

PRACTICE QUESTIONS FOR MIDTERM II

Question 1: True-False. Please explain your choice.

a) If the economy is not in a long-run equilibrium and other things are equal, then prices will eventually adjust to bring the economy to a long-run equilibrium.

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b) The aggregate production curve has a slope of less than one.

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c) The smaller the *mpe*, the more repercussions there are from a change in expenditures or production and hence the greater is the multiplier.

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d) By law, the Fed cannot act as a lender of last resort to commercial banks in need.

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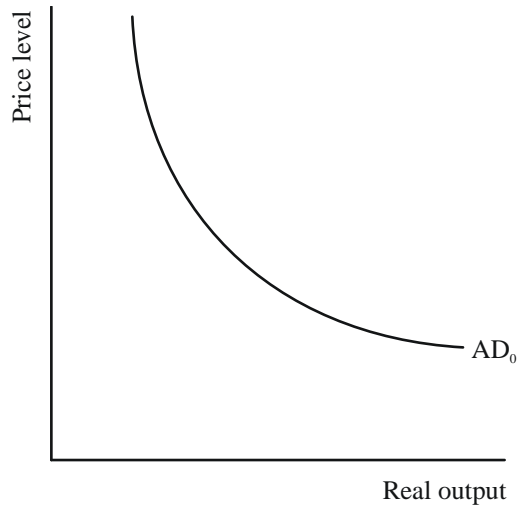
e) An increase in the discount rate is a signal that the Fed wants an easier monetary policy.

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f) The Federal funds rate is the rate the Fed charges commercial banks for any loans it extends to them.

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Question 2: Consider the following diagram



Demonstrate graphically and explain verbally the impact of a decrease of 50 in government spending on the AD curve in the diagram when the multiplier is 3.

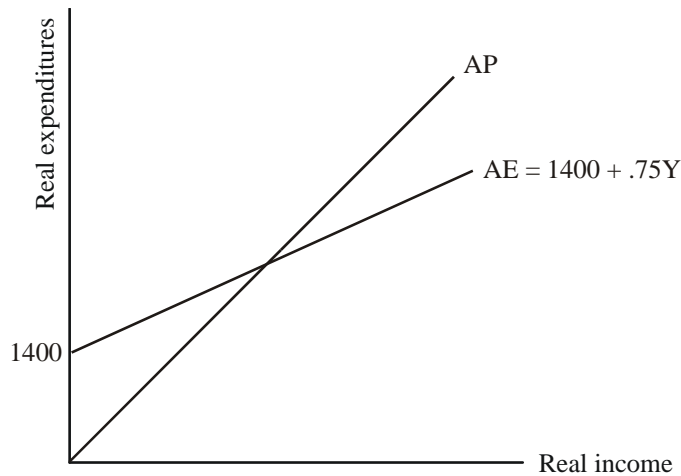
Question 3: What is meant by the term *induced expenditures*? Provide an example.

Question 4: Answer parts (a) - (e) below on the basis of the following table.

Income (Y)	Change in Income (ΔY)	Aggregate Expenditures (AE)	Change in Aggregate Expenditures (ΔAE)
0		500	
500		950	
1000		1400	
1500		1850	
2000		2300	
2500		2750	
3000		3200	

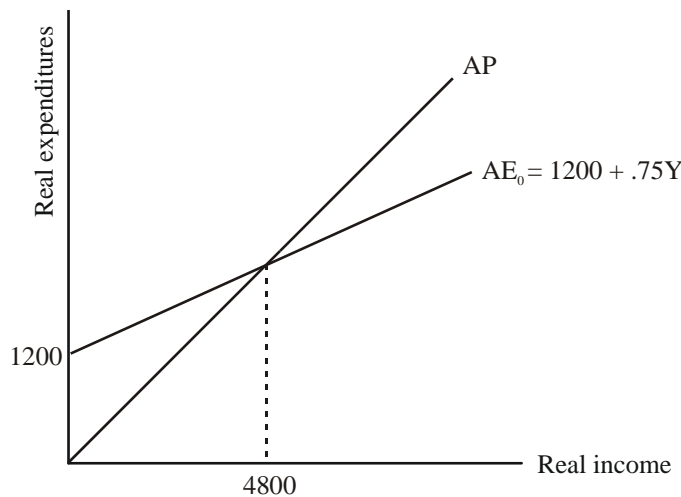
- Fill in columns (2) and (4).
- What is the value of autonomous expenditures?
- What is the mpe?
- What is the AE equation?
- Draw a picture of the AE curve.

Question 5: Consider the following multiplier model diagram:



- What is the value of equilibrium income?
- Demonstrate graphically and explain verbally the impact on equilibrium income of an increase in government spending of 100.
- Explain why the change in equilibrium income exceeds the change in government expenditures in your answer for part (b).

Question 6: Consider the following multiplier model diagram:



For each of the following, draw a picture to show what would happen to the equilibrium level of income in the economy.

- Consumer sentiment about the future improves resulting in an increase in autonomous consumption of 100.
- Foreign economic activity rises, which results in an increase in autonomous exports of 100.
- Because the average life span increases, many people are saving more of their income than ever before. Consequently the mpe falls from .75 to .66.

Question 7: Suppose the monetary base is \$100 billion, banks hold 10% reserves, and the cash-to-deposit ratio is 15%.

- (a) What is the money supply?
- (b) Suppose the Fed wants to increase the money supply so it undertakes a \$10 billion open market purchase but at the same time people decide to hold twice as much cash as they did before. Will the Fed be successful in its attempt to increase the money supply? Explain.
- (c) What lesson for monetary policy can you deduce from your answer to (b)?

Question 8: Assume the money supply is \$1000, the velocity of money is 12, and the price level is \$4. Using the quantity theory of money:

- (a) Determine the level of real output.
- (b) Determine the level of nominal output.
- (c) Assuming velocity remains constant, what will happen if the money supply rises by 10%?