SAMPLE EXAM QUESTIONS

Notes:

- Many of these questions are drawn from past Econ 134 exams.

- The instructions accompanying some of the questions take the form, “Decide whether the statement is true, false, or uncertain and explain why. Your explanation determines your grade; you will receive no credit for an answer without an explanation. Use diagrams where appropriate.” This year, I may not use that format, but use more conventional short answer questions instead. For example, in place of asking you to label the statement, “In the short run, an increase in consumer confidence raises the real interest rate, consumption, investment, and real GDP” as true, false, or uncertain (Question 3 on p. 4 below), I might ask something like, “How will an increase in consumer confidence affect the real interest rate, consumption, investment, and real GDP in the short run?” (However, it will remain the case that it is crucial to use diagrams when appropriate, and to always explain your answer.)

- Other places to get sample questions:
  - The problem sets. On Problem Set 1, all the questions except #5 are in the spirit of potential exam questions, although a few of them are harder than what would usually appear on an exam. On Problem Set 2, all the questions except #6 are in the spirit of potential exam questions, although again some of them are on the hard side.
  - The problems in “Short-Run Fluctuations” and “A Non-Technical Introduction to Regressions.” (In “A Non-Technical Introduction to Regressions,” Questions 4, 6, and 7 are harder and/or more technical than anything that would appear on an exam, and Problem 9 is too far afield. The other questions are in the spirit of potential exam questions, although again some of them are harder than what would usually appear on an exam. I will leave it to you to figure out which problems in “Short-Run Fluctuations” are most useful for studying for exams.
  - Exercises and problems that have come up in section, and examples that have come up in lecture.
  - Write yourself problems. Write problems for your friends. Get your friends to write you problems.

- Although I realize that there is infinite demand for sample questions and for answers, sadly, resources are scarce. Thus, I will not also be distributing sample exams, and we will not be posting answers to these questions.
PART I. Questions that were, or could have been, on past midterms and that would have been reasonable for this year’s midterm

A. MULTIPLE CHOICE

Circle the best answer to N of the following N+1 questions. Note:
– If you wish, you may add a brief explanation of your answer to at most one question. In that case, your grade on that question will be based on your answer and explanation together. This means that an explanation can either raise or lower a grade.
– If you answer all N+1 questions, we will only grade the first N.

1. In the IS-MP model, a tax cut:
   a. Increases consumption.
   b. Increases investment.
   c. Increases output.
   d. Increases the real interest rate.
   e. (b) and (d).
   f. (a), (c), and (d).
   g. All of the above.

2. The effect of expansionary fiscal policy on the AD curve drawn accounting for the zero lower bound is to:
   a. Shift the downward-sloping portion of the curve to the right and not shift the upward-sloping portion.
   b. Shift the upward-sloping portion of the curve to the right and not shift the downward-sloping portion.
   c. Shift the two portions of the curve to the right by equal amounts.
   d. Shift both portions of the curve to the right, but shift the downward-sloping portion more than the upward-sloping portion.
   e. Shift both portions of the curve to the right, but shift the upward-sloping portion more than the downward-sloping portion.

3. If the Federal Reserve is targeting the money supply and decides to tighten monetary policy, this would manifest itself as:
   a. An upward shift of the LM curve.
   b. A downward shift of the LM curve.
   c. A leftward shift of the IS curve.
   d. A rightward shift of the IS curve.
   e. Such a decision cannot be captured in the IS-LM model; we must use IS-MP instead.

4. Suppose that initially $Y > \bar{Y}$. As the economy moves to long-run equilibrium:
   a. Inflation rises.
   b. Output falls.
   c. The real interest rate rises.
   d. (a) and (b).
   e. All of the above.
5. In the United from 1933 to 1941, the unemployment rate:
   a. Was fairly steady at around 5%.
   b. Was fairly steady at around 20% until 1939, and then fell rapidly.
   c. Fell rapidly from 1933 to 1937, rose sharply in 1938, and then fell rapidly until 1941.
   d. Rose gradually from 1933 to 1937, then fell rapidly from 1937 to 1941.

6. The Council of Economic Advisers’ “First Quarterly Report on the Economic Impact of the American Recovery and Reinvestment Act of 2009” provides evidence about the effects of the act from all of the following except:
   a. Narrative evidence from newspaper accounts of people’s reactions to the Recovery Act.
   b. Comparisons of actual outcomes with the predictions of a simple statistical forecast.
   c. Estimates from economic models.
   d. Information about stimulus spending and economic outcomes in different countries.
   e. Information about stimulus spending and economic outcomes in different states.

7. In John Taylor’s specification of the interest-rate rule, $i = \pi + gy + h(\pi - \pi^*) + r_f$, a value of $h$ of 0.5 would mean that:
   a. When inflation rises by 1 percentage point, the Federal Reserve lowers its target for the nominal federal funds rate $(i)$ by $1/2$ percentage point.
   b. When inflation rises by 1 percentage point, the Federal Reserve lowers GDP growth by $1/2$ percent.
   c. When inflation rises by 1 percentage point, the Federal Reserve raises its target for the nominal federal funds rate $(i)$ by $1\frac{1}{2}$ percentage points.
   d. When inflation rises by 1 percentage point, the Federal Reserve raises its target for the nominal federal funds rate $(i)$ by $1/2$ percentage point.

8. Most recessions between World War II and the mid-1980s were preceded by:
   a. Federal Reserve decisions to pursue tight monetary policy to combat inflation.
   b. Large tax increases.
   c. Periods of political gridlock leading to inaction on economic issues.
   d. Sharp falls in government purchases of goods and services.

9. In “A Tale of Two Depressions,” Barry Eichengreen and Kevin O’Rourke argue that:
   a. Both the Great Depression and the recent recession were the result of poor monetary policy.
   b. The decline in world trade was larger in the early stages of the recent recession than in the early stages of the Great Depression.
   c. For the world as a whole, the initial phase of the recent recession was as severe as the initial phase of the Great Depression.
   d. (a) and (b).
   e. (b) and (c).
   f. All of the above.
10. When the economy is in long-run equilibrium;
   a. Output is equal to potential output.
   b. Inflation is steady.
   c. the real interest rate is given by the point on the IS curve where \( Y = \bar{Y} \).
   d. (a) and (b) only.
   e. (a) and (c) only.
   f. All of the above.

B. TRUE, FALSE, OR UNCERTAIN

For each of the following, decide whether the statement is true, false, or uncertain and explain why. Your explanation determines your grade; you will receive no credit for an answer without an explanation. Use diagrams where appropriate. Note: We have given you a full page for each answer so that you have plenty of room to write. We do not expect answers to take up the whole page.

1. The real exchange rate falls (that is, depreciates) as we move down along a conventional downward-sloping AD curve.

2. The key advantage of natural experiments if we are trying to determine the effect of one variable, \( x \), and another variable, \( y \), is that they focus on cases where the only factor affecting \( y \) that changed was \( x \).

3. In the short run, an increase in consumer confidence raises the real interest rate, consumption, investment, and real GDP.

C. PROBLEM(S)

Answer all parts of the question. Be sure to explain your answers and to draw diagrams where they are appropriate. Your explanation and analysis determine your grade.

1. Consider an economy in long-run equilibrium: output is equal to its natural rate (\( \bar{Y} \)), and as a result, inflation is steady. Assume that the central bank is following an interest rate rule, and that nominal interest rates are above zero.

   In this situation, suppose there is an adverse inflation shock. That is, some outside shock (such as a spike in oil prices) causes inflation to change suddenly from its initial level, \( \pi_0 \), to a higher level \( \pi_1 \). Assume that the shock does not change normal output, \( \bar{Y} \).

   a. What is the short-run effect of this development on output, the real interest rate, consumption, and investment?

   b. What is the short-run effect on the real exchange rate and net exports?

   c. How do output and inflation change over time after the initial shock? What will they be in the long run?
D. SHORT ESSAY(S)

1. The chart below is a version of one you have seen several times this semester. It shows inflation in the postwar United States. The shaded regions are recessions. The dashed vertical lines are “Romer and Romer dates” (from the paper, “Does Monetary Policy Matter? A New Test in the Spirit of Friedman and Schwartz”; one example is October 1979, which corresponds to the start of the period of tight monetary policy under Paul Volcker).

Why might it be useful or interesting to show recessions and Romer and Romer dates in trying to understand the behavior of inflation over the postwar period? What are two features of the behavior of inflation over this period that do not appear related to recessions or Romer and Romer dates?

You should structure your answer in the form of an essay. It should have a logical structure, complete sentences, and good analysis. In your discussion, you should use diagrams and cite empirical evidence as appropriate.

![Chart showing Consumer Price Index for All Urban Consumers: All Items (CPIAUCSL) with shaded areas indicating recessions and dashed vertical lines indicating Romer and Romer dates.](image-url)
PART II. Questions that were, or could have been, on past finals and that would have been reasonable for this year's final

Note: A “*” in front of a question means that it could also have been on a midterm.

A. MULTIPLE CHOICE

Circle the best answer to N of the following N+1 questions. Note:
– If you wish, you may add a brief explanation of your answer to at most one question. In that case, your grade on that question will be based on your answer and explanation together. This means that an explanation can either raise or lower a grade.
– If you answer all N+1 questions, we will only grade the first N.

1. In “Disinflation and the NAIRU,” Laurence Ball argues that:
   a. The experiences of Norway, Austria, Italy, Romania, and the Ukraine provide an important challenge to existing theories of disinflation.
   b. The experiences of Nigeria, Angola, the Ivory Coast, Rwanda, and Uganda provide an important challenge to existing theories of disinflation.
   c. Disinflation is politically easier when the natural rate of unemployment is lower.
   d. A prolonged recession to bring inflation down often causes an increase in the natural rate of unemployment.

2. If investment becomes more responsive to the real interest rate:
   a. The planned expenditure line in the Keynesian cross diagram becomes flatter.
   b. The planned expenditure line in the Keynesian cross diagram becomes steeper.
   c. The slope of the planned expenditure line in the Keynesian cross diagram is not affected.
   d. It is not possible to tell.

3. Okun’s law states that the change in the unemployment rate is a decreasing function of the growth rate of real GDP. This hypothesis implies that if we run the regression $U_t - U_{t-1} = a + b \ln Y_t + c \ln Y_{t-1} + e_t$ (where $U$ is the unemployment rate and $Y$ is real GDP), we should expect:
   a. The estimates of both $b$ and $c$ to be positive
   b. The estimates of both $b$ and $c$ to be negative.
   c. The estimate of $b$ to be positive and the estimate of $c$ to be about zero.
   d. The estimate of $b$ to be about zero and the estimate of $c$ to be positive.
   e. The estimates of $b$ and $c$ to be roughly equal and opposite, with $b$ positive and $c$ negative.
   f. The estimates of $b$ and $c$ to be roughly equal and opposite, with $b$ negative and $c$ positive.

4. “Quantitative easing” refers to:
   a. Large-scale asset purchases by the central bank.
   b. Raising limits on the size of government-insured mortgages.
   c. Large reductions in the central bank’s interest-rate target.
   d. An increase in the central bank’s target rate of inflation.
5. Suppose that there are downward shifts of both the consumption function (so that $C$ at a given $Y - T$ is lower than before) and investment demand (so that $I$ at a given $r$ is lower than before). Then:
   a. Investment falls.
   b. Investment rises.
   c. Investment does not change.
   d. Investment can either rise or fall.

6. A combination of policies that reduced the budget deficit without reducing real GDP in the short run would likely involve:
   a. A leftward shift of the IS curve and a downward shift of the MP curve.
   b. A leftward shift of the IS curve and an upward shift of the MP curve.
   c. A leftward shift of the IS curve and no change in the MP curve.
   d. A rightward shift of the IS curve and a downward shift of the MP curve.
   e. A rightward shift of the IS curve and an upward shift of the MP curve.
   f. A rightward shift of the IS curve and no change in the MP curve.

7. The following developments associated with the Great Depression are in chronological order, from earliest to latest:
   a. The crash of the stock market, Britain’s departure from gold, passage of a large increase in taxes, “New Deal” policies.
   b. “New Deal” policies, passage of a large increase in taxes, the crash of the stock market, Britain’s departure from gold.
   c. Passage of a large increase in taxes, Britain’s departure from gold, “New Deal” policies, the crash of the stock market.
   d. Britain’s departure from gold, “New Deal” policies, the crash of the stock market, passage of a large increase in taxes.

8. The IS curve slopes down because:
   a. As the real interest rate rises, the government increases taxes to finance the greater interest payments on its debt.
   b. As the real interest rate rises, the central bank tightens monetary policy.
   c. As the real interest rate rises, the government cuts back on its purchases.
   d. As the real interest rate rises, households invest less in the stock market.
   e. As the real interest rate rises, firms buy fewer machines and build fewer factories.
   f. (a) and (b).
   g. All of the above.

9. The short-run effect of an increase in government purchases on output will be:
   a. Larger when monetary policy is constrained by the zero lower bound than when it is not.
   b. Smaller when monetary policy is constrained by the zero lower bound than when it is not.
   c. Positive when monetary policy is constrained by the zero lower bound, and negative when it is not.
   d. Independent of whether monetary policy is constrained by the zero lower bound or not.
10. The policy response to the Great Recession of 2007–2009 included:
   a. Grants from the U.S. federal government to state governments.
   b. Grants from the U.S. federal government to foreign governments.
   c. Tax cuts for individuals.
   d. Government infrastructure spending.
   e. Guaranteed government jobs for all unemployment workers.
   f. Codes of conduct encouraging industries to collude and raise prices.
   g. (a), (b), and (c).
   h. (a), (c), and (d).
   i. (b), (e), and (f).
   j. (d), (e), and (f).

11. In “Will It Hurt? Macroeconomic Effects of Fiscal Consolidation,” the authors contrast their action-based measure of fiscal consolidations with the standard measure; that standard measure is based on:
   a. Budget documents and other narrative sources.
   b. Changes in the actual budget deficit.
   c. Changes in the debt-to-GDP ratio.
   d. Changes in the cyclically-adjusted deficit.

12. In late 2011 and early 2012, U.S. data showed falls in unemployment that were surprisingly large given the rate of GDP growth. This might have been the result of:
   a. Unusual declines in the labor force.
   b. Favorable inflation shocks.
   c. Innovations that allowed firms to produce more output for a given level of labor input.
   d. Inaccuracies in the data on employment and/or GDP.
   e. A return to more normal staffing levels after a period of extreme caution in hiring.
   f. a, c, and d.
   g. a, d, and e.
   h. b, c, and d.

13. When economists speak of hysteresis, they refer to the fact that:
   a. Once a recession starts, it is likely to last for a while.
   b. High unemployment tends to be followed by low unemployment.
   c. Prolonged high unemployment can cause the natural rate of unemployment to rise.
   d. Prolonged high unemployment will eventually reduce inflation.

*14. The fact that inflation has not fallen very much since 2007 despite the fact that unemployment has been very high over that period could be the result of any of the following except:
   a. Inflation expectations are “anchored.”
   b. The normal or natural rate of unemployment has risen substantially.
   c. The Federal Reserve is constrained by the zero lower bound.
   d. There have been inflation shocks acting to increase the inflation rate.
15. Saying that the regression $y_t = a + bx_t + e_t$ suffers from omitted variable bias means that:
   a. There is correlation between the variables left out of the regression (which show up in $e$) and the variable whose effect on $y$ we are trying to estimate ($x$).
   b. The variables left out of the regression (which show up in $e$) affect the variable whose behavior we are trying to understand ($y$).
   c. The researcher chose to omit some observations because they do not support his or her hypothesis.
   d. $y$ is on average high when $x$ is high, and low when $x$ is low.

16. The LM curve:
   a. Is upward-sloping, like the MP curve.
   b. Shifts if the price level changes.
   c. Is flat when the nominal interest rate is at the zero lower bound.
   d. (a) and (b).
   e. (a) and (c).
   f. (b) and (c).
   g. All of the above.
   h. None of the above.

17. All of the following were created in the 1930s except:
   a. The Federal Deposit Insurance Corporation (FDIC).
   b. The Federal Reserve.
   c. The National Recovery Administration (NRA), created by the National Industrial Recovery Act (NIRA).
   d. Social Security.

18. In “The Great Crash and the Onset of the Great Depression,” Christina Romer argues that the uncertainty caused by the stock market crash in October 1929 lowered spending because:
   a. Uncertainty made consumers and firms so paralyzed with fear that they stopped spending altogether.
   b. Consumers’ and firms’ concern about the possibility that there could be a sharp drop in incomes led them to scale back on their spending as a precaution.
   c. Consumers and firms postponed irreversible spending decisions as they waited for uncertainty to be resolved.
   d. All of the above.

19. The following events are in chronological order, from earliest to latest:
   a. Lehman bankruptcy, the passage of the TARP (Troubled Asset Relief Program) legislation, the passage of the American Recovery and Reinvestment Act.
   b. The passage of the American Recovery and Reinvestment Act, Lehman bankruptcy, the passage of the TARP legislation.
   c. The passage of the TARP legislation, the passage of the American Recovery and Reinvestment Act, Lehman bankruptcy.
   d. The passage of the TARP legislation, Lehman bankruptcy, the passage of the American Recovery and Reinvestment Act.
20. The largest recessions in postwar U.S. history occurred in:

B. TRUE, FALSE, OR UNCERTAIN

For each of the following, decide whether the statement is true, false, or uncertain and explain why. Your explanation determines your grade; you will receive no credit for an answer without an explanation. Use diagrams where appropriate.

1. A fiscal expansion is likely to reduce a country’s net exports.

2. Fiscal austerity is likely to lower output relative to what it otherwise would have been in the short run.

3. The fact that output fell dramatically when the money supply fell sharply from 1929 to 1933, then rose rapidly from 1933 to 1937 as the money supply increased rapidly, then declined together with the money supply from 1937 to 1938, is strong evidence that monetary changes have important effects on output.

4. The gold standard played little role in the Great Depression.

5. If the federal funds rate is zero, there is nothing more the Federal Reserve can do to stimulate the economy.

C. PROBLEMS

Answer all parts of each question. Be sure to explain your answers and to draw diagrams where they are appropriate. Your explanation and analysis determine your grade.

1. Recent research stresses the role of high levels of debt for consumers and firms in causing or exacerbating short-run fluctuations.
   a. What is some of the evidence that high levels of debt affect consumer or firm behavior?
   b. If consumers and firms are trying to reduce their debt (deleverage), how, if at all, is this likely to show up in the IS-MP diagram? Why?
   c. What policy actions would be most effective in combating a recession caused by deleveraging? Why?

2. Consider the IS–MP model extended to include an interest rate spread. Suppose stress in financial markets increases the interest rate spread, \( r^b - r^s \), at a given level of output, \( Y \).
a. How, if at all, does this development affect output, Y, and the saving real interest rate, rs, in the short run?

b. Suppose that, at the same time that financial stress increases, the central bank changes its interest rate rule in such a way that the borrowing interest rate, r^b, at a given Y is the same as before the increase in financial stress.

i. In order to do this, how, if at all, does the central bank need to change the saving interest rate, rs, at a given Y and π?

ii. What, if anything, is the combined effect of the increase in financial stress and the change in the interest rate rule on output and the saving real interest rate?

c. Suppose that the economy is already in a balance sheet recession before the increase in financial stress; and suppose that Koo is right that in a balance sheet recession, investment demand is completely unresponsive to the real interest rate. How, if at all, does the increase in financial stress affect output and the saving real interest rate in the short run? (Ignore the possibility of a change in the central bank’s interest rate rule considered in part (b).)

D. ESSAY(S)

1. Many policymakers advocate a balanced budget amendment to the United States Constitution. Key parts of the text of one version of the amendment read:

   “Prior to each fiscal year, the President shall transmit to the Congress a proposed budget for the United States Government for that fiscal year in which total outlays do not exceed total receipts.

   “Total outlays for any fiscal year shall not exceed total receipts for that fiscal year, unless two-thirds of the whole number of each House of Congress shall provide by law for a specific excess of outlays over receipts by a roll call vote.”

The proposed amendment also provides that, because outlays and receipts cannot be predicted perfectly, Congress may rely on estimates of outlays and receipts in formulating the budget, and that the amendment would not take effect until 5 years from now.

Should such an amendment be adopted? Defend your answer.

You should structure your answer in the form of an essay. It should have a logical structure, complete sentences, and good analysis. In your discussion, you should draw on the ideas, tools, and readings from the course to provide insights into the question, and you should use diagrams and cite empirical evidence as appropriate. Your essay should focus on the economics of the issue.
PART III. Questions that were on past exams that might not be appropriate exam questions this year because of changes in the syllabus, but that might be useful as a guide to the style of questions to expect on exams

A. MULTIPLE CHOICE

1. The “Lucas critique” states that:
   a. A statistical relationship can change when the economic environment changes because of effects through expectations.
   b. The Federal Reserve caused repeated bouts of high inflation by failing to raise the real interest rate when inflation rose.
   c. The Federal Reserve’s inaction led to the Great Depression.
   d. The Federal Reserve’s failure to respond to the housing bubble led to the Great Recession.

2. The following people are discussed in the reading from The Forgotten Man by Amity Shlaes:
   a. Benjamin Strong, George Harrison, and Henry Steagall.
   b. Charlie Chaplin, Babe Ruth, and F. Scott Fitzgerald.
   d. Thomas Edison, Harvey Firestone, and John D. Rockefeller, Jr.

3. According to the Committee for a Responsible Federal Budget, one of the “10 Themes emerging from the New Debt Reduction Plans” is:
   a. There is plenty of room for defense cuts without compromising national security.
   b. The budget gap is too large to keep revenues off the table.
   c. In the longer term, it is all about entitlement reform.
   d. All of the above.
   e. None of the above.

4. In “Costly Capital Reallocation and the Effects of Government Spending,” Valerie Ramey and Matthew Shapiro:
   a. Regress GDP growth on the change in federal government spending, the change in taxes, and a measure of the change in monetary policy.
   b. Regress GDP growth on the change in state and local government spending.
   c. Study the response of GDP to the increase in military spending in World War I.
   d. Study the response of GDP to events that triggered major military buildups.

5. Europe’s response to its recent and ongoing crises has included:
   a. Some countries exiting the euro and returning to using their own currencies.
   b. New legislation allowing workers to move freely among countries in the euro area.
   c. Major moves to fiscal austerity.
   d. Large increases in interest rates by the European Central Bank.
   e. (a) and (b).
   f. (a) and (d).
   g. All of the above.
6. “House lock” refers to the idea that:
   a. The bursting of the housing bubble has caused the market for newly built homes to virtually stop functioning.
   b. High rates of foreclosure in some neighborhoods depress the values of other homes in those neighborhoods, thus “locking in” low home prices.
   c. It is difficult for homeowners who owe more on their mortgages than their homes are worth to move to where jobs are more plentiful.
   d. The low rate of homebuilding is a drag on the rest of the economy, preventing a strong recovery.

**B. TRUE, FALSE, OR UNCERTAIN**

1. A government guarantee of the debts of financial intermediaries can help stop a financial crisis that is due to either confidence contagion or counterparty contagion.

**C. PROBLEMS**

1. Japanese monetary policy has been at the zero lower bound for more than a decade. The Bank of Japan recently announced an increase in its target rate of inflation from 1 percent to 2 percent. The evidence available so far suggests that this announcement has increased expected inflation.

   a. Show the effects of this development in an IS-MP diagram accounting for the zero lower bound. What are the effects on the real interest rate ($r$) and output ($Y$)?

   b. How would this development affect the real exchange rate ($\varepsilon$) and net exports ($NX$)?

   c. The Bank of Japan also announced a program of quantitative easing where it will buy a large amount of long-term public and private debt. What is this program likely to do to long-term nominal interest rates? If investment depends on long-term rates, how would you expect this part of the program to show up in the IS-MP diagram? What will it do to output?

**D. ESSAY(S)**

1. The new conventional wisdom holds that financial crises have severe and long-lasting negative effects on output. In this essay, discuss the theoretical reasons that a financial crisis might affect aggregate output and evaluate some of the existing empirical evidence on this relationship. In your discussion of the empirical evidence, be sure to explain why estimating the effects of financial crises on output is hard, and critically evaluate how well the studies you describe deal with omitted-variable bias and reverse causation.

You should structure your answer in the form of an essay. It should have a logical structure, complete sentences, and good analysis; it should also be free of grammatical errors. A good essay will include diagrams, references to particular papers we have covered in the course, and perhaps an equation describing a regression specification.