SECTION 6

AP® Exam Practice Questions

Multiple-Choice Questions

1. The budget balance is equal to
- **a.** total spending by the government.
- **b.** taxes minus transfer payments.
- **c.** taxes minus government spending and transfer payments.
- **d.** the sum of deficits and surpluses over time.
- **e.** total tax revenues collected.

2. The cyclically adjusted budget deficit adjusts the actual budget deficit for the effect of
- **a.** discretionary fiscal policy.
- **b.** discretionary monetary policy.
- **c.** inflation.
- **d.** transfer payments.
- **e.** the business cycle.

3. The public debt increases when
- **a.** the government collects more in taxes than it spends.
- **b.** the government runs a budget deficit.
- **c.** taxes exceed transfer payments.
- **d.** the budget balance is positive.
- **e.** individuals borrow for goods like houses and cars.

4. Which of the following is a potential problem with persistent increases in government debt?
- **a.** Government borrowing may crowd out private investment.
- **b.** Government debt is caused by budget deficits, which are always bad for the economy.
- **c.** It will always lead the government to default.
- **d.** It creates inflation because the government has to print money to pay it off.
- **e.** It causes automatic stabilizers to raise taxes in the future.

5. The Federal Open Market Committee sets a target for which of the following?
- **a.** the income tax rate
- **b.** the federal funds rate
- **c.** the money supply
- **d.** the prime interest rate
- **e.** the unemployment rate

6. Which of the following will occur if the Federal Reserve buys Treasury bills?
- **a.** The money supply will increase.
- **b.** The money supply curve will shift to the left.
- **c.** The money demand curve will shift to the right.
- **d.** Interest rates will rise.
- **e.** Aggregate demand will decrease.

7. Which of the following actions would the Federal Reserve use to address inflation?
- **a.** make an open-market sale of Treasury bills
- **b.** increase the money supply
- **c.** lower the discount rate
- **d.** decrease money demand
- **e.** raise taxes

8. The Taylor rule sets the target federal funds rate based on which of the following?
- **a.** the inflation rate only
- **b.** the unemployment rate only
- **c.** the output gap only
- **d.** both the inflation rate and the unemployment rate
- **e.** both the output gap and the inflation rate

9. An increase in the money supply will generate which o the following?
- **a.** a negative short-run effect on real GDP
- **b.** an increase in real GDP in the long run
- **c.** a decrease in real GDP in the long run
- **d.** a decrease in the aggregate price level in the long ru
- **e.** an increase in the aggregate price level in the short run and the long run

11. An inflation tax is the result of
- **a.** the federal government running a budget surplus.
- **b.** the Federal Reserve raising the federal funds rate.
- **c.** an increase in the demand for money.
- **d.** printing money to cover a budget deficit.
- **e.** contractionary fiscal policy.

12. An increase in the aggregate price level caused by a significant increase in the price of an input with economy-wide importance is called
- **a.** demand-pull inflation.
- **b.** seignorage inflation.
- **c.** supply-push inflation.
- **d.** cost-push inflation.
- **e.** input-pull inflation.

14. The short-run Phillips curve shows the relationshi
between the inflation rate and the
- **a.** GDP growth rate.
- **b.** unemployment rate.
- **c.** employment rate.
- **d.** real interest rate.
- **e.** nominal interest rate.

15. An increase in expected inflation has what effect on tl
short-run Phillips curve?
- **a.** a movement up and to the left along the curve
- **b.** a movement down and to the right along the curve
- **c.** an upward shift of the curve
- **d.** a downward shift of the curve
- **e.** an increase in the slope of the curve

16. The long-run Phillips curve is
- **a.** horizontal.
- **b.** vertical.
- **c.** upward sloping.
- **d.** downward sloping.
- **e.** U-shaped.

17. The long-run Phillips curve illustrates which of the following?
- **a.** a positive relationship between unemployment and inflation
- **b.** a negative relationship between unemployment and inflation
- **c.** that unemployment will always return to the NAIR
- **d.** that unemployment will adjust so that the econom experiences 2% inflation
- **e.** that output will adjust so that there is no unemplo ment or inflation in the long run

18. The process of bringing down the rate of inflation tha
has become embedded in expectations is known as
- **a.** disinflation.
- **b.** deflation.
- **c.** negative inflation.
- **d.** debt deflation.
- **e.** monetary policy.

19. A liquidity trap occurs when conventional monetary policy is ineffective because
- **a.** the short-run Phillips curve is negatively sloped.
- **b.** the public will not buy or sell Treasury bills.
- **c.** the unemployment rate can't go below 5%.
- **d.** the nominal interest rate can't be negative.
- **e.** the real interest rate can't be negative.

20. According to the Quantity Theory of Money,
- **a.** the money supply times velocity is equal to nominal GDP.
- **b.** velocity varies significantly with the business cycle.
- **c.** changes in the money supply have no long-run effect on the economy.
- **d.** activist monetary policy is necessary to promote economic growth.
- **e.** monetary policy rules promote business-cycle fluctuations.

Free-Response Question

1. Draw a correctly labeled graph showing a short-run Phillips curve.
- **a.** On your graph, show a long-run Phillips curve and label
  - **i.** the NAIRU
  - **ii.** the equilibrium inflation rate
- **b.** On your graph, show the effect of an increase in the expected inflation rate.

(6 points)