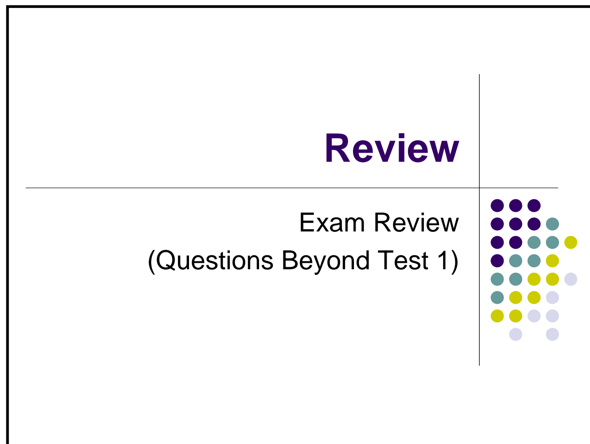
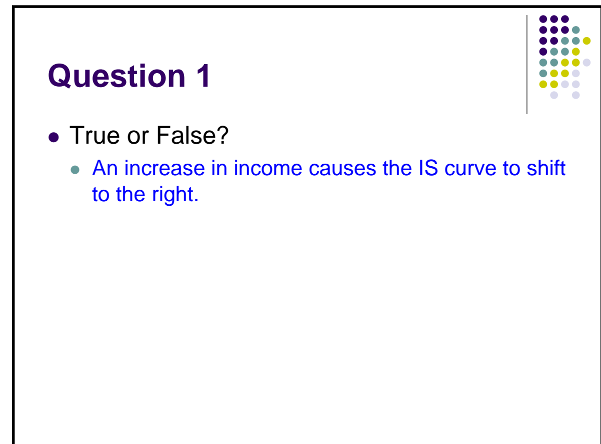
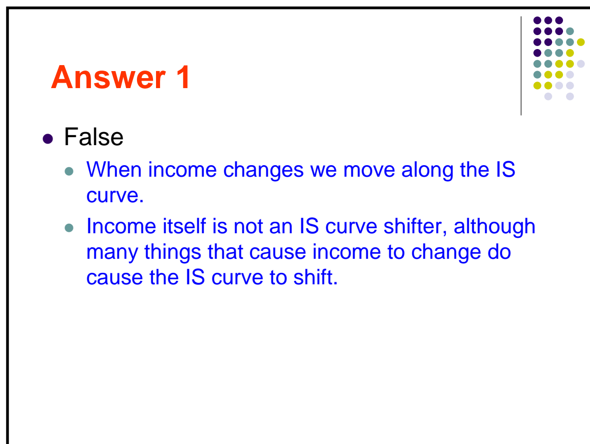
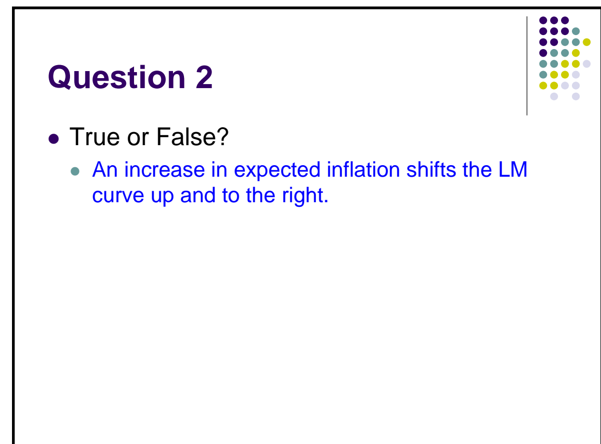
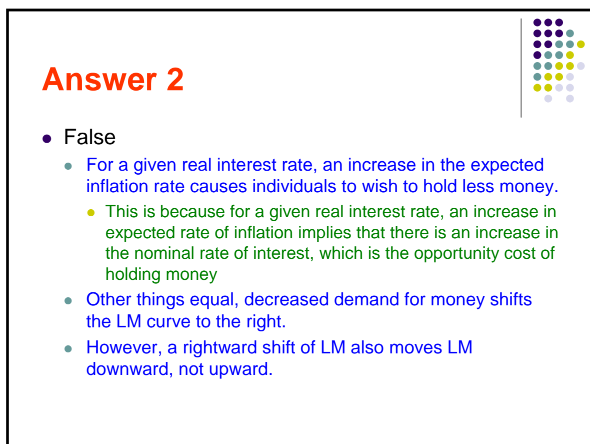
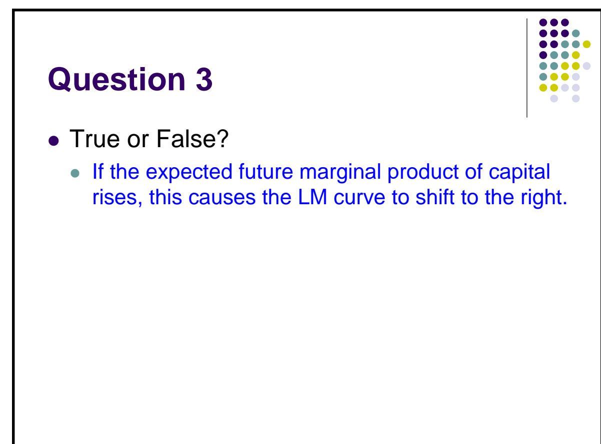

Review
Exam Review
(Questions Beyond Test 1)


Question 1
True or False?
An increase in income causes the IS curve to shift to the right.


Answer 1
False
When income changes we move along the IS curve.
Income itself is not an IS curve shifter, although many things that cause income to change do cause the IS curve to shift.


Question 2
True or False?
An increase in expected inflation shifts the LM curve up and to the right.


Answer 2
False
For a given real interest rate, an increase in the expected inflation rate causes individuals to wish to hold less money.
This is because for a given real interest rate, an increase in expected rate of inflation implies that there is an increase in the nominal rate of interest, which is the opportunity cost of holding money
Other things equal, decreased demand for money shifts the LM curve to the right.
However, a rightward shift of LM also moves LM downward, not upward.


Question 3
True or False?
If the expected future marginal product of capital rises, this causes the LM curve to shift to the right.

Answer 3

- False
  - Expected future marginal product of capital would cause the IS curve to shift, not the LM curve.

Question 4

- True or False?
  - In the classical model, a temporary increase in government spending on the military will cause the FE curve to shift to the right.

Answer 4

- True
  - An increase in military spending makes households feel poorer, which increases work effort.
    - Classical economists emphasize this point; however, Keynesian economists would deemphasize it.

Question 5

- True or False?
  - Suppose that the economy is in a Keynesian short run equilibrium. This means that the economy is located on the IS curve and the FE line, but not necessarily on the LM curve.

Answer 5

- False
  - In the short run equilibrium in the Keynesian model, the economy is located on the IS curve and the LM curve, but not necessarily on the FE line.

Question 6

- True or False?
  - Suppose that expected inflation increases. In the short run this will cause income to rise and the interest rate to fall.

Answer 6

- True
  - As we noted earlier, an increase in the expected inflation rate causes a decrease in the quantity of money demanded at any given real interest rate, so this shifts the LM curve to the right.
  - We slide down the IS curve to a lower interest rate and a higher level of income.

Question 7

- True or False?
  - Every variable that shifts the IS curve or the LM curve will also shift the aggregate demand curve.

Answer 7

- False
  - There is an exception to the statement. Every variable that shifts the IS curve or the LM curve, with the exception of the price level, does shift the aggregate demand curve.

Question 8

- True or False?
  - According to the Keynesian model, in the short run, an increase in government spending will cause income to rise and the expected real rate of interest to fall.

Answer 8

- False
  - An increase in government spending causes the IS curve to shift to the right.
  - We move up the LM curve, so income rises and the interest rate rises.

Question 9

- True or False?
  - According to the classical model, a one-time 20% increase in the money supply causes a one-time increase in the price level of more than 20%.

Answer 9

- False
  - The statement is false because in the classical model an increase in the money supply causes a proportional (20%) increase in the price level.

Question 10

- True or False?
  - Suppose an economy initially as a steady inflation rate of 6%.
  - Then the central bank increases the rate of growth of the money supply and keeps it higher permanently.
  - In the new steady state the rate of inflation is now 13%.
  - The real money supply is higher in the high inflation steady state than it was in the low inflation steady state.

Answer 10

- False
  - In the high inflation steady state, the nominal rate of interest will be higher, causing the real demand for money to be lower.
  - Since the quantities of money demanded and supplied must be equal the real money supply must also be lower in the high inflation steady state.

Question 11

- True or False?
  - In the efficiency wage model, a firm sets a real wage in order to maximize output per worker.

Answer 11

- False
  - In the efficiency wage theory, firms set the real wage in order to maximize effort (effective labor) per real dollar of wages.

Question 12

- True or False?
  - According to the efficiency wage theory, the number of job seekers should be equal to the number of vacancies.

Answer 12

- False
  - According to the efficiency wage theory, the quantity of labor supplied exceeds the quantity of labor demanded at the prevailing real wage
  - This implies that the number of job seekers will normally exceed the number of vacancies.

Question 13

- True or False?
  - In the Lucas misperceptions theory, if the expected price level exceeds the actual price level, then output exceeds the full employment level of output.

Answer 13

- False
  - If actual price is less than expected price output will be less than full employment level of output.

Question 14

- True or False?
  - In the Lucas misperceptions model, each short run aggregate supply curve intersects the long run aggregate supply curve at a point where actual price is equal to expected price.

Answer 14

- True
  - In Lucas misperceptions model the distinction between the long-run and short run is that in the long run actual price must be equal to expected price.
  - A short run aggregate supply curve is drawn for a given expected price level; the actual price level varies.
  - On the short run aggregate supply curve there will be one point where actual price equals expected price.
  - Such a point satisfies the long run equilibrium condition, so that point also lies on the long run aggregate supply curve.

Question 15

- True or False?
  - In the Keynesian model, menu costs refer to the costs of changing prices.

Answer 15

- True
  - True by definition

Question 16

- True or False?
  - In the Keynesian theory, aggregate demand shocks are the primary source of business cycle fluctuations, but in the classical theory, changes in government spending are the primary source of business cycle fluctuations.

Answer 16

- False
  - Productivity shocks are considered to be the primary source a business cycle fluctuations in the classical model.

Question 17

- True or False?
  - An increase in the expected rate of inflation makes the short run Phillips curve shift upwards.

Answer 17

- True
  - The short-run Phillips curve is drawn for a given expected rate of inflation.
  - Each short-run Phillips curve intersects the vertical long-run Phillips curve at a point where actual inflation is equal to expected inflation.
  - A short run Phillips curve with a higher expected inflation rate, will intersect the long-run Phillips curve and a higher points on the vertical long-run Phillips curve.

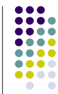
Question 18

- True or False?
  - Because the Phillips curve is negatively sloped, it is possible for an economy to reduce its unemployment rate permanently, if it is willing to endure a higher steady inflation rate.

Answer 18

- False
  - In the long run the unemployment rate must equal the natural rate of unemployment.
  - No matter what the inflation rate, once the inflation rate is expected, unemployment will be at its natural rate.

Question 19



- True or False?
  - The sum of the current account and the official settlements balance is equal to zero.

Answer 19

- False
  - The sum of the current account plus the capital and financial account must equal zero
  - The official settlements balance is equal to the increase in home country official reserve assets (home country central bank holdings of assets denominated in foreign currencies) less the increase in foreign official assets (foreign country central bank holdings of assets denominated in the home country currency).

Question 20

- True or False?
  - If the US is the home country and Europe is the foreign country, then according to our theory the nominal exchange rate would be expressed in terms of dollars per Euro.

Answer 20

- False
  - The nominal exchange rate could be expressed in terms of Euro per dollar.
  - It is the price of the home currency in terms of the foreign currency.

Question 21

- True or False?
  - Suppose that the real exchange rate rises. According to our theory, eventually, this will cause net exports to fall.

Answer 21

- True
  - The increase in the exchange rate makes domestic goods more expensive, so buyers tend to move in the direction of buying foreign goods, and eventually net exports decline.

Question 22

- True or False?
  - The J. curve effect refers to the tendency of the price level to fall before it rises in response to an increase in the money supply.

Answer 22

- False
  - The J curve refers to the tendency is net exports to initially move in the same direction as the real exchange rate when the real exchange rate changes, although it eventually moves in an inverse direction

Question 23

- True or False?
  - Suppose that relative purchasing power parity holds. Also suppose that the inflation rate in the United States to 6% and that the inflation rate in Mexico, the foreign country, is 14%. Then the dollar will be depreciating relative to the peso and the rate of 8% per year.

Answer 23

- False
  - The dollar will be at appreciating at a rate of 8% per year relative to the peso.

$$e = \frac{e_{nom} P}{P_{For}} \qquad \frac{\Delta e}{e} = \frac{\Delta e_{nom}}{e_{nom}} + \frac{\Delta P}{P} - \frac{\Delta P}{P_{for}}$$

Question 24

- True or False?
  - Suppose that income in the rest of the world rises (but no other foreign variables change)
  - The effect of this change on the home country will be that income will rise, net exports will rise, and the the real rate of interest will rise.

Answer 24

- True
  - An increase in foreign income causes foreigners to spend more, and some of that spending will be on goods produced by the home country, which means that net exports from the home country will rise
  - The home country IS curve will consequently shift to the right, increasing income and expected real rate of interest.

Question 25

- True or False?
  - The home country central bank increases the money supply. In the Keynesian short run, this will cause both the nominal exchange rate and the real exchange rate to fall.

Answer 25

- True
  - The IS-LM diagram shows us that an increase in the money supply causes income to rise and the interest rate to fall.
  - The increase in income causes an increase in imports and therefore higher demand for the foreign currency. This causes the exchange rate to depreciate.
  - The reduction in the interest rate, causes investors to favor foreign assets, which increases the demand for the foreign currency, which also causes the exchange rate to depreciate.
  - So the overall effect is that the exchange rate falls.

Question 26

- True or False?
  - In the long run, an increase in the money supply will cause the nominal exchange rate to fall and the real exchange rate to fall.

Answer 26

- False
  - In the long run, the nominal exchange rate will fall, and the domestic price level will rise in equal proportion. This leaves the real exchange rate unchanged.

$$e = \frac{e_{nom} P}{P_{For}}$$

Question 27

- True or False?
  - Suppose that Panama decides to fix its exchange rate to the dollar. If inflation in the United States is 2%, in the inflation rate in Panama will be 10% per year.

Answer 27

- False
  - If Panama fixes its exchange rate of the dollar, then Panama's monetary policy cannot operate independently of US monetary policy
  - In the long run, holding other things unchanged, inflation rates in the two countries would be the same.

Question 28

- True or False?
  - Suppose that investors believe that the Hong Kong monetary Authority will devalue the home currency, the Hong Kong dollar, relative to the US dollar (assume that the Hong Kong dollar is currently fixed to the US dollar).
  - As a result of this expectation, individual investors would like to sell US dollars and buy Hong Kong dollars.

Answer 28

- False
  - Holding other things equal, and expectation that the Hong Kong dollar will be devalued would make investors less likely to want to hold Hong Kong dollars.

The End