12. In the graph above, expansionary fiscal policy would be demonstrated by a movement from

    **(E) point A to point B.**

    Expansionary fiscal policy will cause an increase in aggregate demand. The result of an increase in aggregate demand would be a movement from equilibrium position A to equilibrium position B.

13. In the graph above, contractionary monetary policy would be demonstrated by a movement from

    **(A) point B to point A.**

    Contractionary monetary policy will cause a decrease in aggregate demand. The result of a decrease in aggregate demand would be a movement from equilibrium position B to equilibrium position A.

14. In the graph above, if the economy is presently operating at point B, in the absence of any fiscal or monetary policy action, we could conclude that

    **(C) point B is the short-run equilibrium and long-run equilibrium will be established at point C.**

    Point B is a short-run equilibrium as it is the intersection of the short-run aggregate supply curve and the aggregate demand curve. In this case, that intersection lies beyond the long-run aggregate supply curve and is therefore not sustainable as a long-run equilibrium position. Since the short-run equilibrium is beyond the long-run equilibrium, resource prices will be bid up and create a new equilibrium at higher price levels. In this case, that new equilibrium will occur at point C.

15. Which of the following will decrease aggregate demand?

    **(D) an increase in taxes**

    The components of aggregate demand include consumer, business, government, and foreign expenditures. Anything that would decrease any of these would decrease aggregate demand. An increase in taxes would decrease consumer expenditures or business expenditures, and therefore decrease aggregate demand.

16. In the country of Econostan, an island nation previously closed to contact with the rest of the world, the citizens tend to spend 80 percent of any increase in income. Based on this information, if a traveler from outside were to visit and spend $10,000 on a newly produced product, the GDP of Econostan could increase by a maximum of

    **(E) $50,000**

    If 80 percent of any increase is spent, then 20 percent is saved. The simple spending multiplier is 1/marginal propensity to save, or in this case 1/.20. The simple spending multiplier is therefore 5, so any change in spending would be multiplied by a factor of 5. Five times the spending change of $10,000 is $50,000.

17. A simultaneous and equally sized tax decrease and spending decrease by the federal government would have which of the following effects?

    **(C) decrease the price level and decrease real output**

    An equally sized tax decrease and a decrease in government spending would decrease aggregate demand. A decrease in aggregate demand would decrease the price level and real output. As tax decreases are subject to the marginal propensity to consume and save, their full effect would not be felt by the economy. Only the tax decrease multiplied by the marginal propensity to consume would increase aggregate demand. The entire amount of the decrease in government spending would decrease aggregate demand.

18. An outward shift (to the right) of a production possibility curve would be most closely synonymous with a (an)

    **(A) increase in long-run aggregate supply.**

    An outward shift of the production possibility curve would be the result of an increase in the productive capacity of the economy. A rightward shift of the long-run aggregate supply curve would also demonstrate, or be caused by, an increase in productive capacity.

19. A series of natural disasters like fires, floods, and earthquakes in the short-run could cause

    **(B) supply shocks and inflation.**

    Natural disasters would cause a change in the cost of production. These types of changes would result in a leftward shift in the aggregate supply curve. The result of a decrease, or leftward shift, in aggregate supply would be a rise in the price level, or inflation.

20. A commonly cited shortcoming of the effectiveness of fiscal policy is that

    **(B) the interest rate effect and the foreign purchases effect tend to run counter to the policy action.**

    The effectiveness of fiscal policy is offset by crowding in and crowding out. The unintended effect of interest rates changing in an undesirable way offsets, to some degree, the intended effect of the fiscal policy. The unintended effect is strengthened by the foreign purchases effect, which also runs counter to the intent of the initial fiscal policy.

21. Based on the findings of the Council of Economic Advisors, the complex multiplier is

    **(B) less than the simple spending multiplier.**

    The complex multiplier is less than the simple multiplier because of leakages from the system. The simple multiplier describes the maximum amount by which a change in spending could affect GDP. The complex multiplier describes the actual amount by which a change in spending affects GDP.

22. Cost-push inflation is caused by

    **(D) a decrease in aggregate supply only.**

    Cost-push inflation is inflation caused by an increase in the cost of production. Increased production costs would decrease aggregate supply and drive up the price level.

23. In the graph below, the intersection of which of the aggregate demand curves with the existing aggregate supply curve demonstrates an economy in the most severe recession?

    **(A) A**

    The most severe recession would occur where the aggregate supply curve intersects the aggregate demand curve at the lowest level of real GDP. In this case, that is aggregate demand curve A.

24. Which of the following represents a valid potential limitation of the effectiveness of fiscal policy and monetary policy respectively?

**(A) crowding out; a weak link between interest rate changes and investment changes**

Crowding out is an unintended consequence of expansionary fiscal policy. An expansionary policy would require the government to enter the loanable funds market and increase the demand for loanable funds, driving up the interest rate. The higher interest rates would crowd out private investment and offset, to some degree, the intended effect of the expansionary policy. If there is a weak link between interest rate changes and the level of investment spending, this would limit the effectiveness of monetary policy.

25. In the graph below, crowding out is demonstrated by which of the following shifts?

**(A) Aggregate Demand$_1$ to Aggregate Demand$_4$ to Aggregate Demand$_5$**

Crowding out is associated with expansionary fiscal policy. Expansionary fiscal policy would initially shift aggregate demand outward. The unintended effect of an expansionary policy would be to drive up interest rates which would crowd out private investment and shift aggregate demand inward. This is shown on the graph by a shift of aggregate demand from Aggregate Demand$_1$ to Aggregate Demand$_4$ and then a shift from Aggregate Demand$_4$ to Aggregate Demand$_5$.

26. The effect of a simultaneous decrease in government spending and a decrease in the money supply would be correctly shown in which of the graphs below?

**(C) C**

A decrease in government spending would decrease aggregate demand. A decrease in the money supply would increase interest rates and decrease aggregate demand.

27. The long-run aggregate supply curve is most similar to the

**(D) production possibilities curve.**

The long-run aggregate supply curve describes a potential level of maximum production. This potential output would occur at full employment. The production possibility curve also shows the maximum level of production if all resources are being efficiently used.

28. Which of the following correctly sums up the difference between the classical and Keynesian views of macroeconomic stability?

    **(B) the Keynesian view is that the economy is inherently unstable and needs active counter-cyclical policies to provide stability, while the Classical view is that the best course of action is to allow market forces (through flexible wages and prices) to correct for any short-term economic fluctuations.**

    The Keynesian view is that the economy is inherently unstable and needs active counter-cyclical policies to achieve the desired outcomes. The classical view is that markets will self correct and, through a system of flexible wages and prices, the economy will automatically achieve the desired outcome.

29. Which of the graphs below demonstrates an economy experiencing long-run economic growth?

    **(A) A**

    Long-run economic growth is demonstrated by a rightward shift in the long-run aggregate supply curve.

30. The concept of crowding out (or crowding in) is generally regarded as a limitation of the effectiveness of

    **(A) fiscal policy only.**

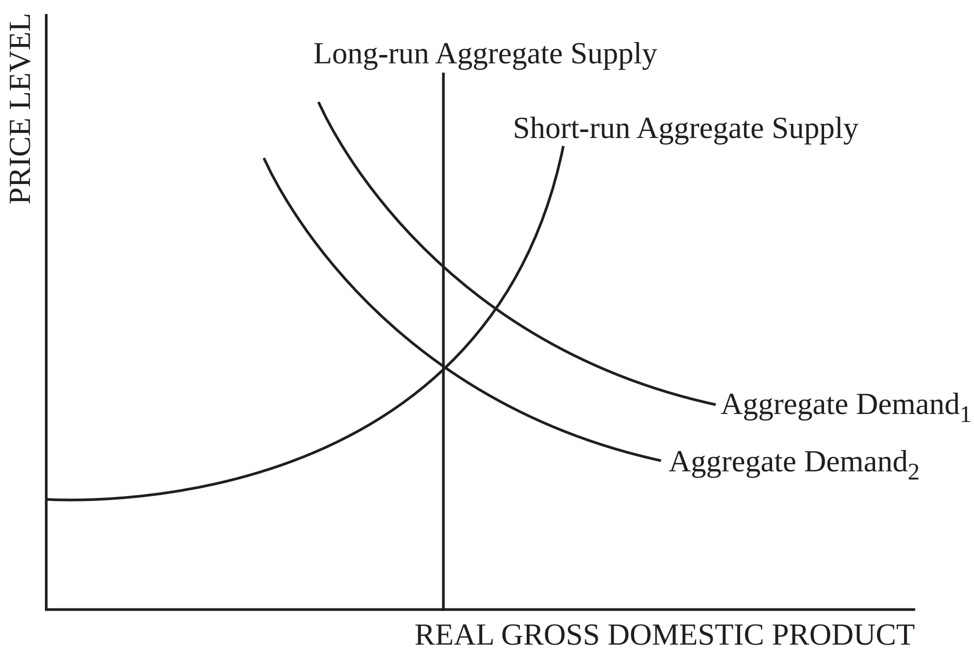
    Crowding out and crowding in are unintended consequences of expansionary and contractionary fiscal policies. An expansionary fiscal policy drives up interest rates and, as a result of the higher interest rates, private investment is crowded out. Contractionary fiscal policy drives down interest rates and crowds in private investment. Both of these are considered limitations of the effectiveness of fiscal policy.

1. Assume the following figures represent the existing condition in the U.S. economy:

| | |
|---|---|
| Unemployment rate | 6% |
| Inflation rate | 6% |
| Annual rate of real GDP growth | 3% |

(a) Is the economy facing any economic problems as described by the data above? Explain.
**Yes, the rate of inflation is high, significantly above the 2-3% range.**

(b) Draw an aggregate supply and aggregate demand diagram to demonstrate the effect of the federal government instituting a massive new tax increase on consumers and businesses in the economy described above.
**See graph below.**



(c) Describe the effect of the Federal Reserve decreasing the money supply on each of the following:

(i) interest rate

**Interest rates would increase as the supply of money decreases.**

(ii) the level of output

**The level of output would decrease as higher interest rates would decrease aggregate demand.**

(iii) the level of unemployment

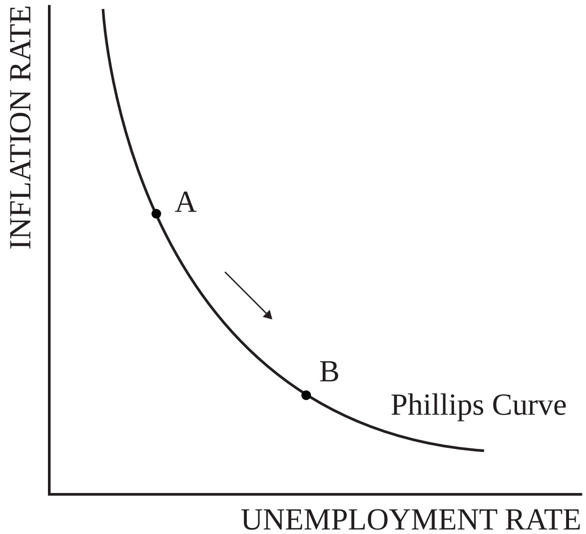
**The level of unemployment would increase as higher interest rates would decrease aggregate demand.**

(iv) the price level

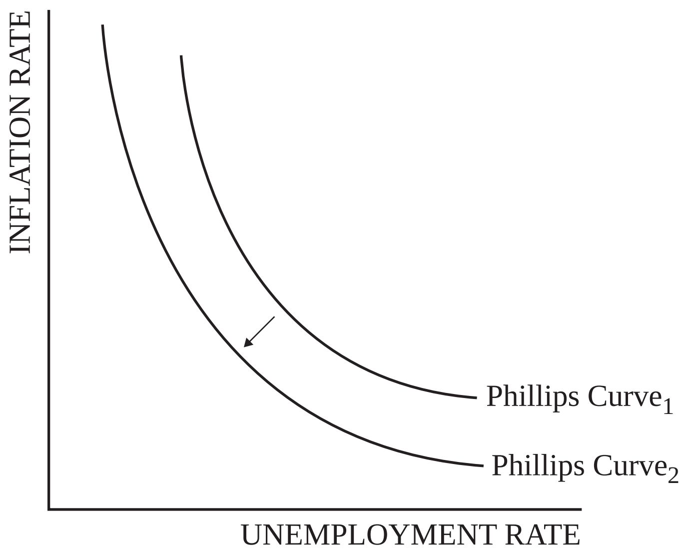
**The price level would decrease as higher interest rates would decrease aggregate demand.**

2. Draw a correctly labeled short-run Phillips curve and then redraw the curve to demonstrate the effect of each of the following:

   (a) a leftward shift of the aggregate demand curve
   **See graph below.**

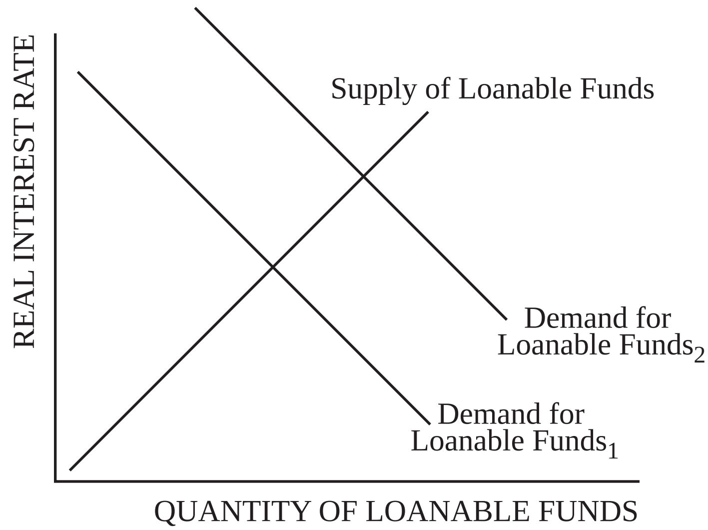



   (b) a rightward shift of the aggregate supply curve
   **See graph below.**



3. Draw a correctly labeled loanable funds graph and then redraw the curve to demonstrate each of the following:

   (a) an increase in deficit spending by the federal government
   **See graph below.**




   (b) an increased desire on the part of consumers to save for their retirement
   **See graph below.**