1. In the Mundell-Fleming model, the domestic interest rate is determined by the:
   A) intersection of the \( LM \) and \( IS \) curves.
   B) domestic rate of inflation.
   C) world rate of inflation.
   D) world interest rate.

2. Assuming there is perfect capital mobility, compared to a \textit{large} open economy, a \textit{small} open economy is one in which the:
   A) exchange rate is fixed.
   B) exchange rate is floating.
   C) domestic interest rate equals the world interest rate.
   D) domestic interest rate is not equal to the world interest rate.

3. In a small open economy with a floating exchange rate, an effective policy to decrease equilibrium output is to:
   A) decrease government spending.
   B) decrease taxes.
   C) increase the money supply.
   D) decrease the money supply.

4. In a small open economy with a floating exchange rate, the supply of real money balances is fixed and a rise in government spending:
   A) raises the interest rate, so that income must rise to maintain equilibrium in the money market.
   B) raises the interest rate so that net exports must fall to maintain equilibrium in the goods market.
   C) cannot change the interest rate so that net exports must fall to maintain equilibrium in the goods market.
   D) cannot change the interest rate so income must rise to maintain equilibrium in the money market.

5. In a small open economy with a floating exchange rate, if the government decreases the money supply, then in the new short-run equilibrium:
   A) income falls and the exchange rate rises.
   B) the exchange rate falls and income rises.
   C) income remains unchanged but the exchange rate rises.
   D) the exchange rate remains unchanged but income falls.
6. In a small open economy with a floating exchange rate, if the government imposes an import quota, then in the new short-run equilibrium the $IS^*$ curve shifts to the right, raising the exchange rate:
A) but not raising net exports or income.
B) and net exports but not income.
C) and income but not net exports.
D) net exports and income.

7. To maintain a fixed-exchange-rate system, if the exchange rate moves below the fixed-exchange-rate level, then the central bank must:
A) buy foreign currency.
B) sell foreign currency from reserves.
C) raise taxes.
D) decrease government spending.

8. If there is a fixed-exchange-rate system, then in the short run described by the Mundell-Fleming model:
A) the nominal exchange rate is fixed, but the real exchange rate is free to vary.
B) the real exchange rate is fixed, but the nominal exchange rate is free to vary.
C) both the nominal and real exchange rates are fixed.
D) the nominal exchange rate is fixed, but whether the real exchange rate is fixed depends on whether the central bank follows a rule of constant growth of the money supply.

9. In a small open economy with a fixed exchange rate, if the country devalues its currency, then in the new short-run equilibrium the exchange rate ______, and the $LM^*$ curve shifts to the ______.
A) decreases; left
B) increases; left
C) decreases; right
D) increases; right

10. A devaluation of a currency under a fixed-exchange-rate system occurs when the level at which the currency is fixed is:
A) increased.
B) decreased.
C) allowed to float.
D) kept fixed within a band.
11. According to the Mundell-Fleming model, under fixed exchange rates expansionary fiscal policy causes income to _______, and under flexible exchange rates expansionary fiscal policy causes income to _______.
   A) increase; increase
   B) increase; remain unchanged
   C) remain unchanged; remain unchanged
   D) remain unchanged; increase

12. The risk premium included in the interest rate of small open economies incorporates:
   A) country risk and expectations of future exchange-rate changes.
   B) the law of one price.
   C) inefficient activity by arbitrageurs.
   D) capital mobility.

13. According to the Mundell-Fleming model with floating exchange rates, political uncertainty in Mexico in 1994 caused the risk premium on Mexican interest rates to ______ and the Mexican exchange rate to _______.
   A) increase; increase
   B) increase; decrease
   C) decrease; increase
   D) decrease; decrease

14. A speculative attack on a currency occurs when:
   A) a central bank switches from a floating to a fixed exchange rate.
   B) investors' perceptions change, making a fixed exchange rate untenable.
   C) a country accepts dollarization.
   D) a central bank adopts a currency board to back the domestic currency with a foreign currency.

15. If a country chooses to have free capital flows and to maintain a fixed exchange rate, then it must:
   A) live with exchange-rate volatility.
   B) restrict its citizens from participating in world financial markets.
   C) give up the use of monetary policy for purposes of domestic stabilization.
   D) give up the use of fiscal policy for purposes of domestic stabilization.
16. According to the sticky-price model:
   A) all firms announce their prices in advance.
   B) all firms set their prices in accord with observed prices and output.
   C) some firms set their prices according to the aggregate supply equation.
   D) some firms announce their prices in advance, and some firms set their prices in accord with observed prices and output.

17. In the sticky-price model, the relationship between output and the price level depends on:
   A) the proportion of firms with flexible prices.
   B) the target real wage rate.
   C) the target nominal wage rate.
   D) the implicit agreements between workers and firms.

18. According to the imperfect-information model, when the price level rises and the producer expects the price level to rise, the producer:
   A) increases production.
   B) does not change production.
   C) decreases production.
   D) hires more workers.

19. After examining international data, the economist Robert Lucas found that aggregate demand has the biggest effect on output in countries where aggregate demand:
   A) and prices are most stable.
   B) and prices are most variable.
   C) is most stable but prices are most variable.
   D) is most variable but prices are most stable.

20. Starting from the natural level of output, an unexpected monetary contraction will cause output and the price level to ______ in the short run, and in the long run the expected price level will ______, causing the level of output to return to the natural level.
   A) increase; increase
   B) increase; decrease
   C) decrease; decrease
   D) decrease; increase
21. Along an aggregate supply curve, if the level of output is less than the natural level of output, then the price level is:
   A) greater than the expected price level.
   B) less than the expected price level.
   C) equal to the natural price level.
   D) stuck at the existing price level.

22. According to the Phillips curve, other things being equal, inflation depends positively on all of the following except:
   A) expected inflation.
   B) the unemployment rate.
   C) the natural unemployment rate.
   D) a supply shock, if one occurs.

23. All of the following are ways that the modern Phillips curve differs from the relationship observed by A. W. Phillips in 1958 except that the modern Phillips curve:
   A) substitutes the output gap for unemployment.
   B) includes supply shocks.
   C) includes expected inflation.
   D) substitutes price inflation for wage inflation.

24. The assumption of adaptive expectations for inflation means that people will form their expectations of inflation by:
   A) taking all information into account using the best economic model available.
   B) asking the opinions of experts.
   C) basing their opinions on recently observed inflation.
   D) flipping a coin.

25. Inflation inertia refers to the idea that inflation:
   A) is always present in economies.
   B) keeps on going unless something acts to stop it.
   C) cannot be reduced unless unemployment is increased.
   D) can be generated by either demand-pull or cost-push forces.

26. Cost-push inflation is the result of:
   A) high aggregate demand.
   B) low aggregate demand.
   C) favorable supply shocks.
   D) adverse supply shocks.
27. The Phillips curve analysis described in Chapter 13 implies that there is a negative 
tradeoff between inflation and unemployment in: 
A) both the short run and long run. 
B) in the short run only. 
C) in the long run only. 
D) in neither the short run nor the long run.

28. The most prominent feature of the U.S. economy in the 1970s was: 
A) cost-push deflation. 
B) cost-push inflation. 
C) demand deflation. 
D) demand inflation.

29. The sacrifice ratio measures the: 
A) number of percentage points of the money supply that must be reduced to reduce 
   inflation by 1 percentage point. 
B) extra taxes that must be paid to balance the budget. 
C) number of months of real gross domestic product (GDP) that must be foregone to 
   reduce the inflation rate by 1 percentage point. 
D) percentage of a year's real gross domestic product (GDP) that must be foregone to 
   reduce inflation by 1 percentage point.

30. Assume that the sacrifice ratio for an economy is 4. If the central bank wishes to reduce 
inflation from 10 percent to 5 percent, this will cost the economy ______ percent of one 
year's GDP. 
A) 4 
B) 5 
C) 20 
D) 40

31. The rational-expectations point of view, in the most extreme case, holds that if 
policymakers are credibly committed to reducing inflation, and rational people 
understand that commitment and quickly lower their inflation expectations, then the 
sacrifice ratio will be approximately: 
A) 5. 
B) 2.8. 
C) 1. 
D) 0.
32. The estimate of the sacrifice ratio from the Volcker disinflation is approximately:
   A) 5–6.
   B) 2.5–3.
   C) 1–1.5.
   D) 0–0.5.

33. A recession may alter an economy's natural rate of unemployment in all of the following ways except by:
   A) changing an unemployed individual's attitude toward work.
   B) reducing an unemployed worker's job skills.
   C) permanently reducing the money supply.
   D) altering the wage-setting process.

34. According to the natural-rate hypothesis, the levels of output and unemployment depend on:
   A) aggregate demand in the short run, but not in the long run.
   B) aggregate demand in the long run, but not in the short run.
   C) the natural rate of unemployment in the short run, but the natural rate of inflation in the long run.
   D) the natural rate of inflation in the short run, but the natural rate of unemployment in the long run.

35. The government can lower inflation with a low sacrifice ratio if the:
   A) money supply is reduced slowly.
   B) public has adaptive expectations.
   C) short-run aggregate supply schedule is relatively flat.
   D) public believes that policymakers are committed to reducing inflation.

36. Assume that an economy has the usual type of Phillips curve except that the natural rate of unemployment in an economy is given by an average of the unemployment rates in the last two years. Then, there is:
   A) a long-run tradeoff between inflation and unemployment.
   B) no long-run tradeoff between inflation and unemployment.
   C) no short-run tradeoff between inflation and unemployment.
   D) a sacrifice ratio that is large but not infinite.
37. In the dynamic model, the demand for goods and services decreases as the natural level of output ______ or the real rate of interest ______.
A) increases; increases  
B) increases; decreases  
C) decreases; decreases 
D) decreases; increases

38. A higher real interest rate reduces the demand for goods and services by:
A) shifting the dynamic aggregate supply curve.  
B) decreasing the natural level of output.  
C) increasing inflation expectations.  
D) reducing investment and consumption spending.

39. According to the Fisher equation, the real interest rate equals the nominal interest rate minus the:
A) natural rate of interest.  
B) expected rate of inflation.  
C) ex post rate of inflation.  
D) ex ante rate of interest.

40. According to the Phillips curve, the inflation rate depends on all of the following except:
A) previously expected inflation.  
B) an exogenous supply shock.  
C) the real interest rate.  
D) the deviation of output from its natural level.

41. In the dynamic model, the supply shock variable, \( v_t \), is a variable appearing in which of the following equations of the model?
A) Fisher equation  
B) Phillips curve  
C) monetary-policy rule  
D) adaptive expectations

42. Expectations of inflation based on recently observed inflation is called the assumption of ______ expectations.
A) natural  
B) rational  
C) dynamic  
D) adaptive
43. According to the monetary policy rule, the central bank sets the nominal interest rate so the real interest rate ______ when inflation is above its target and the real interest rate ______ when output is below its natural level.
   A) rises; falls
   B) rises; rises
   C) falls; falls
   D) falls; rises

44. In order to achieve the target for the nominal interest rate established by the monetary policy rule, the central banks adjusts:
   A) the inflation rate.
   B) the natural rate of interest.
   C) the money supply.
   D) the inflation target.

45. According to the Taylor rule, when real GDP is above its natural level, the nominal federal funds rate should be ______, and when inflation is below 2 percent, the nominal Federal funds rate should be ______.
   A) raised; raised
   B) raised; lowered
   C) lowered; raised
   D) lowered; lowered

46. That output, $Y_t$, and the real interest rate, $r_t$, do not depend on the central bank's inflation target in long-run equilibrium in the dynamic model of aggregate demand and aggregate supply demonstrates:
   A) monetary neutrality.
   B) an impulse response function.
   C) adaptive expectations.
   D) Taylor's principle.

47. The dynamic aggregate supply curve is derived from which of the five equations of the model of aggregate demand and aggregate supply?
   A) the Fisher equation and adaptive expectations
   B) the Phillips curve and adaptive expectations
   C) the monetary policy rule and the Fisher equation
   D) the Phillips curve and the monetary policy rule
48. The dynamic aggregate demand curve illustrates the ______ relationship between the quantity of output demanded in the short run and ______.
A) positive; inflation  
B) positive; the price level  
C) negative; inflation  
D) negative; the price level

49. The dynamic aggregate demand curve is drawn for a given:
A) money supply.  
B) real interest rate.  
C) monetary policy rule.  
D) inflation rate.

50. Graphs that illustrate the time paths of endogenous variables when a shock hits the economy are called:
A) monetary policy paths.  
B) dynamic shock figures.  
C) impulse response functions.  
D) endogenous growth models.

51. In the dynamic model of aggregate demand and aggregate supply, increases in the natural level of output lead to ______ in output and ______ in inflation.
A) increases; increases  
B) increases; no change  
C) no change; increases  
D) no change; no change

52. According to the Taylor Principle, for inflation to be stable, the central bank must respond to an increase in inflation with ______ increase in the nominal interest rate.
A) no  
B) an equal  
C) a greater  
D) a smaller
53. Economists who view the economy as inherently unstable generally argue that:
   A) stabilization policy is too dangerous to be used.
   B) the economy should be stimulated when it is depressed and slowed when it is overheated.
   C) the economy should be slowed when it is depressed and stimulated when it is overheated.
   D) monetary and fiscal policies should follow rigid rules of constant growth.

54. The time between a policy action and its influence on the economy is called the:
   A) automatic stabilizer.
   B) time-inconsistency of policy.
   C) inside lag.
   D) outside lag.

55. The lag between the time that the money supply is increased and the time that investment expenditures increase is an example of a:
   A) fiscal inside lag.
   B) fiscal outside lag.
   C) monetary inside lag.
   D) monetary outside lag.

56. Advocates of passive policy argue that, because monetary and fiscal policy lags are:
   A) short and fixed, these policies should not be used to offset shocks.
   B) long and variable, these policies should not be used to offset shocks.
   C) short and fixed, these policies should be used to offset shocks.
   D) long and variable, these policies should be used to offset shocks.

57. If people's expectations of inflation are formed rationally rather than based on adaptive expectations and if policymakers make a credible policy move to reduce inflation, then the costs of reducing inflation will be ______ traditional estimates of the sacrifice ratio.
   A) much higher than
   B) much lower than
   C) exactly equal to
   D) approximately 2 percent greater than
58. If past economic fluctuations resulted from inept economic policies, then the historical evidence would support using:
   A) active macroeconomic policy only.
   B) passive macroeconomic policy only.
   C) either active or passive macroeconomic policy.
   D) neither active nor passive macroeconomic policy.

59. If policymakers announce in advance how policy will respond to various situations and commit themselves to following through on this announcement, this is:
   A) policy by rule.
   B) policy by discretion.
   C) time inconsistent policy.
   D) monetary policy.

60. If citizens vote on the basis of both low inflation and low unemployment at the time of the election, then presidents might, in order to ensure their reelection:
   A) spur inflation soon after their elections, and then cause a recession.
   B) stimulate the economy throughout their terms.
   C) cause a recession soon after their elections, and then stimulate the economy.
   D) run a tight monetary and fiscal policy throughout their terms.

61. Assume that there is a short-run tradeoff between inflation and unemployment, that the central bank desires both low inflation and low unemployment, and that the central bank follows a fixed rule in conducting monetary policy. Initially, households and firms expect high inflation. Following a credible announcement by the central bank of a low-inflation policy, households and firms will ______ the central bank's announcement and ______ their expectations of inflation.
   A) believe; lower
   B) not believe; not change
   C) believe; not change
   D) not believe; lower

62. In practice, inflation targeting is better considered operating with constrained discretion rather than according to a policy rule because central banks with inflation targets typically:
   A) are not allowed to adjust the target in the event of shocks.
   B) set the inflation target as a range rather than as a particular number.
   C) are not held accountable for achieving their target.
   D) must achieve their target regardless of economic conditions.
63. Government debt equals the:
   A) difference between current government purchases and taxes.
   B) difference between saving and investment.
   C) sum of past budget deficits and surpluses.
   D) \( M1 \) money supply.

64. Historically, the primary cause of increases in government debt is:
   A) printing too much money.
   B) cutting taxes.
   C) increasing interest rates.
   D) financing wars.

65. Holding other factors constant, the ratio of government debt to GDP can decrease as a result of *any* of the following changes *except*:
   A) decreases in government spending.
   B) increases in GDP.
   C) decreases in tax revenues.
   D) decreases in transfer payments.

66. In a time of inflation when the real (i.e., deflated) value of the government debt is constant, then the conventionally:
   A) reported government budget will show a deficit equal to the inflation rate times the outstanding debt.
   B) reported government budget will show a deficit equal to less than the inflation rate times the outstanding debt.
   C) reported government budget will be balanced.
   D) measured government budget will show a surplus equal to the inflation rate times the outstanding debt.

67. If capital budgeting procedures were employed, then a budget deficit would be measured as:
   A) the sum of government debt.
   B) the change in government debt.
   C) the change in government debt minus the change in government capital assets.
   D) the change in government capital assets.
68. Under capital budgeting, all of the following transactions would affect the federal budget deficit except the federal government's:
A) sending a check to a welfare recipient.
B) sending a check to the state of Massachusetts.
C) selling a highway to the state of New York and using the proceeds to retire federal debt.
D) selling an office building.

69. An estimate of what government spending and tax revenue would be if the economy were operating at its natural level of output and employment is called the ______ budget.
A) cyclically adjusted
B) inflation adjusted
C) capital asset
D) generational accounting

70. Measuring the size of government debt is complicated by all of the following factors except:
A) inflation.
B) uncounted liabilities.
C) capital assets of the government.
D) failure of the Office of Management and Budget to disclose figures on capital expenditures and credit programs.

71. According to the traditional viewpoint, a tax cut without a cut in government spending:
A) stimulates consumer spending and reduces national saving.
B) stimulates consumer spending and reduces private saving.
C) has no effect on consumer spending but reduces national saving.
D) has no effect on consumer spending but reduces private saving.

72. According to the theory of Ricardian equivalence, tax cuts that have no plans to reduce government spending ______ public saving and ______ private saving.
A) reduce; reduce
B) reduce; increase
C) increase; increase
D) increase; reduce
73. When President George Bush lowered tax withholding in 1992 without lowering the amount of taxes owed, surveys showed that:
   A) almost everyone spent the higher take-home pay.
   B) almost everyone saved the higher take-home pay.
   C) a majority of respondents said they would spend the higher take-home pay, but a significant minority said they would save it.
   D) a majority of respondents said they would save the higher take-home pay, but a significant minority said they would spend it.

74. One way to shift the tax burden from the current generation to future generations is to finance a war by:
   A) raising taxes.
   B) printing money.
   C) running a budget surplus.
   D) running a budget deficit.

75. To force politicians to judge whether government spending is worth the costs, some economists have argued for:
   A) a balanced-budget rule for fiscal policy.
   B) a constant money-growth rule for monetary policy.
   C) avoiding the assumption of any contingent liabilities.
   D) the application of Ricardian equivalence.

76. The average propensity to consume is the:
   A) ratio of consumption to income.
   B) amount consumed out of an additional dollar of income.
   C) amount available for consumption after precautionary saving.
   D) ratio of consumption to wealth.

77. The Keynesian consumption function exhibits all of the following properties except that:
   A) the marginal propensity to consume is between zero and one.
   B) the average propensity to consume decreases as income increases.
   C) only unexpected policy changes influence consumption.
   D) current income is the primary determinant of consumption.
78. Simon Kuznets found that, over long periods of time in the United States, as income rose, the average propensity to consume:
A) rose.
B) fell.
C) remained constant.
D) rose and then fell.

79. Which of the following conjectures that underlie the Keynesian consumption function is not consistent with aggregate U.S. data in the period after World War II?
A) The marginal propensity to consume is between zero and one.
B) The average propensity to consume decreases as income increases.
C) There is a high correlation between income and consumption.
D) Current income is a determinant of consumption.

80. The consumer's budget constraint reflects the fact that because interest is earned on savings:
A) future income is worth less than current income.
B) future income is worth more than current income.
C) future consumption costs more than current consumption.
D) future consumption is worth more than future income.

81. In the Fisher two-period model, the consumer achieves his or her optimum combination of current and future consumption by selecting:
A) any combination on his or her highest indifference curve.
B) the combination on his or her highest indifference curve that is tangent to his or her budget constraint.
C) any combination on his or her budget constraint.
D) the combination on his or her budget constraint where period-one consumption equals period-one income and period-two consumption equals period-two income.

82. In Irving Fisher's two-period model, if consumption in both periods is a normal good, then an increase in income in period two:
A) increases consumption in period one only.
B) increases consumption in period two only.
C) increases consumption in both periods.
D) does not increase consumption in either period.
83. In Irving Fisher's two-period model, if the consumer is initially borrowing in period one and the real interest rate rises, first-period consumption will:
   A) certainly rise.
   B) certainly fall.
   C) remain constant.
   D) either rise or fall.

84. If a consumer is in a position in which a borrowing constraint limits his or her current consumption and a one-time tax is levied on his or her current income, then the tax will:
   A) lower the consumer's future consumption.
   B) not affect the consumer's future consumption.
   C) increase the consumer's future consumption.
   D) have no effect on either current or future consumption.

85. According to Modigliani's life-cycle hypothesis, if a consumer wants equal consumption in every year and the interest rate is zero, then the marginal propensity to consume out of wealth _____ as years _____ decrease.
   A) increases; of life remaining
   B) decreases; of life remaining
   C) increases; until retirement
   D) decreases; until retirement

86. According to the life-cycle model, the average propensity to consume does not fall as income increases in the long run because:
   A) wealth and income grow together.
   B) as income increases wealth decreases.
   C) saving is constant over the life cycle.
   D) wealth is constant over the life cycle.

87. Transitory income is:
   A) income that persists.
   B) average income.
   C) random deviations from average income.
   D) current income.

88. Precautionary saving is saving for:
   A) retirement, when income falls.
   B) unpredictable expenses.
   C) bequests to benefit children.
   D) repayment of debt previously incurred.
89. Milton Friedman argued that, on average, consumption is:
   A) proportional to income.
   B) a fraction of permanent income that rises as permanent income rises.
   C) a fraction of permanent income that falls as permanent income falls.
   D) proportional to permanent income.

90. Suppose that the government is considering two tax cuts, one temporary and one permanent. Each cut will give each taxpayer the same amount in the first year. The permanent-income hypothesis predicts that:
   A) each tax cut will lead to the same amount of consumption in the first year.
   B) the temporary tax cut will lead to more extra consumption in the first year.
   C) the permanent tax cut will lead to more extra consumption in the first year.
   D) the temporary tax cut will lead to no extra consumption at all in the first year.