Macroeconomic Theory and Stabilization Policy

Multiple Choice Problems
[Select the best alternative]

Module 1: Introduction

1. In stagflation
   (a) potential output of the economy declines.
   (b) the inflation rate is increasing because of rising demand.
   (c) the output gap is negative.

2. The Phillips curve
   (a) is a relationship between unemployment rate and output growth rate.
   (b) is a relationship between inflation rate and unemployment rate.
   (c) is a relationship between employment rate and inflation rate.

3. Stabilization policies
   (a) are discussed in the context of very long run models.
   (b) are discussed in the context of business cycles.
   (c) were first addressed by the classical macroeconomists.

4. Output in long run macroeconomic models
   (a) are entirely demand determined.
   (b) are both demand and supply determined.
   (c) are entirely supply determined.

5. Full employment output
   (a) is also the potential output of the economy.
   (b) is also the trend output of the economy.
   (c) Both (a) and (b) above.

6. The inflation rate
   (a) is positive during stagflation.
   (b) is negative during stagflation.
   (c) is always negative during recession.
Module 2: Measurement of Aggregate Economic Variables

1. The national income accounting methods
   (a) recognize the services rendered in trading activities.
   (b) consider the output of the self employed.
   (c) deduct the value of the services of the housewives.

2. Retained earnings
   (a) are not included in GDP.
   (b) are included in disposable income.
   (c) are included in personal disposable income.

3. Personal disposable income
   (a) includes the dividend incomes.
   (b) excludes the non-tax payments.
   (c) includes the contributions to social insurance.

4. Gross Domestic Product
   (a) ignores the contributions of the foreign factors of production.
   (b) includes the contributions of the domestic factors abroad.
   (c) ignores the contribution of the self-employed factors in the economy.

5. Indirect taxes
   (a) are deducted to obtain GDP.
   (b) are included in national income.
   (c) affect the value of GDP.

6. Transfer payments
   (a) are considered a part of the current economic activities.
   (b) are included in national income.
   (c) are considered in personal income.
Module 3: Classical Model

1. Output level in the classical model can be affected by
   (a) money supply changes.
   (b) tax changes.
   (c) technological improvements.

2. The classical aggregate demand curve is
   (a) linear.
   (b) vertical.
   (c) a rectangular hyperbola.

3. In the classical model
   (a) prices are determined in the labour market.
   (b) interest rate is determined in the goods market.
   (c) output is determined in the money market.

4. The Quantity Theory of Money says
   (a) that output is proportional to prices.
   (b) that prices are proportional to money supply.
   (c) that nominal national income is equal to money supply.

5. Technological advances
   (a) will increase real wages.
   (b) will shift the labour supply function.
   (c) will not affect the aggregate supply function.

Module 4: Keynesian Cross Model

1. The Keynesian Cross Model
   (a) assumes full employment of resources.
   (b) ignores the money market.
   (c) is a supply-determined model.
2. Mismatches in supply – demand for output are signaled to the firms through

(a) intended inventory changes.
(b) unintended inventory changes.
(c) None of the above.

3. The goods market clearing condition says that

(a)
(b) government budget deficit implies excess savings over investment.
(c) government budget surplus implies excess savings over investment.

4. The balanced budget multiplier in the Keynesian Cross Model is

(a) one.
(b) greater than one.
(c) .

5. The tax rate multiplier in the Keynesian Cross Model is

(a)
(b)
(c)

6. If taxes and transfer payments increase by the same amount

(a) output in the economy will not change.
(b) output will increase.
(c) output will decline.

Module 5: Investment Theory

1. The bulk of the investment in any country in a given year

(a) is net investments in fixed capital, residences and inventories.
(b) is replacement investments.
(c) None of the above.

2. The unintended inventory changes are negative
3. In the housing market

(a) the stock supply is a long run phenomenon.
(b) the flow supply curve is valid in the short run.
(c) the flow supply is influenced by the stock supply.

4. Investment

(a) is a part of the demand in the economy.
(b) is a part of the supply in the economy.
(c) is the inherited capital stock of the country.

5. Under profit-maximization, the desired capital stock of a firm
   *assume a Cobb-Douglas production function*

(a) does not depend upon other factor prices.
(b) depends upon the *returns to scale*.
(c) is independent of the price of the product.

6. Under constrained cost minimization, the desired capital stock of a firm

(a) does not depend upon the price of the product.
(b) does not depend upon other factor prices.
(c) does not depend upon the output of the firm.

Module 6: IS-LM Model

1. The rate of interest will adjust

(a) whenever the goods market is in disequilibrium.
(b) whenever the money market is in disequilibrium.
(c) None of the above.

2. If there is excess supply of money in the economy

(a) there will be excess supply in the non-money market.
(b) the prices of securities will fall.
(c) the interest rate will decline.

3. The balanced budget multiplier in the IS-LM Model

(a) is one.
(b) is less than one.
(c) can be greater than one.

4. The most effective policy in liquidity trap is

(a) monetary policy.
(b) fiscal policy.
(c) None of the above.

5. Suppose the investment function is \( I = I(r, Y) \), \( I_r < 0 \) \& \( I_Y > 0 \). The IS curve will be

(a) upward sloping.
(b) downward sloping.
(c) may or may not be negatively sloped.

6. Consider the following economy:

\[
C = 200 + 0.7 \ Y^d \quad : \text{consumption function, } Y^d \text{ is disposable income}
\]

\[
I = 1000 + 0.04 \ Y \quad : \text{investment function}
\]

\[
G = 200 \quad : \text{government expenditure}
\]

\[
T^f = 20 \quad : \text{transfer payments}
\]

\[
T = 0.2 \ Y \quad : \text{income tax function}
\]

\[
h = 0.2 \quad : \text{coefficient of transaction money demand}
\]

\[
I(r) = 600 / r \quad : \text{speculative money demand function}
\]

\[
M / P = 767 \quad : \text{money supply}
\]

(i) The output of the economy is
(ii) The expenditure multiplier is
d
(a) 2.5.
(b) 10.
(c) 0.4.

(iii) Is it true that in this model

(a) monetary policy is totally ineffective.
(b) output is IS determined.
(c) fiscal policy is totally ineffective.

(iv) The rate of interest is

(a) 10.
(b) 20.
(c) 600.

Modules 7 & 8: Variable Price Keynesian Model & Hybrid Model

1. The Keynesian model is demand-determined

(a) when the production function is linear.
(b) when there is excess demand for labour.
(c) when there is no money illusion.

2. When the Keynesian supply curve becomes vertical

(a) people have money illusion.
(b) real wages are rigid.
(c) labour supply is less than labour demand.

3. Textbooks call unemployment ‘voluntary’
(a) when money wages become rigid.
(b) when labour market has cleared.
(c) when there is excess supply of labour.

4. The Keynesian supply function will become steeper
   (a) if labour becomes more productive.
   (b) if the labour supply curve shifts out.
   (c) if labour productivity falls.

5. The necessary assumption required to demonstrate the existence of involuntary unemployment in a textbook macro model is
   (a) money illusion among the workers.
   (b) rigid real wages.
   (c) rigid money wages.

Modules 9 & 10: BOP Account and Exchange Rate Systems, & IS-LM-BP Model

1. Consider the following open economy transactions of an economy to answer Problems (i) to (iv).

<table>
<thead>
<tr>
<th>Import of Goods = 5000</th>
<th>Export of Goods = 3000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Remittances Received = 50</td>
<td>Gifts Made = 10</td>
</tr>
<tr>
<td>Loans Received = 50</td>
<td>Shares Purchased Abroad = 25</td>
</tr>
<tr>
<td>Bank Deposits Received = 15</td>
<td>Royalty Payments Made = 10</td>
</tr>
<tr>
<td>Properties Purchased Abroad = 10</td>
<td>Shipping Payments Made = 25</td>
</tr>
<tr>
<td>Interest Payments Made = 20</td>
<td>Grants Received = 5</td>
</tr>
</tbody>
</table>

(i) The trade account balance will be
   (a) 2000.
   (b) – 2000.
   (c) 8000.

(ii) The services account balance is
(a) – 55.
(b) 45.
(c) – 45.

(iii) The transfer payments account balance is

(a) 40.
(b) 45.
(c) – 15.

(iv) The capital account balance is

(a) – 35.
(b) 30.
(c) 40.

2. Devaluation of the exchange rate occurs when the exchange rate system is

(a) flexible.
(b) fixed.
(c) Devaluation and depreciation of the exchange rate mean the same thing.

3. In the event of a devaluation or depreciation of the exchange rate

(a) the BP curve will become steeper.
(b) the BP curve will become flatter.
(c) the IS curve will become steeper.

4. The effectiveness of fiscal policy under flexible exchange rate

(a) will vary directly with the sensitivity of international capital movement.
(b) will vary inversely with this sensitivity.
(c) will not depend upon international capital movement.

5. Fiscal policy under fixed exchange rate becomes more effective

(a) as international capital mobility decreases.
(b) as international capital mobility increases.
(c) as propenscity to import increases.
6. Monetary policy under fixed exchange rate

(a) is more effective if international capital movement is very sensitive.
(b) is more effective if international capital movement is not sensitive.
(c) is never effective.

7. Devaluation is most effective

(a) if international capital movement is perfectly mobile.
(b) if international capital movement is perfectly immobile.
(c) if marginal propencity to import is high.