Chapter 15
Stabilization

■ Multiple Choice Questions

Choose the one alternative that best completes the statement or answers the question.

1. Informal and formal goals of macroeconomic policy include all of the following except
   (a) price stability.
   (b) full employment.
   (c) a strong and growing currency.
   (d) low interest rates.
   (e) All of the above are informal and formal goals.
   Answer: C

2. The goals of policy activism include all of the following except
   (a) to iron out the business cycle.
   (b) expand output.
   (c) increase employment.
   (d) decrease prices.
   (e) All of the above are goals of policy activism.
   Answer: D

3. In a deflationary gap,
   (a) output is above its natural level.
   (b) there is pressure on prices to rise.
   (c) unemployment exceeds the natural rate.
   (d) the rate of wage inflation will rise.
   (e) None of the above.
   Answer: C

4. When an inflationary gap is present,
   (a) unemployment is greater than the natural rate.
   (b) there is pressure on prices to fall.
   (c) output is below the natural level.
   (d) the rate of wage inflation will rise.
   (e) None of the above.
   Answer: D
5. Contractionary fiscal policy will
(a) increase aggregate supply through increasing taxation and/or decreasing government spending.
(b) increase aggregate demand through increasing taxation and/or decreasing government spending.
(c) decrease aggregate demand through increasing taxation and/or decreasing government spending.
(d) decrease aggregate supply through increasing taxation and/or decreasing government spending.
(e) None of the above.
Answer: C

6. Contractionary monetary policy will
(a) increase aggregate supply decreasing the money supply.
(b) decrease aggregate demand decreasing the money supply.
(c) increase aggregate demand decreasing the money supply.
(d) decrease aggregate supply decreasing the money supply.
(e) None of the above.
Answer: B

7. Automatic fiscal actions
(a) are exemplified by programs such as defense spending.
(b) require the government to certify and pass a law to activate the spending.
(c) are exemplified by programs such as tax collections.
(d) are deliberate decisions made by Congress and the President.
(e) All of the above.
Answer: C

8. A monetary policy action to increase employment would be
(a) an increase in the reserve requirement.
(b) an increase in the discount rate.
(c) an open market purchase.
(d) a decrease in the money supply.
(e) None of the above.
Answer: C

9. If the Fed wants to control inflation, it will
(a) increase interest rates which causes the quantity of money demanded to fall and aggregate demand to increase.
(b) increase interest rates which causes the quantity of money demanded to rise and aggregate demand to increase.
(c) decrease interest rates which causes the quantity of money demanded to rise and aggregate demand to increase.
(d) increase interest rates which causes the quantity of money demanded to fall and aggregate demand to decrease.
(e) None of the above.
Answer: D
10. If the Fed wants to decrease unemployment, it will
   (a) decrease interest rates which causes the quantity of money demanded to fall and aggregate
demand to increase.
   (b) increase interest rates which causes the quantity of money demanded to rise and aggregate
demand to increase.
   (c) decrease interest rates which causes the quantity of money demanded to rise and aggregate
demand to increase.
   (d) increase interest rates which causes the quantity of money demanded to fall and aggregate
demand to decrease.
   (e) None of the above.
   Answer: C

11. The Keynesian case for activist policies is
   (a) that stagnation is the typical state of the economy.
   (b) that waiting for the self-correcting mechanism to cure unemployment is too costly.
   (c) that the self-correcting mechanism will never achieve the natural level of output.
   (d) that the economy is subject to shocks.
   (e) All of the above.
   Answer: B

12. The most compelling evidence supporting the hypothesis of rational expectations is
   (a) the fact that high rates of job creation and job destruction due to structural shifts in the British
economy in the 1920s caused higher unemployment.
   (b) the sudden end to hyperinflation in post-World War I Germany following the announcement of
   policy to greatly reduce monetary growth.
   (c) the increasing effectiveness of tax cuts in the United States in stimulation real GDP after the
   initial tax cut in 1964.
   (d) the speed and efficiency with which information travels due to the Internet.
   (e) All of the above.
   Answer: B

13. Monetarists such as Milton Friedman argue that fluctuations in real GDP can
   (a) never be reduced.
   (b) be increased but not reduced.
   (c) are made worse by discretionary monetary and fiscal policy.
   (d) be controlled by using activist monetary but not fiscal policies.
   (e) not be reduced with fiscal policy instruments.
   Answer: C

14. Nonactivists argue that the Great Depression was caused by
   (a) a capital replacement crisis.
   (b) the stock market crash.
   (c) bad monetary policy.
   (d) a radical change in expectations.
   (e) a large decrease in investment spending.
   Answer: C
15. The case for nonactivism is based on the fact that
   (a) policy-makers can aim for the wrong targets.
   (b) there are long and variable lags in the effect of money on the economy.
   (c) policy-makers cannot know (or forecast) the state of the economy with certainty.
   (d) rational expectations can defeat policy.
   (e) All of the above.
   Answer: E

16. Evidence supporting the claim that activism works includes
   (a) the fact that business cycles have all but disappeared.
   (b) the success of the unemployment-insurance program in preventing poverty.
   (c) the fact that real GDP shows positive growth in every year since 1946.
   (d) less severe business cycles in the post WWII period compared to previous periods.
   (e) the Fed’s experiment with fine-tuning in the 1990s.
   Answer: D

17. A nonactivist policy involves all of the following except
   (a) a fixed monetary-growth rule.
   (b) a balanced federal budget over the business cycle.
   (c) cutting taxes in response to recession.
   (d) reliance on the self-correcting mechanism.
   (e) All of the above are nonactivist policies.
   Answer: C

18. Monetarist reasons for following a constant-monetary-growth rule include all of the following except that
   (a) activist policies can aim for the wrong targets.
   (b) there are short lags in the effect of money on GDP.
   (c) the effects of fiscal policy are uncertain.
   (d) policy-makers cannot accurately predict a recession.
   (e) All of the above are monetarist reasons.
   Answer: B

19. The basic Keynesian case for activism is that
   (a) there is no long-run self-correcting mechanism.
   (b) the self-correcting mechanism is too costly.
   (c) economists need employment.
   (d) expectations are rational.
   (e) inflationary expectations by the public and businesses are generally correct.
   Answer: B
20. Monetarists believe the greater stability of the economy in the past 35 years has resulted from
   (a) the use of countercyclical monetary policy.
   (b) the fact that the private economy is more stable today than in the past.
   (c) backing the dollar up more solidly than prior to World War II.
   (d) a sharp reduction in the fluctuations in money supply growth.
   (e) the fact that the government is a more important part of the economy.
   Answer: D

21. The rational-expectations school argues that countercyclical policy will not work when the policy is
   (a) anticipated by business and consumers.
   (b) offset by higher interest rates.
   (c) anticipated by traders in the foreign exchange markets.
   (d) offset by the Fed’s inclination towards procyclical monetary policy.
   (e) unanticipated by businesses and consumers.
   Answer: A

22. The self-correcting mechanism had difficulty working during the Great Depression because
   (a) incomes policies were not used then.
   (b) the money supply was reduced and government policies fostered supply-side inflation.
   (c) the money supply and the government deficit were increased in the early 1930s.
   (d) reserve requirements were reduced when they should have been increased.
   (e) None of the above.
   Answer: B

23. According to the monetarists, the reduced fluctuations in real GDP since World War II are due to the
   fact that
   (a) monetary policy rather than fiscal policy has been used.
   (b) when fiscal policy has been used, changes in taxes have been favored over changes in spending.
   (c) monetary growth rates have become more stable.
   (d) there are more money substitutes today.
   (e) All of the above.
   Answer: C

24. Monetarists believe that countercyclical policy might prove destabilizing because
   (a) the private economy is basically stable so that anything the government does must be destabilizing.
   (b) the effects of monetary and fiscal policy are known with certainty.
   (c) fiscal policy has no effect on real GDP.
   (d) long and variable lags characterize the effect of money on the economy.
   (e) None of the above.
   Answer: D
25. Keynesians criticize fixed-money-growth rules because
   (a) fiscal policy is more important than monetary policy.
   (b) the fixed rate of growth in the money supply may be too small.
   (c) policy-makers would be unable to respond to severe recessions or runaway inflation.
   (d) monetary policy does not work.
   (e) of policy lags.
   Answer: C

26. Recent monetary and fiscal policy may be characterized by
   (a) a return to the gold standard.
   (b) constant money supply growth.
   (c) a cyclically balanced budget.
   (d) discretionary changes in government spending rather than in taxes.
   (e) an activist approach to macroeconomic policy.
   Answer: E

27. One shortcoming of the rational expectations model is that it does not account well for
   (a) large-scale unemployment.
   (b) stagflation.
   (c) rising and declining rates of inflation.
   (d) the effect of money on the economy.
   (e) the natural rate of unemployment.
   Answer: A

28. To Keynesians, the cost of business downturns is
   (a) the full-employment deficit.
   (b) inflation.
   (c) the GDP gap.
   (d) high interest rates.
   (e) All of the above.
   Answer: C

29. According to activist economists, the historical data on annual growth rates of real GDP show that
   (a) the business cycle is no longer a problem.
   (b) since World War II negative growth rates occur as often as before World War II.
   (c) real GDP fluctuations are just as sharp today as they were prior to World War II.
   (d) the economy has become more unstable over time.
   (e) since World War II, cyclical volatility has been lower than prior to the Great Depression.
   Answer: E

30. Opponents of activism argue that
   (a) activist policy can effect inflation, but not real GDP.
   (b) it is difficult to devise countercyclical policies.
   (c) the natural rate of unemployment is not fixed.
   (d) All of the above.
   Answer: D
31. Which of the following is correct? Monetarists contend that
(a) fluctuations in the money supply have been a destabilizing factor historically.
(b) money supply growth is difficult to control.
(c) the effects of money on the economy are well known and understood, thus monetary policy is preferred.
(d) discretionary monetary policy should work better than fixed rules.
(e) monetary policy makers make fewer mistakes than fiscal policy makers, thus monetary policy is preferred.
Answer: A

32. Which of the following is correct? U.S. macroeconomic policy-makers rely on
(a) nonactivist monetary policies and activist government spending policies.
(b) activist tax changes plus discretionary changes in monetary growth.
(c) nonactivist fiscal policy and activist monetary growth targets.
(d) nonactivist monetary and fiscal policies.
(e) automatic stabilizers and fixed money growth rules.
Answer: B

33. The Keynesian case for activism is that the
(a) self-correcting mechanism works but it is too inflationary.
(b) self-correcting mechanism does not work in the long run.
(c) self-correcting mechanism works but it is too slow and costly.
(d) level of unemployment must grow because of stagnation.
(e) policy lags prevent the mechanism to work quickly enough.
Answer: C

34. Which of the following is correct? Milton Friedman, Robert Lucas and other nonactivists argue that
(a) inept government policy causes business cycles.
(b) attempts to control business cycles by means of discretionary economic policy will not work.
(c) lags in data collection and lags in policy implementation make it difficult for the government to control the business cycle.
(d) All of the above.
Answer: D

35. Which of the following is a problem in pursuing an activist monetary policy?
(a) The lag between a change in the money supply and its effect on economic activity may be long and variable.
(b) We often don’t know we’re in a recession until it has occurred.
(c) It’s not certain we are aiming at the correct targets.
(d) All of the above.
Answer: D
36. One (Keynesian) criticism of the monetarist money-growth rule is that
   (a) policy makers can’t fine-tune a complicated modern economy.
   (b) rational expectations may defeat the policy.
   (c) the Fed should have the ability to change monetary policy as economic conditions warrant.
   (d) monetary policy has been destabilizing in the past.
   (e) All of the above.
   Answer: C

37. The monetarist and rational expectations view of stabilization policy is that
   (a) monetary and fiscal policies should be predictable.
   (b) only monetary policy should be used to stabilize the economy.
   (c) fiscal and monetary policies must be coordinated to stabilize the economy.
   (d) it is better to do nothing in the face of demand and supply shocks.
   (e) supply shocks should be offset by fiscal policies and demand shocks by monetary policy.
   Answer: D

38. According to the rational expectations hypothesis, expectations can defeat an expansionary monetary policy by
   (a) a downward shift in the aggregate demand curve.
   (b) a downward shift in the aggregate supply curve.
   (c) an upward shift in the aggregate supply curve.
   (d) an upward shift in the aggregate demand curve.
   (e) neither curve will shift.
   Answer: C

39. In Figure A and Figure B, the economy is in a recession-equilibrium real GDP is below the natural level of real GDP. The diagrams illustrate different approaches toward macroeconomic policy. Which of the following statements is correct?
   (a) Figure A represents the nonactivist approach; Figure B represents the activist approach.
   (b) Figure A represents the feedback rules approach; Figure B represents the discretionary approach.
   (c) Figure A represents the activist approach; Figure B represents the nonactivist approach.
   (d) Figure A represents the fiscal policy approach; Figure B represents the monetary policy approach.
   Answer: C
40. In the rational expectations model, anticipated shifts in the aggregate demand curve
   (a) cause price surprises.
   (b) changes prices but not output.
   (c) do not change unemployment.
   (d) do not affect the long-run output level
   (e) All of the above.
   Answer: D

41. Which of the following is required for policy-makers to be able to effectively conduct activist policy?
   (a) Policy-makers must be able to anticipate turning points in the business cycle.
   (b) Policy-makers must know the natural rate of unemployment.
   (c) Policy-makers must know the lag between the policy’s implementation and its effect on the economy.
   (d) Policy-makers must know the magnitude of each policy’s effect on the economy.
   (e) All of the above.
   Answer: E

42. One argument in favor of activist policies to adjust the state of the economy is that
   (a) most activist policy is carried out by the Federal Reserve and these policies are therefore free of political influences.
   (b) the economy tends to be relatively stable and therefore policy adjustments are required infrequently.
   (c) discretionary monetary or fiscal policy can be altered relatively quickly when the state of the economy changes.
   (d) discretionary tax cuts in 1964 and 1982 were followed by extended periods of economic growth.
   (e) None of the above.
   Answer: D

43. According to the rational expectations hypothesis, an increase in the rate of monetary expansion that is not anticipated will
   (a) raise inflation and raise real GDP.
   (b) raise inflation and not affect real GDP.
   (c) lower inflation and not affect real GDP.
   (d) raise inflation and lower real GDP.
   (e) lower inflation and lower real GDP.
   Answer: A

44. According to the rational expectations model, unanticipated inflation would
   (a) have no impact on output.
   (b) never take place.
   (c) increase output because prices would rise faster than wages.
   (d) increase output because businesses and wage earners specialize in price information most relevant to them.
   (e) only increase prices.
   Answer: D
45. Proponents of activist policies believe that several pieces of empirical evidence help make a good case for activist policy. Which of the following is a correct statement of one such piece of evidence?
(a) The low unemployment rate that accompanied roughly constant monetary growth in the mid-1970s.
(b) Less severe cyclical fluctuations in real GDP in the post-WWII period.
(c) Christina Romer’s finding that the stability of the unemployment rate in the post-war period is due to improved data.
(d) The random rate of technological change and consequent supply shocks.
(e) Ineffective cuts in personal income taxes in 1964 and 1982.
Answer: B

46. Keynesians believe that discretionary policy is the cause of reduced fluctuations in real GDP in the post-war period. The monetarists, however, believe there is another explanation. This explanation is
(a) increased stability of the rate of monetary growth.
(b) that policy-makers have been extremely fortunate in the timing of policy changes.
(c) that time and experience has improved policy-makers’ ability to use policy correctly.
(d) the relatively small number of times the Fed has changed the reserve requirement.
(e) technological growth in the economy has created stability.
Answer: A

47. In the rational expectations view, the expansionary effects of monetary policy on real GDP can be defeated by
(a) an upward shift in the short-run aggregate supply curve.
(b) congressional interference.
(c) a downward shift in the short-run aggregate supply curve.
(d) unforeseen effects of the policies.
(e) None of the above.
Answer: A

48. Economists who stress rational expectations believe that
(a) fiscal and monetary policy will tend to offset each other, leaving the state of the economy unchanged.
(b) monetary policy may be ineffective since individuals can (correctly) anticipate the policies of the Fed but fiscal policy cannot be anticipated.
(c) monetary and fiscal policy will only be effective if (correctly) anticipated by individuals affected by the policy.
(d) anticipated and unanticipated changes in (monetary or fiscal) policy will have identical effects on the state of the economy.
(e) fiscal and monetary policy may be ineffective if individuals in the economy (correctly) anticipate the actions of government policy-makers.
Answer: E
49. Rational expectations theorists believe that activist policy may not affect real GDP or unemployment because
   (a) policy-makers must use monetary policy or fiscal policy (but not both) for the public to understand the policy.
   (b) activist policies work only if their effects are unanticipated.
   (c) policy-makers will be unable to anticipate the effects of their own policies.
   (d) the fiscal and monetary authorities tend to implement contradictory policies.
   (e) activist policies work if their effects are anticipated.
   Answer: B

50. The major policy implication of real business cycle theory is that
   (a) the Federal Reserve should not be independent of the Executive Branch.
   (b) discretionary monetary policy is the most effective instrument of macroeconomic policy.
   (c) no macroeconomic policy is needed.
   (d) tax policy is most effective if the tax cut is perceived to be permanent.
   (e) the correct target for monetary policy is the growth rate of the money supply.
   Answer: C

51. The argument of real business cycle theorists in favor of nonactivism is that
   (a) discretionary policy is subject to mistakes.
   (b) the business cycle is the result of unpredictable changes in the rate of technological innovation.
   (c) the effects of discretionary policy on the economy are uncertain.
   (d) if policy-makers believe the natural rate of unemployment is 5 percent when it is actually 7 percent, expansionary fiscal policy can accelerate the rate of inflation.
   (e) None of the above.
   Answer: B

52. One interesting implication of real business cycle theory is that the model predicts
   (a) the need for discretionary fiscal or monetary policy.
   (b) relatively stable nominal interest rates over the course of a business cycle.
   (c) real wages rise in booms and fall in recessions.
   (d) the economy is subject to random shocks to aggregate demand.
   (e) falling labor productivity as the cycle moves towards the peak and rising labor productivity at the trough.
   Answer: C

53. One assumption of rational expectations macroeconomics is that
   (a) people have imperfect information.
   (b) wage earners and businesses are well-informed about changes in wage rates and product prices.
   (c) price-level surprises can occur.
   (d) All of the above.
   Answer: D
54. Which of the following is correct? A price-level surprise
   (a) is impossible if expectations are rational.
   (b) occurs if the aggregate demand curve shifts.
   (c) occurs if the short-run aggregate supply curve shifts.
   (d) causes the aggregate demand curve to shift.
   (e) occurs when the expected price level and the actual level differ.
   Answer: E

55. According to rational expectations, the business cycle is explainable in terms of
   (a) the lack of a monetary growth rule.
   (b) anticipated changes in discretionary policy.
   (c) the fixed duration of price and wage contracts.
   (d) unanticipated changes in the price level.
   (e) announced changes in the discretionary policy.
   Answer: D

56. In the view of the rational expectationists, the major difference between the response to an
   anticipated increase in the money supply and an unanticipated increase in the money supply is that
   when an anticipated increase in the money supply occurs,
   (a) individuals know that the price level will rise and adjust their behavior accordingly.
   (b) rational expectation results in a slow and lengthy change in inflationary expectations.
   (c) government policy-makers are following a predetermined rule for the growth rate of the money
   supply.
   (d) nominal interest rates fall in response to an anticipated increase in the money supply.
   (e) individuals are still surprised and unable to adjust their behavior.
   Answer: A

57. The major instrument of fiscal policy has been
   (a) changes in the supply of money through open-market purchases or sales.
   (b) increases or decreases in defense spending.
   (c) increases or decreases in public-works expenditures.
   (d) discretionary tax cuts.
   (e) federal grants to the states.
   Answer: D

58. An ideal activist policy requires that policy-makers be able to do which of the following?
   (a) Anticipate changes in the economy.
   (b) Know the natural rate of unemployment.
   (c) Know the effects of policy on the economy.
   (d) Act in a timely fashion.
   (e) All of the above.
   Answer: E
59. The Keynesian explanation of the business cycle rests on several concepts, including
   (a) sticky wages.
   (b) unstable money demand.
   (c) random shocks to the rate of technological change.
   (d) the desire of politicians to be re-elected.
   (e) pork barrel spending by politicians.
   Answer: A

60. Evidence supporting the sector-shift hypothesis of business cycles includes
   (a) a rising unemployment rate when unanticipated monetary growth occurs.
   (b) rapid and unforseen improvements in technology.
   (c) a higher rate of variation in job destruction than in job creation.
   (d) roughly similar swings in the growth rate of real GDP in the last 100 years.
   (e) a substantial reduction in changes in the rate of monetary growth after WWII.
   Answer: C

61. The Keynesian theory of the business cycle predicts
   (a) countercyclical behavior of investment demand.
   (b) countercyclical behavior of real wages.
   (c) procyclical money supply growth rates.
   (d) countercyclical interest rate behavior.
   (e) procyclical behavior of the natural rate of unemployment.
   Answer: B

62. The most important criticism of the Keynesian theory of business cycles is that empirical data show
   (a) real wages are highest when real GDP is highest while the theory predicts real wages should be
       lowest when real GDP is highest.
   (b) money supply growth is lowest when GDP is highest while the theory predicts money supply
       growth should be highest when real GDP is highest.
   (c) real interest rates should be highest when real GDP is highest while the theory predicts real
       interest rates should be lowest when real GDP is highest.
   (d) None of the above are important criticisms.
   Answer: A

63. Which of the following is a problem in pursuing an activist monetary policy?
   (a) The lag between a change in the money supply and its effect on economic activity may be long
       and variable.
   (b) We often don’t know we’re in a recession until it has occurred.
   (c) It’s not certain we are aiming at the correct targets.
   (d) All of the above.
   Answer: D
64. Real business cycle theory explains the business cycle as the result of
   (a) excess growth of the money supply.
   (b) unstable investment demand.
   (c) random shocks to consumer spending habits.
   (d) frequent changes to the tax code.
   (e) random shocks to the rate of technological change.
   Answer: E

65. Evidence against the sector-shift hypothesis includes which of the following?
   (a) A negative correlation between job vacancies in growing sectors and unemployment in
      declining sectors.
   (b) The fact that innovation occurs in only a few sectors of the economy at any one time.
   (c) A decrease in unanticipated inflation over time.
   (d) Stable monetary growth since the Depression.
   (e) Gradual changes in unemployment in different sectors of the economy.
   Answer: A

66. The Keynesian explanation of the business cycle is at odds with some empirical evidence, including
   (a) sectoral shifts in employment and output.
   (b) highly variable rates of monetary growth in the United States following WWII.
   (c) unemployment was mild immediately following WWII, in spite of a 60% decrease in
      government spending in 1946.
   (d) improvements in the quality of macroeconomic data that are the major factor in apparent
      reductions in cyclical instability.
   (e) None of the above is at odds with the Keynesian explanation.
   Answer: C

67. The inability of macroeconomists to find one all-encompassing theory of business cycles may
   indicate that
   (a) macroeconomists have some wonderful theories, but none of them are very practical.
   (b) the Chairman of the Federal Reserve, whose actions greatly influence U.S. business cycles,
      cannot be “modeled.”
   (c) the implementation of various activist policies in the United States have made testing for the
      causes of business cycles nearly impossible.
   (d) real-world business cycles have a multiplicity of causes.
   Answer: D

68. The case for nonactivism rests on the claim that
   (a) the business cycle is the result of random shocks in the rate of technological innovation.
   (b) it is too difficult to select the right policies in a world of uncertainty.
   (c) activist policies can make matters worse rather than better.
   (d) rational expectations can defeat activist policies.
   (e) All of the above.
   Answer: E
69. One (Keynesian) criticism of the monetarist money-growth rule is that
   (a) policy makers can’t fine-tune a complicated modern economy.
   (b) rational expectations may defeat the policy.
   (c) the Fed should have the ability to change monetary policy as economic conditions warrant.
   (d) monetary policy has been destabilizing in the past.
   (e) All of the above.
   
   Answer: C

70. The major weakness of real business cycle theory is that
   (a) it cannot explain the behavior of real wages.
   (b) the rate of technological change, in the real world, is not subject to random shocks.
   (c) the behavior of the Federal Reserve is not well explained.
   (d) supply shocks to a few sectors will have an insignificant impact on the entire economy.
   (e) empirical data on consumption expenditures varies much more over the business cycle than predicted by the theory.

   Answer: D