

Practice questions (Reading: Ch. 6)

1. Frictional unemployment is unemployment caused by _____.
2. A typical worker in the United States who is covered by unemployment insurance receives _____ percent of his or her former wages for _____ weeks.
3. When there is wait unemployment, the real wage is rigid at a level below the market-clearing level. T/F?
4. All of the following are causes of wait unemployment except: (i) minimum-wage laws; (ii) the monopoly power of unions; (iii) unemployment insurance; (iv) efficiency wages. Answer _____.
5. Permitting a lower minimum wage for teenagers would likely raise unemployment among unskilled adults. T/F?
6. In the case of unions, the conflict of interest between different groups of workers results in insiders wanting _____, while outsiders want _____.
7. Efficiency-wage theories suggest that a firm may pay workers more than the market-clearing wage for all of the following reasons except to (i) reduce labor turnover; (ii) improve the quality of the firm's labor force; (iii) increase worker efforts; (iv) reduce firm's wage bill. Answer _____.
8. If the steady-state rate of unemployment equals 0.10 and the fraction of employed workers who lose their job each month (the rate of job separation) is 0.02, then the fraction of unemployment workers who find jobs each month (the rate of job findings) must be _____.

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9. A hypothetical economy is described by the following set of equations:

Real GDP:	$Y = 5000$
Consumption:	$C = 1000 + 0.3 (Y-T)$
Investment:	$I = 1500 - 50 r$
Taxes:	$T = 1000$
Government purchases	$G = 1500$

a) What are the equilibrium values of investment and the interest rate? Show your work.

b) Government increases its taxes to 1500. What are the new equilibrium values of investment and the interest rate? Draw a diagram for the loanable funds market and mark the initial and new equilibrium of the economy by (1) and (2). Show your work.

c) (Bonus: 2 points) Assume that there is a technological innovation that makes business want to invest more. (Assume that taxes remain as before at 1000.) It raises the investment function to $I = 1800 - 50r$. What are the new equilibrium values of investment and the interest rate? Show your work.

Practice questions (Reading: Ch. 9)

1. Most economists believe that the classical dichotomy holds approximately in the short run but not at all in the long run. T/F
2. According to the quantity equation, if the velocity of money and the supply of money are fixed, and the price level increases, then the quantity of goods and services purchased _____.
 - a. output; output
 - b. prices; prices
 - c. prices; output
 - d. output; prices
3. A short-run aggregate supply curve shows fixed _____, and a long-run aggregate supply curve shows fixed _____.
 - a. output; output
 - b. prices; prices
 - c. prices; output
 - d. output; prices
4. The natural level of output is the level of output at which the unemployment rate is zero. T/F
5. The long run refers to a period during which prices are flexible. T/F
6. Assume that the economy starts from long-run equilibrium. If the Federal Reserve increases the money supply, then _____ increase(s) in the short run and _____ increase(s) in the long run.
7. Which of the following is an example of a demand shock?
 - a. a large oil-price increase
 - b. the introduction and greater availability of credit cards
 - c. a drought that destroys agricultural crops
 - d. unions obtain a substantial wage increase
8. An adverse supply shock raises the short-run aggregate supply curve and, if permanent, may also lower the natural level of output. T/F
9. Starting from long-run equilibrium, if a drought pushes up food prices throughout the economy, the Fed could move the economy more rapidly back to full-employment output by increasing the money supply, which would restore the original price level. T/F
10. Problem 9-3 in Mankiw 7th edition. Use the back page.

Practice questions (Reading: Ch. 10)

[Hint: Try to draw a diagram for each question to verify your reasoning.]

1. The IS curve plots the relationship between the interest rate and _____ that arise in the market for _____.
2. As the interest rate increases, the quantity of investment _____, and this shifts the expenditure function _____, thereby decreasing income.
3. In the loanable funds model, a decrease in income _____ national saving and _____ the equilibrium interest rate.
4. A rise in government purchase shifts the IS curve because it _____ national saving for any given level of income, which _____ the interest rate for any given level of income.
5. If the interest rate is above the equilibrium, the supply of real money balances exceeds the demand. T/F
6. An explanation for the slope of the LM curve is that as income rises, money demand rises, and a lower interest rate is required.
7. A decrease in the nominal money supply, other things being equal, will shift the LM curve to the _____.
8. According to the theory of liquidity preference, velocity is negatively related to the interest rate. T/F
9. The intersection of the IS and LM curves determines the values of r , Y , and P given G , T , and M . T/F
10. Consider a closed economy for the following question. Consumption is given by $C = 200 + (2/3)(Y - T)$. Planned investment is 300, as are government spending and taxes.
 - a. If Y is 1500, what is planned spending? What is inventory accumulation or decumulation in this case?
 - b. What is equilibrium value of Y ?
 - c. Draw a diagram that depicts the situation in (a) and the equilibrium described in (b).
 - d. What are equilibrium consumption, private saving, and national saving?
 - e. What is the multiplier for government spending?
11. [For your own review] Derive the IS curve using the loanable funds market equilibrium condition.
12. [For your own review] Derive the LM curve using the money market equilibrium condition.

Practice questions (Reading: Ch. 11)

1. If the LM curve is vertical and government spending increases by ΔG , in the IS-LM analysis, then equilibrium income rises by $\Delta G/(1-MPC)$. T/F?
2. In the IS-LM model when M rises but P remains constant, in short-run equilibrium, in the usual case, the interest rate _____ and output _____.
3. The monetary transmission mechanism works through the effects of changes in the money supply on:
 - a. the budget deficit
 - b. investment
 - c. government expenditure
 - d. taxation
4. If taxes are raised, but the Fed prevents income from falling by raising the money supply, then:
 - a. both consumption and investment remain unchanged.
 - b. consumption rises but investment falls.
 - c. investment rises but consumption falls.
 - d. both consumption and investment fall.
5. Within the IS-LM framework, an increase in the demand for money, at any given income level and level of interest rates, will _____ output and _____ interest rates.
6. The aggregate demand curve generally slopes downward and to the right because, for any given money supply M, a higher price level P causes a _____ real money supply M/P , which _____ the interest rate and _____ spending.
7. If the short-run IS-LM equilibrium occurs at a level of income below the natural rate of output, then in the long run the price level will _____, shifting the _____ curve to the right and returning output to the natural rate.
8. The macroeconomic model may be completed by adding either the Keynesian assumption that _____ or the classical assumption that _____.
 - a. output is fixed; prices are fixed
 - b. prices are fixed; output is fixed
 - c. the interest rate is fixed; the money supply is fixed
 - d. prices are flexible; output varies
9. The debt-deflation theory of the Great Depression suggests that a(n) _____ deflation redistributes wealth in such a way to _____ spending on goods and services.
10. [For your own review] Problem 5, chapter 10.

11. Assume the following model of the economy, with the price level fixed at 1.0:

$$C = 0.8(Y-T)$$

$$I = 800 - 20r$$

$$Y = C + I + G$$

$$M^d/P = 0.4Y - 40r$$

$$T = 1000$$

$$G = 1000$$

$$M^s = 1200$$

- a. Write an equation for the IS curve, showing Y as a function of r alone.
- b. Write an equation for the LM curve, showing Y as a function of r alone.
- c. What are the short-run equilibrium values of Y and r ?
- d. Obtain private saving, government saving, and national saving. Check that national saving indeed I.
- e. Assume that G increases by 200. Obtain the new short-run equilibrium values of Y and r . What is the government-purchases multiplier?