Chapter 15 Assignment

C 1. When the Bank of Canada sets a target for the interest rate, to which of the following does it commit itself?
   a. to revealing its target to the public
   b. to adjusting the demand for money in order to meet the interest rate target
   c. to adjusting the money supply in order to meet the interest rate target
   d. to increasing the interest rate, and decreasing investment and consumption

B 2. According to the crowding-out effect, an increase in government spending leads to which of the following?
   a. increased interest rates and greater investment spending
   b. increased interest rates and reduced investment spending
   c. decreased interest rates and greater investment spending
   d. decreased interest rates and reduced investment spending

B 3. When interest rates rise in Canada, the opportunity cost of holding money does which of the following?
   a. It increases, so the quantity of money demanded increases.
   b. It increases, so the quantity of money demanded decreases.
   c. It decreases, so the quantity of money demanded increases.
   d. It decreases, so the quantity of money demanded decreases.

B 4. Which of the following serves as an automatic stabilizer?
   a. the Bank of Canada
   b. the income tax system
   c. the crowding-in effect
   d. autonomous consumption

A 5. Fiscal policy includes which of the following?
   a. lowering taxes, raising taxes and changing government spending
   b. lowering taxes and changing government spending
   c. raising taxes and changing government spending
   d. maintaining taxes and spending at the current level

B 6. The main reason for holding a money balance is which of the following?
   a. It is a form of interest-free wealth.
   b. It can be used to buy things.
   c. It appreciates over time.
   d. It depreciates over time.

A 7. Which of the following is a problem for those in charge of fiscal policy?
   a. Policymakers do not have accurate information about the economy in advance.
   b. Policymakers have accurate information about the economy in advance.
   c. Fiscal policy is less powerful than monetary policy.
   d. Policymakers can use fiscal policy to respond immediately to changes ineconomic conditions.

B 8. When the price level increases, which of the following occurs?
   a. The money-demand curve shifts right, causing interest rates to fall.
   b. The money-demand curve shifts right, causing interest rates to rise.
   c. The money-demand curve shifts left, causing interest rates to rise.
   d. The money-demand curve shifts left, causing interest rates to fall.

D 9. Other things being equal, an increase in the supply of money does which of the following?
   a. It lowers both interest rates and aggregate demand.
   b. It raises both interest rates and aggregate demand.
   c. It raises interest rates and lowers aggregate demand.
   d. It lowers interest rates and raises aggregate demand.

B 10. In the short run, an open-market sale of government bonds by the Bank of Canada causes which of the following?
   a. The money-supply curve shifts to the right.
   b. The money-supply curve shifts to the left.
   c. The rate of interest falls.
   d. The government pursues a fiscal policy designed to decrease aggregate demand.

B 11. Other things being equal, an increase in the demand for money does which of the following?
   a. increases aggregate demand
   b. decreases aggregate demand
   c. increases aggregate supply
   d. decreases aggregate supply

C 12. Taking the multiplier effect into account, and assuming no crowding out effect, a $100 million increase in government spending will have what effect?
   a. increase real output by less than $100 million
   b. decrease real output by less than $100 million
   c. increase real output by more than $100 million
   d. decrease real output by more than $100 million

B 13. The opportunity cost of holding assets in the form of money is which of the following?
   a. foregone liquidity
   b. foregone interest
   c. It is a form of interest-free wealth
   d. It depreciates over time

True or False?

F 14. When the Bank of Canada buys and sells bonds in the market for foreign-currency exchange, this is referred to as foreign exchange market operations.

T 15. The supply of money in an economy is fixed by the central bank of the country, which in Canada is the Bank of Canada.

F 16. The demand for money is not influenced by changes in the dollar value of transactions due to an increase in prices.

T 17. The multiplier effect is the additional change in aggregate demand that results when expansionary fiscal policy increases income and thereby increases consumer spending.

18. Explain the logic according to liquidity preference theory by which an increase in the money supply changes the aggregate demand curve.

$\uparrow M^s \rightarrow r\downarrow \rightarrow I\uparrow \rightarrow AD\uparrow$

19. During a recession what would be the appropriate monetary policy?

Monetary expansion, $\uparrow M^s$ to $\uparrow AD$ & thus $\uparrow Y$

20. During an inflationary boom what would be the appropriate monetary policy?

Monetary contraction, $\downarrow M^s$ to $\downarrow AD$ & thus $\downarrow Y$

21. During a recession what would be the appropriate fiscal policy?

Fiscal expansion, $\uparrow G$ &/or $\downarrow T$ to $\uparrow AD$ & thus $\uparrow Y$

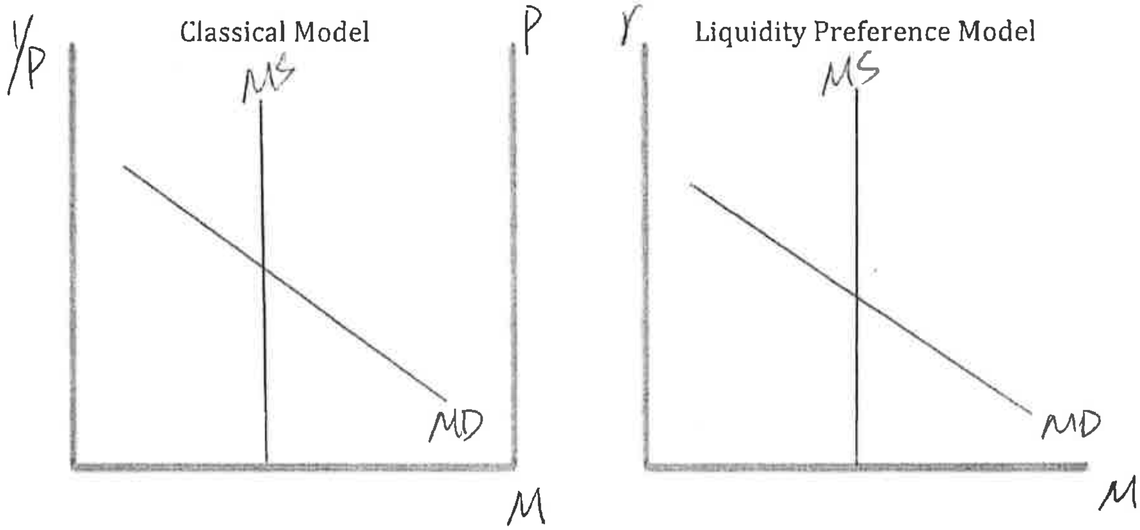
22. During an inflationary boom what would be the appropriate fiscal policy?

Fiscal contraction, $\downarrow G$ &/or $\uparrow T$ to $\downarrow AD$ & thus $\downarrow Y$

23. What curve in the AD-AS model shifts because of monetary or fiscal policy?

AD curve

24. Compare the classical model of money market (chapter 11) with the liquidity preference model from this chapter.



What determines the money supply in both models?

Central Bank

What happens to money demand in each model if there is an increase in the real interest rate?

classical model : MD shifts to the left
Liquidity Preference model : quantity of money demanded ↓, upward movement along MD

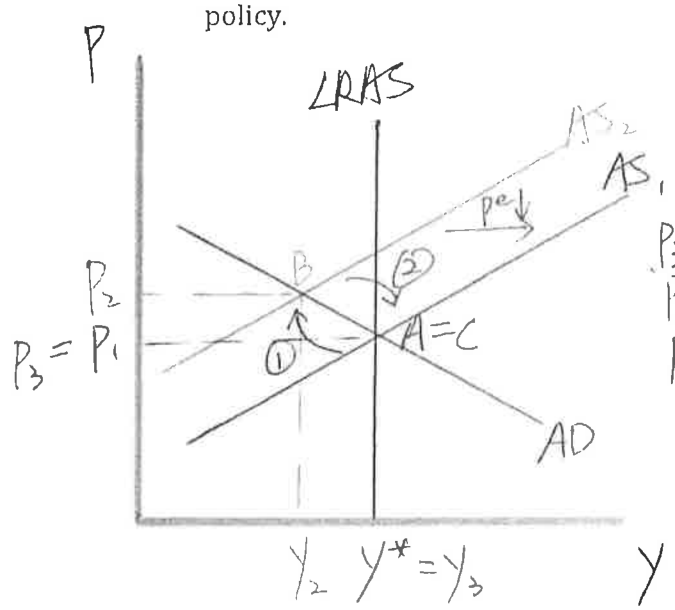
What happens to money demand in each model if there is an increase in the price level?

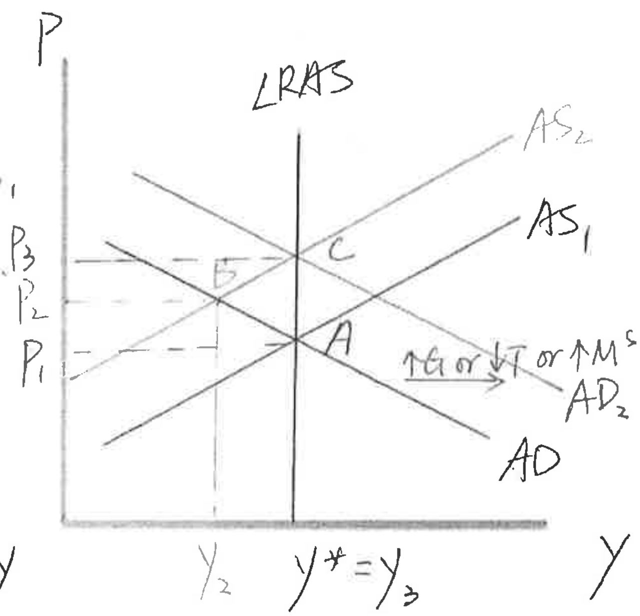
classical model : downward movement along MD curve
Liquidity Preference model : rightward shift of MD curve

What happens to money demand in each model if there is an increase in real GDP?

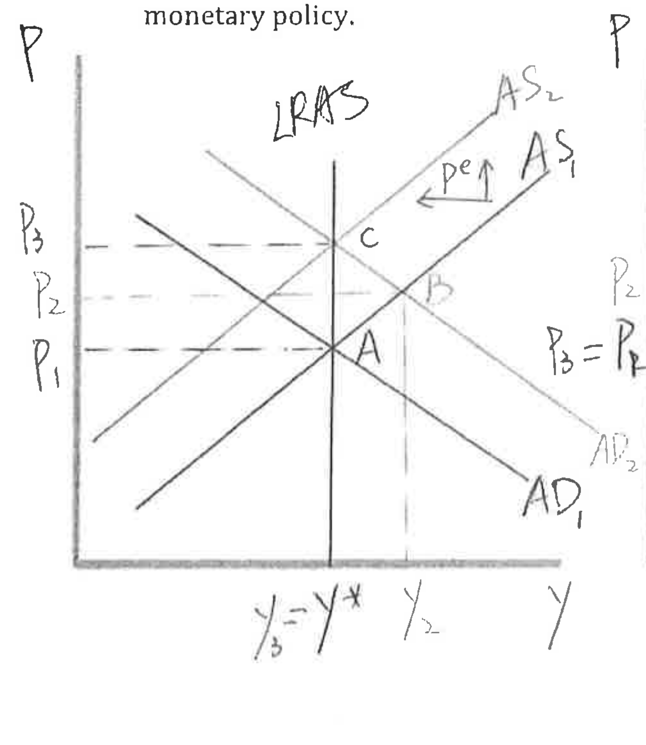
Rightward shift of MD curve in both models

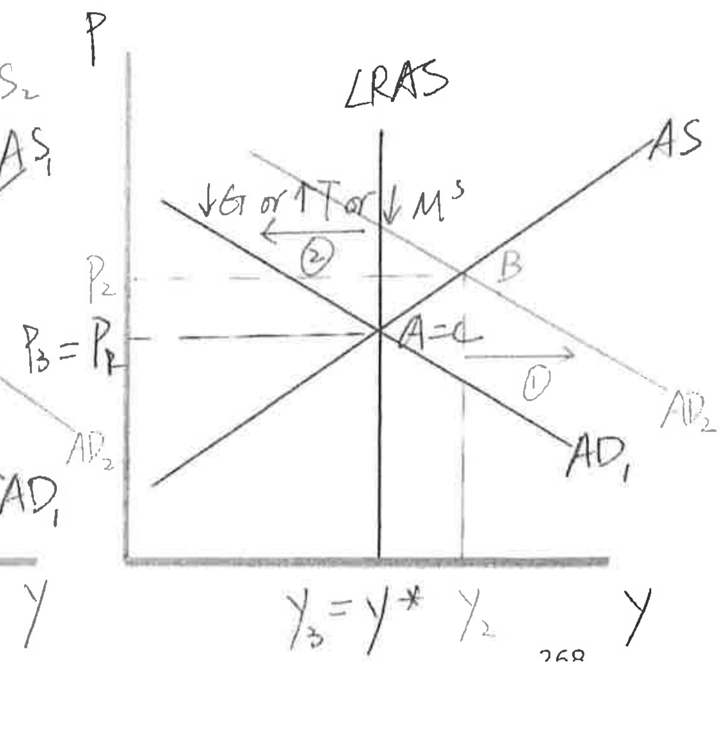
25. Draw the AD-AS model in both diagrams. Show an economy in a long run equilibrium in both diagrams and label the point A. Show the economy entering a recession because of an adverse supply shock (SRAS shifts left). Label the short-run equilibrium B. In the diagram on the left show what will happen in the long-run without fiscal or monetary policy. In the diagram on the right show what will happen in the long-run with fiscal or monetary policy.





26. Draw the AD-AS model in both diagrams. Show an economy in a long run equilibrium in both diagrams and label the point A. Show the economy entering an inflationary boom because of a favourable demand shock (AD shifts right). Label the short-run equilibrium B. In the diagram on the left show what will happen in the long-run without fiscal or monetary policy. In the diagram on the right show what will happen in the long-run with fiscal or monetary policy.





27. Calculate the government-purchases multiplier in ~~an open~~ a closed economy using the following information. The marginal propensity to consume (MPC) is 0.8, and the marginal propensity to import (MPI) is 0.2. If the government increases its purchases by 10 million,

a. What will be the expected increase in aggregate demand if there is no crowding out effect?

$$\text{multiplier} = \frac{1}{1-MPC} = \frac{1}{0.2} = 5$$

$$\Delta Y = \Delta G \times 5 = 10 \times 5 = \$50m$$

b. What will be the expected increase in aggregate demand if the crowding out effect is equal to 0.5 times the change in government purchases?

$$\text{crowding out effect} = 0.5 \times 10 = 5m$$

$$\Delta AD = 50m - 5m = \$45m$$

28. What are automatic stabilizers?

changes in fiscal policy that stimulate AD without any policy change when the economy enters a recession.

a. Explain how *government spending on transfer payments* (e.g. welfare and EI) works as an automatic stabilizer.

recession $Y < Y^* \to \downarrow T = tY \to AD\uparrow \to$ weaken economic fluctuations

b. Explain how the income tax system works as an automatic stabilizer.

recession $Y < Y^* \to$ unemployment $\uparrow \to$ more people apply for EI benefit & social assistance benefits $\to \uparrow AD \to$ weaken economic fluctuations.