

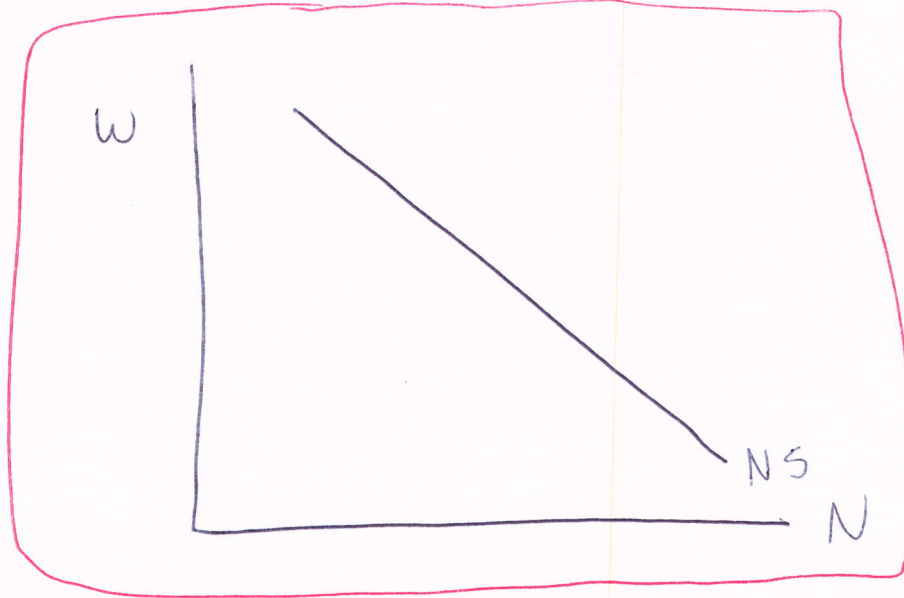
Answer Key

Testname: TEST01

- 1) A
- 2) A
- 3) D
- 4) B
- 5) B
- 6) A
- 7) A
- 8) C
- 9) C
- 10) B
- 11) B
- 12) D
- 13) B
- 14) A
- 15) C
- 16) A
- 17) B
- 18) C
- 19) A
- 20) B
- 21) B
- 22) D
- 23) D
- 24) C

Part II. Analytical Questions

1. (12 points) Draw a diagram that plots a competitive firm's demand curve for labor (label all curves and axes carefully).

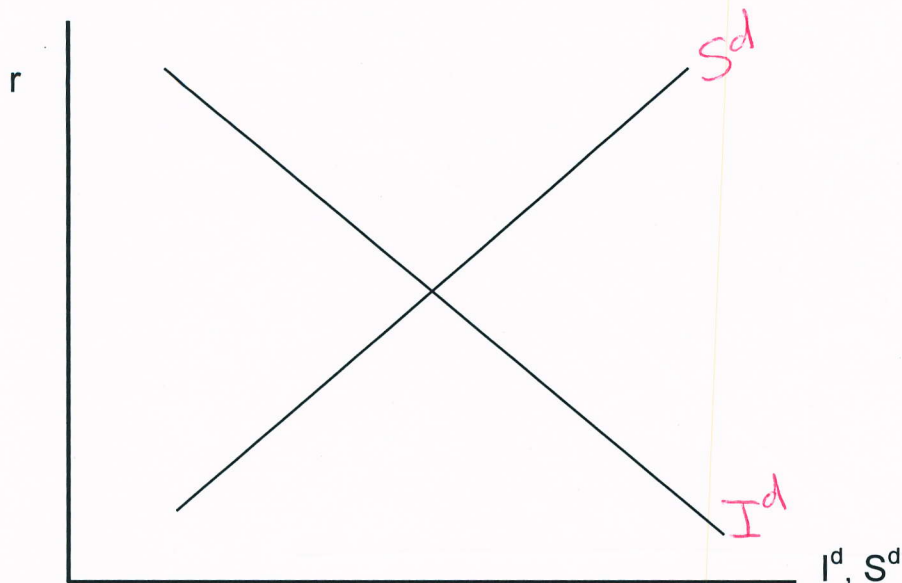


Why is the firm's labor demand schedule downward sloping? (Briefly explain what condition a firm must satisfy to maximize profit in hiring labor, and why satisfaction of this condition implies that the labor demand curve is downward sloping).

The profit maximization condition requires that a firm hire additional workers so long as $MPN > w$, and to hire up to the point where $MPN = w$. Also, note that MPN declines with increasing N .

Suppose that a firm is satisfying the profit maximization condition, but then w falls. At the previously prevailing N , MPN would now be higher than w , since w has declined. But then the firm would want to hire more workers, since $MPN > w$. The firm would continue to add workers until MPN declines to equal the new, lower real wage. So a lower w leads to higher N , and the demand curve for labor is downward sloping.

2. Answer the questions below that make use of the diagram illustrating desired saving and desired investment curves.



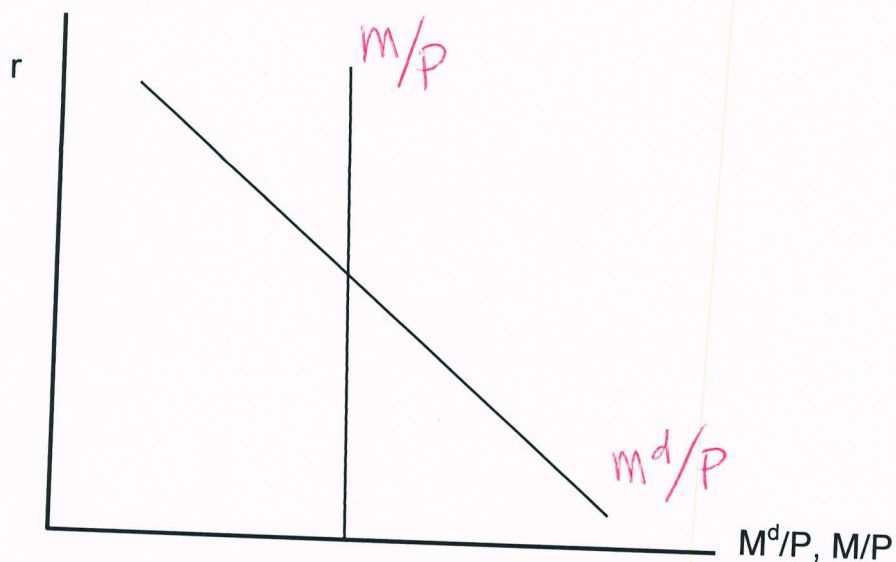
- (a) (4 points) Label the diagram to show which curve is the desired saving curve and which is the desired investment curve.
- (b) (4 points) Briefly explain why the I^d curve has the slope that your diagram shows.

The I^d curve is downward sloping because a lower real interest rate lowers the user cost of capital, which increases the desired capital stock (in accord with the profit maximization condition, $MPK^f = uc$) and, for any current existing K , leads to higher desired investment spending.

- (c) (4 points) Suppose that real income, Y , rises. In your diagram, show which curve shifts and the direction of the shift. Briefly explain why the curve shifts in this manner.

An increase in income normally increases both consumption and saving, so the desired saving curve will shift to the right.

3. The diagram below shows real money supply and real money demand curves. Answer the questions below the diagram.



(a) (4 points) Label the curves to indicate which is the money demand curve and which is the money supply curve.

(b) (2 points each) For each of the following events, indicate which curve shifts and which direction. Fill in your answers in the table.

- i) Real income, Y , rises.
- ii) The central bank increases the money supply.
- iii) The price level falls.
- iv) The expected rate of inflation rises.

Which curve shifts? (M^d/P or M/P)	Which Direction? (Right or Left)
i) M^d/P	R
ii) M/P	R
iii) M/P	R
iv) M^d/P	L