

Assigned Seat _____

Name _____

ECO202: PRINCIPLES OF MACROECONOMICS

SECOND MIDTERM EXAM

SPRING 2006

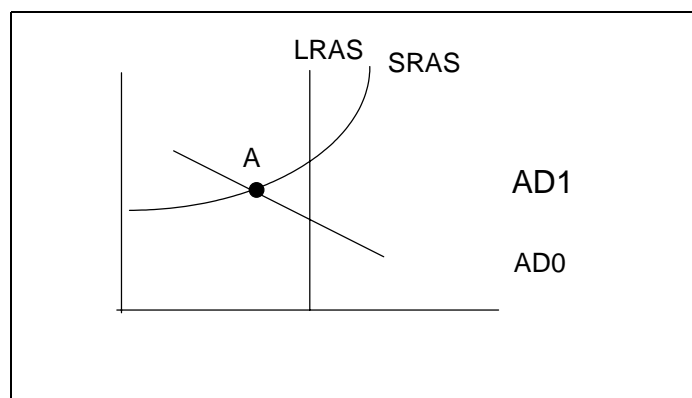
Prof. Bill Even

FORM 1

Directions

1. There are 36 questions on the exam. You will receive a 2 percentage point bonus for properly filling in your unique id on the scantron. Your grade is determined entirely by the answers you record on the scantron.
2. You may use a calculator. No cell phones or devices capable of storing text are allowed.
3. You have until the end of the period to finish the exam. No extra time will be allowed.
4. Academic dishonesty is a serious offense. If I find someone behaving in a dishonest manner, I will ask that the maximum penalty allowed by the university be imposed.

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- 1) Which of the following combination of events would **ALL** shift the long run aggregate supply curve to the left?
- an increase in labor demand, an increase in labor supply, or an upward shift in the production function.
 - an increase in labor demand, a decrease in labor supply, or a downward shift in the production function.
 - a decrease in labor demand, an increase in labor supply, or a downward shift in the production function.
 - none of the above.
- 2) When the price level falls and the economy moves along the **short run** aggregate supply curve, the real wage _____, the nominal wage _____, and real GDP _____.
- rises; rises; rises.
 - does not change; falls; rises.
 - falls; does not change; rises.
 - none of the above.
- 3) When the price level rises, the aggregate quantity of goods and services demanded falls:
- because there is an intertemporal substitution effect that causes people to save more and consume less.
 - because people's real wealth declines causing them to consume less.
 - because people will tend to import more goods and purchase fewer goods domestically.
 - all of the above.
- 4) Which of the following would ALL contribute to a rightward shift of the AD curve?
- a weaker dollar in foreign exchange markets; a tax cut; and higher interest rates.
 - a stronger dollar in foreign exchange markets; a tax increase; and lower interest rates.
 - a stronger dollar in foreign exchange markets; a tax cut; and higher interest rates.
 - none of the above.



- 5) Suppose the economy is at the point A in the above diagram. At this point, the unemployment rate is (above, below) the natural rate and there is (upward, downward) pressure on real wages.
- above; downward.
 - above; upward.
 - below; downward.
 - below; upward.
- 6) Suppose that the economy is at the point A in the above diagram. As the economy returns to its long run equilibrium, we should expect to see the price level (*rise, fall*), real wages (*rise, fall*) and the unemployment rate (*rise, fall*).
- rise; rise; rise.
 - rise; fall; rise.
 - rise; fall; fall.
 - none of the above.
- 7) Suppose that the economy is currently at a long run equilibrium. If consumers become less confident of their job security, the short run effect would be that prices would (*rise, fall*), real wages would (*rise, fall*), and the unemployment rate would (*rise, fall*).
- rise; fall; fall.
 - rise; fall; fall.
 - fall; rise; rise.
 - none of the above.
- 8) Suppose that the economy is at a long run equilibrium. If the Federal Reserve raises interest rates, we should expect that in the LONG RUN,
- prices and nominal wages would be lower than originally, but the real wage and employment would be unchanged.
 - prices and nominal wages would be higher than originally, but the real wage and employment would be unchanged.
 - prices and real wages would be higher than originally, but the real wage and employment would be unchanged.
 - prices and nominal wages would be lower than originally, but the real wage and employment would be higher than originally.
- 9) Bank panics
- in the 1800s could be caused by a drought which raised questions about the ability of borrowers to pay off their loans.
 - occurred in Ohio in the 1980s when Home State Bank experienced losses that wiped out the Ohio Insurance for State Savings Banks.
 - were substantially reduced by the establishment of FDIC in the 1930s.
 - all of the above.

- 10) Which of the following statements is true?
- Ben Bernanke is the current chair of the Federal Reserve Board of Governors.
 - There are 12 districts in the U.S. Federal Reserve System.
 - The Federal Open Market Committee makes the main policy decisions for the Federal Reserve.
 - All of the above.

- 11) Over the past 2 years, the Federal Reserve has gradually:
- increased interest rates because of its concerns that inflationary pressures were rising.
 - decreased interest rates because of its concerns that inflationary pressures were rising.
 - increased interest rates because of its concerns that inflationary pressures were falling.
 - decreased interest rates because of its concerns that inflationary pressures were falling.

To answer the next 3 questions, assume that the banking system starts with the following "base case" balance sheet and that

* the public initially holds \$10 billion of cash outside the bank.

* the reserve ratio is 5%

* banks always loan out the maximum amount allowed.

BALANCE SHEET (all figures are in billions of \$)

Loans	\$35,000	Demand Dep.'s	\$40,000
Reserves	\$2,000		
Govt. Secur.'s	<u>\$13,000</u>	Owner's Equity	<u>\$10,000</u>
	\$50,000		\$50,000

12) Start with the base case balance sheet. The M1 is _____ and the monetary base is _____. (You may assume there are no travelers checks in circulation.)

- \$50,010 billion; \$42,000 billion.
- \$40,010 billion; \$2,010 billion.
- \$40,000 billion; \$2,000 billion.
- none of the above.

13) **Start with the base case balance sheet and the 5% reserve ratio.** If the Fed sells \$20 billion of government securities to banks and the banking system completely adjusts to this change in their balance sheet, M1 will _____ and the monetary base will _____.

- increase \$400 b.; increase \$20 b.
- decrease \$400b.; decrease \$20 b.
- increase \$20 b. ; increase \$20 b.
- none of the above.

14) **Start with the base case balance sheet and the 5% reserve ratio.** If the Fed raises the reserve ratio from 5% to 10% and the bank system completely adjusts to this change, M1 would _____.

- decrease by \$20,000 b.
- increase by \$20,000 b.
- increase by \$40,000 b.
- none of the above.

15) **Start with the base case balance sheet and the 5% reserve ratio.** If people decide to hold \$2 billion less as cash outside of the bank and hold \$2 billion more as demand deposits, after the banking system fully adjusts to the change, M1 would _____.

- not change.
- increase by \$2 billion.
- increase by \$40 billion.
- none of the above.

16) Suppose that the Federal Reserve decides that it wants to lower interest rates. Which of the following combination of policies would all support the Fed's goals?

- a. The Fed sells government securities and lowers the discount rate.
- b. The Fed sells government securities and raises the discount rate.
- c. The Fed buys government securities and raises the required reserve ratio.
- d. The Fed buys government securities and lowers the required reserve ratio.

17) In early U.S. history, there was a bimetallic standard where both gold and silver coins circulated and there was a political movement to switch to a system relying on a single metal (gold). A popular movie that reflects many of the issues raised in this debate is:

- a. The Wizard of Oz.
- b. The Color of Money.
- c. The Treasure of the Sierra Madre.
- d. Goldfinger.

18) Suppose that there is a bi-metallic standard. A one dollar gold coin contains 20 grains of gold and a one dollar silver coin contains 100 grains of silver. If the free market price of one grain of gold is four times as high as that for one grain of silver, we should expect that:

- a. gold coins will circulate as money and silver coins will be melted.
- b. silver coins will circulate as money and gold coins will be melted.
- c. neither silver or gold coins will circulate as money; both will be melted.
- d. both silver and gold coins will circulate as money; neither will be melted.

19) Suppose that a one year bond has a coupon rate of 8% and a maturity value of \$1000. If the bond is purchased today for \$1020, its yield if held to maturity would be:

- a. 5.9%
- b. 7.8%
- c. 8.1%
- d. 8.4%

20) Suppose that a 5 year zero coupon bond with a maturity value of \$1000 sells for \$800 today. What is the yield on this bond?

- a. 8.2%
- b. 5.7%
- c. 5.0%
- d. 4.6%

21) Suppose that the yield curve is currently upward sloping. This implies that:

- a. interest rates are higher on short term than long term bonds
- b. interest rates are higher on long term than short term bonds
- c. interest rates are higher on corporate than government bonds.
- d. interest rates are higher on government than corporate bonds.

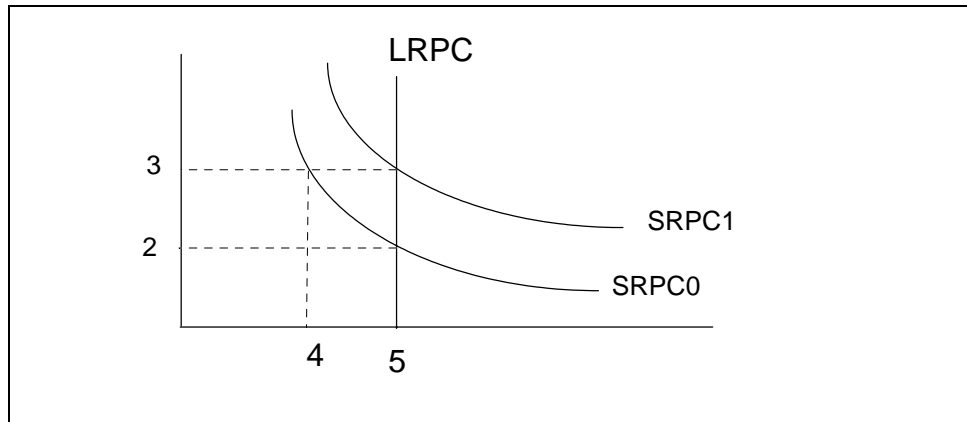
22) An "inverted yield curve" :

- a. occurs when financial markets believe short term interest rates will fall in the future.
- b. occurs when interest rates on short term bonds are higher than those on long term bonds.
- c. has frequently preceded the onset of a recession.
- d. all of the above.

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- 23) Other things being the same, the yield on a municipal bond tends to be:
- higher than that on a federal government bond, partly because the interest on municipal bonds is exempt from federal taxes.
 - lower than that on a federal government bond, partly because the interest on municipal bonds is exempt from federal taxes.
 - higher than that on a federal government bond, partly because the interest on municipal bonds is not exempt from federal taxes.
 - lower than that on a federal government bond, partly because the interest on municipal bonds is not exempt from federal taxes.
- 24) According to the equation of exchange, if the money supply grows at 4% per year and velocity is constant, inflation will be:
- 4% per year regardless of whether real GDP is rising or falling.
 - more than 4% per year if real GDP is growing
 - more than 4% per year if real GDP is falling.
 - none of the above
- 25) During a hyperinflation,
- the velocity of money tends to fall because workers do not want to spend money quickly.
 - the inflation rate often exceeds the rate of growth in the money supply.
 - there is often a "flight to money" because barter becomes less attractive.
 - all of the above.
- 26) According to the article posted on the web about hyperinflation,
- hyperinflation usually results from government attempts to finance operations without raising taxes.
 - some Latin American countries experienced "dollarization" during the hyperinflation of the 1970s and 1980s, where citizens attempted to convert the domestic currency into dollars.
 - during the hyperinflation that occurred in Germany, workers were paid as often as twice per day.
 - all of the above.
- 27) If inflation is well below what everyone expects,
- lenders will win and borrowers will lose.
 - real wages will rise and unemployment will fall.
 - real wages will fall and unemployment will rise.
 - both a and b.
 - both a and c.
- 28) If there is inflation but everyone anticipates the inflation ,
- all markets adjust and there are no gains or losses caused by the inflation.
 - borrowers will win and lenders will lose.
 - shoe leather and menu costs would still result.
 - both b and c.

- 29) Suppose there is 10% inflation in the economy and your nominal income rises by 10%.
- If there is nonindexed progressive income tax system, your taxes will rise by more than 10%.
 - If there is an indexed progressive income tax system, your taxes will rise by more than 10%.
 - If there is a proportional income tax system, your taxes will rise by more than 10%.
 - If there is a proportional income tax system, your taxes will rise by less than 10%.

To answer the next 2 questions, consider the short run (SRPC) and long run (LRPC) Phillips curves drawn below.



- 30) If the current short run Phillips curve is SRPC1 and the long run Phillips curve is as depicted, the natural rate of unemployment must be ____ and the expected rate of inflation must be ____.
- 5; 3
 - 3; 5
 - 4; 3
 - none of the above.
- 31) Suppose the current short run Phillips curve is SRPC1 and inflation is originally 3 percent. If the Federal Reserve pursues policies that reduce inflation to 1 percent,
- real wages will fall and unemployment will fall because nominal wages will rise less than the inflation rate.
 - real wages will rise and unemployment will fall because nominal wages will rise less than the inflation rate.
 - real wages will fall and unemployment will rise because nominal wages will rise more than the inflation rate.
 - real wages will rise and unemployment will rise because nominal wages will rise more than the inflation rate.
- 32) Which of the following would move the economy upward and to the left along its short run Phillips curve?
- an increase in aggregate demand.
 - a decrease in aggregate demand.
 - an increase in short run aggregate supply.
 - a decrease in short run aggregate supply.
- 33) Which of the following would shift an economy's short run Phillips curve upward and to the right?
- an increase in expected inflation.
 - a decrease in expected inflation.
 - an increase in future expected unemployment rates.
 - a decrease in future expected unemployment rates.

34) Suppose that inflation expectations are currently 3% per year for the foreseeable future. If there is news that leads financial markets to believe that inflation will fall to 1% per year, we should expect to see real interest rates _____ and nominal interest rates _____.

- a. not change; fall. b. fall; fall. c. fall; not change. d. none of the above.

35) Suppose that everyone currently believes that inflation will be 3% forever. Tomorrow, a new chair is appointed to the Federal Reserve and it is believed that she will allow inflation to gradually rise over time. If the yield curve is currently upward sloping, this news should cause:

- a. the yield curve to steepen and the short run Phillips curve to shift to the right.
b. the yield curve to flatten and the short run Phillips curve to shift to the right.
c. the yield curve to steepen and the short run Phillips curve to shift to the left.
d. the yield curve to flatten and the short run Phillips curve to shift to the left.

36) Suppose that you have the choice between two bonds that both mature in 10 years. Both are selling at par. The first is a nonindexed bond that has a coupon rate of 6% and the second is an indexed bond that has a coupon rate of 4%. Based on this information, you should prefer:

- a. the nonindexed bond if and only if inflation is expected to be greater than 2%.
b. the nonindexed bond if and only if inflation is expected to be greater than 10%.
c. the nonindexed bond if and only if inflation is expected to be less than 2%.
d. the nonindexed bond if and only if inflation is expected to be less than 10%.

Form 1	Answer	Form 2	Form 3
1	d	d	a
2	d	a	d
3	d	a	a
4	d	c	d
5	a	d	a
6	d	d	d
7	c	d	b
8	a	d	a
9	d	d	d
10	d	a	b
11	a	a	a
12	b	d	b
13	b	d	d
14	a	a	a
15	d	b	a
16	d	d	c
17	a	c	d
18	a	b	d
19	a	a	d
20	d	c	d
21	b	d	c
22	d	b	b
23	b	a	d
24	c	d	b
25	b	b	c
26	d	d	a
27	a	a	c
28	c	d	a
29	a	a	d
30	a	a	a
31	d	c	d
32	a	a	a
33	a	a	d
34	a	d	a
35	a	a	a
36	c	a	a