FINAL EXAMINATION

PART I: MULTIPLE CHOICE [40 POINTS TOTAL]

Circle the best answer to each question. Each question is worth 2 points.

1. 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.

2. If investment becomes more responsive to the real interest rate, the planned expenditure line in the Keynesian cross diagram:
   a. Becomes steeper.
   b. Becomes flatter.
   c. Has the same slope as before.
   d. It is not possible to tell.

3. In “Can Severe Fiscal Contractions Be Expansionary? Tales of Two Small European Countries,” Giavazzi and Pagano call the two positions on the effects of fiscal policy that they consider:
   a. The “Danish” view and the “Irish” view.
   b. The “confidence” view and the “stimulus” view.
   c. The “German” view and the “Keynesian” view.
   d. The “empirical” view and the “theoretical” view.

4. 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.
5. 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.

6. 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).

7. 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.

8. 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.
9. 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.

10. An “asset price bubble” means:
   a. A large, rapid rise in asset prices.
   b. A rise in asset prices that is reversed.
   c. A rise in asset prices in response to reductions in interest rates.
   d. Asset prices being greater than their “fundamental” values.

11. The fact that the bankruptcy of Lehman Brothers nearly caused the failure of institutions that had made loans to Lehman Brothers is an example of:
   a. “Confidence” contagion.
   b. “Coordination” or “Fire sale” contagion.
   c. “Counterparty” contagion.
   d. None of the above.

12. In “Collateral Damage: Effects of the Japanese Bank Crisis on Real Activity in the United States,” Peek and Rosengren devote particular attention to the lending in:
   b. Agricultural regions of the United States.
   c. U.S. cities with over a million residents.
   d. Korea, Taiwan, and the United States.

13. Uncertainty is likely to have an especially large negative short-run effect on spending by households and firms if:
   a. They do not expect the uncertainty to be resolved soon.
   b. There are large costs to reversing their spending decisions.
   c. The real interest rate is high.
   d. Inflation is high.
   e. All of the above.
   f. None of the above.
14. Researchers who are trying to estimate the effects of changes in government purchases on real GDP often focus on military purchases because:
   a. The types of government purchases that policymakers are likely to use to combat a recession are similar in important ways to military purchases.
   b. Wars are often accompanied by price controls, which makes them particularly good times for isolating the effects of changes in government purchases.
   c. Changes in military purchases are caused mainly by geopolitical developments outside the United States, not by other factors affecting U.S. GDP.
   d. It is hard to obtain data on non-military purchases.

15. 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.

16. The three “coping mechanisms” that Reich argues middle class families used to deal with stagnating incomes included all of the following except:
   a. Women move into paid work.
   b. Everyone works longer hours.
   c. Families stop investing in their children’s education.
   d. We draw down savings and borrow to the hilt.

17. Saying that the regression $y_t = a + b x_t + e_t$ 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.

18. From 1930 to 1933, the LM curve shifted substantially upward because of:
   a. Households' uncertainty about the likely path of the economy.
   b. A major tax increase under Herbert Hoover.
   c. Repeated waves of banking panics.
   d. Households and firms coming to expect deflation.
   e. (a) and (b).
   f. (c) and (d).
   g. All of the above.
   h. None of the above.
19. 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.

20. The TARP legislation passed in October 2008 was used to:
   a. Inject capital into financial institutions.
   b. Build roads and other infrastructure projects.
   c. Provide a tax rebate to households.
   d. All of the above.
   e. None of the above.

PART II: TRUE, FALSE, OR UNCERTAIN [60 POINTS TOTAL]

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.

21. If consumers decide to save more at a given level of disposable income than before, investment will rise, and so output will rise. [12 points]

22. High income inequality can result in a long-lasting shortfall of aggregate demand and very prolonged high unemployment. [12 points]

23. The gold standard played little role in the Great Depression. [12 points]

24. In the IS-MP model extended to include an interest rate differential, a loss of confidence in the soundness of the financial system will reduce output. [12 points]

25. If the federal funds rate is zero, there is nothing more the Federal Reserve can do to stimulate the economy. [12 points]
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.

26. 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? [11 points]
   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? [12 points]
   c. What policy actions would be most effective in combating a recession caused by deleveraging? Why? [12 points]

27. Suppose a researcher runs a regression of real GDP growth on the change in real residential (housing) investment. Specifically, using annual data for the postwar United States, the researcher runs the regression:
   \[
   \frac{Y_t - Y_{t-1}}{Y_{t-1}} = a + b \frac{H_t - H_{t-1}}{Y_{t-1}} + e_t,
   \]
   where \( Y \) is real GDP and \( H \) is real residential investment. (That is, the researcher finds the straight line through a scatter plot of \((Y_t - Y_{t-1})/Y_{t-1}\) against \((H_t - H_{t-1})/Y_{t-1}\) that provides the best possible fit to the data.) The resulting estimate of \( b \) is about 6 (with a small standard error and a large t-statistic).

   Based on these results, the researcher concludes that the “multiplier” for housing investment is about 6.
   a. How does an estimated multiplier of 6 compare with existing estimates of the multiplier for tax cuts or increases in government purchases? [11 points]
   b. Describe two reasons that the regression the researcher ran might be a poor way of estimating the effect of housing investment on real GDP. For each reason, explain whether it would tend to cause the regression to lead to an underestimate or to an overestimate of the effect of housing on GDP. [12 points]
   c. Propose one way of estimating the effect of housing investment on GDP that may be less subject to the problem or problems you described in part (b). For example, you could propose running a different regression, focusing on a different sample, looking at different data, or concentrating on particular episodes. [12 points]
28. Many researchers and policymakers argue that the Great Depression had important lessons that could have helped to improve the policy response to the Great Recession. Identify two lessons from the Great Depression – one that policymakers in the Great Recession learned from, and one that they would have benefited from taking more seriously. Explain what those lessons were, and how the first improved the policy response to the Great Recession, and how the second should have done so.

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 economic lessons, not political ones.