

Name \_\_\_\_\_

Last 5 Digits \_\_\_\_\_

Test 2  
Economics 322  
April 8, 2010

Instructions

**Part I Multiple Choice.** (25 questions, 2.4 points each, 60 points total).

Answer each multiple choice question on the form provided provided. Please fill in your name and also bubble in the grid below your name on the answer sheet. In the field for student number, fill in only the last 5 digits on your student number and bubble in the grid below those numbers.

Answer questions on the attached Scantron form.

**Part II Analytical Questions** (40 points total)

Answer the analytical questions directly on this test sheet.

**Part I Multiple Choice.** (25 questions, 2.4 points each, 60 points total).

Choose the one alternative that best completes the statement or answers the question.

- 1) An increase in investment spending would cause the current period *FE* line to \_\_\_\_\_  
1) \_\_\_\_\_  
A) shift to the left.  
B) remain unchanged if Ricardian equivalence holds; otherwise, shift to the right.  
C) shift to the right.  
D) remain unchanged.
- 2) A decrease in wealth would cause the *IS* curve to \_\_\_\_\_  
2) \_\_\_\_\_  
A) shift down and to the left.                      B) remain unchanged.  
C) shift up and to the left.                         D) shift up and to the right.
- 3) The *IS* curve would unambiguously shift up and to the right if there were \_\_\_\_\_  
3) \_\_\_\_\_  
A) an increase in both government purchases and corporate taxes.  
B) a decrease in both corporate taxes and the expected future marginal product of capital.  
C) an increase in both government purchases and the expected future marginal product of capital.  
D) an increase in the expected future marginal product of capital and a decrease in expected future output.
- 4) You have just read that the Federal Reserve has increased the money supply to avoid a recession. For a given price level, you would expect the *LM* curve to \_\_\_\_\_  
4) \_\_\_\_\_  
A) shift up and to the left as the real money supply falls.  
B) shift down and to the right as the real money supply falls.  
C) shift up and to the left as the real money supply rises.  
D) shift down and to the right as the real money supply rises.
- 5) In the Keynesian model, a temporary decrease in government purchases causes the real interest rate to \_\_\_\_\_ and output to \_\_\_\_\_ in the short run.  
5) \_\_\_\_\_  
A) fall; rise                      B) fall; fall                      C) rise; rise                      D) rise; fall
- 6) Suppose the intersection of the *IS* and *LM* curves is to the left of the *FE* line. What would eliminate a disequilibrium among the asset, labor, and goods markets?  
6) \_\_\_\_\_  
A) A rise in the price level, shifting the *LM* curve up and to the left  
B) A fall in the price level, shifting the *LM* curve down and to the right  
C) A fall in the price level, shifting the *IS* curve down and to the left  
D) A rise in the price level, shifting the *IS* curve up and to the right

- 7) Keynesian economists believe that in the short run, \_\_\_\_\_  
 A) money neutrality does not exist and prices adjust rapidly.  
 B) money neutrality exists and prices adjust rapidly.  
 C) money neutrality exists and prices do not adjust rapidly.  
 D) money neutrality does not exist and prices do not adjust rapidly.
- 8) An increase in money supply causes the real interest rate to \_\_\_\_\_ and the price level to \_\_\_\_\_ in general equilibrium in the classical model.  
 A) remain unchanged; rise                      B) remain unchanged; fall  
 C) rise; rise    D) fall; fall
- 9) Which of the following changes shifts the *AD* curve to the right?  
 A) An increase in the risk on nonmonetary assets  
 B) An increase in income taxes  
 C) A rise in the nominal money supply  
 D) A decrease in the future marginal productivity of capital
- 10) When the money supply declines by 10%, in the long run, output \_\_\_\_\_ and the price level \_\_\_\_\_.  
 A) is unchanged; falls                      B) is unchanged; is unchanged  
 C) declines; falls                              D) declines; is unchanged
- 11) Real business cycle theorists think that most business cycle fluctuations are caused by shocks to  
 A) the real quantity of government purchases.  
 B) the spending and saving decisions of consumers.  
 C) the production function.  
 D) the size of the labor force.
- 12) According to the misperceptions theory, an unanticipated decrease in the money supply shifts the *AD* curve \_\_\_\_\_, causing output to \_\_\_\_\_ in the short run.  
 A) up and to the right; fall                      B) down and to the left; fall  
 C) down and to the left; rise                      D) up and to the right; rise
- 13) According to the efficiency wage model, firms will pay the real wage that  
 A) maximizes the marginal productivity of capital and the marginal productivity of labor together.  
 B) maximizes effort per dollar of real wage.  
 C) maximizes workers' marginal productivity.  
 D) minimizes hiring and training costs to the firm.
- 14) In the efficiency wage model with the efficiency wage above the market-clearing wage,  
 A) there could be either an excess demand for, or an excess supply of, labor.  
 B) labor supply equals labor demand.  
 C) there is an excess demand for labor.  
 D) there is an excess supply of labor.

- 15) According to the menu cost theory, firms will be slow in changing their prices because 15) \_\_\_\_\_
- A) demand for their product would fall because consumers would purchase goods from firms that had not raised their prices.
  - B) if prices changed frequently, individuals would reduce their demand for that good because of uncertainty.
  - C) frequent price changes would be a sign of monopolistic behavior.
  - D) the cost of changing the price might exceed the additional revenue the price change would generate.
- 16) In the Keynesian model, short-run equilibrium occurs 16) \_\_\_\_\_
- A) where the *IS* curve, *LM* curve, and *FE* lines intersect.
  - B) where the *IS* and *LM* curves intersect.
  - C) where the *IS* curve intersects the *FE* line.
  - D) where the *LM* curve intersects the *FE* line.
- 17) In the Keynesian model in the long run, a decrease in the money supply will cause 17) \_\_\_\_\_
- A) an increase in the real interest rate but no change in output.
  - B) a decrease in the real interest rate and a decrease in output.
  - C) a decrease in output and an increase in the real interest rate.
  - D) no change in either the real interest rate or output.
- 18) Suppose the government decided to tighten monetary policy and decrease government expenditures. In the short run in the Keynesian model, the effect of these policies would be to \_\_\_\_\_ the real interest rate and \_\_\_\_\_ the level of output. 18) \_\_\_\_\_
- A) lower; decrease
  - B) lower; have an ambiguous effect on
  - C) raise; decrease
  - D) have an ambiguous effect on; decrease
- 19) A situation in which expansionary monetary policy has no effect on the economy is known as 19) \_\_\_\_\_
- A) macroeconomic stabilization.
  - B) a depression.
  - C) capital flight.
  - D) a liquidity trap.
- 20) Suppose most people had anticipated that inflation would be 3% in the coming year because the Fed would increase the money supply by 3%. Instead, the Fed increases the money supply by 5%. In the short run, this would cause actual output to be \_\_\_\_\_ full-employment output and prices to increase by \_\_\_\_\_ 3%. 20) \_\_\_\_\_
- A) above; less than
  - B) above; more than
  - C) below; less than
  - D) below; more than

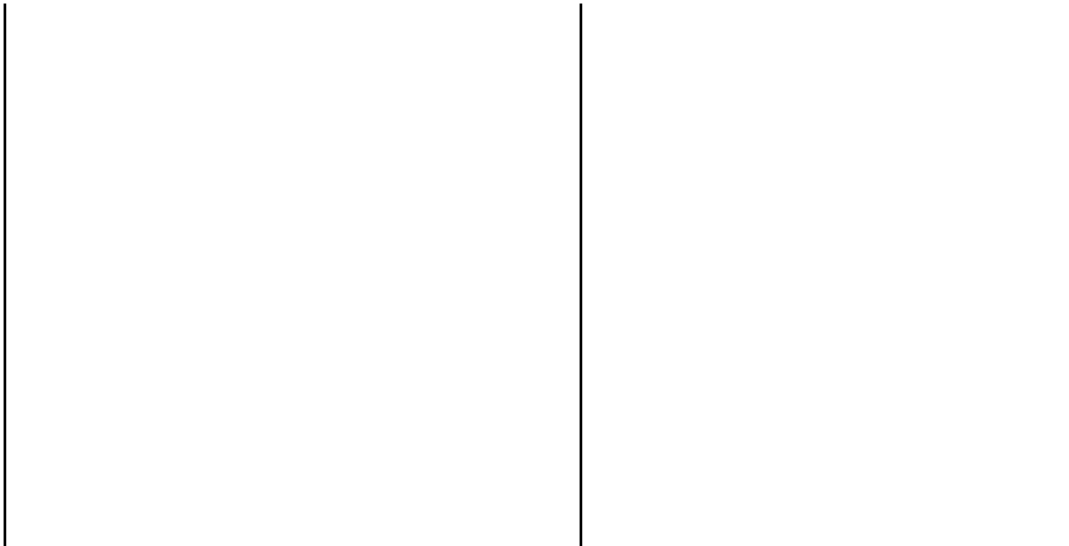
- 21) Both classicals and Keynesians agree that policymakers 21) \_\_\_\_\_
- A) cannot keep the unemployment rate permanently below the natural rate by permanently running a high rate of inflation.
  - B) cannot exploit the Phillips curve in the short run.
  - C) can exploit the Phillips curve in the short run.
  - D) can keep the unemployment rate permanently below the natural rate by permanently running a high rate of inflation.
- 22) One purpose of securitization of mortgages is to: 22) \_\_\_\_\_
- A) Help to bail out banks that would otherwise be insolvent.
  - B) Reduce risk to lenders by pooling many mortgages together.
  - C) Increase the riskiness of mortgages to lenders.
  - D) Decrease mortgage availability by denying mortgages to low income borrowers.
- 23) When a financial institution is highly levered, this means that: 23) \_\_\_\_\_
- A) It finances a large part of its asset purchases by borrowing.
  - B) Most of its loans are mortgages on homes rather than loans to businesses.
  - C) Legally, the firm is a commercial bank rather than an investment bank, so it is more lightly regulated.
  - D) Its executives receive a very large portion of their salaries in the form of year-end bonuses.
- 24) According to Professor Chappell's Recession paper: 24) \_\_\_\_\_
- A) Some large financial firms undertook excessively risky strategies because of the existence of moral hazard problems.
  - B) The cash-for-clunkers program was the single most influential and successful policy adopted to fight the recession.
  - C) The primary cause of the housing bubble and the subsequent panic was the long period of excessively low interest rates following the recession of 2005–2006.
  - D) The primary cause of the housing bubble and subsequent panic was an increase in greed by executives at banks.
- 25) According to Professor Chappell's Recession paper, the major **fiscal** policy action taken in response to the recession was the: 25) \_\_\_\_\_
- A) The adoption of Article 13.3 amending the Federal Reserve Act, which permitted the Federal Reserve to make loans to corporations under unusual and exigent circumstances.
  - B) The Housing and Economic Recovery Act of 2008, which expanded regulatory authority over Fannie Mae and Freddie Mac.
  - C) Emergency Economic Stabilization Act of 2008, which created TARP and permitted the Federal Reserve to buy equity in banks.
  - D) The American Recovery and Reinvestment Act of 2009, which called for increased spending and cuts in taxes of around \$787 billion.

## Part II Analytical Questions

### Question 1 (10 points)

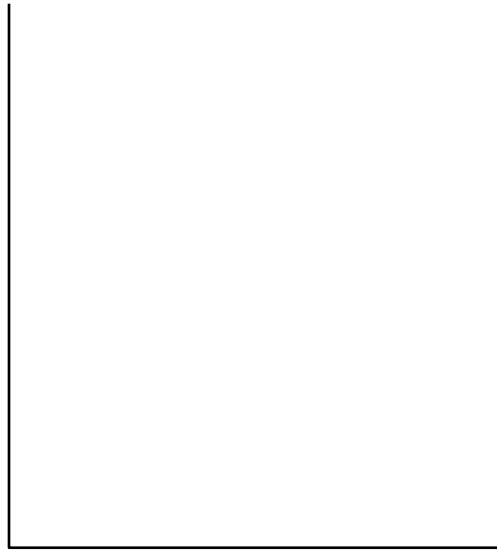
Illustrate the diagrammatic derivation of the LM Curve. In the left-hand panel below, you should plot a curve showing real money supply and real money demand curves. Be sure to label axes and curves carefully.

In the right-hand panel, you should plot the LM curve. Add to the diagrams as needed to explain how the LM curve is related to the money demand-money supply diagram. Again, be sure to label axes and curves correctly. Briefly explain any curve shifts that are required in your derivation.



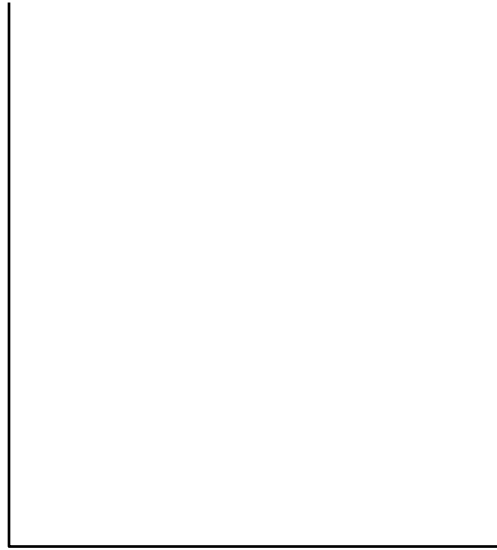
**Question 2A Classical Model (5 points)**

In the space provide below, illustrate the consequences of a temporary increase in government spending (to fight a foreign war) in the **classical model**. The upper panel should plot IS, LM, and FE. The lower panel should plot AD and AS. You should initially illustrate an economy in long-run general equilibrium. You should then illustrate the consequences of the government spending shock. Be sure to label all axes and curves carefully. If a curve shifts, provide a brief explanation for the shift.



**Question 2B Keynesian Model (5 points)**

In the space provide below, illustrate the consequences of a temporary increase in government spending (to fight a foreign war) in the **Keynesian** model. The upper panel should plot IS, LM, and FE. The lower panel should plot AD, SRAS, and LRAS. You should initially illustrate an economy in long-run general equilibrium. You should then illustrate the consequences of the **government spending shock in the short run**. Be sure to label all axes and curves carefully. If a curve shifts, provide a brief explanation for the shift.



**Question 2C Keynesian and Classical Models (5 points)**

Do your diagrams (for questions 2A and 2B) show similar qualitative results for the effects of government spending on output and the interest rate? In words, briefly explain how the Keynesian and Classical models account for these results differently.

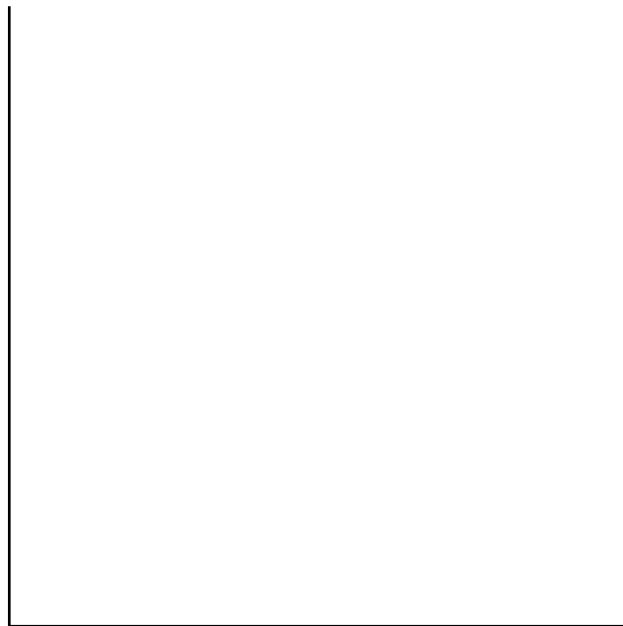
### Question 3 The Recession and the Classical Model (15 points)

In Professor Chappell's paper on the recession, he argued that one might interpret financial market turmoil as a supply-shock; that is, the break-down in financial intermediation could be thought of as reduced availability of an intermediate good in the **classical model**. Under this interpretation, the production function is shifted downward.

Complete the AD-AS diagram below to illustrate the effects of such a shock. Initially assume that the economy is in a general equilibrium. Then illustrate the effects of the financial market shock. Assume that the shock is permanent—the production function shift will NOT reverse itself. Under this interpretation, the shock will affect future output and income, and therefore current wealth. So your diagram should show both (1) the direct effects of the shock to the production function and (2) the effects of a reduction in wealth.

What does your diagram imply about the change in the price level? Is this prediction unambiguous, or does it depend on the magnitudes of curve shifts that you drew?

(Use the next page as needed for your answer).



**Question 3 (Continued)**

Continue your answer below as needed.