Week 12 Tutorial Solution
ECON203: Macroeconomics 2
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Semester 2, 2019
Tutorial Time: 25/10/2019

Multiple Choice Questions

Question 1. An increase in wealth that doesn't affect labour supply would cause the IS curve to ________ and the FE line to ________.
(a) shift down and to the left; be unchanged
(b) shift down and to the left; shift left
(c) shift up and to the right; be unchanged
(d) shift up and to the right; shift left

Answer: C

Question 2. To reach general equilibrium, the price level adjusts to shift the ________ until it intersects with the ________.
(a) IS curve; FE line and LM curve
(b) FE line; LM and IS curves
(c) LM curve; FE line and IS curve
(d) ND curve; FE line and NS curve

Answer: C

Question 3. You have just read that Australia has suffered a drought, destroying its wheat crop for this year. The effect of this adverse supply shock on Australia would probably be
(a) an increase in prices and an increase in real interest rates.
(b) an increase in prices, an increase in nominal interest rates, but a decrease in real interest rates.
(c) a decrease in prices and a decrease in real interest rates.
(d) a decrease in prices, a decrease in nominal interest rates, but an increase in real interest rates.

Answer: A

Question 4. Which market adjusts the quickest in response to shocks to the economy?
(a) The asset market
(b) The labour market
(c) The goods market
(d) The asset, labour, and goods markets adjust at about the same speed to eliminate a disequilibrium in the macroeconomy.

Answer: A

Question 5. Keynesian economists think general equilibrium is not attained quickly because
(a) the real interest rate adjusts slowly.
(b) the level of output adjusts slowly.
(c) the real wage rate adjusts slowly.

(d) the price level adjusts slowly.

Answer: D

Question 6. Under an assumption of monetary neutrality, a change in the nominal money supply has
(a) no effect on the price level.
(b) a less than proportionate effect on the price level.
(c) a proportionate effect on the price level.
(d) a more than proportionate effect on the price level.

Answer: C

Question 7. Which of the following changes shifts the AD curve down and to the left?
(a) A temporary increase in government purchases
(b) A rise in the nominal money supply
(c) A decrease in corporate taxes
(d) A decrease in consumer confidence

Answer: D

Question 8. Which of the following changes shifts the $SRAS$ curve up?
(a) An increase in the labour force
(b) An increase in firms' costs
(c) A decrease in government purchases
(d) An increase in the money supply

Answer: B

Question 9. When the money supply rises by 10%, in the short run, output ________ and the price level ________.
(a) rises; is unchanged
(b) declines; falls
(c) is unchanged; falls
(d) declines; is unchanged

Answer: A

Question 10. When the money supply declines by 10%, in the long run, output ________ and the price level ________.
(a) is unchanged; is unchanged
(b) declines; falls
(c) is unchanged; falls
(d) declines; is unchanged

Answer: C

Problem Solving Questions

Question 11. Explain the differences between demand-pull inflation and cost-push inflation.

Demand-pull inflation results from high aggregate demand: the increase in demand "pulls" prices and output up. Cost-push inflation comes from adverse supply shocks that push up the cost of production. For example, the increases in oil prices in the mid- and late-1970s.

Question 12. Describe the short-run effects of each of the following shocks on the aggregate price level and on aggregate output.

(a) The government sharply increases the minimum wage, raising the wages of many workers.

An increase in the minimum wage raises the short-run aggregate supply curve to the left. As a result of this negative supply shock, the aggregate price level rises and aggregate output falls.

(b) Solar energy firms launch a major program of investment spending.

Increased investment spending shifts the aggregate demand curve to the right. As a result of this positive demand shock, both the aggregate price level and aggregate output rise.

(c) Congress raises taxes and cuts spending.

An increase in taxes and a reduction in government spending both result in negative demand shocks, shifting the aggregate demand curve to the left. As a result, both the aggregate price level and aggregate output fall.

(d) Severe weather destroys crops around the world.

This is a negative supply shock, shifting the short-run aggregate supply curve to the left. As a result, the aggregate price level rises and aggregate output falls.

Question 13. Suppose that the interest rate has no effect on investment.

(a) Can you think of a situation where this may happen?

If for example, financial markets function poorly, and firms cannot borrow and have to finance investment through profits (retained earnings), then the interest rate will have no effect on investment. This is admittedly an extreme case.

(b) What does this imply for the slope of the IS curve?

The IS curve becomes vertical, i.e. $\frac{dY}{di} = 0$

(c) What does this imply for the slope of the LM curve?

The slope of the LM curve remains the same.

(d) What does this imply for the slope of the AD curve?

The AD curve also becomes vertical, i.e. $\frac{dY}{dP} = 0$. **An increase in P shifts the LM curve up. However, given a vertical IS curve, the shift of the LM curve has no effect on output. In other words, the increase in the price level increases the interest rate. But the increase in the interest rate does not affect investment and so does not affect demand.**