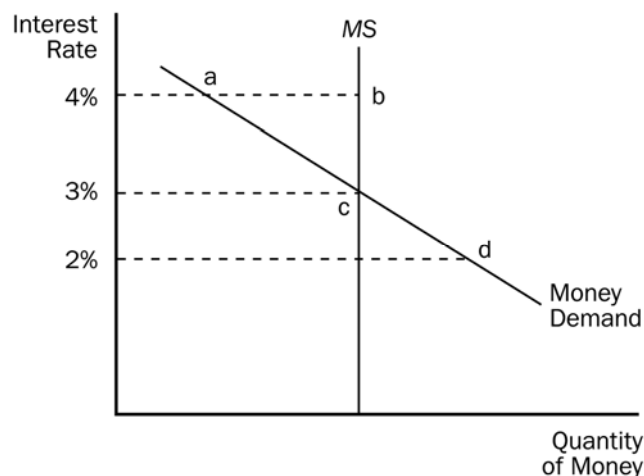


Econ 20B- Additional Problem Set 8

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.
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.

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.
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.

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.
  
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
  
7. Other things the same, which of the following responses would we expect to result from an 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.
  
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.
  
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
  
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.
  
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

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.

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

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

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.

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.

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.

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.

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.

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?

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

1. What is the difference between monetary policy and fiscal policy?
2. Describe the process in the money market by which the interest rate reaches its equilibrium value if it starts above equilibrium.
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?
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?