

Midsummer Examinations 2011

Subject	ECONOMICS
Title of Paper	MACROECONOMICS
Time Allowed	Two Hours (2 Hours)

Instructions to candidates

This paper is in two sections. Students should attempt ALL the questions in Section A and ONE in Section B. The maximum mark awarded for Section A is 73.33 marks. The maximum mark awarded for Section B is 33 marks. The maximum mark for the entire paper is 100 (any marks over 100 are disregarded).

SECTION A: Multiple Choice

*All questions should be attempted. Use the answer sheet provided to record the **one** response you believe to be the most appropriate for each question.*

The marking scheme is the following. 3/1.35 marks (this is 3 divided by 1.35) for each right answer, - 1/1.35 marks (this is one negative mark divided by 1.35) for each wrong answer, and Zero mark if no answer is given.

1. Assume net exports are -\$220, consumption is \$5,000, tax revenues are \$1,000, government purchases are \$1,500, and 1997 GDP, calculated by the expenditures approach, is \$8,000. We can conclude that
- private investment was \$1,940.
 - public investment was \$310.
 - private investment was \$320.
 - private investment was \$1,720.

Table 1

An economy produces only two goods, oranges and VCRs. The quantities and prices for the years 1998 and 1999 are shown in the table. The base year is 1998.

	1998		1999	
	Price	Quantity	Price	Quantity
Oranges	\$2	5,000	\$3	4,000
VCRs	\$400	1,000	\$300	2,000

2. Refer to Table 1. The growth rate of real GDP in 1999 was about
 - a. 24 percent.
 - b. 50 percent.
 - c. 97 percent.
 - d. 125 percent.

3. Which item would receive the most weight in the consumer price index?
 - a. salt
 - b. toothpicks
 - c. pencils
 - d. food

4. Substitution bias
 - a. is one factor that causes the CPI to underestimate the inflation rate.
 - b. is caused by the poor quality of many imported products.
 - c. is one of the primary causes of inflation.
 - d. involves consumer behavior that helps explain why the CPI overestimates the inflation rate.

5. When the inflation rate ends up being lower than expected,
 - a. everyone benefits because money is cheaper.
 - b. everyone benefits because prices do not increase.
 - c. lenders of fixed-rate mortgages generally benefit because they will make higher profits than they had calculated.
 - d. borrowers with fixed-rate loans will benefit because their purchasing power will not decline as much.

6. If the capital stock increases faster than employment, then we would expect
 - a. both output and labor productivity to rise.
 - b. output to rise but labor productivity to fall.
 - c. both output and labor productivity to fall.
 - d. output to fall but labor productivity to rise.

7. Countries like South Korea and Singapore have shown tremendous growth rates in recent years because
- of diminishing returns.
 - of the catch-up effect.
 - of lower levels of domestic investment in recent years.
 - they have limited international trade.
8. A singular important link between politics and economics in countries that are attempting to increase their economic growth rates is that
- democracies are more productive than non-democracies.
 - democracies must constantly make difficult budgetary choices.
 - political instability is incompatible with long-term private investment.
 - conservative governments tend to focus development on military industries.
9. The major advantage of mutual funds is that
- they allow people with limited funds to diversify.
 - they encourage households to spend their money on current consumption.
 - fund managers are replaced by household administrators.
 - they always use index funds to limit investor risk.
10. Bonds are preferred to stocks by individual investors who
- need to have immediate access to their money.
 - don't think the business is profitable.
 - prefer a guaranteed lower return to a risky higher return.
 - prefer a risky higher return to a guaranteed lower return.
11. The efficient markets view of the stock market says that new information
- is quickly and completely incorporated into stock prices.
 - is incorporated into stock prices only when discovered by fundamental analysis.
 - causes stock prices to increase.
 - has little impact on stock prices.
12. Jobs that require more costly training generally have
- higher wages.
 - lower employment levels.
 - higher personal risk levels.
 - lower wages.
13. Horizontal equity in taxation refers to the idea that people
- in unequal conditions should be treated differently.
 - in equal conditions should pay equal taxes.
 - should be taxed according to their ability to pay.
 - should receive government benefits according to how much they have been taxed.

14. The irrelevance of monetary changes for real variables is called
- the classical dichotomy.
 - the equation of exchange.
 - monetary neutrality.
 - hyperinflation.
15. Hyperinflation occurs because governments want to _____ spending but they ignore the fact that increasing the money supply will _____.
- decrease, require greater government spending
 - increase, also increase the price level
 - increase, put upward pressure on interest rates
 - decrease, put downward pressure on interest rates
16. A country's balance of international trade is positive when
- exports exceed imports.
 - exports plus investment exceed imports plus domestic saving.
 - imports exceed exports.
 - imports plus domestic saving exceed exports plus investment.
17. Foreign direct investment differs from foreign portfolio investment in that
- direct investments involve stocks and bonds.
 - direct investments can only be made by the International Monetary Fund.
 - direct investments involve physical capital; portfolio investments involve financial capital
 - a government must be involved in direct investment, but portfolio investment can involve private firms.
18. U.K. trade deficits are a sign of
- reduced national savings.
 - reduced production of manufactured goods.
 - an over reliance on the service economy.
 - high rates of unemployment in the U.K. economy.
19. Arbitrage refers to
- simultaneously buying and selling a currency in order to profit from a difference in exchange rates.
 - simultaneously buying and selling a currency in order to change the exchange rate.
 - buying a currency when its price is high and selling it when its price is low.
 - exchanging the domestic currency for a foreign currency.
20. Currently, the U.K. government is running a budget deficit. This means that the
- supply of loanable funds has increased.
 - supply of loanable funds has decreased.
 - real interest rate has fallen.
 - real exchange rate has fallen.

21. Government trade policies
- can eliminate a trade imbalance.
 - often increase a trade deficit.
 - have no real affect on the trade balance.
 - can lower a deficit on current account but not on the capital account.
22. A tariff is a
- tax on goods produced domestically.
 - tax on exported goods.
 - tax on imported goods.
 - limit placed on the quantity of goods that a country can import.
23. In response to an import quota
- exports increase by more than imports.
 - imports increase by more than exports.
 - imports and exports are unaffected, but the government collects revenues.
 - imports and exports are both reduced but net exports are unchanged.
24. Capital flight is often caused by
- political stability.
 - shifts away from the industrial sector and towards the service sector.
 - political instability.
 - policies of the International Monetary Fund.
25. Which of the following will cause stagflation?
- an increase in the money supply
 - an increase in oil prices
 - a decrease in the money supply
 - technical progress
26. The equilibrium interest rate occurs in the money market where the
- quantity of money available is zero.
 - the maximum quantity of funds has been borrowed and loaned.
 - the money supply is equal to the money demand.
 - the quantity of money demanded is zero.
27. In the short-run macro model, an open-market purchase of bonds by the Fed will
- raise the interest rate, reduce spending, and increase output.
 - raise the interest rate, reduce spending, and decrease output.
 - lower the interest rate, reduce spending, and decrease output.
 - lower the interest rate, increase spending, and increase output.

28. The multiplier effect
- tells us that a change in government spending changes equilibrium GDP by more than the change in government spending.
 - works only for increases in investment.
 - is relevant only in situations where the Marginal Propensity to Consume cannot be determined.
 - tells us whether a change in government policy has been effective.
29. Which of the following is not true for the crowding-out effect?
- Government budget deficits increase interest rates, which reduces investment spending.
 - Crowding out reduces the ability of fiscal policy to combat a recession.
 - If the government spends more on education, *ceteris paribus*, households may be forced to spend less on new homes.
 - Crowding out occurs especially when the economy is in a deep recession and people are not spending all the available money.
30. The Phillips curve traces a set of combinations of rates of
- interest and unemployment.
 - real GDP and inflation.
 - real GDP and interest.
 - unemployment and inflation.
31. As prices adjust to a change in economic conditions, the
- aggregate demand curve becomes horizontal.
 - aggregate demand curve becomes vertical.
 - Phillips curve and the aggregate supply curves become vertical.
 - Phillips curve and the aggregate supply curves become horizontal.
32. To bring inflation down, an economy must sacrifice
- real GDP.
 - exports.
 - employment for some people.
 - Both a and c are correct.
33. Stabilization policy is useful because
- there is no reason for society to suffer through the booms and busts of the business cycle.
 - the economy would stabilize itself too quickly without government intervention.
 - there are significant lags due to the nature of the political process.
 - All of the above are correct.

SECTION B

Answer **one and only one** of the questions numbered 34 to 37. The maximum number of marks awarded for this Section is 33.

34. Answer both (a) and (b).

(a) List the three major problems in using the CPI as a measure of the cost of living.

(b) Romeo and Juliet meet Mervin, the banker, to work out the details of a mortgage. They all expect that inflation will be 2 percent over the term of the loan, and they agree on a nominal interest rate of 6 percent. As it turns out, the inflation rate is 5 percent over the term of the loan.

i. What was the expected real interest rate?

ii. What was the actual real interest rate?

iii. Who benefited and who lost because of the unexpected inflation?

35. Answer both part (a) and (b).

(a) Economists agree that increases in the money supply growth rate increases inflation and that inflation is undesirable. So why have there been hyperinflations and how have they ended?

(b) Suppose the Bank of England sells some treasury bonds. Use a graph of the money market to show what this does to the value of money.

36. Answer both part (a) and (b).

(a) How does an import quota differ from an equivalent tariff?

(b) Define each of the symbols and explain the meaning of $M \times V = P \times Y$ and its implications for monetary policy.

37. The model of the market for loanable funds shows that an investment tax credit will cause interest rates to rise and investment to rise. Yet we also suppose that higher interest rates lead to lower investment. How can these two conclusions be reconciled?