

Econ 20B- Additional Problem Set

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

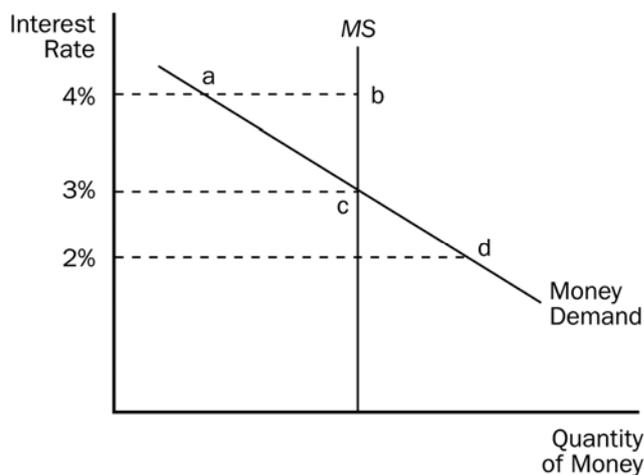
1. According to the theory of liquidity preference, the money supply
 - a. and money demand are positively related to the interest rate.
 - b. and money demand are negatively related to the interest rate.
 - c. is negatively related to the interest rate while money demand is positively related to the interest rate.
 - d. is independent of the interest rate, while money demand is negatively related to the interest rate.

ANS: D PTS: 1 DIF: 2 REF: 34-1

2. The theory of liquidity preference assumes that the nominal supply of money is determined by the
 - a. level of real GDP.
 - b. rate of inflation.
 - c. interest rate.
 - d. the Federal Reserve.

ANS: D PTS: 1 DIF: 1 REF: 34-1

Figure 34-1



3. Refer to Figure 34-1. If the current interest rate is 2 percent,
 - a. there is excess money supply.
 - b. people will sell more bonds, which drives interest rates up.
 - c. as the money market moves to equilibrium, people will buy more goods.
 - d. All of the above are correct.

ANS: B PTS: 1 DIF: 2 REF: 34-1

4. Refer to Figure 34-1. At an interest rate of 4 percent there is excess
 - a. money demand equal to the distance between a and b.

- b. money demand equal to the distance between b and c.
- c. money supply equal to the distance between b and a.
- d. money supply equal to the distance between c and b.

ANS: C PTS: 1 DIF: 2 REF: 34-1

5. People will want to hold more money if the price level
- a. or the interest rate increases.
 - b. or the interest rate decreases.
 - c. increases or the interest rate decreases.
 - d. decreases or the interest rate increases.

ANS: C PTS: 1 DIF: 2 REF: 34-1

6. Which of the following shifts money demand to the right?
- a. an increase in the price level
 - b. a decrease in the price level
 - c. an increase in the interest rate
 - d. a decrease in the interest rate

ANS: A PTS: 1 DIF: 1 REF: 34-1

7. Other things the same, which of the following responses would we expect to result from a decrease in U.S. interest rates?
- a. U.S. citizens decide to hold more foreign bonds.
 - b. people choose to hold more currency.
 - c. You decide to purchase a new oven for your cookie factory.
 - d. All of the above are correct.

ANS: D PTS: 1 DIF: 2 REF: 34-1

8. If the Fed conducts open-market sales, the money supply
- a. increases and aggregate demand shifts right.
 - b. increases and aggregate demand shifts left.
 - c. decreases and aggregate demand shifts right.
 - d. decreases and aggregate demand shifts left.

ANS: D PTS: 1 DIF: 2 REF: 34-1

9. Which of the following shifts aggregate demand right?
- a. an increase in government expenditures or a decrease in the price level
 - b. a decrease in government expenditures or an increase in the price level
 - c. an increase in government expenditures, but not a change in the price level
 - d. a decrease in the price level, but not an increase in government expenditures

ANS: C PTS: 1 DIF: 1 REF: 34-2

10. The government buys new weapons systems. The manufacturers of weapons pay their employees. The employees spend this money on goods and services. The firms they buy goods and services from pay their employees. This illustrates

- a. the crowding-out effect.
- b. the multiplier effect.
- c. the Fisher effect.
- d. None of the above is correct.

ANS: B PTS: 1 DIF: 1 REF: 34-2

11. If there is crowding out, which of the following might decrease as government expenditures increased?

- a. real GDP
- b. the demand for money curve
- c. interest rates
- d. demand for capital goods

ANS: D PTS: 1 DIF: 2 REF: 34-2

12. An increase in government purchases is likely to

- a. decrease interest rates.
- b. result in a net decrease in aggregate demand.
- c. crowd out investment spending by business.
- d. decrease money demand.

ANS: C PTS: 1 DIF: 2 REF: 34-2

13. If households view a tax cut as temporary, the tax cut

- a. has no affect on aggregate demand.
- b. has more of an affect on aggregate demand than if households view it as permanent.
- c. has the same affect as when households view the cut as permanent.
- d. has less of an affect on aggregate demand than if households view it as permanent.

ANS: D PTS: 1 DIF: 2 REF: 34-2

14. If Congress cuts spending to balance the federal budget, the Fed can act to prevent unemployment and recession by

- a. buying bonds to increase the money supply
- b. buying bonds to decrease the money supply.
- c. selling bonds to increase the money supply.
- d. selling bonds to decrease the money supply.

ANS: A PTS: 1 DIF: 2 REF: 34-2

15. If businesses and consumers become pessimistic, the Federal Reserve can attempt to reduce the impact on the price level and real GDP by

- a. increasing the money supply which raises interest rates.
- b. increasing the money supply which lowers interest rates.
- c. decreasing the money supply which raises interest rates.
- d. decreasing the money supply which lowers interest rates.

ANS: B PTS: 1 DIF: 2 REF: 34-3

16. Which of the following policies would Keynes' followers support when an increase in business optimism shifts the aggregate demand curve away from long-run equilibrium?

- a. decrease taxes
- b. increase government expenditures
- c. increase the money supply
- d. None of the above is correct.

ANS: D PTS: 1 DIF: 2 REF: 34-3

17. Other things the same, automatic stabilizers tend to

- a. raise expenditures during expansions and recessions.
- b. lower expenditures during expansions and recessions.
- c. raise expenditures during recessions and lower expenditures during expansions.
- d. raise expenditures during expansions and lower expenditures during recessions.

ANS: C PTS: 1 DIF: 2 REF: 34-3

18. When Congress reduces spending in order to balance the budget, it needs to consider

- a. both the short-run effects on aggregate demand and aggregate supply, and the long-run effects on saving and growth.
- b. only the short-run effects on aggregate demand and aggregate supply.
- c. only the long-run effects on saving and growth.
- d. the long-run effects on aggregate demand and aggregate supply.

ANS: A PTS: 1 DIF: 1 REF: 34-4

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

1. Suppose that the government increases expenditures by \$150 billion while increasing taxes by \$150 billion. Suppose that the MPC is .80 and that there are no crowding out or accelerator effects. What is the combined effects of these changes? Why is the combined change not equal to zero?

ANS:

The multiplier is $1/(1-MPC) = 1/(1-.8) = 1/.2 = 5$. The increase of \$150 in government expenditures leads to a shift of $\$150 \text{ billion} \times 5 = \750 billion in aggregate demand. The increase in taxes decreases income by \$150 and so initially decreases consumption by $\$150 \text{ billion} \times MPC = \$150 \text{ billion} \times .8 = \120 billion . This change in consumption will create a multiplier effect of $\$120 \text{ billion} \times 5 = \600 . Thus the net change is $\$750 \text{ billion} - \$600 \text{ billion} = \$150 \text{ billion}$. The changes don't cancel each other out, because a tax increase decreases consumption by less than the tax increase.

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

1. What is the difference between monetary policy and fiscal policy?

ANS:

The Federal Reserve Bank conducts U.S. monetary policy. It consists of policies to affect the financial side of the economy—most notably the supply of money in the economy. Fiscal policy is conducted by the executive and Congressional branches of government, and entails decisions about taxes and government spending.

2. Describe the process in the money market by which the interest rate reaches its equilibrium value if it starts above equilibrium.

ANS:

If the interest rate is above equilibrium, there is an excess supply of money. People with more money than they want to hold given the current interest rate deposit the money in banks and buy bonds. The increase in funds to lend out causes the interest rate to fall. As the interest rate falls, the quantity of money demanded increases, which tends to diminish the excess supply of money.

3. Suppose that the government spends more on a missile defense program. What does this do to aggregate demand? How is your answer affected by the presence of the multiplier, crowding-out, taxes, and investment-accelerator effects?

ANS:

The increase in expenditures means that government spending rises. The aggregate demand curve shifts to the right. Aggregate demand shifts farther if there is a multiplier effect or an investment accelerator and shifts less if there is crowding out or if taxes are raised to increase government expenditures.

4. Suppose that consumers become pessimistic about the future health of the economy. What will happen to aggregate demand and to output? What might the president and Congress have to do to keep output stable?

ANS:

As consumers become pessimistic about the future of the economy, they cut their expenditures so that aggregate demand shifts left and output falls. The president and Congress could adjust fiscal policy to increase aggregate demand. They could either increase government spending, or cut taxes, or both.