Test 2 Multiple Choice Answers

1. Answer B.
Currency is the most liquid asset, which implies that it can be directly used to make transactions. It is the convenience of making transactions that induces people to hold money in savings accounts and other financial assets pay interest.

2. Answer D
The opportunity cost of holding currency is equal to the difference between the nominal rate of interest paid on bonds and the rate of interest on currency. The rate of interest on currency is of course equal to zero. Therefore the opportunity cost of holding currency is equal to the nominal rate of interest on bonds. If the interest rate on bonds falls in the opportunity cost of holding currency falls.

3. Answer B
When expected inflation increases, then, for given real interest rate the nominal interest rate is higher. This means that the opportunity cost of holding money is higher, and the quantity of money demanded falls. Real balances refers to real money balances.

4. Answer A.

If a financial panic increases uncertainty about returns in the stock market and the bond market, then, other things held equal, individuals are less likely to want to hold stocks and bonds. Instead, they are more likely to want to hold money. Therefore the quantity of money demanded will be higher.

5. Answer D.
This is simply a definition: velocity is equal to the ratio of nominal GDP to the nominal money stock. It is interpreted as the number of times a dollar in the money stock turns over in final goods transactions in a year.

6. Answer D.
If real money demand is unchanged, then an equilibrium the real money supply must also be unchanged. If the money supply doubles, the real money supply can be unchanged only if the price level doubles. This is the money neutrality result.

7. Answer D.
An adverse supply shock lowers the production function for all levels of employment. It also decreases the marginal product of labor at any level of employment. Because of the latter result, the demand for labor curve shifts to the left. This implies that employment is lower. With employment lower and with the production function shifted downward output must be lower in equilibrium. Therefore the FE curve has shifted to the left.

8. Answer C.
An increase in the labor supply has no effect on the IS curve. Labor supply and labor demand inter-our model only through the supply side. The IS curve involves goods market equilibrium.

9. Answer B.
For given income a decrease in wealth because spending to be lower, and saving to be higher. With lower spending be I is curve shifts to the left.

10. Answer A.
Bond prices and bond yields are inversely related. Therefore when the price of a bond rises the yield on the bond falls.

11. AnswerB.
An increase in the money supply results in a rightward shift of the LM curve. This is considered

further in one of the analytical questions. For a given price level an increase in the money supply implies an increase in the real money supply, therefore the answer is B, rather than C.

12. Answer D.
if the IS curve and the LM curve intersect to the right of the FE line, then the economy is not in a long-run equilibrium. Ultimately the economy must return to the FE line. This is accomplished as the price level adjusts to make the LM curve move. An increase in the price level is required to make the LM curve shift to the left. More intuitively, when ISN the LM intersect to the right of the FE, that means that at the prevailing price level aggregate demand exceeds aggregate supply. This puts upward pressure on the price level.

13. Answer D.
in the short run Keynesians believe that the price level is stuck. An increase in the money supply shifts aggregate demand to the right, and with the price level stuck, output must rise. Therefore money neutrality does not hold in the short run. Obviously it has also been assumed that prices do not adjust rapidly.

14. Answer C.
A decrease in consumer confidence normally means that consumers only their incomes will be lower in the future. As a consequence they spend less today, causing the IS curve and the aggregate demand curve to shift to the left. All of the alternative answers would result in rightward shifts of the aggregate demand curve.

15. Answer B.
The long-run aggregate supply curve is vertical. In the long run output is determined by equilibrium employment in the labor market and the production function. The price level affects neither the labor market equilibrium nor the production function, so output is independent of the price level. This leads to the vertical long-run aggregate supply curve.

16. Answer A.
in a recession firms normally encounter lower demand for their output. As a consequence firms will normally produce less output, and if they produce less output, they need a lower quantity of labor. However because a recession is likely to be temporary, firms recognize that in the future they will again need more labor. Although firms could fire workers today and rehire workers in the future, this is costly: firms will have to retrain new workers in the future. To avoid this, firms will avoid laying off workers in proportion to the reduction in output; instead they keep workers. This is labor hoarding, which is best described by answer A.

17. Answer D.
In the classical model, and increasing government purchases makes workers feel less wealthy. The example discussed in class was that of a temporary foreign war. If the government spends today in order to carry out a war, then less output is available for other needs; effectively this is a wealth reduction. This is true whether the additional current spending is financed by current taxes, or by debt, which implies that taxes will be higher in the future. According to the classical view, with lower wealth, individuals are likely to want to work more (that is, they consume not only fewer goods, but they also consume less leisure). If individuals want to work more, then the labor supply curve has shifted to the right. In the classical model, the labor demand schedule is identical to the marginal product of labor schedule, which is derived from the production function. Because the production function has not changed, the labor demand curve has not shifted. Therefore answer A is not correct.

18. Answer B.
if the central bank correctly expects output to increase in the future, then they anticipate that money demand will be high future. If the central bank wishes to keep the interest rate unchanged, then it must increase the money supply to match the increase in money demand. This kind of behavior by the central bank will generate a correlation between money growth and output. For example, the money supply and output are typically both high in the fourth quarter of

every year. This is because of a high normal level of economic activity surrounding Christmas, not because the federal reserve causes a small boom every year in the fourth quarter by manipulating the money supply.

19. Answer D.
The scenario described characterizes Lucas's misperceptions theory. According to this theory, when the price level is less than expected, output and employment fall. When the price level is greater than expected output and employment rise. With variations in the money supply producing variations in the price level, we will observe a positive correlation between output and the price level. This relationship is that the short run aggregate supply curve, which is upward sloping.

20. Answer A.
if the price level is below the expected price level, the economy does move down into the left along the short run aggregate supply curve, leading to lower output. This is a movement along SRAS.

21. Answer B.
According to the efficiency wage theory, firms will choose a real wage that maximizes effective labor, or effort, per dollar. Essentially, choosing a higher hourly wage leads to a lower effective cost of labor.

22. Answer D.
According to the efficiency wage model, firms choose an efficiency wage to maximize effort per real dollar, and then they choose a quantity of labor to maximize profit. This means that given the efficiency wage, firms choose to employ the amount of labor on the labor demand curve at that wage. This determines what is referred to as the full employment level of output in the Keynesian model. Because employment is demand determined, answer A is not correct; an increase in labor supply would only increase the number unemployed. Answer B is also not correct, because we do not have a demand supply equilibrium if the efficiency wage theory applies. Answer C is also incorrect, because only the efficiency wage and the labor demand curve determine the quantity of labor employed -- labor supply does not affect the quantity of labor employed.

23. Answer D.
According to the Keynesian theory, firms are monopolistically competitive. When a firm has market power, it's profits are not very sensitive to small deviations from of price from the profit maximizing level. So when demand shifts, and when changing prices is costly, firms may choose not to change prices. At a given price firms will meet demand. For firms with market power price is set above marginal costs so the firm does gain profit when it produces an additional unit.

24. Answer D.
The Keynesian model is a sticky price model. IS and LM determine output for given price level. The Keynesian model equilibrium requires that the economy be on IS and LM. In the short run the economy need not be on the FE line. It is only when the price level adjusts, in the long run, that LM will shift to assure that IS, LM, and LRAS all intersect.

25. Answer A.
In the Keynesian model, money neutrality prevails in the long run but not the short run. In the short run an increase in the money supply shifts LM and aggregate demand to the right causing output to rise, so money is not neutral. However in the long run the price level will adjust upward and output will return to the full employment level. This is the money neutrality result.

26. Answer D.
if the government eases monetary policy then the LM curve shifts to the right. If the government increases taxes the IS curve shifts to the left. If you drive diagram showing each of these two shifts, you will see that the new IS-LM intersection must result in a lower interest rate. However, output could be either higher or lower than before, depending on which curve shifts by a larger

amount.