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AP Macroeconomics — Practice Exam

Instructions: Section I style multiple choice (20 questions, five answer choices each, 1 point each) followed by one free-response question (10 points), 35 minutes in total. No calculator is needed. Wrong multiple-choice answers are not penalized. On the free-response question, show your work for every calculation and draw graphs large, labeling all axes, curves and equilibrium points.

Time Limit: 35 minutes

Multiple Choice (20 questions)

- [1 point] 1. Which of the following would shift Lorane's aggregate demand curve to the right?
- A. A decrease in Lorane's price level
 - B. An increase in personal income tax rates
 - C. An appreciation of Lorane's currency on the foreign exchange market
 - D. A decline in business confidence about future sales
 - E. An increase in real incomes in Lorane's major trading partners
- [1 point] 2. Which of the following is best described as a movement along the aggregate demand curve rather than a shift of the curve?
- A. A fall in the price level reduces the demand for money, which lowers interest rates and raises investment spending
 - B. The central bank increases the money supply, which lowers interest rates and raises investment spending
 - C. A rise in stock prices increases household wealth and consumption spending
 - D. A cut in lump-sum taxes raises disposable income and consumption spending
 - E. Faster income growth abroad raises foreign demand for the country's exports

- [1 point]** 3. The table shows consumption spending at three levels of disposable income in Lorane (billions of dollars). Lorane's marginal propensity to consume and its spending multiplier are, respectively:

Disposable income	Consumption
2,000	1,700
2,400	2,000
2,800	2,300

- A. 0.25 and 4
B. 0.75 and 4
C. 0.75 and 1.33
D. 0.85 and 6.67
E. 0.75 and 3
- [1 point]** 4. Firms in Kesh become pessimistic about future profits and cut their investment spending by 15 billion dollars. The marginal propensity to save is 0.2. Assuming a constant price level, the maximum resulting change in real GDP is:
- A. a decrease of 3 billion dollars
B. a decrease of 12 billion dollars
C. a decrease of 60 billion dollars
D. a decrease of 75 billion dollars
E. a decrease of 15 billion dollars
- [1 point]** 5. In Lorane an increase in government purchases of 12 billion dollars raised real GDP by 48 billion dollars, with no change in the price level. If the government had instead cut lump-sum taxes by 12 billion dollars, the maximum increase in real GDP would have been:
- A. 12 billion dollars
B. 36 billion dollars
C. 48 billion dollars
D. 9 billion dollars
E. 64 billion dollars
- [1 point]** 6. Nominal wages in Kesh are fixed by three-year contracts at 25 dollars per hour. The price index then rises unexpectedly from 100 to 125. In the short run, the real wage (measured in base-year dollars) and the quantity of output firms are willing to supply will:
- A. rise to 31.25 dollars, so firms reduce output
B. remain at 25 dollars, so output is unchanged
C. fall to 20 dollars, so firms reduce output
D. fall to 20 dollars, so firms increase output
E. fall to 18.75 dollars, so firms increase output

- [1 point]** 7. Firms across Kesh adopt new software that raises output per worker in every industry. In the short run, the most likely effect is that:
- A. short-run aggregate supply shifts to the left, raising the price level and lowering real GDP
 - B. aggregate demand shifts to the right, raising both the price level and real GDP
 - C. short-run aggregate supply shifts to the right, along with long-run aggregate supply, lowering the price level and raising real GDP
 - D. aggregate demand shifts to the left, lowering both the price level and real GDP
 - E. short-run aggregate supply shifts to the right but long-run aggregate supply is unchanged, because productivity affects only short-run costs
- [1 point]** 8. Workers and firms in Lorane come to expect that inflation over the coming year will be much higher than they previously believed. In the short run this will most likely cause:
- A. long-run aggregate supply to shift to the left, lowering full-employment output
 - B. short-run aggregate supply to shift to the right, lowering the price level
 - C. a movement up along the short-run aggregate supply curve, with no shift of any curve
 - D. short-run aggregate supply to shift to the left, raising the price level and lowering real GDP
 - E. no change in either curve, because expectations affect only the long run
- [1 point]** 9. An economy is producing the level of real GDP shown by its long-run aggregate supply curve. Which of the following must be true?
- A. The unemployment rate is zero
 - B. The inflation rate is zero
 - C. The unemployment rate equals the natural rate of unemployment, so cyclical unemployment is zero
 - D. Frictional and structural unemployment have been eliminated
 - E. Real GDP cannot rise above this level in the short run
- [1 point]** 10. The table shows the aggregate demand and short-run aggregate supply schedules for Lorane, with real GDP in billions of dollars. Full-employment output is 1,050 billion dollars. Lorane's short-run equilibrium is at:

Price level	Real GDP demanded	Real GDP supplied
100	1,100	900
110	1,000	1,000
120	900	1,100
130	800	1,200

- A. a price level of 100 and real GDP of 1,100 billion dollars, with an inflationary gap of 50 billion dollars
- B. a price level of 110 and real GDP of 1,000 billion dollars, with an inflationary gap of 50 billion dollars
- C. a price level of 110 and real GDP of 1,000 billion dollars, with a recessionary gap of 50 billion dollars
- D. a price level of 120 and real GDP of 1,100 billion dollars, with an inflationary gap of 50 billion dollars
- E. a price level of 120 and real GDP of 900 billion dollars, with a recessionary gap of 150 billion dollars

- [1 point]** 11. In Kesh the natural rate of unemployment is 5 percent and the current unemployment rate is 8 percent. Real GDP is 950 billion dollars and full-employment output is 1,000 billion dollars. Which of the following correctly describes Kesh's situation and an appropriate discretionary fiscal policy response?
- A. An inflationary gap of 50 billion dollars; the government should reduce its purchases of goods and services
 - B. A recessionary gap of 50 billion dollars; the central bank should buy government bonds
 - C. A recessionary gap of 950 billion dollars; the government should raise income tax rates
 - D. Full employment, because the unemployment rate is positive; no policy response is needed
 - E. A recessionary gap of 50 billion dollars; the government should increase its purchases or cut taxes
- [1 point]** 12. Consumer confidence in Kesh falls sharply at the same time as a large fall in the world price of oil lowers firms' production costs. In the short run, the most likely effects on the price level and real GDP are:
- A. the price level falls; the change in real GDP is indeterminate
 - B. the change in the price level is indeterminate; real GDP falls
 - C. both the price level and real GDP fall
 - D. the price level falls and real GDP rises
 - E. the changes in both the price level and real GDP are indeterminate
- [1 point]** 13. Lorane's real GDP is 5,150 billion dollars, its full-employment output is 5,000 billion dollars, and its unemployment rate is below the natural rate. If no policy action is taken, which of the following describes how the economy adjusts in the long run?
- A. Aggregate demand shifts to the left as households run down their savings, returning output to 5,000 billion dollars at a lower price level
 - B. Nominal wages rise, short-run aggregate supply shifts to the left, and output falls to 5,000 billion dollars at a higher price level
 - C. Nominal wages fall, short-run aggregate supply shifts to the right, and output rises further above 5,000 billion dollars
 - D. Long-run aggregate supply shifts to the right to 5,150 billion dollars, closing the gap with no change in the price level
 - E. The economy stays at 5,150 billion dollars indefinitely, because a short-run equilibrium is stable
- [1 point]** 14. Lorane's real GDP is 2,940 billion dollars and its full-employment output is 3,000 billion dollars. The marginal propensity to consume is 0.9. Assuming a constant price level and no crowding out, the minimum increase in government purchases that would close the output gap is:
- A. 6 billion dollars
 - B. 6.67 billion dollars
 - C. 54 billion dollars
 - D. 60 billion dollars
 - E. 600 billion dollars

- [1 point]** 15. Kesh is producing a real GDP of 1,260 billion dollars, while its full-employment output is 1,200 billion dollars. The marginal propensity to consume is 0.6. To eliminate the gap using a change in lump-sum taxes alone, with a constant price level, the government should:
- A. cut taxes by 40 billion dollars
 - B. raise taxes by 24 billion dollars
 - C. raise taxes by 36 billion dollars
 - D. raise taxes by 60 billion dollars
 - E. raise taxes by 40 billion dollars
- [1 point]** 16. In Lorane the marginal propensity to consume is 0.5. The government is choosing between an increase in its purchases of goods and services of 30 billion dollars and a cut in lump-sum taxes of 30 billion dollars. Assuming a constant price level and no crowding out, the maximum increases in real GDP from the two policies are, respectively:
- A. 60 billion dollars and 60 billion dollars
 - B. 30 billion dollars and 15 billion dollars
 - C. 60 billion dollars and 30 billion dollars
 - D. 60 billion dollars and 15 billion dollars
 - E. 30 billion dollars and 30 billion dollars
- [1 point]** 17. Kesh has a recessionary gap of 40 billion dollars and a marginal propensity to consume of 0.8. The legislature wants to close the gap with an increase in government purchases that is fully paid for by an equal increase in lump-sum taxes, leaving the budget balance unchanged. Assuming a constant price level and no crowding out, government purchases and taxes must each rise by:
- A. 8 billion dollars
 - B. 10 billion dollars
 - C. 32 billion dollars
 - D. 40 billion dollars
 - E. 200 billion dollars
- [1 point]** 18. Lorane has a recessionary gap of 200 billion dollars and a marginal propensity to consume of 0.8. The government increases its purchases of goods and services by 20 billion dollars. Assuming a constant price level and no crowding out, after the full multiplier effect has worked through, Lorane will have:
- A. a recessionary gap of 100 billion dollars
 - B. no output gap
 - C. a recessionary gap of 180 billion dollars
 - D. a recessionary gap of 120 billion dollars
 - E. a recessionary gap of 196 billion dollars

- [1 point]** 19. Compared with an otherwise identical economy that has no automatic stabilizers, an economy with a progressive income tax and unemployment insurance will most likely experience:
- A. larger fluctuations in real GDP, because tax revenue rises during expansions
 - B. smaller fluctuations in real GDP, because disposable income changes by less than GDP when spending changes
 - C. a larger spending multiplier, because transfer payments add to aggregate demand
 - D. a budget that stays balanced over the business cycle without any new legislation
 - E. no recessions, because the stabilizers fully offset any fall in aggregate demand
- [1 point]** 20. A recession begins in Lorane in January. In September the legislature approves a one-time tax rebate, and the rebate checks reach households the following March. By then the economy has already returned to full-employment output on its own. The most likely effect of the rebate is:
- A. no effect on real GDP or the price level, because the recession has ended
 - B. a rightward shift of short-run aggregate supply, as households spend the rebate
 - C. a lower price level, because the rebate replaces income lost during the recession
 - D. a recessionary gap, because the delay has reduced the size of the multiplier
 - E. an inflationary gap, because the stimulus raises aggregate demand after the economy is already at full employment

Short Answer (1 question)

- [10 points]** 21. Fiscal policy and the output gap. The economy of Tessaly is in short-run equilibrium with real GDP of 1,800 billion dollars, while full-employment output is 1,900 billion dollars. The table shows consumption spending at three levels of disposable income (billions of dollars).

Disposable income	Consumption
400	370
500	450
600	530

- [2 points]** (a) (i) Using the table, calculate Tessaly's marginal propensity to consume. Show your work. (ii) Calculate the spending multiplier. Show your work.

- [3 points]** (b) Draw a correctly labeled graph of aggregate demand, short-run aggregate supply and long-run aggregate supply for Tessaly. Show the current equilibrium price level and real GDP, labeled PL_1 and Y_1 , and full-employment output, labeled Y_f . Identify the type of output gap Tessaly is experiencing and calculate its size.

- [3 points]** (c) For this part, assume that the price level is constant and that there is no crowding out. (i) Calculate the minimum increase in government purchases of goods and services that would close the output gap. Show your work. (ii) Calculate the minimum decrease in lump-sum taxes that would close the output gap. Show your work. (iii) Explain why the two amounts differ.

[2 points]

- (d) Assume instead that the government takes no action. Explain how Tessaly's economy will adjust to full employment in the long run. In your explanation, state what happens to nominal wages, which curve shifts and in which direction, and what happens to the price level and real GDP relative to PL_1 and Y_1 .