Homework 6

1. The aggregate demand curve shows the relationship between inflation and:
   A) the nominal interest rate.  D) the exchange rate.
   B) the real interest rate.  E) short-run equilibrium output.
   C) the unemployment rate.

2. Any value of the money supply chosen by the Federal Reserve implies a specific value for ______.
   A) potential output  D) the budget deficit
   B) net exports  E) the nominal interest rate
   C) government purchases

3. All else equal, an increase in the rate of inflation ____ planned spending and ____ short-run equilibrium output.
   A) increases; increases  D) decreases; increases
   B) increases; decreases  E) decreases; decreases
   C) does not change; does not change

4. Because the Fed determines the money supply, the:
   A) money demand curve is downward sloping.  D) money supply curve is downward sloping.
   B) money demand curve is upward sloping.  E) money supply curve is upward sloping.
   C) money supply curve is vertical.

5. If the Fed wishes to reduce nominal interest rates, it must engage in an open market ____ of bonds that ____ the
   money supply.
   A) sale; increases  D) purchase; increases
   B) sale; decreases  E) purchase; decreases
   C) sale; does not change

6. If the Fed wishes to increase nominal interest rates, it must engage in an open market ____ of bonds that ____ the
   money supply.
   A) sale; increases  D) purchase; increases
   B) sale; decreases  E) purchase; decreases
   C) sale; does not change

7. When the Fed engages in an open market purchase, the money supply ____ and the nominal interest rate ____.
   A) increases; increases
   B) increases; decreases
   C) increases; may either increase or decrease depending on money demand
   D) decreases; increases
   E) decreases; decreases

8. If the Fed's monetary policy reaction function does not change, then when inflation increases the Fed responds by
   ____ the real interest rate, which ____ consumption and investment spending, which ____ output.
   A) increasing; increases; increases  D) decreasing; decreases; increases
   B) increasing; increases; decreases  E) decreasing; decreases; decreases
   C) increasing; decreases; decreases

9. Lower rates of inflation increase planned spending because:
   A) the Fed reacts to the lower inflation by lowering interest rates.
   B) the reduction in wealth, resulting from the reduced real value of money, restrains spending.
   C) resources are redistributed from high-spending households to low-spending households.
   D) the prices of domestic goods sold abroad increase (with a constant exchange rate).
   E) the real value of money decreases.
10. Changes in exogenous spending and the Fed’s reaction function shift the:
   A) short-run aggregate supply line.  D) aggregate demand curve.
   B) long-run aggregate supply line  E) 45º line.
   C) potential output line.

11. Exogenous changes in spending refer to changes in planned spending:
   A) caused by changes in output.
   B) caused by changes in the real interest rate.
   C) caused by changes in output and changes in the real interest rate.
   D) not caused by changes in output and changes in the real interest rate.
   E) not caused by changes in consumer confidence.

12. For a given level of inflation, if concerns about future weakness in the economy cause businesses to reduce their spending on new capital, then the _____ shifts ____.  
   A) aggregate demand curve; right  D) short-run aggregate supply line; downward
   B) aggregate demand curve; left  E) long-run aggregate supply line; left
   C) short-run aggregate supply line; upward

13. For a given level of inflation, if an increase in threats to domestic security causes the government to increase military spending, then the _____ shifts ____.  
   A) aggregate demand curve; right  D) short-run aggregate supply line; downward
   B) aggregate demand curve; left  E) long-run aggregate supply line; left
   C) short-run aggregate supply line; upward

14. Which of the following will shift the aggregate demand curve to the left?  
   A) Income taxes are raised.
   B) The government increases spending on education.
   C) Consumers become optimistic about the future.
   D) A new technology is developed that will increase profits.
   E) Foreign economies boom, increasing their demand for domestic exports.

15. An upward shift in the Fed’s policy reaction function is a monetary _____ , and the aggregate demand curve ____.  
   A) tightening; shifts right  D) easing; shifts right
   B) tightening; shifts left  E) easing; shifts left
   C) tightening; does not shift

16. A downward shift in the Fed’s policy reaction function is a monetary _____ , and the aggregate demand curve ____.  
   A) tightening; shifts right  D) easing; shifts right
   B) tightening; shifts left  E) easing; shifts left
   C) tightening; does not shift

17. If the Federal Reserve lowers its target inflation rate, the monetary policy reaction function _____ and the aggregate demand curve _____.  
   A) shifts upward to the left; shifts to the right  D) shifts downward to the right; shifts to the right
   B) shifts upward to the left; shifts to the left  E) shifts downward to the right; shifts to the left
   C) shifts upward to the left; does not shift

18. When the Federal Reserve reduces its target rate of inflation, it will set a _____ real interest rate at every inflation rate and the aggregate demand curve will ____.  
   A) higher; shift to the right  D) lower; shift to the right
   B) higher; shift to the left  E) lower; shift to the left
   C) higher; not change
19. The aggregate demand curve shifts to the right if, the Fed ____ its inflation rate target, making monetary policy _____.
A) raises; easier    B) raises; tighter    C) raises; faster    D) lowers; easier    E) lowers; tighter

20. For a fixed inflation rate target, an increase in the inflation rate corresponds to a _____ the aggregate demand curve and an increase in exogenous spending corresponds to a _____ the aggregate demand curve.
A) shift left of; movement up
B) shift left of; shift right of
C) movement up; movement down
D) movement up; shift right of
E) movement down; shift left of

21. When actual output is less than potential output, there is ____ output gap and the rate of inflation will tend to _____.
A) an expansionary; increase    D) a recessionary; increase
B) an expansionary; decrease    E) a recessionary; decrease
C) no; remain the same

22. When a recessionary gap exists, actual output _____ potential output and the rate of inflation will tend to _____.
A) exceeds; increase    D) is less than; increase
B) exceeds; decrease    E) is less than; decrease
C) equals; remain the same

23. A vicious circle of high expected inflation leads to ____ increases in wages and costs and to ____ actual inflation.
A) large; high    B) large; low    C) zero; high    D) small; high    E) small; low

24. When actual output equals potential output there is ____ output gap and the rate of inflation will tend to _____.
A) an expansionary; increase    D) a recessionary; increase
B) an expansionary; decrease    E) a recessionary; decrease
C) no; remain the same

25. Graphically short-run equilibrium occurs at the intersection of the aggregate demand curve and the:
A) 45° line.
B) expenditure line.
C) short-run aggregate supply line.
D) long-run aggregate supply line.
E) short-run aggregate supply line and the long-run aggregate supply line.

26. If the aggregate demand curve in an economy is \( Y = 10,000 - 10,000 \pi \), current inflation (\( \pi \)) equals 0.07 (7 %), and potential output (\( Y^* \)) equals 9,500, then in the short run equilibrium output equals ____ and in the long run the inflation rate equals ___ percent.
A) 9,700; 3    B) 9,500; 5    C) 9,500; 7    D) 9,300; 5    E) 9,300; 7

27. The self-correcting tendency of the economy means that recessionary gaps are eventually eliminated by:
A) rising inflation.    D) decreasing potential output.
B) falling inflation.    E) government policy.
C) increasing potential output.

28. The self-correcting tendency of the economy means that expansionary gaps are eventually eliminated by:
A) rising inflation.    D) decreasing potential output.
B) falling inflation.    E) government policy.
C) increasing potential output.

29. Policymakers' use of stabilization policy to eliminate output gaps is more appropriate when an economy self corrects very ____ and when the output gap is very _____.
30. Starting from long-run equilibrium, a large tax increase will result in a(n) _____ gap in the short-run and ____ inflation and ____ output in the long-run.
   A) expansionary; higher; potential  D) recessionary; higher; potential
   B) expansionary; lower; potential  E) recessionary; lower; potential
   C) expansionary; higher; higher

31. An inflation shock is:
   A) the level of inflation consistent with output in a recessionary gap.
   B) the level of inflation consistent with output in an expansionary gap.
   C) a sudden change in the normal behavior of inflation, unrelated to the nation's output gap.
   D) a change in the inflation rate generated by excessive aggregate spending.
   E) a change in inflation brought about by changes in inflation expectations and pricing decisions.

32. Starting from long-run equilibrium, an adverse inflation shock results in a short-run equilibrium with ___ inflation and ____ output.
   A) higher; higher  B) higher; lower  C) higher; potential  D) lower; lower  E) lower; higher

33. If policymakers attempt to offset an adverse inflation shock with monetary _____, the resulting long-run equilibrium will be at _____ inflation rate compared to allowing the self-correcting mechanism return the economy to potential output.
   A) tightening; a higher  D) easing; a lower
   B) tightening; a lower  E) easing; the same
   C) easing; a higher

34. If the self-correction process of the economy takes place very slowly, so that actual output differs from potential output for protracted periods of time, then active:
   A) stabilization policies are probably not justified.
   B) stabilization policies may end up doing more harm than good.
   C) use of monetary and fiscal policy can cause actual output to overshoot potential output.
   D) use of monetary and fiscal policy can help to stabilize output.
   E) stabilization policy can cause the output gap to become larger.

35. A current high rate of inflation will tend to promote a:
   A) virtuous circle of high expected inflation and a high rate of actual inflation.
   B) virtuous circle of low expected inflation and a low rate of actual inflation.
   C) vicious circle of high expected inflation and a high rate of actual inflation.
   D) vicious circle of low expected inflation and a low rate of actual inflation.
   E) built-in expectation of low inflation in the future.