below.

In this situation, the recession will lead to a \_\_\_\_\_, and government will react by \_\_\_\_\_, which has a \_\_\_\_\_ effect on the business cycle.

- a. budget surplus; increasing government expenditure; countercyclical
- b. budget deficit; decreasing government expenditure; procyclical
- c. budget surplus; decreasing government expenditure; procyclical
- d. budget surplus; increasing government expenditure; procyclical
- e. budget deficit; increasing government expenditure; countercyclical

**Part 2. Short Answer Questions (20 points overall)**

*The equations below correspond with Questions #1-3. To ensure that you receive full credit on each question, please show any relevant work. No work means no credit.*

Assume these equations describe expenditure in an economy that fits the assumptions of the AE model from class.

$C = 0.8(DI) + 4000$        $C =$  consumption expenditure,  $DI =$  disposable income

$I = 8000$                        $I =$  investment

$G = 5000$                        $G =$  government expenditure

$X = 3000$                        $X =$  exports

$M = 2000$                        $M =$  imports

$T = 5000$                        $T =$  tax revenues

$DI = Y - T$                        $Y =$  real GDP

**[5 pts]** 1. Assume that Potential GDP is equal to 80,000 and then show what type of output gap this economy experiences when producing at equilibrium (real) GDP.



**Part 2. Short Answer Questions cont.**

*In Questions #2-3, ignore the value for Potential GDP provided in Question 1. Questions #2-3 involve the use of a specific multiplier to answer the question. Note that in order to get full credit, you must use that multiplier and show any relevant work or make it clear as to how you got your answer. Simply writing a number down without supporting work will get no credit.*

**[5 pts]** 2. Assume that this economy is producing \$5000 less than their Potential GDP and use the tax multiplier to show how much of a change in taxes are needed to close this gap.

**[5 pts]** 3. Use the government expenditure multiplier to show how a \$2000 decrease in government expenditure will affect equilibrium GDP.

**Part 2. Short Answer Questions cont.**

*Credit on the question below will depend upon how clearly you show that you understand the concept that's being addressed.*

**[5 pts]** 4. Explain the validity of the following statement: "government borrowing today is a burden on the taxpayers of tomorrow".