

Econ 20B- Additional Problem Set

I. MULTIPLE CHOICES. Choose the one alternative that best completes the statement to answer the question.

1. Which of the following is correct?
 - a. Over the business cycle consumption fluctuates more than investment.
 - b. Economic fluctuations are easy to predict.
 - c. During recessions sales and profits tend to fall.
 - d. Because of government policy the U.S. has suffered no recessions in the last 25 years.

ANS: C PTS: 1 DIF: 1 REF: 33-1

2. Most economists use the aggregate demand and aggregate supply model primarily to analyze
 - a. short-run fluctuations in the economy.
 - b. the effects of macroeconomic policy on the prices of individual goods.
 - c. the long-run effects of international trade policies.
 - d. productivity and economic growth.

ANS: A PTS: 1 DIF: 1 REF: 33-1

3. During recessions investment
 - a. falls by a larger percentage than GDP.
 - b. falls by about the same percentage as GDP.
 - c. falls by a smaller percentage than GDP.
 - d. falls but the percentage change is sometimes much larger and sometimes much smaller.

ANS: A PTS: 1 DIF: 2 REF: 33-1

4. According to classical macroeconomic theory, changes in the money supply affect
 - a. nominal variables and real variables.
 - b. nominal variables, but not real variables.
 - c. real variables, but not nominal variables.
 - d. neither nominal nor real variables.

ANS: B PTS: 1 DIF: 1 REF: 33-2

5. Real and nominal variables are highly intertwined, and changes in the money supply change real GDP. Most economists would agree that this statement accurately describes
 - a. both the short run and the long run.
 - b. the short run, but not the long run.
 - c. the long run, but not the short run.
 - d. neither the long run nor the short run.

ANS: B PTS: 1 DIF: 2 REF: 33-2

- 6 . Other things the same, an increase in the price level makes consumers feel
- less wealthy, so the quantity of goods and services demanded falls.
 - less wealthy, so the quantity of goods and services demanded rises.
 - more wealthy, so the quantity of goods and services demanded rises.
 - more wealthy, so the quantity of goods and services demanded falls.

ANS: A PTS: 1 DIF: 1 REF: 33-3

- 7 . Other things the same, when the price level rises,
- interest rates rise, so firms increase investment.
 - interest rates rise, so firms decrease investment.
 - interest rates fall, so firms increase investment.
 - interest rates fall, so firms decrease investment.

ANS: B PTS: 1 DIF: 2 REF: 33-3

- 8 . Suppose a fall in stock prices makes people feel poorer. The decrease in wealth would induce people to
- decrease consumption, shown as a movement to the left along a given aggregate demand curve.
 - increase consumption, shown as a movement to the right along a given aggregate demand curve.
 - decrease consumption, shifting the aggregate demand curve to the left.
 - increase consumption, shifting the aggregate demand curve to the right.

ANS: C PTS: 1 DIF: 2 REF: 33-3

- 9 . Aggregate demand would shift right if either
- the price level decreased, or government expenditures increased.
 - the price level decreased, or the government instituted an investment tax credit.
 - government expenditures or the money supply increased.
 - All of the above are correct.

ANS: C PTS: 1 DIF: 2 REF: 33-3

- 10 . Imagine two economies that are identical except that for a long time, economy A has had a money supply of \$500 billion while economy B has had a money supply of \$1,000 billion. It follows that
- real GDP and the price level are higher in country B.
 - real GDP, but not the price level, is higher in country B.
 - the price level, but not real GDP is higher in country B.
 - neither the price level nor real GDP is higher in country B.

ANS: C PTS: 1 DIF: 2 REF: 33-4

- 11 . The long-run aggregate supply curve would shift right if the government were to
- increase the minimum-wage.

- b. make unemployment benefits more generous.
- c. raise taxes on investment spending.
- d. None of the above is correct.

ANS: D PTS: 1 DIF: 2 REF: 33-4

12 . The sticky-wage theory of the short-run aggregate supply curve says that when the price level rises more than expected,

- a. production is more profitable and employment rises.
- b. production is more profitable and employment falls.
- c. production is less profitable and employment rises.
- d. production is less profitable and employment falls.

ANS: A PTS: 1 DIF: 2 REF: 33-4

13 . Other things the same, if the price level is lower than expected, then some firms believe that the relative price of what they produce has

- a. decreased, so they increase production.
- b. decreased, so they decrease production.
- c. increased, so they increase production.
- d. increased, so they decrease production.

ANS: B PTS: 1 DIF: 2 REF: 33-4

14 . The effects of a higher than expected price level are shown by

- a. shifting the short-run aggregate supply curve right.
- b. shifting the short-run aggregate supply curve left.
- c. moving to the right along a given aggregate supply curve.
- d. moving to the left along a given aggregate supply curve.

ANS: C PTS: 1 DIF: 2 REF: 33-

15 . Which of the following shifts both short-run and long-run aggregate supply left?

- a. a decrease in the actual price level
- b. a decrease in the expected price level
- c. a decrease in the capital stock
- d. a decrease in the money supply

ANS: C PTS: 1 DIF: 2 REF: 33-4

16. Which of the following would cause prices to fall and output to rise in the short run?

- a. Short-run aggregate supply shifts right.
- b. Short-run aggregate supply shifts left.
- c. Aggregate demand shifts right.
- d. Aggregate demand shifts left.

ANS: A PTS: 1 DIF: 2 REF: 33-5

17 . An economic contraction caused by a shift in aggregate demand causes prices to

- a. rise in the short run, and rise even more in the long run.
- b. rise in the short run, and fall back to their original level in the long run.
- c. fall in the short run, and fall even more in the long run.
- d. fall in the short run, and rise back to their original level in the long run.

ANS: C PTS: 1 DIF: 3 REF: 33-5

II. CALCULATIONS AND EXPLANATIONS. Compute the numbers and provide explanations when necessary.

III. SHORT ESSAYS. Answer the following questions briefly but concisely.

1. Explain how an increase in the price level changes interest rates. How does this change in interest rates lead to changes in investment and net exports?

ANS:

When the price level increases, the purchasing power of money held in purses and bank accounts declines. This decline makes people feel less wealthy so that they lend less. The reduction in lending causes the interest rate to rise. The rise in interest rates discourages spending on investment goods so that the aggregate quantity of goods and services demanded decreases. As the interest rate increases, the supply of dollars in the market for foreign-currency exchange falls as people wish to purchase fewer foreign assets. This makes the dollar appreciate which decreases net exports.

PTS: 1 DIF: 3 REF: 33-3

2. Suppose that a decrease in the demand for goods and services pushes the economy into recession. What happens to the price level? If the government does nothing, what ensures that the economy still eventually gets back to the natural rate of output?

ANS:

A decrease in aggregate demand causes the price level to fall. If the government takes no action to counter this, then the actual price level will be below the price level that people expected. Individuals will eventually correct their expectations of the price level. As they do so, prices and wages will adjust accordingly, shifting the aggregate supply curve to the right. For example if wages are sticky, in light of the lower price level, firms and workers will eventually make bargains for lower nominal wages. The reduction in wages lowers costs of production, so firms are willing to produce more at any given price level. Consequently, the short-run aggregate supply curve shifts right. The rightward shift in aggregate supply eventually causes output to rise back to the natural rate.

PTS: 1 DIF: 3 REF: 33-1

3. Discuss what economists believe is different about the long and short run.

ANS:

Most economists believe that in the long run, real variables are not affected by nominal variables. So, for example, changes in the money supply do not change real

variables in the long run. However, most economists believe that nominal variables do change real variables in the short run. In the short-run prices and wages may be fixed based on the expected price level. If the actual price level differs from the expected price level, real variables are affected.

PTS: 1 DIF: 2 REF: 33-2

4. Make a list of things that would shift the aggregate demand curve to the right.

ANS:

Examples (and variations on examples) in the text include a stock market boom that increases consumption spending, a tax cut that increases consumption, improvements in capital goods such as computers that increase investment, increased optimism about the future of the economy induces increased investment, an investment tax credit, an increase in the money supply, an increase in government defense expenditures, and economic expansions overseas that create increases in net exports.

PTS: 1 DIF: 2 REF: 33-3

5. Make a list of things that would shift the long-run aggregate supply curve to the right.

ANS:

Examples in the text (or variations) include increased immigration, a decrease in the minimum wage, less generous unemployment insurance, an increase in the capital stock, an increase in the average level of education, a discovery of new mineral deposits, advances in technology, and removal of barriers to international trade.

PTS: 1 DIF: 2 REF: 33-4