Extra Questions
Chapter 11

1. An increase in taxes lowers income:
   A) and the interest rate in the short run, but leaves both unchanged in the long run.
   B) in the short run, but leaves it unchanged in the long run, while increasing consumption and lowering investment.
   C) in the short run, but leaves it unchanged in the long run, while lowering consumption and increasing investment.
   D) and the interest rate in both the short and long runs.

2. An increase in the money supply:
   A) increases income and lowers the interest rate in both the short and long runs.
   B) increases income in both the short and long runs, but leaves the interest rate unchanged in the long run.
   C) lowers the interest rate in both the short and long runs, but leaves income unchanged in the long run.
   D) lowers the interest rate and increases income in the short run, but leaves both unchanged in the long run.

3. If money demand does not depend on the interest rate, then the LM curve is ______ and ______ policy has no effect on output.
   A) horizontal; fiscal
   B) vertical; fiscal
   C) horizontal; monetary
   D) vertical; monetary

4. Other things equal, a given change in money supply has a larger effect on demand the:
   A) flatter the IS curve.
   B) steeper the IS curve.
   C) smaller the interest sensitivity of expenditure demand.
   D) smaller the income sensitivity of expenditure demand.

5. Possible explanations put forth for the Great Depression do not include:
   A) a shift in the IS curve.
   B) a shift in the LM curve.
   C) the debt-deflation theory.
   D) the Pigou effect.
6. An increase in investment demand for any given level of income and interest rates—due, for example, to more optimistic “animal spirits”—will, within the IS-LM framework, ______ output and ______ interest rates.
A) increase; lower  
B) increase; raise  
C) lower; lower  
D) lower; raise

7. The monetary transmission mechanism in the IS-LM model is a process whereby an increase in the money supply increases the demand for goods and services:
A) directly.  
B) by lowering the interest rate so that investment spending increases.  
C) by raising the interest rate so that investment spending increases.  
D) by increasing government spending on goods and services.

8. If the demand for real money balances does not depend on the interest rate, then the LM curve:
A) slopes up to the right.  
B) slopes down to the right.  
C) is horizontal.  
D) is vertical.

9. If \( MPC = 0.75 \) (and there are no income taxes but only lump-sum taxes) when \( T \) decreases by 100, then the IS curve for any given interest rate shifts to the right by:
A) 100.  
B) 200.  
C) 300.  
D) 400.

10. In the IS-LM model, a decrease in government purchases leads to a(n) ______ in planned expenditures, a(n) ______ in total income, a(n) ______ in money demand, and a(n) ______ in the equilibrium interest rate.
A) decrease; decrease; decrease; decrease  
B) increases; increase; increases; increase  
C) decrease; decrease; increase; increase  
D) increase; increase; decrease; decrease
11. In the *IS-LM* model, a decrease in output would be the result of a(n):
   A) decrease in taxes.
   B) increase in the money supply.
   C) increase in money demand.
   D) increase in government purchases.

12. If the short-run *IS-LM* equilibrium occurs at a level of income below the natural level of output, then in the long run the price level will ______, shifting the ______ curve to the right and returning output to the natural level.
   A) increase; *IS*
   B) decrease; *IS*
   C) increase; *LM*
   D) decrease; *LM*

13. In the *IS-LM* model, changes in taxes initially affect planned expenditures through:
   A) consumption.
   B) investment.
   C) government spending.
   D) the interest rate.

**Answer Key**

1. C
2. D
3. B
4. A
5. D
6. B
7. B
8. D
9. C
10. A
11. C
12. D
13. A
Chapter 12

1. The Mundell-Fleming model assumes that:
   A) prices are flexible, whereas the IS–LM model assumes that prices are fixed.
   B) prices are fixed, whereas the IS–LM model assumes that prices are flexible.
   C) as in the IS–LM model, prices are fixed.
   D) as in the IS–LM model, prices are flexible.

2. In a small open economy with a floating exchange rate, an effective policy to decrease equilibrium output is to:
   A) decrease government spending.
   B) decrease taxes.
   C) increase the money supply.
   D) decrease the money supply.

3. In a small open economy with a floating exchange rate, the supply of real money balances is fixed and a rise in government spending:
   A) raises the interest rate, so that income must rise to maintain equilibrium in the money market.
   B) raises the interest rate so that net exports must fall to maintain equilibrium in the goods market.
   C) cannot change the interest rate so that net exports must fall to maintain equilibrium in the goods market.
   D) cannot change the interest rate so income must rise to maintain equilibrium in the money market.

Use the following to answer question 4:

Exhibit: $I^*_S–LM^*$

[Diagram with labels and axes for exchange rate, $e$, LM{}, IS{}, e1, e2, e3, Y1, Y2, Income, output, Y]
4. (Exhibit: $IS^*\text{-}LM^*$) A small open economy with a floating exchange rate is initially at equilibrium A with $IS^*_1$, $LM^*_1$, equilibrium exchange rate $e_2$, and equilibrium output $Y_1$. If there is an increase in government spending to $IS^*_2$, the new equilibrium will be at ______, holding everything else constant.
   A) A
   B) B
   C) C
   D) D

5. In a small open economy with a floating exchange rate, if the government imposes an import quota, then in the new short-run equilibrium the $IS^*$ curve shifts to the right, raising the exchange rate:
   A) but not raising net exports or income.
   B) and net exports but not income.
   C) and income but not net exports.
   D) net exports and income.

Use the following to answer question 6:

Exhibit: Risk Premium

6. (Exhibit: Risk Premium) A small open economy with a floating exchange rate is initially in equilibrium at A with $IS^*_1$, $LM^*_1$. Holding all else constant, if the government imposes a tariff on imports in order to protect domestic jobs, then the ______ curve will shift to ______.
   A) $LM^*$; $LM^*_2$
   B) $LM^*$; $LM^*_3$
   C) $IS^*$; $IS^*_2$
   D) $IS^*$; $IS^*_3$
7. If there is a fixed-exchange-rate system, then in the long run:
   A) the nominal exchange rate is fixed, but the real exchange rate is free to vary.
   B) the real exchange rate is fixed, but the nominal exchange rate is free to vary.
   C) both the nominal and real exchange rates are fixed.
   D) the nominal and real exchange rates vary by a fixed amount.

8. In a small open economy with a fixed exchange rate, if the government increases government purchases, then in the process of adjusting to the new short-run equilibrium, the money supply:
   A) increases to keep the exchange rate unchanged, thus augmenting the effect of government spending on income.
   B) decreases to keep the exchange rate unchanged, thus offsetting the effect of government spending on income.
   C) remains unchanged, and there is no effect of government spending on income.
   D) remains unchanged to keep the interest rate at the world interest, so that government spending reduces income.

9. In a small open economy with a fixed exchange rate, if the country devalues its currency, then in the new short-run equilibrium the exchange rate ______, and the $LM^*$ curve shifts to the ______.
   A) decreases; left
   B) increases; left
   C) decreases; right
   D) increases; right

10. According to the Mundell-Fleming model, under floating exchange rates a fiscal expansion:
    A) lowers the exchange rate, but a monetary expansion raises it.
    B) raises the exchange rate, but a monetary expansion or an import restriction lowers it.
    C) or an import restriction lowers the exchange rate, but a monetary expansion raises it.
    D) or an import restriction raises the exchange rate, but a monetary expansion lowers it.
11. According to the Mundell-Fleming model, import restrictions in an economy with flexible exchange rates cause net exports to ______ and in an economy with fixed exchange rates import restrictions cause net exports to ______.
   A) increase; increase  
   B) increase; remain unchanged  
   C) remain unchanged; remain unchanged  
   D) remain unchanged; increase

12. If a country chooses to have free capital flows and to conduct an independent monetary policy, then it must:
   A) live with exchange-rate volatility.  
   B) restrict its citizens from participating in world financial markets.  
   C) give up the use of monetary policy for purposes of domestic stabilization.  
   D) have a fixed exchange rate.

13. In a large open economy with a floating exchange rate, such as in the United States, in the short run a monetary contraction:
   A) raises the interest rate, lowers investment and income, but does not affect the exchange rate.  
   B) raises the exchange rate, lowers net exports and income, but does not affect the interest rate.  
   C) initially raises the exchange rate, causing arbitrageurs to sell dollars and return the money supply to its initial level.  
   D) raises the interest rate and lowers investment and income, but also raises the exchange rate and lowers net exports.
Answer Key

1. C
2. D
3. C
4. B
5. A
6. C
7. A
8. A
9. C
10. D
11. D
12. A
13. D