Econ 302
Spring 2004

Don’t forget to download a copy of the Homework Cover Sheet. Mark the location where you handed in your work.

Homework #5: Chapter 11. This homework has three parts (A, B, C). Each part will be separately graded.

Part A, HW #5, Ch #11.

Go to technical problems, page 297. Do the following problems. Show your work.

1. 
2.

Part B, HW#5, Ch #11.

Go to empirical problems, page 297. Do the following problems. Show your work.

1. 
2.

Part C, HW#5, CH#11.

MC Quiz, 25 questions, use red score sheet handed out in class or available outside Heady 281 or Heady 67.

We will use the following grading scale.

<table>
<thead>
<tr>
<th>Grade</th>
<th>Score</th>
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<tbody>
<tr>
<td>A</td>
<td>20+</td>
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<tr>
<td>B</td>
<td>19, 18, 17</td>
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<td>C</td>
<td>16, 15, 14</td>
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<td>D</td>
<td>13, 12, 11</td>
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<td>F</td>
<td>&lt; 11</td>
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1. A change in which of the following will NOT shift the IS-curve?
   A) autonomous investment
   B) autonomous money demand
   C) autonomous consumption
   D) autonomous net exports
   E) autonomous saving
2. If money supply is held constant, a cut in government transfer payments will eventually cause interest rates to
   A) decline, enhancing the expansionary impact of the policy
   B) decline, decreasing the restrictive impact of the policy
   C) increase, decreasing the expansionary impact of the policy
   D) increase, decreasing the restrictive impact of the policy
   E) increase, enhancing the restrictive impact of the policy

3. Restrictive fiscal policy
   A) decreases the interest rate and the level of investment spending
   B) increases the interest rate but decreases income
   C) shifts the LM-curve to the left
   D) lowers both income and the interest rate
   E) lowers the level of investment due to the crowding out effect

4. Monetary policy becomes more effective as
   A) the marginal propensity to save increases
   B) the interest sensitivity of money demand increases
   C) the interest sensitivity of investment decreases
   D) the income tax rate decreases
   E) none of the above

5. Monetary policy becomes less effective as
   A) the marginal propensity to consume increases
   B) the interest sensitivity of money demand decreases
   C) the interest sensitivity of investment decreases
   D) the LM-curve becomes steeper
   E) the IS-curve becomes flatter

6. The liquidity trap exists when
   A) the IS-curve is vertical
   B) the LM-curve is vertical
   C) the LM-curve is horizontal
   D) an increase in government spending is always fully crowded out
   E) money demand is completely insensitive to changes in the interest rate

7. If we have a normal IS-curve but a horizontal LM-curve, 
   A) fiscal policy is the most effective way to reduce unemployment
   B) fiscal policy is at its weakest in reducing unemployment
   C) monetary policy can aid fiscal policy in reducing unemployment
   D) monetary policy is the most effective way to reduce unemployment
   E) neither fiscal nor monetary policy is effective in reducing unemployment

8. The view that "only money matters" is accurate when 
   A) investment is totally interest insensitive
   B) money demand is completely interest inelastic
   C) money demand is completely interest elastic
   D) we are in the liquidity trap
   E) both C) and D)
9. When the LM-curve is vertical,
   A) the monetary policy multiplier is zero
   B) monetary policy is at its weakest but fiscal policy has a maximum effect on income
   C) monetary policy has a maximum effect, but fiscal policy has no effect on income
   D) fiscal policy's impact on interest rates will not affect investment
   E) monetary policy affects interest rates but no change in investment spending results

10. The LM-curve is vertical when
   A) the interest elasticity of investment is zero
   B) the Fed refuses to change the money supply
   C) we are in the classical case
   D) we are in the liquidity trap
   E) none of the above

11. In the classical case,
   A) the fiscal policy multiplier is zero
   B) crowding out cannot occur
   C) investment does not respond to interest rate changes
   D) an increase in the income tax rate cannot lower the budget deficit
   E) monetary policy is totally ineffective

12. In an IS-LM model, if we assume that money demand is completely insensitive to changes in the interest rate, then
   A) fiscal policy is totally ineffective in changing the level of output
   B) monetary policy is totally ineffective in changing the level of output
   C) interest rates cannot be lowered by fiscal or monetary policy
   D) the economy cannot be stimulated by fiscal or monetary policy
   E) monetary policy can change income but not interest rates

13. The transmission mechanism
   A) is the process by which fiscal policy affects aggregate demand
   B) works best if money demand is completely interest elastic
   C) fails if spending does not respond to changes in interest rates
   D) relates to the effects of tax rate changes on the fiscal multiplier
   E) all of the above

14. The transmission mechanism between an open market purchase by the Fed and an increase in aggregate demand can break down if
   A) banks are unwilling to lend to private firms
   B) money demand is totally interest inelastic
   C) investment is very interest sensitive
   D) bond prices increase too much
   E) none of the above
15. If the Fed undertakes open market sales, then
A) the LM-curve will shift to the right
B) the LM-curve will shift to the left
C) interest rates will decrease and income will increase
D) bond prices will increase
E) both A) and C)

16. Fiscal policy becomes more powerful in changing the level of output as
A) investment becomes more interest elastic
B) money demand becomes more interest inelastic
C) money demand becomes more income elastic
D) the marginal propensity to save gets smaller
E) the marginal propensity to consume gets smaller

17. Assume we combine restrictive monetary policy with expansionary fiscal policy. Which is most likely to occur?
A) unemployment and interest rates will both go down
B) unemployment will go down but interest rates will stay the same
C) investment and consumption will both increase
D) interest rates and the budget deficit will both decrease
E) investment will decrease and the budget deficit will increase

18. Monetary policy is said to be accommodating when
A) the Fed undertakes open market sales to fight inflation
B) the Fed responds to a tax increase by lowering the discount rate
C) the Fed responds to fiscal expansion by undertaking open market sales
D) in the course of fiscal expansion, the Fed increases money supply to prevent interest rates from rising
E) restrictive fiscal policy is combined with expansionary monetary policy

19. Assume the government wants to stimulate consumption and investment. Which of the following policies should be implemented?
A) higher investment tax credits
B) removal of investment subsidies combined with monetary restriction
C) an income tax cut combined with monetary restriction
D) an increase in government transfer payments to low income households financed by a tax increase on high income households
E) none of these

20. Assume you would like to stimulate investment but leave the level of GDP roughly the same. What policy mix would you propose?
A) an income tax cut combined with monetary expansion
B) a tax cut combined with monetary restriction
C) a cut in government spending combined with monetary expansion
D) a cut in government spending combined with monetary restriction
E) an investment subsidy combined with monetary expansion
21. In an IS-LM model, which is most likely to occur?
A) expansionary fiscal policy will not be crowded out if the Fed undertakes open market sales at the same time
B) expansionary monetary policy will increase the level of spending on investment and consumption
C) increased government spending will not affect the level or the composition of GDP unless it is financed by an increase in money supply
D) tax rate cuts will increase the slope of the IS-curve and thus increase income
E) investment subsidies will increase the level of investment at the expense of lowering the level of consumption

22. In an IS-LM model, if income taxes and money supply both increase, which of the following is most likely to occur?
A) income and the interest rate will both increase
B) consumption and investment will both decrease
C) income will decrease but the interest rate will increase
D) investment will increase but consumption will decrease
E) consumption will decrease but saving will increase

23. The crowding out effect is zero if
A) the LM-curve is horizontal
B) the LM-curve is vertical
C) the Fed conducts open market sales following fiscal expansion
D) income is stimulated via a tax cut rather than an increase in government spending
E) none of the above

24. Crowding out occurs when
A) an increase in defense spending causes a decrease in consumption
B) expansionary monetary policy fails to stimulate economic growth
C) expansionary fiscal policy causes interest rates to rise, thereby reducing private spending
D) tax increases result in a drop in both consumption and investment
E) a policy designed to increase the budget surplus causes the economy to enter a recession

25. When conducting monetary policy, the Fed should
A) never monetize the budget deficit since this will lower the level of investment
B) be less concerned with current conditions than with future conditions
C) always try to keep interest rates low
D) always respond to expansionary fiscal policy by expanding money supply
E) none of the above