Homework #4 (Chapter 9, 10 and 11)
(ECON 410, Spring 2009)
(Due 04/09 in class)

(A) Multiple Choice Questions: (3 points per multiple choice problem), 25 questions.

1. In the Economic Stimulus Tax Rebate in 2008, people would get $600 from the government. This is a policy most consistent with:

A) supply side proposals to improve workers' incentives.
B) Monetarist monetary policy to increase the money supply.
C) policies to move the economy to the Golden Rule level of output.
D) Keynesian proposals to stimulate aggregate demand.

2. If the *IS* curve is given by $Y = 1{,}700 - 100r$ and the *LM* curve is given by $Y = 500 + 100r$, then equilibrium income and interest rate are given by:

A) $Y = 1{,}100$, $r = 6$ percent.
B) $Y = 1{,}200$, $r = 5$ percent.
C) $Y = 1{,}000$, $r = 5$ percent.
D) $Y = 1{,}100$, $r = 5$ percent.

3. A difference between the economic long run and the short run is that:

A) the classical dichotomy holds in the short run but not in the long run.
B) monetary and fiscal policy affect output only in the long run.
C) demand can affect output and employment in the short run, whereas supply is the ruling force in the long run.
D) prices and wages are sticky in the long run only.

4. When the Federal Reserve increases the money supply, at a given price level the amount of output demanded is ______ and the aggregate demand curve shifts ______.

A) greater; inward
B) greater; outward
C) lower; inward
D) lower; outward

5. If the long-run aggregate supply curve is vertical, then changes in aggregate demand affect:

A) neither prices nor level of output.
B) both prices and level of output.
C) level of output but not prices.
D) prices but not level of output.

6. A 5-percent reduction in the money supply will, according to most economists, reduce prices 5 percent:
A) in both the short and long runs.
B) in neither the short nor long run.
C) in the short run but lead to unemployment in the long run.
D) in the long run but lead to unemployment in the short run.

7. Assume that the economy starts from long-run equilibrium. If the Federal Reserve increases the money supply, then ______ increase(s) in the short run and ______ increase(s) in the long run.
A) prices; output
B) output; prices
C) output; output
D) prices; prices

8. If consumption is given by $C = 200 + 0.75(Y - T)$ and investment is given by $I = 200 - 25r$, then the formula for the *IS* curve is:
A) $Y = 400 - 0.75T - 25r + G$.
B) $Y = 1{,}600 - 3T - 100r + 4G$.
C) $Y = 400 + 0.75T - 25r - G$.
D) $Y = 1{,}600 + 3T - 100r - 4G$.

9. In the Keynesian-cross model, if government purchases increase by 250, and the marginal propensity to consume is 0.5, then the equilibrium level of income:
A) increases by 250.
B) increases by 500.
C) decreases by 250.
D) increases, but by less than 250.

10. In the current financial crisis, the banks have tightened their rules to lending money. In the IS-LM framework:
A) *IS* curve shifts left.
B) *IS* curve shifts right.
C) *LM* curve shifts left.
D) *LM* curve shifts right.

11. In the current financial crisis, the banks have tightened their rules to lending money. In the IS-LM framework, the following can be done to maintain the same income level but with a higher interest rate:
A) Fed increases money supply.
B) Fed decreases money supply.
C) Government increases its purchase.
D) Government decreases its purchase.

12. In the current financial crisis, the banks have tightened their rules to lending money. In the IS-LM framework, the following can be done to maintain the same income level but with a lower interest rate:
A) Fed increases money supply.
B) Fed decreases money supply.
C) Government increases its purchase.
D) Government decreases its purchase.

13. If interest is fixed (this can happen if interest rate is determined in the international capital market), then:
A) Both *IS* and *LM* curves are vertical.
B) *IS* curve is negatively sloped and *LM* curve is positively sloped.
C) Both *IS* and *LM* curves are flat.
D) *IS* curve is flat but *LM* curve is vertical.

14. If the *IS* curve is given by $Y = 1{,}700 - 100r$, the money demand function is given by $(M/P)^d = Y - 100r$, the money supply is 1,000, and the price level is 2, then if the money supply is raised to 1,200, equilibrium income rises by:
A) 200 and the interest rate falls by 2 percent.
B) 100 and the interest rate falls by 1 percent.
C) 50 and the interest rate falls by 0.5 percent.
D) 200 and the interest rate remains unchanged.

15. If the quantity theory of money is valid, and the velocity does not depend on interest rate, then the *LM* curve:
A) slopes upward and to the right.
B) slopes downward and to the right.
C) is vertical.
D) is horizontal.

16. The congress reduces the capital gains tax such that at the same interest level there is more investment demand. To maintain the same income level:
A) Fed would increase money supply.
B) Fed would decrease money supply.
C) Because of lower tax revenue, government would lower the income tax rates to encourage working, so the tax revenue would increase.
D) Income would not change.

17. In the Great Depression, which of the following did NOT happen:
A) Unemployment rate had risen substantially.
B) Real money balance had dropped substantially.
C) Nominal money supply had dropped substantially.
D) Real GDP had dropped substantially.

18. The Great Depression in the United States:
A) was likely caused by a fall in the money supply because it fell by 25 percent from 1929 to 1933.
B) cannot be attributed to a fall in the money supply because the money supply did not fall.
C) probably cannot be considered to have started because of a leftward shift in the *LM* curve because real balances did not fall between 1929 and 1931.
D) probably was caused by a leftward shift in the *LM* curve because interest rates remained high between 1929 and 1933.

19. The debt-deflation theory of the Great Depression suggests that a(n) ______ deflation redistributes wealth in such a way as to ______ spending on goods and services.
A) unexpected; reduce
B) unexpected; increase
C) expected; reduce
D) expected; increase

20. In the *IS-LM* analysis, the increase in income resulting from a tax cut is usually _____ the increase in income resulting from an equal rise in government spending.
A) less than
B) greater than
C) equal to
D) sometimes less and sometimes greater than

21. In the *IS-LM* model when the Federal Reserve decreases the money supply, people ______ bonds and the interest rate ______, leading to a(n) ______ in investment and income.
A) buy; rises; increase
B) sell; falls; decrease
C) sell; rises; decrease
D) buy; rises; decrease

22. If Congress passed a tax increase at the request of the president to reduce the budget deficit, but the Fed held the money supply constant, then the two policies together would generally lead to ______ income and a ______ interest rate.
A) lower; lower
B) lower; higher
C) no change in; lower
D) no change in; higher

23. *All* of the following were observed during both the Great Depression of the 1930s in the United States and the Japanese slump of the 1990s *except*:
A) stock prices declined significantly.
B) banks ran into trouble.
C) the unemployment rate soared above 20 percent.
D) interest rates fell to extremely low levels.

24. If the short-run *IS-LM* equilibrium occurs at a level of income above the natural rate of output, in the long run the ______ will ______ in order to return output to the natural rate.
A) price level; increase
B) interest rate; decrease
C) money supply; increase
D) consumption function; decrease

25. A tax cut combined with tight money, as was the case in the United States in the early 1980s, should lead to a:
A) rise in the real interest rate and a fall in investment.
B) fall in the real interest rate and a rise in investment.
C) rise in both the real interest rate and investment.
D) fall in both the real interest rate and investment.

(B) Essay Questions
1. (10 points)
Mankiw textbook, Chapter 10, question 3, pp302.

2. (15 points)
Mankiw textbook, Chapter 11, question 3, pp327-328.