THE FLETCHER SCHOOL

TUFTS UNIVERSITY

E212 Macroeconomics
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Sample Questions for Final Test

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For each of the statements and questions below, choose the most suitable answer among A,B,C and D, by circling the relevant letter. Choose only one answer.

1. For given expectations about inflation, the Phillips curve implies,

A. A negative short-run relation between inflation and unemployment
B. A positive short-run relation between inflation and output
C. Both of the above
D. None of the above

2. Consider an economy in which unemployment is higher than the “natural” rate. An expansionary monetary policy, in the form of a cut in nominal interest rates, will result in,

A. A rise in unemployment and a fall in output and inflation in the short run
B. A fall in unemployment and a rise in output and inflation in the short run
C. No change in unemployment and output but a rise in inflation in the short run
D. None of the above

3. Consider an economy in which unemployment is higher than its “natural” rate, and in which the current account deficit is abnormally high. This economy has adopted a system of fixed exchange rates and free capital mobility. The conflict between the objectives of internal and external balance can be addressed in the short-run through,

A. A short run tax increase.
B. A short run reduction in the nominal interest rate.
C. A devaluation of the exchange rate.
D. It cannot be addressed in any of the above ways.

4. Consider an economy in which in the medium run real wages and the "natural" rate of unemployment are determined by the interaction of wage and price setting. The setting of real wages depends positively on productivity and the reservation wage of workers, and negatively on the unemployment rate. Price setting depends positively on nominal wages relative to productivity (unit labor costs) and the market power of firms in imperfectly competitive product markets. In the medium run, an increase in the market power of firms will result in,

A. An increase in real wages and a reduction in the "natural" rate of unemployment.
B. An increase in real wages and an increase in the "natural" rate of unemployment.
C. A reduction in real wages and a reduction in the "natural" rate of unemployment.
D. A reduction in real wages and an increase in the "natural" rate of unemployment.

5. Consider an economy in which nominal wages and prices are determined as follows: Nominal wages are set at the beginning of each period, before prices and inflation have been determined. The setting of nominal wages depends positively and proportionally on expected inflation and productivity and the reservation wage of workers, and negatively on the expected unemployment rate. Expected inflation is equal to inflation in the previous period. Price setting, which takes place after wages have been set, depends positively on nominal wages relative to productivity and the market power of firms in imperfectly competitive product markets. Productivity is a negative function of employment, so when firms increase employment the marginal product of labor declines. A previously unanticipated reduction in interest rates will result,

A. In lower unemployment and higher inflation, because firms will increase employment to meet the higher aggregate demand, and will also increase prices by more than past inflation, to compensate for the higher rise in unit labor costs.
B. In lower unemployment but the same rate of inflation, because firms will increase employment to meet the higher aggregate demand, and will also increase prices by the same rate as past inflation, because wages have increased by the same rate as past inflation.
C. In unchanged unemployment and inflation, as the unemployment rate will remain at its natural rate and inflation will remain equal to past inflation.
D. None of the above.

6. Assume that the central bank lowers interest rates in order to reduce unemployment below its "natural" rate, and continues using this policy is order to keep unemployment at this reduced rate.

A. Inflation will initially rise and then remain constant.
B. Inflation will initially rise and then fall back to its initial level.
C. Inflation will initially rise and keep rising, as long as the unemployment rate remains below its "natural" rate.
D. None of the above.

7. Assume two different economies. In economy 1 the central bank has low credibility, and inflationary expectations are adaptive. Expected inflation is equal to past inflation. In economy 2, the central bank has high credibility, and can affect inflationary expectations through its announcement of its inflation target. Thus, expected inflation is equal to the announced inflation target of the central bank. Both economies are initially at their "natural rate" of unemployment and output, but inflation is higher than the medium run target of their respective central banks. In both economies, central banks announce that they will use monetary policy in order to reduce inflation towards a lower inflation target.

A. Unemployment in both economies will initially rise, and then gradually return to its "natural" rate, as expectations of inflation gradually adapt towards the lower inflation target of the respective central banks.
B. Unemployment in economy 1 will initially rise, and then gradually return to its "natural" rate, as expectations of inflation gradually adapt towards the lower inflation target of the central bank. Unemployment in economy 2 will remain at its natural rate, as inflationary expectations will immediately adapt to the lower inflation target of the central bank.
C. Unemployment will not be affected in either economy, and inflation will immediately fall to the lower central bank target, as expectations will adapt immediately.
D. None of the above.

8. Inflation, in the medium to long run, is equal to,

A. The rate of growth of the money supply.
B. The difference between the rate of growth of the money supply and the rate of growth of output.
C. Both the level and the rate of growth of the money supply.
D. None of the above.

9. Compared with low inflation economies, high inflation economies are characterized by,

A. Higher nominal interest rates because of higher inflation expectations
B. Lower nominal interest rates because of more expansionary monetary policies
C. Lower real interest rates because of higher inflation expectations
D. None of the above

10. The theory of "purchasing power parity" predicts that,

A. The purchasing power of money will be the same in all countries.
B. The real exchange rate of any two countries will tend to the ratio of their labor productivities.
C. The nominal exchange rate of any two currencies will tend to the ratio of the price levels of the home countries of the two currencies.
D. All of the above.

11. A general theory of the long run determination of nominal exchange rates must,

A. Combine purchasing power parity with the monetary approach to the long run determination of price levels.
B. Combine a theory of the long run determination of real exchange rates, based on the determinants of the relative demands and supplies of the goods and services of the countries concerned, with the monetary approach to the long run determination of price levels.
C. Rely exclusively of the factors determining money demands and supplies in the countries concerned.
D. No such general theory exists.

12. In the absence of capital controls, the main disadvantage of fixed exchange rate regimes is that,

A. A country cannot use its own monetary policy to stabilize the economy
B. The risk of a foreign exchange crisis, which may destabilize the economy
C. Both of the above
D. None of the above

13. Longer term bonds by the same borrower involve more risk than shorter term bonds.

A. False. The risk of default is the same, as the borrower is the same.
B. True. Changes in interest rates affect the rate of return of long term bonds more than the rate of return of short term bonds, even if the borrower is the same.
C. Both of the above.
D. None of the above.

14. The factors that affect the risk premium of corporate bonds are,

A. The probability of default.
B. The degree of risk aversion of lenders.
C. Both of the above.
D. None of the above.

15. For commercial banks, higher leverage increases the expected rate of return on capital. On the other hand, higher leverage increases the vulnerability of a bank to systemic risks. Thus,

A. A bank must choose a leverage ratio that will balance the expected returns to capital against the risk of insolvency.
B. Financial authorities must have rules about leverage and monitor the conformity of bank behavior against such rules.
C. Both of the above.
D. None of the above.

16. Assume an economy in which investment depends on the risk adjusted real interest rate. A financial crisis leads to an increase in the risk premium. Hence,

A. Other things equal, a financial crisis will lead to a fall in investment, a decrease in aggregate demand and a recession.
B. Other things equal, a financial crisis will affect the financial sector, but will not affect the real economy, unless the central bank increases its own interest rates.
C. A financial crisis will not affect the risk premium on interest rates.
D. None of the above.

17. The appropriate response of a central bank to a financial crisis is to,

A. Reduce interest rates.
B. Act as a lender of last resort to the financial sector.
C. Both of the above.
D. None of the above.

18. The government budget constraint implies that a solvent government must,

A. Always maintain a balanced budget
B. The present value of future taxes is equal to the present value of primary government expenditure plus the current value of government debt
C. Both of the above
D. None of the above

19. The reductions of post war debt to GDP ratios in the OECD countries until the late 1970s were chiefly due to,

A. High growth rates
B. Low real interest rates
C. Both of the above
D. High primary surpluses

20. The higher vulnerability of less developed economies to sovereign debt crises is the result of,

A. Their low per capita income and their less well developed financial markets
B. The fact that they have to borrow mostly in foreign exchange from international financial markets unlike the more developed economies which borrow in their own currency.
C. The fact that they systematically mismanage their borrowed funds.
D. None of the above.