MACROECONOMIC THEORY I
ECO2142 C
Fall 2016
prof. Francesca Rondina

Practice Questions for the Final Exam - 1

1. Consider the $AD - AS$ model of the economy where the $SRAS$ is: $Y = \overline{Y} + \alpha[P - E(P)]$, with $\alpha > 0$. In this model stagflation - a period of rising unemployment coupled with rising prices - could most easily result from:

   (a) an increase in the money supply.
   (b) a decrease in government spending.
   (c) an adverse supply shock.
   (d) a positive supply shock.

2. Consider the $AD - AS$ model of the economy where the $SRAS$ is: $Y = \overline{Y} + \alpha[P - E(P)]$, with $\alpha > 0$. Suppose that the economy is affected by an adverse supply shock. If the central bank wants to stabilize output, it should:

   (a) decrease the money supply.
   (b) increase the money supply.
   (c) increase taxes.
   (d) increase government spending.

3. Consider the $AD - AS$ model of the economy where the $SRAS$ is: $Y = \overline{Y} + \alpha[P - E(P)]$, with $\alpha > 0$. Assume that because of a tax incentive, the quantity of investment demanded at each level of the real interest rate increases. If the central bank of this country wants to prevent inflation, it should:

   (a) decrease the money supply.
   (b) increase the money supply.
   (c) decrease government spending.
   (d) increase government spending.

4. Suppose the price level falls but suppliers only notice that the price of their particular product has fallen. Thinking there has been a fall in the relative price of their product, they cut back on production. This is a demonstration of the

   (a) imperfect information theory of the short-run aggregate supply curve.
   (b) classical dichotomy theory of the short-run aggregate supply curve.
   (c) sticky-price theory of the short-run aggregate supply curve.
   (d) flexible price theory of the short-run aggregate supply curve.

5. In the sticky price theory, if $P = \$120$, $E(P) = \$100$, $E(Y) = E(\overline{Y})$, and $(Y - \overline{Y}) = \$50$, the price set by firms with sticky prices

   (a) will depend on the fraction of firms with sticky prices.
   (b) is \$100.
   (c) is \$120.
   (d) is \$150.

6. Assume that the sticky price theory holds. If the $SRAS$ is $Y = \overline{Y} + 2[P - E(P)]$ and the fraction of firms with sticky prices is 0.2, then the price set by firms with flexible prices is

   (a) $p_f = P + 0.5(Y - \overline{Y})$
   (b) $p_f = P + 0.8(Y - \overline{Y})$
   (c) $p_f = P + 0.125(Y - \overline{Y})$
   (d) $p_f = 0.8E(P)$

7. Consider the following model of the Phillips curve: $\pi = E(\pi) - 0.25(u - u^n) + v$. Assume that a fraction γ of the agents form expectations rationally, while the rest form expectations according to an adaptive scheme. This implies that we can write $E(\pi) = \gamma\pi + (1 - \gamma)\pi_{-1}$, where π_{-1} is inflation in the previous period. Which of the following statements about this Phillips curve is NOT correct?

   (a) If the fraction of agents with rational expectations γ increases, changes in cyclical unemployment will have a larger impact on the inflation rate.
   (b) This Phillips curve can be rewritten as: $\pi = \pi_{-1} - [0.25/(1 - \gamma)](u - u^n) + [1/(1 - \gamma)]v$
   (c) The fraction of agents with rational expectations γ will not affect the tradeoff between inflation and unemployment.
   (d) If the fraction of agents with rational expectations γ increases, supply shocks will have a larger impact on the inflation rate.

8. According to the Phillips curve model, the inflation rate π will increase when

   (a) cyclical unemployment is positive, and the tradeoff between inflation and unemployment becomes more negative.
   (b) the economy is hit by a beneficial supply shock ($v < 0$).
   (c) cyclical unemployment increases.
   (d) expected inflation increases.

9. Consider the $AD - AS$ model of the economy with an upward sloping $SRAS$, and assume that the economy is initially in the long-run equilibrium. Suppose there is an increase in military spending due to rising international tensions (military spending is a form of government spending). What will happen to output and prices in the long run?

   (a) Output will be higher than before the increase in military spending, but prices will be the same as before.
   (b) Both output and prices will be the same as before the increase in military spending.

(c) Output will be the same as before the increase in military spending, but prices will be lower than before.

(d) Output will be the same as before the increase in military spending, but prices will be higher than before.

10. Consider the following expression for the marginal rate of substitution: $MRS = Y_2/(C_1 - Y_1)$, and assume that the consumer doesn't have any borrowing constraints. This MRS implies that at the optimal consumption combination:

(a) the consumer will consume only in the second period, i.e. $C_1 = 0$.

(b) the consumer will consume only in the first period, i.e. $C_2 = 0$.

(c) C_1 will be larger than Y_1 if $Y_2 > 0$.

(d) C_1 will always be equal to C_2.

11. In the two-period intertemporal consumption model, $MRS = C_2/(4C_1)$, $r = 5\%$, $Y_1 = 50$ and $Y_2 = 105$. Given this information, the optimal consumption combination for this consumer

(a) is $C_1 = 50$ and $C_2 = 100$.

(b) is $C_1 = 30$ and $C_2 = 120$.

(c) is $C_1 = 30$ and $C_2 = 126$.

(d) will depend on whether he/she has a borrowing constraint.

12. If Friedman's permanent-income hypothesis is correct, which of the following will you observe?

(a) The average propensity to consume will be constant in the short run and decreasing in the long run.

(b) Consumption will be a function of transitory income only, so it will change when transitory income changes.

(c) The average propensity to consume will be higher for agents with lower ratio of permanent to transitory income.

(d) The average propensity to consume will be higher for agents with higher ratio of permanent to transitory income.

13. The life-cycle hypothesis predicts that consumers will

(a) save during their working years, and consume out of their savings after retirement.

(b) save during their working years and after retirement.

(c) consume all of their income in each period of their life.

(d) borrow during their working years, and repay their loans after retirement.

14. The Phillips curve is an extension of the model of aggregate supply and aggregate demand because, in the short run, an increase in aggregate demand increases prices and

(a) decreases growth of real GDP.

(b) increases output and, according to Okun's law, decreases unemployment.

(c) increases output and, according to Okun's law, increases unemployment.

(d) decreases inflation.

15. In the Phillips curve model, if expected inflation increases while actual inflation does not change

    (a) the Phillips curve will shift upward and cyclical unemployment will increase.
    (b) the Phillips curve will shift downward and cyclical unemployment will decrease.
    (c) the Phillips curve will shift downward but cyclical unemployment will remain unchanged.
    (d) the Phillips curve will not change so cyclical unemployment will remain unchanged.

16. According to the Phillips curve model, if people have rational expectations, a contractionary monetary policy that is announced and is credible could

    (a) reduce inflation with little or no increase in unemployment.
    (b) increase inflation but decrease unemployment by an unusually large amount.
    (c) increase inflation with little or no decrease in unemployment.
    (d) reduce inflation but increase unemployment by an unusually large amount.

17. Economists who argue that policy makers should not try to stabilize the economy make all of the following arguments except which one?

    (a) Since stabilization policy affects the economy with a lag, well-intended policy could be destabilizing.
    (b) Stabilization policy has no effect on the economy in the short run or the long run.
    (c) Since forecasting shocks to the economy is difficult, well-intended policy could be destabilizing.
    (d) Preferences and agents' behavior can change over time, so forecasting the magnitude of the impact of policies might be difficult.

18. Consider the $AD - AS$ model of the economy where the $SRAS$ is: $Y = \overline{Y} + \alpha[P - E(P)]$, with $\alpha > 0$. If the value of α is very small

    (a) the short run level of output will not be much affected by deviations of prices from their expected value, and the $SRAS$ will be very steep.
    (b) the short run level of output will not be much affected by deviations of prices from their expected value, and the $SRAS$ will be horizontal.
    (c) the short run level of output will be very affected by deviations of prices from their expected value, and the $SRAS$ will be very flat.
    (d) the short run level of output will be very affected by deviations of prices from their expected value, and the $SRAS$ will be very steep.

Answers

1. c	6. c	11. c	16. a
2. b	7. c	12. d	17. b
3. a	8. d	13. a	18. a
4. a	9. d	14. b	
5. b	10. b	15. a	