Week 10 Tutorial Solution
ECON203: Macroeconomics 2
Dr. Lei Pan — Semester 2, 2019
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Multiple Choice Questions

Question 1. A disadvantage of the barter system is that
(a) no trade occurs.
(b) people must produce all their own food, clothing, and shelter.
(c) the opportunity to specialize is greatly reduced.
(d) gold is the only unit of account.

Answer: C

Question 2. Money's primary role in the economy comes from the benefits of lowering transactions costs and allowing specialization. This function of money is called
(a) store of value.
(b) medium of exchange.
(c) standard of deferred payment.
(d) unit of account.

Answer: B

Question 3. In some countries, prices in stores are listed in terms of U.S. dollars, rather than in units of the local currency. That's most likely because
(a) the country's political system is unstable.
(b) interest rates are higher using U.S. dollars than using the local currency.
(c) there is no other store of value.
(d) the country has experienced high rates of inflation.

Answer: D

Question 4. Why do people keep currency in their pockets when bank deposits pay interest?
(a) Because banks might steal your money.
(b) Because currency is more liquid.
(c) Because bank deposits lose value due to inflation.
(d) Because bank deposits lose value due to changes in interest rates.

Answer: B

Question 5. Which of the following measures is the best measure of money as a medium of exchange?
(a) M1
(b) M2
(c) M3
(d) None of the above

Answer: A

Question 6. Which of the following statements about M1 and M2 is true?
(a) Demand deposits are not part of M1.
(b) M2 is more liquid than M1.
(c) M1 is larger than M2.
(d) Savings deposits are part of M2.

Answer: D

Question 7. M2 does not include
(a) Treasury bonds.
(b) passbook savings accounts.
(c) small-denomination time deposits.
(d) M1.

Answer: A

Question 8. Over half of U.S. currency is
(a) held abroad.
(b) used in the underground economy.
(c) held by banks as reserves.
(d) held by businesses, especially retailers, for making transactions.

Answer: A

Question 9. What's the most common way for a central bank to reduce the money supply?
(a) Collect higher taxes
(b) Sell bonds to the public
(c) Buy bonds from the government
(d) Buy bonds from the public

Answer: B

Question 10. A developing country does not have enough taxes to cover its expenditures and is unable to borrow. This government would be most likely to cover its deficit by
(a) purchasing government bonds from the public.
(b) selling government bonds to the public.
(c) selling newly issued government bonds directly to the central bank.
(d) buying newly issued government bonds directly from the central bank.

Answer: C

Problem Solving Questions

Question 11. All else being equal, how would each of the following affect the demand for M1? The demand for M2? Explain.

(a) The maximum number of checks per month that can be written on money market mutual funds and money market deposit accounts is raised from three to thirty.

People would probably take money out of checking accounts and put it into money market mutual funds and money market deposit accounts. Money market mutual funds and money market deposit accounts are included in M2 but are not part of M1. The result is a decrease in M1, but no change in M2. M2 does not increase because M1 is part of M2, so the decrease in M1 offsets the increase in the rest of M2.

(b) Home equity lines of credit that allow home-owners to write checks against the value of their homes are introduced.

This would reduce both M1 and M2, as people would have reduced need for money in checking accounts, and home equity lines of credit are not included in either M1 or M2.

(c) The stock market crashes, and further sharp declines in the market are widely feared.

If people fear a stock market collapse, they will want greater liquidity, so they will hold more money. Also, since stocks are an alternative asset to money, and the expected return to stocks has fallen, money demand will increase. Both effects will lead to people investing less in stocks and more in cash, checking accounts, and other items that provide liquidity and safety, so M1 and M2 will both rise.

(d) Banks introduce overdraft protection, under which funds are automatically transferred from savings to checking as needed to cover checks.

People would have less need for money in checking accounts, and would put more in savings deposits. So M1 will decrease, while M2 will remain unchanged. (Again, M1 is part of M2, so reducing the amount that is in M1, and increasing the amount that is in M2 but not in M1, has no effect on M2.)

(e) A crackdown reduces the illegal drug trades (which is carried out largely in currency).

If currency demand falls, this decreases M1, thus also decreasing M2.

Question 12. Assume that prices and wages adjust rapidly so that the markets for labour, goods and assets are always in equilibrium. What are the effects of each of the following on output, the real interest rate, and the current price level?

(a) A temporary increase in government purchases.

A temporary increase in government purchases reduces national saving, causing the real interest rate to rise for a fixed level of income. If the real interest rate is higher, then real money demand will be lower. So prices must rise to make money supply equal money demand. The result is that output is unchanged, the real interest rate increases, and the price level increases.

(b) A reduction in expected inflation.

When expected inflation falls, real money demand increases. With no effect on employment or saving and investment, output and the real interest rate remain unchanged. With higher real money demand and an unchanged nominal money supply, the equilibrium price level must decline. So output and the real interest rate are unchanged and prices decline.

(c) A temporary increase in labour supply.

When labour supply rises, full-employment output increases. Also, with higher output, saving will increase, so the real interest rate will decline. Both higher

output and a lower real interest rate increase real money demand. The price level must decline to equate money supply with money demand. The result is an increase in output and a decrease in both the real interest rate and the price level.

(d) An increase in the interest rate paid on money.

When the interest rate paid on money increases, real money demand rises. With no effect on employment or saving and investment, output and the real interest rate remain unchanged. With higher real money demand and an unchanged nominal money supply, the equilibrium price level must decline. So output and the real interest rate are unchanged and prices decline.