Review Multiple Choice Questions for Mid Term II

I. Multiple Choice Questions on Chapter 5

1. The LM curve tells us, for each interest rate, the level of output where
a. the good market is in equilibrium.
b. there is no inventory investment.
c. output is equal to demand.
d. all of the above.
e. none of the above.

2. Which of the following occurs as we move rightward along the LM curve?
a. A rise in the interest rate causes investment spending to decrease.
b. A drop in the interest rate causes investment spending to increase.
c. A rise in the interest rate causes the central bank to create more money.
d. A rise in the interest rate causes the government to increase spending.
e. A rise in the interest rate causes the demand for money to decrease.

3. After a contractionary or expansionary fiscal policy,
a. the LM curve shifts and we move along the IS curve.
b. the IS curve shifts and we move along the LM curve.
c. both the IS and LM curves shift.
d. neither the IS nor the LM curve shifts.
e. the LM curve shifts; the IS curve may or may not shift depending on the actions of the central bank.

4. Suppose that we observe a policy mix of contractionary monetary policy and expansionary fiscal policy. We can expect with certainty
a. an increase in output
b. a reduction in output
c. an increase in the interest rate
d. a reduction in the interest rate
e. an increase in consumption

5. A reduction in consumer’s confidence will likely have which of the following effect?
a. a leftward shift of the IS curve
b. a rightward shift of the IS curve
c. a downward (SE) shift of the LM curve
d. an upward (NW) shift of the LM curve
e. none of the above
II. Multiple Choice Questions on chapter 6 and 7
Choose the one alternative that best completes the statement or answers the question.

1) An individual is considered unemployed if he or she:
   A) works only part-time.
   B) works full-time in a family business.
   C) is not working and is not looking for work.
   D) all of the above
   E) none of the above

2) The reservation wage is:
   A) the wage that an employer must pay workers to reduce turnover to a reasonable level.
   B) the wage that ensures a laid-off individual will wait for re-hire, rather than find
      another job.
   C) the wage that would make an individual indifferent between working or not working.
   D) the wage offer that will end a labor-strike.
   E) the bribe that must be paid to a maître d' when you want a table but did not call in
      advance.

3) Efficiency wage theory suggests that:
   A) workers will be paid more than their reservation wage.
   B) productivity might drop if the wage rate is too high.
   C) the government can only set tax rates so high before people will prefer not to work.
   D) unskilled workers will have a lower turnover rate than skilled workers.
   E) firms will be more resistant to wage increases as the labor market tightens.

4) In the wage-setting relation, the nominal wage falls when:
   A) the price level falls.
   B) the unemployment rate falls.
   C) unemployment benefits increase.
   D) the minimum wage increases.
   E) all of the above

5) The natural rate of unemployment is the rate of unemployment:
   A) that occurs when the money market is in equilibrium.
   B) where the markup of prices over costs is zero.
   C) where the markup of prices over costs is equal to its historical value.
   D) that occurs when both the goods and financial markets are in equilibrium.
   E) consistent with both the wage-setting and price-setting equations.
6) The aggregate demand curve will shift to the right when which of the following occurs?
A) a decrease in the money supply
B) a reduction in consumer confidence
C) a rise in the price level
D) a decrease in taxes
E) a decrease in the price level

7) "Money is neutral" means that a change in the money supply:
A) will make society neither more nor less moral than it was before.
B) will not change output in the short run.
C) will not change output in the medium run.
D) will not change the price level in the short run.
E) will not change the price level in the medium run.

8) An increase in government spending will, in the medium run, cause no change in:
A) unemployment.
B) the interest rate.
C) the price level.
D) all of the above
E) none of the above

9) Suppose there is a reduction in the price of oil. This change in the price of oil will cause which of the following in the medium run?
A) a decrease in output
B) an increase in the price level
C) an increase in the interest rate
D) all of the above
E) none of the above

10) The aggregate supply curve will shift north west when which of the following occurs?
A) a decrease in the money supply.
B) a reduction in $z$ (in the WS relation)
C) a rise in the price level
D) an increase in the mark-up
E) a decrease in the price level

Key: E C A A E
D C A E D
III. Monetary policy in the medium run

Use the following IS-LM model to calculate the effect on various aggregates of an increase in the money supply.

<table>
<thead>
<tr>
<th>Aggregate</th>
<th>Equation</th>
</tr>
</thead>
<tbody>
<tr>
<td>consumption</td>
<td>( C = 100 + 0.66Y_D )</td>
</tr>
<tr>
<td>investment</td>
<td>( I = 800 - 16.66i )</td>
</tr>
<tr>
<td>tax</td>
<td>( T = 600 )</td>
</tr>
<tr>
<td>government expenditure</td>
<td>( G = 500 )</td>
</tr>
<tr>
<td>real money demand</td>
<td>( L = Y - 100i )</td>
</tr>
<tr>
<td>money supply</td>
<td>( M = 1200 )</td>
</tr>
<tr>
<td>price level</td>
<td>( P = 1 )</td>
</tr>
</tbody>
</table>

\( Y \) is output, \( Y_D \) is disposable income and \( i \) the rate of interest expressed as a percentage.

The IS curve is: \( Y = 3000 - 50i \) and the LM curve: \( i = 0.01Y - 12 \) and the short run equilibrium of the economy is \( Y = 2400 \) and \( i = 12\% \) - let’s also assume that the economy is at its medium run equilibrium level.

a. Calculate the corresponding levels of consumption, investment and the real money supply.

\[
C = \underline{\text{consumption level}} \quad \quad I = \underline{\text{investment level}}
\]

\[
\frac{M}{P} = \underline{\text{real money supply level}}
\]

b. Now assume that the Fed doubles the nominal money supply. Solve the model i.e. what are the equations for the IS and the LM curves and the corresponding equilibrium values of \( Y \) and \( i \) in the short run.
IS curve: \[ Y = \ \] 

LM curve: \[ i = \ \] 

Calculate the corresponding levels of consumption, investment and the real money supply.

\[ C = \ \] \[ I = \ \] 

\[ M/P = \ \]

c. Is the economy now beyond or below its full employment level?

What happens to the price level in the medium run?
What is the price level consistent with the medium run equilibrium: \( P = \) 
(note that in this model the price level is proportional to the nominal money supply)

Now solve the model i.e. what are the equations for the IS and the LM curves and the corresponding equilibrium values of \( Y \) and \( i \) in the medium run.

**IS curve:** 
\( Y = \) 

**LM curve:** 
\( i = \) 

\( Y = \) \( i = \) 

Calculate the corresponding levels of consumption, investment and the real money supply.

\( C = \) \( I = \)
M/P = ________________

d. Compare the values of consumption and of investment in the 3 cases above i.e. the original position, the short run adjustment and the medium run adjustment.

Consumption has …

Investment has …

(Finish the sentences above.)

Is monetary policy neutral or non-neutral in the medium run