Problem Set for Chapter 20 (Multiple choices)

1. According to the theory of liquidity preference,
   a. if the interest rate is below the equilibrium level, then the quantity of money people want to hold is less than the quantity of money the Fed has created.
   b. if the interest rate is above the equilibrium level, then the quantity of money people want to hold is greater than the quantity of money the Fed has created.
   c. the demand for money is represented by a downward-sloping line on a supply-and-demand graph.
   d. All of the above are correct.
   ANS: C

2. Liquidity preference theory is most relevant to the
   a. short run and supposes that the price level adjusts to bring money supply and money demand into balance.
   b. short run and supposes that the interest rate adjusts to bring money supply and money demand into balance.
   c. long run and supposes that the price level adjusts to bring money supply and money demand into balance.
   d. long run and supposes that the interest rate adjusts to bring money supply and money demand into balance.
   ANS: B

3. In which of the following cases would the quantity of money demanded be smallest?
   a. \( r = 0.06, P = 1.2 \)
   b. \( r = 0.05, P = 1.0 \)
   c. \( r = 0.04, P = 1.2 \)
   d. \( r = 0.06, P = 1.0 \)
   ANS: D
4. **Refer to Figure 21-1.** If the current interest rate is 2 percent,
   a. there is an excess supply of money.
   b. people will sell more bonds, which drives interest rates up.
   c. as the money market moves to equilibrium, people will buy more goods.
   d. All of the above are correct.

   **ANS:** B

5. **Refer to Figure 21-1.** There is an **excess** demand for money at an interest rate of
   a. 2 percent.
   b. 3 percent.
   c. 4 percent.
   d. None of the above is correct.

   **ANS:** A

6. **Refer to Figure 21-1.** At an interest rate of 4 percent, there is an excess
   a. demand for money equal to the distance between points a and b.
   b. demand for money equal to the distance between points b and c.
   c. supply of money equal to the distance between points a and b.
   d. supply of money equal to the distance between points b and c.

   **ANS:** C

7. **Refer to Figure 21-1.** Which of the following is correct?
   a. If the interest rate is 4 percent, there is excess money demand, and the interest rate will fall.
   b. If the interest rate is 3 percent, there is excess money supply, and the interest rate will rise.
   c. Starting with an interest rate of 4 percent, the demand for goods and services will increase until the money market reaches a new equilibrium.
   d. None of the above is correct.

   **ANS:** C
8. Refer to Figure 21-3. What quantity is represented by the vertical line on the left-hand graph?
   a. the supply of money  
   b. the demand for money  
   c. the rate of inflation  
   d. the quantity of bonds that was most recently sold or purchased by the Federal Reserve  
   ANS: A

9. Refer to Figure 21-3. Which of the following sequences (numbered arrows) shows the logic of the interest-rate effect?
   a. 1, 2, 3, 4  
   b. 1, 4, 3, 2  
   c. 3, 4, 2, 1  
   d. 3, 2, 1, 4  
   ANS: D

10. Refer to Figure 21-3. For an economy such as the United States, what component of the demand for goods and services is most responsible for the decrease in output from $Y_1$ to $Y_2$?  
   a. consumption  
   b. investment  
   c. net exports  
   d. government spending  
   ANS: B

11. Which of the following statements is correct?
   a. Both liquidity preference theory and classical theory assume the interest rate adjusts to bring the money market into equilibrium.  
   b. Both liquidity preference theory and classical theory assume the price level adjusts to bring the money market into equilibrium.  
   c. Liquidity preference theory assumes the interest rate adjusts to bring the money market into equilibrium; classical theory assumes the price level adjusts to bring the money market into equilibrium.  
   d. Liquidity preference theory assumes the price level adjusts to bring the money market into equilibrium; classical theory assumes the interest rate adjusts to bring the money market into equilibrium.  
   ANS: C
12. If the interest rate increases
   a. or if the price level increases, then people will want to hold more money.
   b. or if the price level increases, then people will want to hold less money.
   c. or if the price level decreases, then people will want to hold more money.
   d. or if the price level decreases, then people will want to hold less money.

ANS: D

13. Other things equal, in the short run a higher price level leads households to
   a. increase consumption and firms to buy more capital goods.
   b. increase consumption and firms to buy fewer capital goods.
   c. decrease consumption and firms to buy more capital goods.
   d. decrease consumption and firms to buy fewer capital goods.

ANS: D

14. Which of the following shifts aggregate demand to the left?
   a. an increase in the price level
   b. an increase in the money supply
   c. a decrease in the price level
   d. a decrease in the money supply

ANS: D

15. If the stock market booms, then
   a. aggregate demand increases, which the Fed could offset by increasing the money supply.
   b. aggregate supply increases, which the Fed could offset by increasing the money supply.
   c. aggregate demand increases, which the Fed could offset by decreasing the money supply.
   d. aggregate supply increases, which the Fed could offset by decreasing the money supply.

ANS: C

On the figure, MS represents money supply and MD represents money demand.
16. **Refer to Figure 21-4.** Which of the following events could explain a shift of the money-demand curve from \( MD_1 \) to \( MD_2 \)?
   a. a decrease in the price level
   b. a decrease in the cost of borrowing
   c. an increase in the price level
   d. an increase in the cost of borrowing
   
   ANS: C

17. **Refer to Figure 21-4.** Which of the following events could explain a decrease in the equilibrium interest rate from \( r_3 \) to \( r_1 \)?
   a. a decrease in the price level
   b. a decrease in the number of firms building new factories and buying new equipment
   c. an increase in the price level
   d. an increase in the number of firms building new factories and buying new equipment
   
   ANS: A

18. **Refer to Figure 21-4.** Suppose the money-demand curve is currently \( MD_1 \). If the current interest rate is \( r_2 \), then
   a. the quantity of money that people want to hold is less than the quantity of money that the Federal Reserve has supplied.
   b. people will respond by selling interest-bearing bonds or by withdrawing money from interest-bearing bank accounts.
   c. bond issuers and banks will respond by raising the interest rates they offer.
   d. in response, the money-demand curve will shift upward from its current position to establish equilibrium in the money market.
   
   ANS: A

19. **Refer to Figure 21-4.** Suppose the money-demand curve is currently \( MD_2 \). If the current interest rate is \( r_2 \), then
   a. in response, the money-demand curve will shift downward from its current position to establish equilibrium in the money market.
   b. people will respond by selling interest-bearing bonds or by withdrawing money from interest-bearing bank accounts.
   c. bond issuers and banks will respond by lowering the interest rates they offer.
   d. there is a surplus of money.
   
   ANS: B

20. **Refer to Figure 21-4.** Suppose the current equilibrium interest rate is \( r_1 \). Which of the following events would cause the equilibrium interest rate to increase?
   a. The Federal Reserve increases the money supply.
   b. Money demand increases.
   c. The price level decreases.
   d. All of the above are correct.
   
   ANS: B

21. **Refer to Figure 21-4.** Suppose the current equilibrium interest rate is \( r_3 \). Which of the following events would cause the equilibrium interest rate to decrease?
   a. The Federal Reserve increases the money supply.
   b. Money demand decreases.
   c. The price level decreases.
   d. All of the above are correct.
   
   ANS: D
22. Refer to Figure 21-4. Suppose the current equilibrium interest rate is $r_1$. Let $Y_1$ represent the corresponding quantity of goods and services demanded, and let $P_1$ represent the corresponding price level. Starting from this situation, if the Federal Reserve increases the money supply and if the price level remains at $P_1$, then
a. there will be an increase in the equilibrium quantity of goods and services demanded.
b. there will be a decrease in the equilibrium quantity of goods and services demanded.
c. there will be an increase in the equilibrium interest rate.
d. fewer firms will choose to borrow to build new factories and buy new equipment.
ANS: A

23. Refer to Figure 21-4. Suppose the current equilibrium interest rate is $r_3$. Let $Y_3$ represent the corresponding quantity of goods and services demanded, and let $P_3$ represent the corresponding price level. Starting from this situation, if the Federal Reserve decreases the money supply and if the price level remains at $P_3$, then
a. there will be an increase in the equilibrium quantity of goods and services demanded.
b. there will be a decrease in the equilibrium interest rate.
c. the aggregate-demand curve will shift to the right.
d. fewer firms will choose to borrow to build new factories and buy new equipment.
ANS: D

24. Which of the following policy actions shifts the aggregate-demand curve?
   a. an increase in the money supply
   b. an increase in taxes
   c. an increase in government spending
   d. All of the above are correct.
ANS: D

25. An increase in the MPC
   a. increases the multiplier, so that changes in government expenditures have a larger effect on aggregate demand.
b. increases the multiplier, so that changes in government expenditures have a smaller effect on aggregate demand.
c. decreases the multiplier, so that changes in government expenditures have a larger effect on aggregate demand.
d. decreases the multiplier, so that changes in government expenditures have a smaller effect on aggregate demand.
ANS: A

26. If the $MPC$ is 0, then the multiplier is
   a. 0.
b. 1.
c. infinite.
d. None of the above is correct.
ANS: B
27. An increase in government purchases is likely to
   a. decrease interest rates.
   b. result in a net decrease in aggregate demand.
   c. crowd out investment spending by business firms.
   d. decrease money demand.

   ANS: C

28. An aide to a U.S. Congressman computes the effect on aggregate demand of a $20 billion tax cut. The actual increase in aggregate demand is less than the aide expected. Which of the following errors in the aide's computation would be consistent with an overestimation of the impact on aggregate demand?
   a. The actual MPC was larger than the MPC the aide used to compute the multiplier.
   b. The aide thought the tax cut would be permanent, but the actual tax cut was temporary.
   c. The increase in income shifted money demand less than the aide had anticipated.
   d. The increase in income resulted in investment rising more than the aide had anticipated.

   ANS: B

29. If Congress cuts spending to balance the federal budget, the Fed can act to prevent unemployment and recession by
   a. buying bonds to increase the money supply
   b. buying bonds to decrease the money supply.
   c. selling bonds to increase the money supply.
   d. selling bonds to decrease the money supply.

   ANS: A

30. Monetary policy
   a. can be implemented quickly and most of its impact on aggregate demand occurs very soon after policy is implemented.
   b. can be implemented quickly, but most of its impact on aggregate demand occurs months after policy is implemented.
   c. cannot be implemented quickly, but once implemented most of its impact on aggregate demand occurs very soon afterward.
   d. cannot be implemented quickly and most of its impact on aggregate demand occurs months after policy is implemented.

   ANS: B
31. Refer to Figure 21-7. The aggregate-demand curve could shift from \( AD_1 \) to \( AD_2 \) as a result of
a. an increase in government purchases.
b. a decrease in stock prices.
c. consumers and firms becoming more optimistic about the future.
d. an increase in the price level.
ANS: B

32. Refer to Figure 21-7. If the economy is at point b, a policy to restore full employment would be
a. an increase in the money supply.
b. a decrease in government purchases.
c. an increase in taxes.
d. All of the above are correct.
ANS: A

33. Refer to Figure 21-7. Which of the following is correct?
a. A wave of optimism could move the economy from point a to point b.
b. If aggregate demand moves from \( AD_1 \) to \( AD_2 \), the economy will stay at point b in both the short run and long run.
c. It is possible that either fiscal or monetary policy might have caused the shift from \( AD_1 \) to \( AD_2 \).
d. All of the above are correct.
ANS: C

34. Refer to Figure 21-7. Which of the following is correct?
a. Unemployment rises as the economy moves from point a to point b.
b. Either fiscal or monetary policy could be used to move the economy from point b to point a.
c. If the economy is left alone, then as the economy moves from point b to long-run equilibrium, the price level will fall farther.
d. All of the above are correct.
ANS: D

35. Other things the same, automatic stabilizers tend to
a. raise expenditures during expansions and recessions.
b. lower expenditures during expansions and recessions.
c. raise expenditures during recessions and lower expenditures during expansions.
d. raise expenditures during expansions and lower expenditures during recessions.

36. In the short run,
   a. the price level alone adjusts to balance the supply and demand for money.
   b. output responds to changes in the aggregate demand for goods and services.
   c. changes in the money supply cause a proportional change in the price level.
   d. increases in the money supply shift the aggregate supply curve causing output to rise.

ANS: B