Ch.15 FAQ’s

4) Which of the following is CORRECT regarding business cycles?
   I. Expansions usually last for about 4 years.
   II. Recessions usually last for about 1 year.
   III. The NBER has identified 5 recessions and expansions since 1920.
   A) I and II  
   B) I, II and III  
   C) II and III  
   D) I and III

**Answer:** from question 2), the NBER has identified 16 recessions and expansions since 1920. From the book, recessions have lasted for over a year on the average while expansions have lasted for almost 4 years. (the book 7th edition, p. 336)

5) Analysis shows that
   A) long recessions are followed by short expansions.
   B) there is no relationship between the length of expansions and the preceding recessions.
   C) long recessions are followed by long expansions.
   D) short recessions are followed by long expansions.

**Answer:** from the book, there is no correlation between the length of an expansion and the length of the preceding recession. (the book 7th edition, p. 336)

6) When economists describe business cycles, they usually
   A) disagree upon which impulses are responsible for starting business cycles.
   B) agree that the mechanisms that perpetuate business cycles are similar.
   C) disagree as to the role investment plays in business cycles.
   D) agree that the impulses that start business cycles are similar.

7) Economists agree that ________ play(s) a crucial role in the development of recessions and expansions.
   A) government purchases  
   B) investment  
   C) consumption expenditure  
   D) net exports

**Answer:** although there are several different theories of business cycles, they all agree about one aspect of the cycle: the central role played by investment and the accumulation of capital. There can be different impulses according to different business cycle theories. However, whatever the impulses are that hit the economy, they hit one crucial variable: investment. When there is a change in investment, capital also changes. Therefore, it is said that investment and capital are a crucial part of the business cycle mechanism. However, there are still other parts of the mechanism that are not agreed upon by everyone. (p. 337-338)
9) The country of Belize is experiencing an economic expansion. Place the following events in the proper sequence to describe what will occur.
   I. The quantity of capital increases.
   II. Firms increase investment.
   III. Labor productivity increases.
   IV. Diminishing returns to capital occur.
   A) IV, I, II, III  
   B) II, I, III, IV  
   C) I, II, IV, III  
   D) III, I, II, IV

   **Answer:** with economic expansion, investment is up. Capital stock grows. With more capitals to work with, labor productivity rises. However, with the same amount of labor, the marginal product of capital falls as the amount of capital increases. The law of diminishing returns to capital kicks in. (p. 338)

13) The Keynesian explanation of the business cycle is based on
   A) unstable inflationary expectations.
   B) volatile expectations about future sales and profits.
   C) the inability of government policy-makers to predict the future course of the economy.
   D) shifts in monetary policy undertaken by the Federal Reserve.

14) The Keynesian explanation of the business cycle rests on several concepts, including
   A) unstable monetary policy by the Fed.
   B) the desire of politicians to be re-elected.
   C) sticky money wage rates.
   D) shocks to the rate of technological change.

   **Answer:** Keynesian regards volatile expectations as the main source of economic fluctuations. The impulse is expected future sales and profits. As for mechanism, there are several important elements: change in investment (multiplier effect), the horizontal short run aggregate supply, and the sticky money wage when recession. For instance, a decrease in expected future sales and profits lowers the demand for new capital. Investment then goes down and, with multiplier effect, aggregate demand shifts to the left. With horizontal SAS and sticky money wage in recession, the economy gets stuck in a below full employment equilibrium. (p. 339)
16) The curves in the above figure show the economy as viewed from a
A) new classical rational expectations viewpoint.  B) Keynesian viewpoint.
C) real business cycle viewpoint.      D) monetarist viewpoint.

17) In the above figure, suppose the economy is initially at point A. If firms expect profits to decrease, in the
Keynesian theory the economy will move to point
A) C.       B) E.     C) D.     D) B.

Answer: because of the presence of the horizontal SAS, the figure shows the economy from a Keynesian viewpoint. Again, Keynesian says that the money wage is sticky when the economy is in recession. Therefore, starting at point A, if firms expect profits to decrease, they would want to invest less. Investment goes down and, with multiplier effect, aggregate demand shifts from AD₀ to AD¹. So now the economy is at point B and will be here if nothing else changes, because there is no natural force that would restore it back to full employment, i.e. the money wage is sticky in recession time. (p. 339)
18) Which of the following are elements of the monetarist theory of the business cycle?
   I. The “impulse” is a change in the growth rate of the quantity of money.
   II. The “mechanism” initially affects only the SAS curve.
   III. Prices are temporarily sticky.
   A) I and III  B) I, II and III  C) I and II  D) II and III

19) Monetarists contend that
   A) the Keynesian multiplier is too small.
   B) wages are “sticky” the entire time that the economy is in a recession.
   C) increases in money growth increase investment.
   D) exports decrease as a result of an increase in money growth.

Answer: monetarist impulse is change in the growth rate of money by the Fed. As for mechanism, there are several important elements: the change in aggregate demand (investment, export, and multiplier effect), the response of aggregate supply to the change in aggregate demand (SAS is upward sloping and deviation from full employment is only temporary), and the temporarily sticky money wage and the prices. For instance, the increase in quantity of money by the Fed brings down interest rate. With lower interest rate, investment is up. At the same time, it is more profitable to invest abroad where the interest rates are higher. The fund is moved out of the country. There is capital outflow. The value of the dollar goes down, making it cheaper for other countries to buy from the US. Export of the US goes up. Note that the magnitude of the multiplier effect under monetarist should be smaller than that under Keynesian because of the horizontal SAS in the latter. (p. 340)

28) According to the real business cycle theory, which do people consider when deciding when to work?
   A) the inflation rate  B) the nominal interest rate  C) the current money wage rate only  D) the real interest rate

Answer: according to RBC, people decide whether to work now or later by doing a cost-benefit analysis. For example, if work now, they get the real wage of $1. This real wage can be deposited at financial institutions and earn real interest of, let’s say, 6% over the period. Therefore, this person will have the total of $1.06 in his or her account in the next period. If work next period and not now, he or she will be paid the next period real wage, let’s say, of $1.05. In this case, this person would decide to work now because he or she would get $1.06 instead of $1.05. Therefore, when-to-work decision depends on the real interest rate. (p. 346)

30) In the real business cycle model, there is no
   A) LAS curve.  B) price level.  C) SAS curve.  D) AD curve.

Answer: in the RBC, labor market can adjust freely. Because of that, the economy is always at full employment (though this full employment level can change over time). Therefore, there is no SAS curve. (p. 347)
33) Which of the following statements regarding the Great Depression is correct?

A) Evidence collected by Milton Friedman and Anna Schwartz show that the stock market crash was the primary cause of the depression.
B) If a person was able to keep his or her job, the person's real wage rate generally increased.
C) Increased government spending helped to spur consumer spending.
D) Real GDP fell by about 10 percent.

Answer: from the book, Friedman and Schwartz assign primary responsibility of the causes of the contraction phase of the Great Depression to the quantity of money and regard the other factors (fall in autonomous expenditure) as being of limited importance. Also both the money wage and the price level fell during the Great Depression. However, the decrease in price level happened to be larger, making the real wage go up for those who managed to keep the jobs. By the year 1933, real GDP had fallen by 29% compared to 1929. Note that the government was quite small at that time, i.e. the government spending was of very small percentage of the real GDP. Therefore, increased government spending would not help boost consumer spending much. In fact, the consumer spending went down especially on new home and house appliances. (p. 352, 355)

34) Which of the following contributed to the collapse of the economy during the Great Depression?

I. a severe decrease in government spending
II. a decrease in investment
III. a large decrease in the monetary base

A) II and III  B) I and II  C) II only  D) I and III

Answer: the Great Depression began with the increase in uncertainty faced by domestic firms from international currency fluctuations and the introduction of restrictive trade policies. This environment of uncertainty led to a slow down in consumer spending. With this lower consumer spending, the profit of the firms went down and people expected to get less profit out of investing in the stock market. So they pulled out their money. That contributed to the stock market crash. The crash, in turn, heightened people’s fears about economic prospects in the foreseeable future. Fear fed fear. Investment went down further. Industries collapsed. Non-performing loans went up. Pessimism increased. People rushed to the banks to get their money out in fear that the banks would not have enough money to pay them as part of deposits at the banks had been lent out and those loans went bad. With people getting money out of the banks, the quantity of money decreased. Therefore, this decrease in quantity of money was not directly induced by the Fed's actions. In fact, the monetary base hardly fell at all.