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 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.

<table>
<thead>
<tr>
<th>Real domestic output demanded (in billions)</th>
<th>Price level</th>
<th>Real domestic output supplied (in billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ 500</td>
<td>350</td>
<td>$3000</td>
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<tr>
<td>$3000</td>
<td>150</td>
<td>$1000</td>
</tr>
</tbody>
</table>

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 AE₁ to AE₂ would:
   A) move the economy from A to B along AD₁.
   B) move the economy from B to A along AD₁.
   C) increase aggregate demand from AD₁ to AD₂.
   D) decrease aggregate demand from AD₂ to AD₁.

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?

![Diagram showing four lines labeled T1, T2, T3, and T4, intersecting at different points with GDP.]

A) T4  
B) T3  
C) T2  
D) T1

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.
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
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.
15. Refer to the above diagram. Cost-push inflation can be illustrated by a:
   A) shift in the aggregate supply curve from AS₁ to AS₂.
   B) shift in the aggregate supply curve from AS₁ to AS₃.
   C) shift in the aggregate supply curve from AS₂ to AS₃.
   D) movement along the aggregate demand curve from e₁ to e₃.
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:

\[ C = 60 + 0.6Y_d \]

\[ T = 40 + 0.25Y \]

\[ I = 60 \]

\[ G = 70 \]

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]