

ECON 2103 Winter 2014
Multiple-Choice Questions with Answers

1. According to the sticky-price model, output will be at the natural level if:
 - A) firms expect a high price level and the demand for goods is high.
 - B) the proportion of firms with flexible prices equals the proportion of firms with sticky prices.
 - C) the price level equals the expected price level.
 - D) expectations are formed adaptively, but not if expectations are formed rationally.

2. The basic aggregate supply equation implies that output exceeds natural output when the price level is:
 - A) low.
 - B) high.
 - C) less than the expected price level.
 - D) greater than the expected price level.

3. According to the Phillips curve, other things being equal, inflation depends positively on *all* of the following *except*:
 - A) expected inflation.
 - B) the unemployment rate.
 - C) the natural unemployment rate.
 - D) a supply shock, if one occurs.

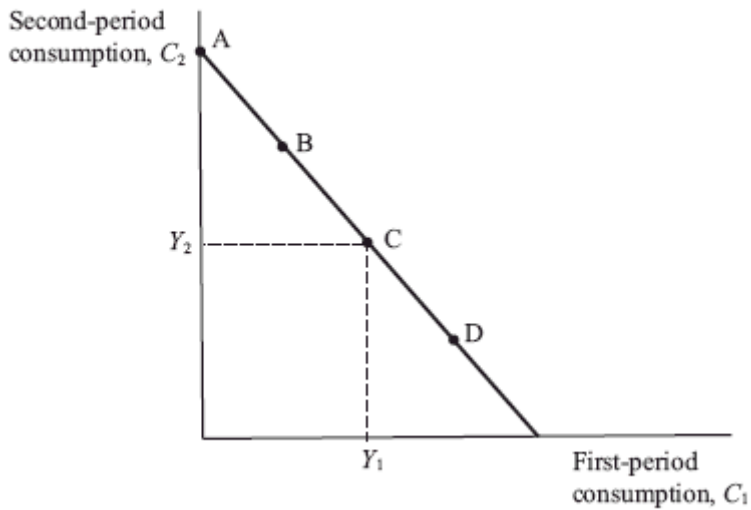
4. The Phillips curve shows a _____ relationship between inflation and unemployment, and the short-run aggregate supply curve shows a _____ relationship between the price level and output.
 - A) positive; positive
 - B) positive; negative
 - C) negative; negative
 - D) negative; positive

5. The rational-expectations point of view, in the most extreme case, holds that if policymakers are credibly committed to reducing inflation, and rational people understand that commitment and quickly lower their inflation expectations, then the sacrifice ratio will be approximately:
 - A) 5.
 - B) 2.8.
 - C) 1.
 - D) 0.

6. Assume that the sacrifice ratio for an economy is 4. If the central bank wishes to reduce inflation from 10 percent to 5 percent, this will cost the economy _____ percent of one year's GDP.
- A) 4
 - B) 5
 - C) 20
 - D) 40
7. If an example of a Keynesian consumption function is $C = 2,000 + 0.8Y$, and Y is 30,000, then the average propensity to consume is about:
- A) 0.8.
 - B) 0.82.
 - C) 0.85.
 - D) 0.87.
8. The Keynesian consumption function exhibits *all* of the following properties *except* that:
- A) the marginal propensity to consume is between zero and one.
 - B) the average propensity to consume decreases as income increases.
 - C) only unexpected policy changes influence consumption.
 - D) current income is the primary determinant of consumption.
9. In Irving Fisher's two-period consumption model, if $Y_1 = 20,000$, $Y_2 = 15,000$, and the interest rate r is 0.50 (50 percent), then the maximum possible consumption in period one is:
- A) 20,000.
 - B) 25,000.
 - C) 30,000.
 - D) 35,000.
10. A consumer's budget constraint for two periods with positive interest rate r may be represented by the equation:
- A) $C_1 + C_2 = Y_1 + Y_2$.
 - B) $C_1 + C_2/(1 + r) = Y_1 + Y_2/(1 + r)$.
 - C) $C_1 + C_2(1 + r) = Y_1 + Y_2(1 + r)$.
 - D) $C_1/(1 + r) + C_2 = Y_1/(1 + r) + Y_2$.

Use the following to answer question 11:

Exhibit: Budget Constraint



11. (Exhibit: Budget Constraint) Based on the graph, if Y_1 and Y_2 represent income in period one and period two, respectively, at which point along the budget constraint would a consumer be a borrower in period one?
- A) A
 - B) B
 - C) C
 - D) D
12. In the Fisher two-period model, the consumer achieves his or her optimum combination of current and future consumption by selecting:
- A) any combination on his or her highest indifference curve.
 - B) the combination on his or her highest indifference curve that is tangent to his or her budget constraint.
 - C) any combination on his or her budget constraint.
 - D) the combination on his or her budget constraint where period-one consumption equals period-one income and period-two consumption equals period-two income.
13. The Fisher two-period model shows that current consumption depends on:
- A) only current income.
 - B) only future income.
 - C) current income, future income, and the interest rate.
 - D) current income, future income, the interest rate, and the rate of inflation.

14. In Irving Fisher's two-period model, if the consumer is initially borrowing in period one and the real interest rate rises, first-period consumption will:
- A) certainly rise.
 - B) certainly fall.
 - C) remain constant.
 - D) either rise or fall.
15. The life-cycle model assumes that consumers use saving and borrowing to _____ consumption over their life cycle.
- A) increase
 - B) decrease
 - C) smooth
 - D) vary
16. According to Modigliani's life-cycle hypothesis, if a consumer wants equal consumption in every year, and the interest rate is zero, there are 40 years until retirement, and 60 years of life remaining, then the marginal propensity to consume out of income equals:
- A) 0.016.
 - B) 0.40.
 - C) 0.60.
 - D) 0.67.
17. Milton Friedman argued that, on average, consumption is:
- A) proportional to income.
 - B) a fraction of permanent income that rises as permanent income rises.
 - C) a fraction of permanent income that falls as permanent income falls.
 - D) proportional to permanent income.
18. According to the permanent-income hypothesis, households will finance a temporary increase in taxes by reducing _____ or increasing _____.
- A) consumption; saving
 - B) saving; borrowing
 - C) permanent income; transitory income
 - D) transitory income; permanent income

19. 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:
- A) \$5,000.
 - B) \$45,000.
 - C) \$49,500.
 - D) \$55,000.
20. If consumers obey the permanent-income hypothesis and have rational expectations, then _____ policy changes influence consumption.
- A) only unexpected
 - B) only expected
 - C) both expected and unexpected
 - D) neither expected nor unexpected
21. If firms are earning a profit, then this raises the _____ value of installed capital and implies a _____ value of Tobin's q .
- A) market; low
 - B) market; high
 - C) replacement; low
 - D) replacement; high
22. Holding other factors constant, the decline in aggregate income during a recession will _____ the price of housing and _____ the flow of residential housing investment.
- A) increase; increase
 - B) increase; decrease
 - C) decrease; increase
 - D) decrease; decrease
23. In the mortgage market, a rise in the real interest rate:
- A) lowers housing demand, housing prices, and residential investment.
 - B) raises housing demand, housing prices, and residential investment.
 - C) lowers housing demand and residential investment but raises housing prices.
 - D) raises housing demand but lowers housing prices and residential investment.
24. Inventory investment, at least in theory, should:
- A) rise when the real interest rate rises, other things being equal.
 - B) not depend on the real interest rate, other things being equal.
 - C) fall when the real interest rate rises, other things being equal.
 - D) depend only on the change in real GDP.

25. According to the neoclassical model of investment, when the real interest rate increases, business fixed investment _____ because the _____ of capital increases.
- A) increases; marginal product
 - B) increases; cost of
 - C) decreases; marginal product
 - D) decreases; cost of

Answer Key

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