

REVIEW QUESTIONS FOR THE SECOND MIDTERM

CHAPTER 26

1. Explain why the aggregate demand curve is downward sloping. List five factors that might cause the AD curve to shift outward.

Answer:

Three reasons why the aggregate quantity demanded is inversely related to the price level are the interest rate effect, the international effect and the money wealth effect.

The interest rate effect refers to the fact that a lower price level stimulates investment expenditures. A reduction in the price level will increase real cash on hand. Because the price level falls, people will be holding more money for transactions purposes than they need to. So they deposit the extra money in the bank, giving banks more money to lend out. This causes banks to lower interest rates and thereby calls forth more investment expenditures.

The international effect refers to the fact that as the price level falls (assuming the exchange rate does not change), domestically produced goods become more competitive in foreign markets, while foreign goods become less competitive in domestic markets. Therefore, net exports will rise.

The money wealth effect refers to the fact that a fall in the price level will make the holders of money richer, so they buy more.

Factors that might cause the AD curve to shift outward are: (Any five of the following)

1. A rise in foreign income
2. A fall in the exchange rate
3. Expectations of rapid growth in the future AD.
4. Expectations of higher future prices
5. More equal distribution of income
6. Expansionary fiscal policy
7. Expansionary monetary policy.

2. The shape of the short-run aggregate supply (SAS) curve reflects two different types of microeconomic markets (auction markets and the posted price markets). How is the price level linked to the level of output in each market? List five factors that might cause an upward shift of the SAS curve.

Answer:

Auction markets are described by the microeconomic supply curve in the supply and demand model. Thus, when output rises, the price in these markets rises to cover the increased marginal costs of producers. The producers' marginal costs rise due to the law of diminishing returns. This is true even though input prices remain constant in the short run.

Posted price markets are markets in which the price is set by the producer and changes infrequently. These markets are often called quantity-adjusted markets, where firms respond to changes in demand primarily by modifying their output instead of changing their price. Even in these markets, prices adjust to reflect changes in demand. If demand increases, firms

respond by raising their markup prices. This tendency to raise markups as aggregate demand increases contributes to the upward slope of the SAS curve.

The following changes will shift the SAS curve upward.

- (1) A rise in input prices
- (2) Expectation of higher future prices
- (3) Higher excise or sales taxes
- (4) Lower worker productivity schedules
- (5) Higher import prices

3. Explain why the long-run aggregate supply (LAS) curve is vertical. What determines the position of the LAS curve?

Answer:

The LAS curve is vertical because at potential output, a rise in the price level means that all prices, including input prices, rise. Available resources do not rise and thus neither does potential output.

The position of the LAS curve is determined by potential output. However, the LAS curve is an abstraction that reduces what is actually a range of potential outputs to a single value.

4. What are the effects of an increase in aggregate demand (AD) in the short run and the long run? What is the effect of an increase in the short run aggregate supply (SAS)? What is the effect of an increase in Long run Aggregate Supply (LAS)?

Answer:

The short run effect of an increase in Aggregate Demand (AD), all other things remaining constant, is an increase in output and an increase in the price level. In the long run, the level of output is constant so an increase in aggregate demand will simply increase the price level.

The effect of an increase in Short run Aggregate Supply (SAS), all other things remaining constant, is an increase in output and a decrease in the price level.

The effect of an increase in Long run Aggregate Supply (LAS), all other things remaining constant, is an increase in output. The effect on the price level is indeterminate.

5. What is the paradox of thrift?

Answer:

The paradox of thrift is when attempts by individuals to increase their savings rate leads to a decrease in expenditures and aggregate output, and a lowering of total savings.

6. Explain what will happen to the SAS curve if productivity increases.

Answer:

An increase in productivity will shift the SAS curve down. This is the case because an increase in productivity will lower the costs of production for firms.

7. What factors shift the short-run aggregate supply (SAS) curve? Explain the impact of changes in each factor on the SAS curve.

Answer:

- (a) Input prices. A rise (decline) in input prices shifts the SAS curve to the left (right).
- (b) Changes in expectation of inflation. Expectation of higher (lower) future prices shifts the SAS curve to the left (right).
- (c) Excise and sales taxes. Higher (lower) excise or sales taxes shifts the SAS curve to the left (right).
- (d) Productivity. Higher (lower) workers' productivity schedules shifts the SAS curve to the right (left).
- (e) Import prices. Higher (lower) import prices shifts the SAS curve to the left (right).

CHAPTER 28

8. What is money? What are the three functions of money?

Answer:

Money is a highly liquid financial asset that's generally accepted in exchange for other goods. (It is a medium of exchange.) Money is used as a reference in valuing other goods. (It is a standard of value.) And money can be stored as wealth. (It is a store of value.)

9. What are three reasons people hold money?

Answer:

People hold money for spending. This is called the transactions motive. People hold money for unexpected purchases. This is called the precautionary motive. People hold money to avoid holding financial assets whose prices are falling. This is called the speculative motive.

10. State whether the following illustrates the speculative, precautionary or transactions motive for holding money.

- (a.) A bond broker holds cash for the possibility of buying a bond whose price is expected to rise.**
- (b.) John's mother tells him to keep \$10 in his pocket any time he goes out in case he needs to put gas in the car.**
- (c.) Julio withdraws \$100 from the bank to buy vegetables at the local organic farm market.**
- (d.) Mary takes out \$50 from the bank to buy lunches during the week.**
- (c.) As stock prices begin to tumble, investors sell stock and increase their cash holdings.**

Answer:

- (a.) Speculative.
- (b.) Precautionary.
- (c.) Transactions.
- (d.) Transactions.
- (e.) Speculative.

11. A financial asset is liquid:

- A) if it can be carried easily from one place to another.
- B) if it can be readily exchanged for another asset or good.
- C) only if it takes the form of cash.
- D) if it is held by the public and earning interest.

Answer: B

12. The 100 TL. you have in your wallet is:

- A) liabilities of the Central Bank.
- B) assets of the Central Bank.
- C) liabilities of the Central Bank until it is spent.
- D) your liabilities if you hold that banknote.

Answer: A

13. A bank has a reserve requirement of 0.08. If it has demand deposits of 200,000 TL. and is holding 4,000 TL. in reserves:

- A) all the bank's reserves are excess reserves.
- B) the bank is not meeting its reserve requirement.
- C) the bank is holding 2,000 TL. in excess reserves.
- D) the bank could extend additional loans and still meet its reserve requirement.

Answer: B

14. After there has been a change in bank reserves, the multiplier process continues until:

- A) required reserves are the same for all banks.
- B) each bank holds its desired reserve-to-deposit ratio.
- C) banks start to extend new loans.
- D) the Central Bank runs out of government securities.

Answer: B

15. Which of the following is the path through which contractionary monetary policy works?

- A) Money down implies interest rate up implies investment down implies income down.
- B) Money down implies interest rate down implies investment down implies income down.
- C) Money down implies interest rate up implies investment up implies income down.
- D) Money down implies interest rate down implies investment up implies income down.

Answer: A

CHAPTER 29

16. An expansionary monetary policy raises nominal income but never raises real income. True or False? Explain.

Answer:

This is a false statement. An expansionary monetary policy definitely can increase nominal income. Its effect on real income, however, depends on how the price level responds. The general rule is: $\% \Delta \text{ real income} = \% \Delta \text{ nominal income} - \% \Delta \text{ price level}$. If the $\% \Delta$ nominal income is greater than the $\% \Delta$ price level as a result of an expansionary monetary policy, real income will rise. Expansionary monetary policy will generally lead to a rise in real income when the economy is below full employment.

17. Describe how the Central Bank uses Open Market Operations to change the money supply.

Answer:

Open market operations are the Central Bank's buying and selling of government securities. U.S. government securities, while highly secure and liquid, do not qualify as reserves (banks cannot count their holdings of U.S. government securities toward meeting their reserve requirement). Therefore, when the Central Bank sells a bond, it takes reserves out of the system and reduces the money supply (with the effect magnified by the money multiplier process). When the Central Bank buys a bond from a bank it injects reserves into the system (the bank gives up the bond, which was not counted toward the reserve requirement, and receives cash from the Central Bank, which is counted toward the reserve requirement). Thus, an open market purchase by the Central Bank increases the money supply (with the effect magnified by the multiplier process).

18. Define reserve requirement ratio, and explain how it can be used as a tool for the conduct of monetary policy.

Answer:

The reserve requirement ratio is the percentage the Central Bank sets as the minimum amount of reserves a bank must hold. As was shown in the chapter on money, the total amount of money that can be created from a given amount of cash depends on the reserve ratio. The reserve requirement is a legal minimum reserve. Banks must have at least the reserves specified by the reserve requirement.

By changing the reserve requirement, the Central Bank can increase or decrease the money supply. If the Central Bank increases the reserve requirement, the money supply contracts. Banks must keep more reserves, and lend less. The effect of diminished loans is magnified by the money multiplier effect. If the Central Bank reduces the reserve requirement, the money supply expands, because this frees up reserves to make additional loans (again, with magnification due to the money multiplier effect).

19. Define the term “liquidity trap” and describe the problem it creates for the Central Bank.

Answer:

A liquidity trap is a situation in which increases in reserves do not increase the money supply, but instead are simply held as excess reserves by banks. When the economy is in a liquidity trap, the Central Bank loses its ability to increase the money supply. It's like pushing on a string.

20. Explain how the Central Bank uses the discount rate to influence the money supply.

Answer:

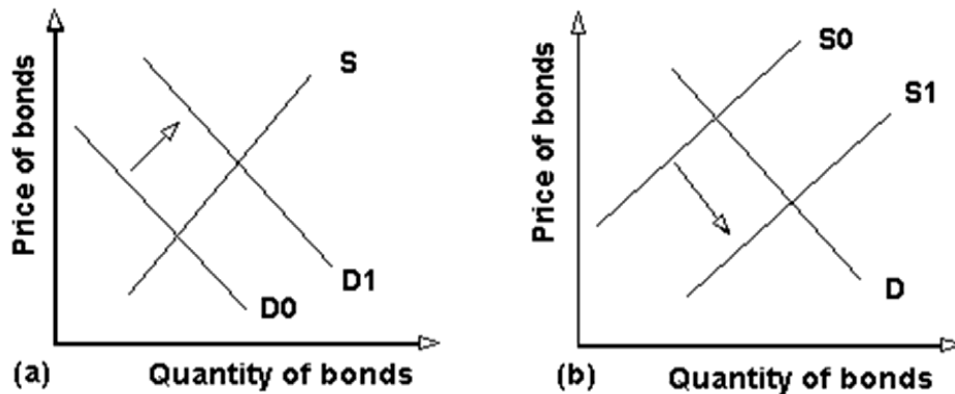
An increase in the discount rate discourages banks from borrowing and thus contracts the money supply; a decrease in the discount rate encourages banks to borrow from the Central Bank and thus increases the money supply.

21. (a) Show the effects of expansionary and contractionary open market operations on the interest rate using demand and supply curves and the market for government bonds.

(b) What should the Central Bank do if the interest rate is below its target rate? What should the Central Bank do if the interest rate is above its target rate?

Answer:

(a) An open market purchase (expansionary) will shift the demand for government bonds to the right, increasing their price and decreasing their yield (interest rate). This is shown in graph (a) below as a shift from D_0 to D_1 . An open market sale (contractionary) will shift the supply of government bonds to the right, decreasing their price and increasing their yield (interest rate). This is shown in graph (b) below as a shift from S_0 to S_1 .

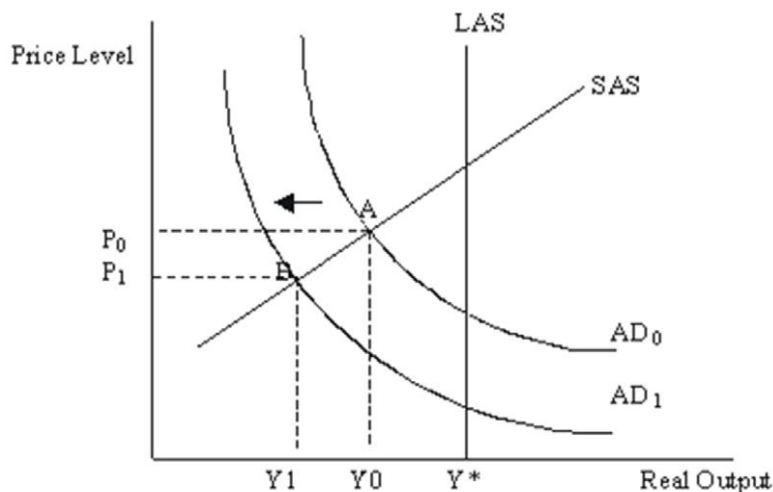


(b) If the interest rate is below (above) its target, it should sell (buy) bonds to raise (lower) the interest rate.

22. Demonstrate graphically and explain verbally (using the AS/AD model) the effect of the Central Bank's sale of government bonds when the economy is below potential.

Answer:

The diagram:



The explanation:

The economy is initially in equilibrium at point A with a price level of P_0 and real income of Y_0 . When the Central Bank sells bonds (contractionary monetary policy), interest rates rise, increasing the cost of borrowing. Aggregate expenditures then fall shifting the AD curve to

the left from AD_0 to AD_1 . Short-run equilibrium is now Point B with a drop in the price level to $P_1 < P_0$ and a drop in real income to $Y_1 < Y_0$. The way this comes about is as follows. Sale of bonds decreases the money supply and makes loans scarcer, which, in turn, increases interest rates. The increase in interest rates means businesses will cut back on investment spending. The drop in investment will bring into play the multiplier effect and the result is a magnified drop in income (output). In the long-run, the SAS curve will shift down, lowering the price level even further, but bringing the economy to potential output, Y^* .