

Name:

Student # :

Section:

RYERSON UNIVERSITY
Department of Economics

ECN 204 (Section-7)
TERM TEST 2
November, 2004

Instructor: Sharif F. Khan

Time Limit: 50 minutes

Total Pages Including the Cover Sheet: 12

Instructions:

Important! Read the instructions carefully before you start your exam.

Mark your selections for **PART A** on the examination question booklet by circling the right choice in **PENCIL**. If you make changes, be sure to erase completely. Please record your name, student number, and your section of the course on the top of your examination question booklet.

Write your answers for **Part B** and **Part C** in the space provided on the exam question booklet.

Marking Scheme:

Part A [30 marks] TEN multiple-choice questions – 2 marks each

Part B [10 marks] ONE True/ False/Uncertain question.

Part C [10 marks] ONE problem solving question

Notes:

- If doubt exists as to the interpretation of any question, please include a clear statement of any assumptions made in your answer.
- You may use a calculator.
- You are NOT ALLOWED to use any textbooks, notes or other study materials.

Part A

Multiple-Choice Questions

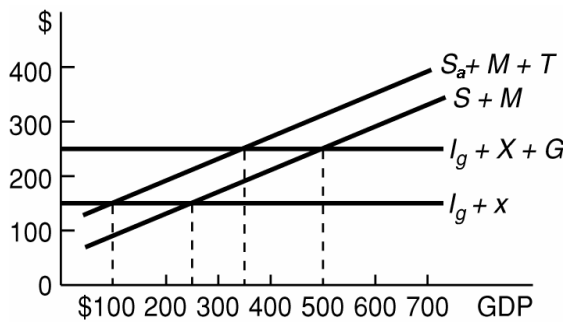
[30 marks]

Each question is worth 2 marks. There is no negative marking for wrong answers. To answer each question correctly, you have to choose (make a circle in PENCIL) the best answer from the given four choices.

1. Suppose government finds it can increase the equilibrium real GDP \$45 billion by increasing government purchases by \$18 billion. On the basis of this information we can say that the:

A) MPS in this economy is .4.
B) MPC in this economy is .4.
C) MPC in this economy is .3
D) multiplier is 3.

Use the following to answer question 2:



2. The equilibrium level of GDP in the above mixed open economy:
A) is \$100.
B) is \$250.
C) is \$350.
D) is \$500.

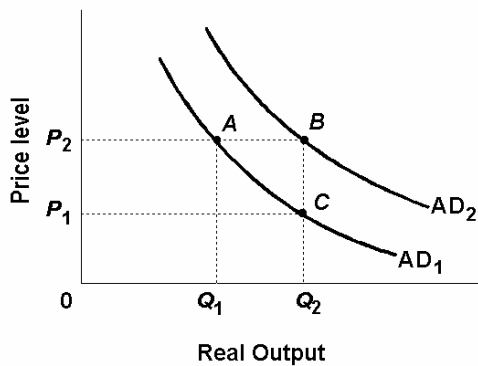
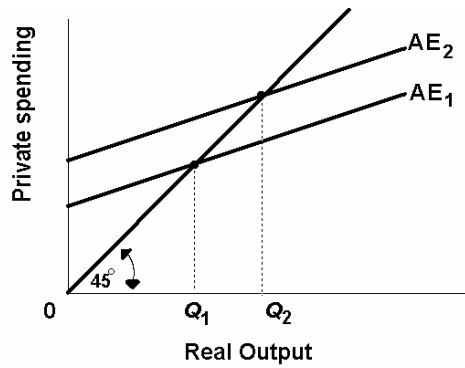
Use the following to answer question 3:

It shows the aggregate demand and aggregate supply schedule for a hypothetical economy.

Real domestic output demanded (in billions)	Price level	Real domestic output supplied (in billions)
\$ 500	350	\$3000
\$1000	300	\$3000
\$1500	250	\$2500
\$2000	200	\$2000
\$2500	150	\$1500
\$3000	150	\$1000

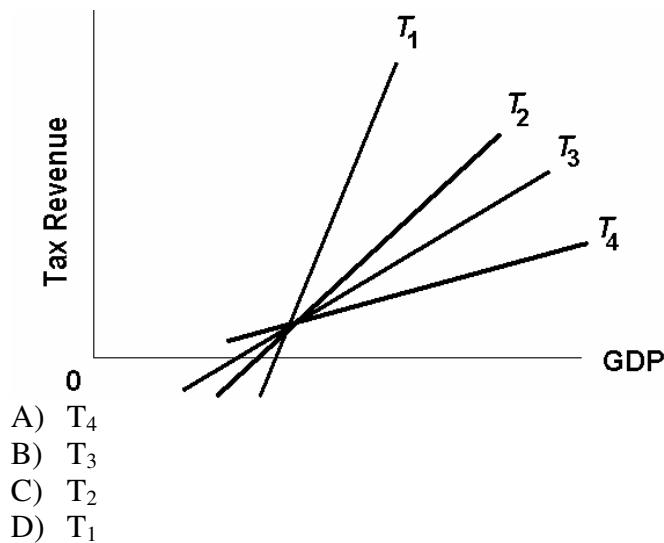
3. Refer to the above table. The equilibrium price level and quantity of real domestic output will be:
- A) 150 and \$1000.
 - B) 150 and \$1500.
 - C) 200 and \$2000.
 - D) 250 and \$2500.
4. Wage contracts, efficiency wages, and the minimum wage are explanations for why:
- A) competition results in price wars.
 - B) wages tend to be inflexible downward.
 - C) the aggregate demand curve slopes downward.
 - D) there is little support for the existence of a real-balances effect.

Use the following to answer question 5:



5. Refer to the above diagrams. Assuming a constant price level, an increase in aggregate expenditures from AE_1 to AE_2 would:
- A) move the economy from A to B along AD_1 .
 - B) move the economy from B to A along AD_1 .
 - C) increase aggregate demand from AD_1 to AD_2 .
 - D) decrease aggregate demand from AD_2 to AD_1 .
6. An appropriate fiscal policy for severe demand-pull inflation is:
- A) an increase in government spending.
 - B) depreciation of the dollar.
 - C) a reduction in interest rates.
 - D) a tax rate increase.

7. Refer to the diagram below. Which tax system will generate the largest cyclical deficits?



8. The "political business cycle" refers to the possibility that:

- A) incumbent politicians will be reelected regardless of the state of the economy.
- B) politicians will manipulate the economy to enhance their chances of being reelected.
- C) there is more inflation during Liberal administrations than during Progressive Conservative administrations.
- D) recessions coincide with election years.

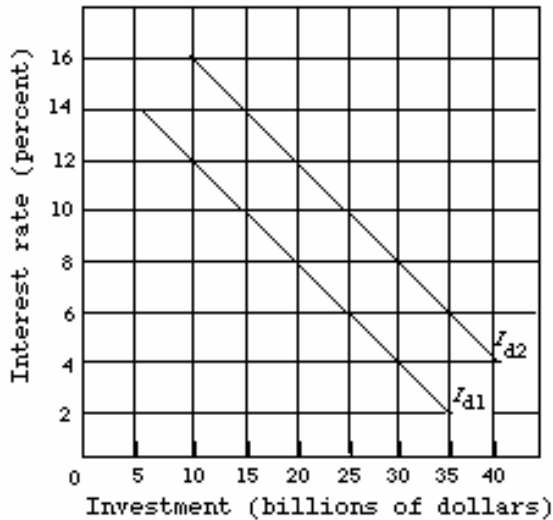
9. Crowding-out is the notion that:

- A) since tax revenues vary directly with GDP, a rise in the level of GDP will increase the budget surplus and limit expansion.
- B) deficit financing will increase the demand for money, increase the interest rate, and reduce the level of investment spending in the economy.
- C) the full-employment budget is the best indicator of whether a budget deficit crowds out investment.
- D) the actual budget is the best indicator of whether a budget deficit crowds out saving.

10. A major criticism of the idea of a cyclically balanced budget is that:

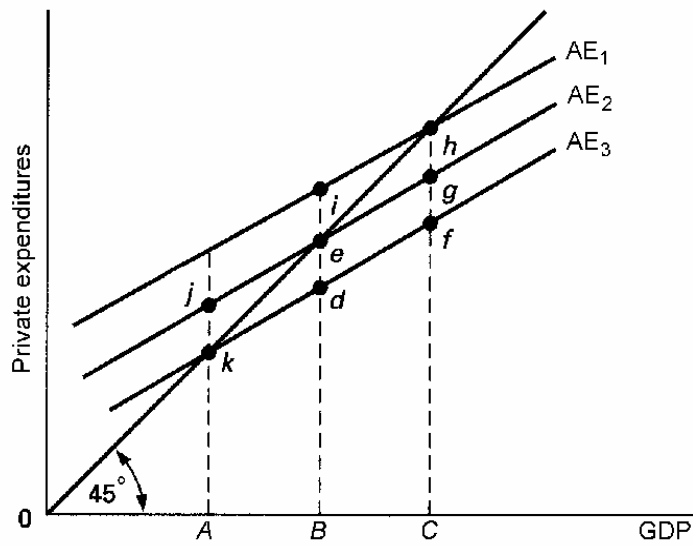
- A) tax revenues automatically fall in recessions, but do not automatically increase in expansions.
- B) automatic (built-in) stabilizers are so effective that discretionary fiscal policy is unnecessary.
- C) such a policy has an inflationary bias.
- D) upswings and downswings of the business cycle are not always of equal magnitude and duration.

Use the following to answer question 11:



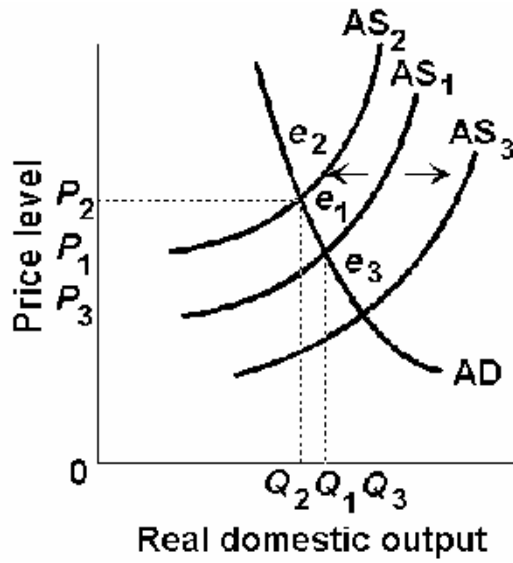
11. Refer to the above diagram. Initially assume that the investment demand curve is I_{d1} . Which of the following effects of a budget deficit might shift the investment demand curve from I_{d1} to I_{d2} , wholly offsetting any crowding-out effect?
- A) an improvement in profit expectations by businesses
 - B) a decrease in saving
 - C) a decline in the interest rate
 - D) an increase in the marginal propensity to consume
12. If government adhered strictly to an annually balanced budget, the government's budget would:
- A) vary in a countercyclical fashion.
 - B) tend to destabilize the economy.
 - C) have no impact upon domestic output and employment.
 - D) tend to stabilize the economy.
13. What function is money serving when you buy a ticket to a movie?
- A) a store of value
 - B) a unit of account
 - C) a transaction demand
 - D) a medium of exchange

Use the following to answer question 14:



14. Refer to the above diagram. If the full-employment level of GDP is B and aggregate expenditures are at AE_2 , the:
- A) inflationary gap is ed .
 - B) recessionary gap is BC .
 - C) inflationary gap is eg .
 - D) economy is in equilibrium, at full employment.

Use the following to answer question 15:



15. Refer to the above diagram. Cost-push inflation can be illustrated by a:
- A) shift in the aggregate supply curve from AS_1 to AS_2 .
 - B) shift in the aggregate supply curve from AS_1 to AS_3 .
 - C) shift in the aggregate supply curve from AS_2 to AS_3 .
 - D) movement along the aggregate demand curve from e_1 to e_3 .

Part B**True/False/Uncertain Questions [10 marks]**

Explain why the following statement is True, False, or Uncertain according to economic principles. Use diagrams and / or numerical examples where appropriate. Unsupported answers will receive no marks. It is the explanation that is important.

B1. A net export effect may partially offset a contractionary fiscal policy.

Part C**Problem Solving Question****[20 marks]**

Answer all parts of the following question.

C-1

Consider the following simple, fixed price, closed economy model of an economy with excess capacity:

$$C = 60 + .6Y_d$$

$$T = 40 + 0.25Y$$

$$I = 60$$

$$G = 70$$

where, C is consumption, Y_d is disposable income, T is taxes (net of transfers), Y is real GDP, I is investment and G is government expenditures on goods and services.

- (a) Solve for aggregate expenditures (AE) as a function of Y , and calculate the equilibrium level of real GDP. Illustrate your equilibrium in a diagram with AE on the vertical and Y on the horizontal axis. What is the value of the multiplier? Is the government running a surplus or deficit? [10 marks]
- (b) What happens to the equilibrium Y in part (a), if the government increases G to 100 as a measure of its expansionary fiscal policy? Find the new equilibrium Y and show it in the diagram. What is the new level of government budget balance? Derive graphically (in a separate graph) the aggregate demand (AD) curve from the AE function and show in the diagram how the AD curve will respond with this increase in G . [10 marks]