Problem Set 6

Multiple choice questions:

1. Aggregate demand will increase if:
    a. Consumption falls
    b. Investment falls
    c. Exports fall
    d. Imports fall

2. Which of the following would decrease aggregate demand?
    a. Increased consumption
    b. Increasing export revenue
    c. Increased taxation revenue
    d. Increased investment

3. Which of the following statements is true about a country with a trade surplus?
    a. Net exports are negative and net capital outflow must be positive.
    b. Net exports are negative and net capital outflow must be negative.
    c. Net exports are positive and net capital outflow must be negative.
    d. Net exports are positive and net capital outflow must be positive.

4. The theory of purchasing-power parity does not always hold in practice because:
    a. many goods are not easily traded across borders.
    b. tradable goods are not always perfect substitutes when they are produced in different countries.
    c. real exchange rates fluctuate over time.
    d. both a. and b. are correct

5. When the French company Airbus sells a new plane to Southwest Airlines in the U.S.:
    a. U.S. net exports fall and the U.S. trade deficit falls.
    b. U.S. net exports fall and the U.S. trade deficit rises.
    c. U.S. net exports rise and the U.S. trade deficit rises.
    d. U.S. net exports rise and the U.S. trade deficit falls.

6. Which component of real GDP fluctuates the most over the course of the business cycle?
    a. consumption
    b. government expenditure
    c. investments

d. net exports

7. According to the wealth effect, one of the reasons for the slope of the aggregate demand curve is that falling prices
   a. increases the value of money holdings so consumer spending increases.
   b. decreases the value of money holdings so consumer spending increases.
   c. increases the value of money holdings so consumer spending decreases.
   d. decreases the value of money holdings so consumer spending decreases.

8. Suppose there is an increase in net exports. To stabilize output the government could
   a. increase government expenditures. The smaller the multiplier, the more it would need to increase expenditures.
   b. increase government expenditures. The smaller the multiplier, the less it would need to increase expenditures.
   c. decrease government expenditures. The smaller the multiplier, the more it would need to decrease expenditures.
   d. decrease government expenditures. The smaller the multiplier, the less it would need to decrease expenditures.

9. Which of the following would NOT cause a shift in AD?
   a. a reduction in income tax.
   b. a reduction in interest rates.
   c. an increase in government spending.
   d. a fall in the cost of production.

10. Suppose the economy is initially in long-run equilibrium. Then suppose there is an increase in military spending. According to the model of aggregate demand and aggregate supply, what happens to prices and employment in the short run?
    a. prices rise, employment rises
    b. prices rise, employment falls
    c. prices fall, employment falls
    d. prices fall, employment rises

True/False questions:

1. A real exchange rate is the price of one currency expressed in terms of another, with no other adjustment.

2. A trade deficit exists when imports exceed exports. In this instance, the net capital outflow is negative.

3. If the dollar appreciates relative to the euro, French and German consumers will find American products less attractive.

4. The larger the MPC, the smaller the multiplier.

5. Over time technological progress shifts the aggregate supply curve to the right making the inflation rate higher than otherwise.

Answer the following questions:

1) Define net exports and net capital outflow (net foreign investment). Explain how and why they are related.?

2) Define the nominal exchange rate and real exchange rate and explain how they are related. If the nominal exchange rate goes from 100 to 120 yen per dollar, has the dollar appreciated or depreciated??

3) Explain why the long-run aggregate-supply curve is vertical. Explain three theories for why the short-run aggregate-supply curve is upward sloping.

4) What might shift the aggregate-demand curve to the left? Use the model of aggregate demand and aggregate supply to trace through the effects of such a shift?

5) For each of the three theories for the upward slope of the short-run aggregate-supply curve, carefully explain the following:

a. how the economy recovers from a recession and returns to its long-run equilibrium without any policy intervention.

b. what determines the speed of that recovery?

6) Give an example of a government policy that acts as an automatic stabilizer. Explain why this policy has this effect.

7) Suppose government spending increases. Would the effect on aggregate demand be larger if the Federal Reserve took no action in response, or if the Fed were committed to maintaining a fixed interest rate? Explain.