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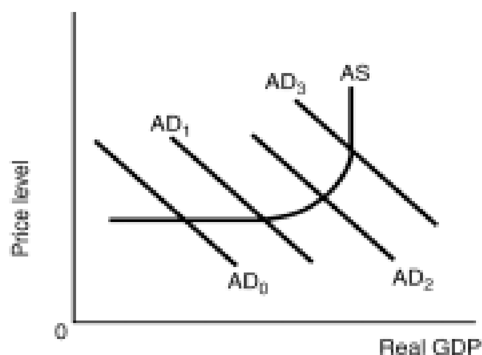
Economics 152
Solution to Sample Midterm 2

PART 1 (84 POINTS): Answer the following 28 multiple choice questions on the scan sheet. Each question is worth 3 points.

1. If Congress passes legislation to make a substantial increase in government spending to counter the effects of a severe recession, this would be an example of a
A) supply-side fiscal policy.
B) contractionary fiscal policy.
C) expansionary monetary policy.
D) expansionary fiscal policy.

2. Which combination of policies would be the most expansionary?
A) an increase in government spending and a decrease in taxes.
B) a decrease in government spending and an increase in taxes.
C) an increase in government spending and an increase in taxes.
D) a decrease in government spending and a decrease in taxes.

Use the following diagram to answer questions 3 – 6:



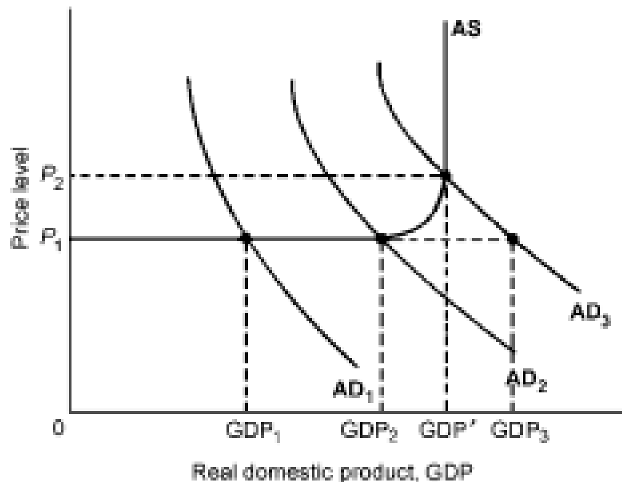
3. Refer to the above diagram. A contractionary fiscal policy would be most appropriate if the economy's present aggregate demand curve were at:
A) AD_0 B) AD_1 C) AD_2 D) AD_3

4. Refer to the above diagram. An expansionary fiscal policy would be most appropriate if the economy's present aggregate demand curve were at:
A) AD_0 B) AD_1 C) AD_2 D) AD_3

5. Refer to the above diagram. If the economy's present aggregate demand curve is AD_2:
A) the most appropriate fiscal policy is an increase in government expenditures or a reduction of taxes.
B) the most appropriate fiscal policy is a reduction in government expenditures or an increase of taxes.
C) the most appropriate fiscal policy is a reduction in government expenditures or an increase in transfer payments.
D) the most appropriate fiscal policy depends upon the level of output relative to the full-employment level of output.

6. Refer to the above diagram. Assume that the initial aggregate demand curve is AD_1 and the government undertakes a fiscal policy which shifts the aggregate demand curve to AD_2. If the horizontal distance between AD_1 and AD_2 is $100 billion, the change in real GDP in this situation:
A) would be less than $100 billion.
B) would be $100 billion.
C) would be more than $100 billion.
D) cannot be measured without knowing the size of the economy's multiplier.

Use the following diagram to answer questions 7 and 8:



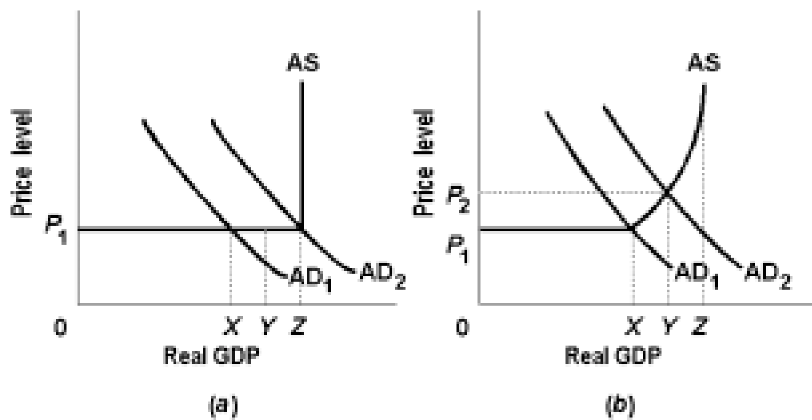
7. Refer to the above diagram. The full-strength multiplier is represented by a shift in aggregate demand from:
A) AD_2 to AD_1 and a decline in real output from GDP_2 to GDP_1.
B) AD_2 to AD_3 and an increase in real output from GDP_2 to GDP'.
C) AD_1 to AD_3 and an increase in real output from GDP_1 to GDP'.
D) AD_3 to AD_2 and a decrease in real output from GDP' to GDP_2.

8. Refer to the above diagram. Over the GDP_2 to GDP' range of real output, increases in aggregate demand produce price-level increases which:
A) increase the size of the multiplier.
B) represent cost-push inflation.
C) reduce the size of the multiplier.
D) result in a multiplier of zero.

9. The effect of an expansionary fiscal policy on the real GDP of an economy operating in the horizontal range of the aggregate supply curve is partially or fully
A) reinforced by the crowding-out effect.
B) offset by the crowding-out effect.
C) reinforced by raising tax rates.
D) offset by lowering tax rates.

10. Supply-side fiscal policy is generally enacted through
A) a decrease in tax rates.
B) a decrease in investment spending.
C) an increase in government spending.
D) an increase in automatic stabilizers.

Use the following to answer questions 11 and 12:



11. Refer to the above diagrams. Suppose that government undertakes a fiscal policy action designed to increase aggregate demand from AD_1 to AD_2 and thereby to increase GDP from *X* to *Z*. In terms of graph *a*, which of the following might explain why GDP increases to *Y* rather than to *Z* ?
A) inflation. B) an increase in stock prices. C) a net export effect. D) a ratchet effect.

12. Refer to the above diagrams. A second correct answer to the previous question would be:
A) a depreciation of the dollar.
B) an increase in net exports.
C) a decrease in the saving schedule.
D) a crowding-out effect.

13. An expansionary U.S. fiscal policy which drives up U.S. interest rates is most likely to:
A) decrease the foreign demand for dollars and appreciate the international value of the dollar.
B) decrease the foreign demand for dollars and depreciate the international value of the dollar.
C) increase the foreign demand for dollars and appreciate the international value of the dollar.
D) increase the foreign demand for dollars and depreciate the international value of the dollar.

14. If you are estimating your total expenses for school next semester, you are using money primarily as:
A) a medium of exchange. B) a store of value. C) a unit of account. D) a measure of asset demand.

15. The major component of the money supply (*M*1) is:
A) money market mutual funds. B) checkable deposits. C) paper money in circulation. D) coins.

16. Which of the following is *not* part of the *M*2 money supply?
A) money market mutual funds.
B) money market deposit accounts.
C) currency.
D) large ($100,000 or more) time deposits.

17. Which of the following statements is correct? Other things equal:
A) a decline in real output will shift both the transactions demand curve for money and the total money demand curve to the right.
B) a decline in the interest rate will shift the asset demand curve for money to the right, but leave the total money demand curve unchanged.
C) deflation will shift both the transactions demand curve for money and the total money demand curve to the left.
D) inflation will shift the transactions demand curve for money to the right, but leave the total money demand curve unchanged.

18. The basic policy-making body in the U.S. banking system is:
A) the Open Market Committee.
B) the Board of Governors of the Federal Reserve.
C) the Federal Advisory Council.
D) the Council of Economic Advisers.

19. To say that the Federal Reserve Banks are "quasi-public" banks means that:
A) they are privately owned, but managed in the public interest.
B) they deal only with banks of foreign nations and do not have direct business contact with American banks.
C) they deal only with commercial banks, and not the public.
D) they are publicly owned, but privately managed.

20. Suppose the demand for money and the supply of money increase simultaneously. We can:
A) expect the interest rate to rise and bond prices to fall.
B) expect the interest rate to fall and bond prices to rise.
C) the nominal GDP to expand.
D) not predict what will happen to interest rates or bond prices.

21. Other things equal, if there is an increase in nominal GDP:
A) the demand for money will decrease.
B) the interest rate will rise.
C) bond prices will rise.
D) consumption spending will fall.

22. Other things equal, if the supply of money is reduced:
A) the demand for money will increase.
B) the interest rates will fall.
C) bond prices will fall.
D) investment spending will increase.

23. If in the money market the quantity of money demanded exceeds the money supplied, the interest rate will:
A) fall, causing household and businesses to hold less money.
B) rise, causing households and businesses to hold less money.
C) rise, causing households and businesses to hold more money.
D) fall, causing households and businesses to hold more money.

24. An increase in the reserve ratio:
A) increases the size of the spending income multiplier.
B) increases the size of the money multiplier.
C) decreases the size of the spending income multiplier.
D) decreases the size of the money multiplier.

25. The basic reason why the commercial banking system can increase its demand deposits by a multiple of its excess reserves is that:
A) the banking system must keep reserves equal to 100 percent of its demand-deposit liabilities.
B) the MPC of borrowers is greater than zero, but less than 1.
C) the central banks follow policies that prevent reserves from falling below a certain required level.
D) reserves lost by any particular bank will be gained by some other bank.

26. When the money market is in equilibrium:
A) the quantity of money demanded equals the quantity of money supplied.
B) the interest rate is neither increasing nor decreasing.
C) the bond market is in equilibrium.
D) all of the above are true.

27. If actual reserves in the banking system are $40,000, excess reserves are $10,000 and demand deposits are $240,000, then the reserve ratio is:
A) 10.5 percent.
B) 11.5 percent.
C) 12.5 percent.
D) 13.5 percent.

28. If actual reserves in the banking system are $50,000, excess reserves are $5,000 and demand deposits are $225,000, then the money multiplier is:
A) 10
B) 4
C) 5
D) 8

<u>PART 2 (6 POINTS)</u>: Answer the following 2 questions. Each question is worth 3 points.

Use the table below to answer the questions:

Interest rate (in %)	**Asset demand (billions)**
14	$200
13	300
12	400
11	500

1. If the transactions demand for money equals 10% of nominal GDP, the nominal GDP is $5,000 billion (bn) and the supply of money is $900 billion (bn) what is the equilibrium interest rate?

$D_t = 10\ \%$ of $5000 = \$\ 500$ bn

$D_m = S_m$

$D_t + D_a = S_m$

$500 + D_a = 900$

$D_a = \$\ 400$ bn

Hence the equilibrium interest rate = 12 %

2. If nominal GDP remains constant, and transactions demand is still 10% of nominal GDP, but the money supply is decreased from $900 to $800 billion, what will the equilibrium rate of interest be?

$D_m = S_m$

$D_t + D_a = S_m$

$500 + D_a = 800$

$D_a = \$\ 300$ bn

Hence the equilibrium interest rate = 13%

PART 3 (10 POINTS): **Answer the following 2 questions. Each question is worth 5 points.**

1. Suppose the economy is in a recession and the government wants to conduct an expansionary fiscal policy. (Assume that the government has a budget deficit, so that to finance its expenditures, it needs to borrow from the money market). Critics' of such a policy say that fiscal policy would not be effective because of "crowding out". Answer the following two questions. **Illustrate your answers by using graphs**. (Please write legibly).

(a) Explain what is crowding out.

Crowding out is a phenomena associated with an expansionary fiscal policy (an increase in G) in the presence of a budget deficit. In order to finance its increased expenditures, the government would need to borrow money from the money market. This would raise interest rates and reduce interest sensitive investment and consumption, especially investment. This would cause the AD curve to shift to the right but not by the full extent that it would have. Thus, the effectiveness of an expansionary fiscal policy is reduced. **To illustrate the above idea please use the three graphs that we went over in class – i.e. use the graphs related to the money market, the investment market and the product/goods market.**

(b) What is your reaction to the critics' skepticism about fiscal policy and crowding out?

In order to defend fiscal policy and as a reaction to the critics' skepticism about fiscal policy, one could argue that the Federal Reserve (Fed) could intervene in the money market and expand the money supply keeping interest rates constant and thereby not affecting investment. In this situation an expansionary fiscal policy (an increase in G) would have its desired effect on output and employment. This is called an "monetizing the debt" or an accomodating monetary policy. **Again to illustrate this idea please use the three graphs that I have referred to in the answer above.**

Please note that fiscal and monetary policies are undertaken by different agents – the former by Congress and the latter by the Fed. This is an example that although fiscal and monetary policies are different, the Congress and the Fed interact closely to stabilize the economy and promote economic growth.

Answer Key – Midterm2_01S

1. D
2. A
3. D
4. A
5. D
6. A
7. A
8. C
9. B
10. A
11. C
12. D
13. C
14. C
15. B
16. D
17. C
18. B
19. A
20. D
21. B
22. C
23. B
24. D
25. D
26. D
27. C
28. C