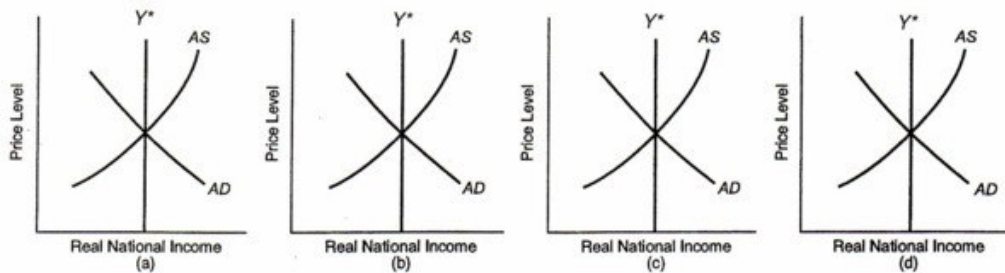


### Assignment III

- 1) An inflationary gap triggers
  - a. Factor price decreases and the AS curve begins to shift rightward
  - b. Factor price increases and the AS curve begins to shift rightward
  - c. An increase in the level of potential real GDP
  - d. Factor price decreases and the AS curve begins to shift rightward
  - e. Factor price increases and the AS curve begins to shift leftward
  
- 2) The appropriate fiscal policy to eliminate a recessionary gap is to
  - a. Increase taxes
  - b. Increase government purchases of goods and services
  - c. Decrease transfer payments
  - d. Increase the budget surplus
  - e. Decrease government purchases of goods and services
  
- 3) The paradox of thrift suggest that
  - a. Increased saving directly generates economic growth in the short run
  - b. Increased saving reduces aggregate demand and increases unemployment in the short run
  - c. By providing larger funding sources for investment expenditure, increased domestic saving fosters economic growth in the long run
  - d. Both (b) and (c)
  - e. Increased thrift has no effect on the economy either in the short or long run

- 4) Show graphically in the four panels that follow, and explain the short-run and long-run adjustments that you expect from the following economic changes. Assume that the economy starts from an equilibrium position where actual DGP equals potential income. Indicate what type of short-run output gap is created by the event. Assume that the level of potential GDP ( $Y^*$ ) is not affected by these events.



- a) Greater optimism over the future economic prospects increases planned desired investment expenditure.
  
- b) A maturing of the baby-boom generation increases the savings rate.
  
- c) Political instability in major producing regions increases the price of imported oil.
  
- d) A domestic economy experiences a decrease in its export sales of raw materials.

5)

**1. The short-run and long-run effects of a demand shock**

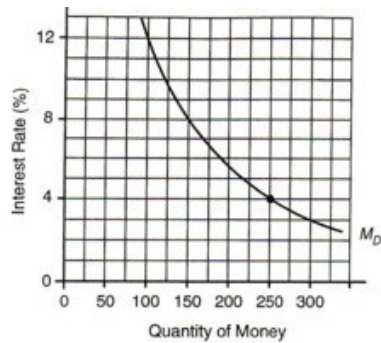
An economy's *AS* function,  $P = 1 + 0.01Y$ , is presented below in schedule form, where  $P$  is the price level and  $Y$  is the level of real national income. Potential real GDP is constant at 1000. Two schedules for the *AD* curve are presented, with Case I being the initial situation.

AS		Potential GDP		AD			
				Case I		Case II	
Y	P	Y	P	Y	P	Y	P
0	1.0	1000	1.0	0	111.0	0	116.5
500	6.0	1000	6.0	500	61.0	500	66.5
1000	11.0	1000	11.0	1000	11.0	1000	16.5
1050	11.5	1000	11.5	1050	6.0	1050	11.5

- Taking Case I for the *AD* curve, what are the equilibrium levels of  $P$  and  $Y$ ? What is the value of the output gap?
- Assume that the *AD* curve shifts right, represented by Case II. If the *AS* curve does not change immediately, what are the new short-run equilibrium values for  $P$  and  $Y$ ? What type of gap exists, and what is its magnitude?
- Given the shift of the *AD* curve, what factor price adjustments do you anticipate? What happens to the *AS* curve as these adjustments occur? What happens to the inflationary gap?
- What long run levels of  $P$  and  $Y$  would you anticipate?

- 6) An increase in the price level
  - a. Decreases the demand for money
  - b. Increases the demand for money
  - c. Has no effect on the demand for money
  - d. Causes a movement up to the  $M_d$  curve
  - e. Causes a movement down the money demand curve
  
- 7) The investment demand curve illustrate the
  - a. Positive relation between the quantity of desired investment and the real rate of interest
  - b. Negative relation between the quantity of desired investment and the real rate of interest
  - c. Negative relation between the quantity demand for bonds and the rate of interest
  - d. Positive relation between the quantity supply of bonds and the rate of interest
  - e. Positive relation between the demand for bonds and GDP
  
- 8) If the Bank of Canada purchases bonds in the open market,
  - a. The price of bonds falls and the interest rate rises
  - b. Both the price of bonds and the interest rate rise
  - c. Both the price of bonds and the interest rate fall
  - d. The price of bonds rises and the interest rate falls
  - e. Reserves in the banks fall

9)



- . If the central bank chose an interest rate target of 12 percent,
    - (a) both the money supply and the quantity of money demanded must be 100.
    - (b) an adjustment in the money supply is not needed.
    - (c) a money supply of 150 would create an excess supply of bonds at an interest rate of 12 percent.
    - (d) a money supply of 250 would create an equilibrium situation at 12 percent.
    - (e) Both (a) and (c).
  - . If the money supply were set at 150 and the central bank's interest rate target were 12 percent, the central bank
    - (a) need do nothing since a money supply of 150 achieves its interest-rate target.
    - (b) must sell bonds in the open market, thereby lowering bond prices.
    - (c) will lower the bank rate to indicate its intentions to decrease the supply of money.
    - (d) must increase government deposits in the banks in order to increase their reserves.
    - (e) must buy bonds in the open market.
  - . If the central bank set a monetary supply target of 150, then according to the  $M_D$  curve,
    - (a) there would be an excess supply of money at an interest rate of 12 percent.
    - (b) there would be an excess supply of bonds at an interest rate of 4 percent.
    - (c) the equilibrium interest rate must be 8 percent.
    - (d) All of the above.
    - (e) None of the above.
- 10) the bank rate is defined as the interest rate
- a. charged to preferred customers by a bank
  - b. charged by banks for overdrafts of large corporations
  - c. on credit card accounts
  - d. on three-month treasury bills
  - e. at which the Bank of Canada lends to the commercial banks