

Exam 2

Pernecky

Pledge: "I pledge my honor that during this examination I have neither given nor received assistance, and that I have seen no dishonest work."

Pledge: _____

Name: _____

I have intentionally not signed the pledge: _____
(check if appropriate)

On multiple choice questions, circle the letter of the best answer.

The number of points each question is worth out of a total of 250 points is indicated in ()s next to each question.

On graphs, remember to label all axes, curves, and equilibrium points where appropriate.

(10) 1. Derive the LM curve assuming the following:

(1) $M = M$ where $M = 4000$

(2) $M^d = L_0 + L_Y Y - L_r r$ where $L_0 = 1000$, $L_r = 2500$, $L_Y = 10$

and M is the money supply, M^d is money demand, L_0 is autonomous money demand, L_r is the sensitivity of money demand to the interest rate, and L_Y is the sensitivity of money demand to income.

(20) 2. Derive the IS Curve from the following Keynesian model,

(1) $C = a + bY^d$ where $Y^d = Y - T + TR$, $T = 16$,

$$TR = TR_0 - TR_Y Y, \text{ where } TR_0 = 20, TR_Y = .2,$$

$$a = 220, \text{ and } b = .75$$

(2) $I = I$

where $I = I_0 - I_r r$, where $I_0 = 37$, $I_r = 50$

(3) $G = G$

where $G = 100$

(4) $X = X$

where $X = 100$

(5) $m = m$

where $m = 40$

where C is consumption, a is autonomous consumption, b is the marginal propensity to consume, Y is income, Y^d is disposable income, T is taxes, TR is transfers, TR_0 is autonomous transfers, TR_Y is the change in transfers from a change in income, I is investment, I_0 is autonomous investment, I_r is the sensitivity of investment to the interest rate, G is government spending, X is exports, and m is imports,

(10) 3. Numerically solve the IS/LM model for the equilibrium interest rate and equilibrium income level, given the information in questions 1 and 2.

(20)4. Now, assume that the only change from question 2 in deriving the IS curve is that imports change from 40 to 190.

a) Derive the new IS curve with $m = 190$.

b) Numerically solve the IS/LM model for the new equilibrium interest rate and the new equilibrium income level, assuming the information for the LM curve in question 1.

(20) 5. Graphically depict the IS/LM diagram based on questions

(1) - (4) with the original and new equilibrium levels for the interest rate and income, ie. from before and after the change in imports.

(40) 6. Utilize an IS/LM diagram to depict the impact of a tight monetary policy (a reduction in the money supply) and a loose fiscal policy (a reduction in autonomous taxes) assuming a low sensitivity of investment to the interest rate and a high sensitivity of money demand to the interest rate.

(60) 7. Graphically depict the impact of an increase in gross exports in the following (“Keynesian”) diagrams.

a) IS/LM

b) labor market

c) Aggregate Supply Curve

(5) 8. According to Keynes, investment would increase if

- a. the interest rate exceeded the marginal efficiency of capital
- b. the overall state of business confidence became more positive
- c. current GDP fell
- d. none of the above

(5) 9. According to Keynes, an increase in investment would (directly or indirectly) cause

- a. an increase in labor demand in the investment (capital) goods industry
- b. an increase in labor demand in the consumption goods industry
- c. both a and b
- d. neither a nor b

(5) 10. Which of the following would make the slope of the IS curve more negatively sloped (steeper)?

- a. a lower marginal propensity to consume
- b. a greater sensitivity of investment to the interest rate
- c. both a and b
- d. neither a nor b

(5) 11. Which of the following would make the slope of the LM curve more positively sloped (steeper)?

- a. a greater sensitivity of money demand to income
- b. a greater sensitivity of money demand to the interest rate
- c. a greater sensitivity of investment to the interest rate
- d. a lower marginal propensity to consume

(5) 12. When government spending increases and the LM curve is steeper, there is

- a. less crowding in
- b. more crowding in
- c. less crowding out
- d. more crowding out

(5) 13. Post Keynesians criticize the standard IS/LM model for

- a. assuming exogenous money
- b. granting too important a role for the interest rate in re-equilibrating the economy
- c. both a and b
- d. neither a nor b

(5) 14. The IS/LM model has which of the following Keynesian characteristics?

- a. output is determined without employment being determined first
- b. an underemployment equilibrium can persist
- c. government spending can play a positive role
- d. all of the above

(35) 15. Assume an income/expenditure model where the Marginal Propensity to Consume equals .8, and only consumption is a function of income (ie. taxes, transfers, imports, investment are all autonomous of income, and investment is autonomous of the interest rate), then

a) what is the numerical value of the tax multiplier, according to this income/expenditure model?

b) what would income increase by if taxes fell by \$1 billion?

DID YOU REMEMBER TO CONSIDER THE PLEDGE?

