

# Macroeconomics 1 – Seminar 10

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The theory by John Maynard Keynes arguing that the interest rate adjusts to bring money supply and money demand into balance is called the:

- a. liquidity adjustment theory.
- b. money demand theory.
- c. liquidity preference theory.
- d. money supply theory

If the interest rate is above equilibrium in the Money Market,

people will be holding more/~~less~~ money than they want to,

so they will want to deposit in interest bearing accounts more/~~less~~ than before.

If the interest rate is below equilibrium in the Money Market, people will choose to \_\_\_\_\_ their interest bearing accounts in banks, causing the interest rate in the economy to \_\_\_\_\_.

- a. deposit some money into, increase
- b. deposit some money into, decrease
- c. withdraw some money from, increase
- d. withdraw some money from, decrease

The money supply curve is:

- a. upward sloping, because people wish to lend more at higher interest rates.
- b. upward sloping, because people want to hold less money at higher interest rates.
- c. vertical, because the Fed controls and determines the amount of money in the economy.
- d. downward sloping, because people want to hold less money at higher interest rates.

When the government increases its expenditures, the multiplier effect will \_\_\_\_\_ its impact on aggregate demand, and the crowding out effect will \_\_\_\_\_.

a. enhance, dampen it

b. enhance, enhance it as well

c. dampen, dampen it as well

d. dampen, enhance it

If the government cuts taxes by \$100 billion, aggregate expenditure:

- a. will increase by \$100 billion right away.
- b. might not change at all, if people perceive the tax cut to be temporary.
- c. will increase more than if the government had instead increased spending by the \$100 billion.
- d. will decrease, as the government will be forced to cut spending to meet its lower tax revenue

When an economy is in recession, household incomes tend to decrease, which results in households paying

- a. more taxes, thus helping stimulate the economy.
- b. fewer taxes, further dampening the economy.
- c. more taxes, further dampening the economy.
- d. fewer taxes, thus helping stimulate the economy.



Suppose the government increases its spending by \$200 billion.

How much will aggregate demand increase overall, if the marginal propensity to consume is 0.9 and if we assume there is no crowding out?

**\$2,000 billion (\$2 trillion)**

Explain how each of the following developments would affect the supply of money, the demand for money, and the interest rate. Illustrate your answer with diagrams.

- A) The Fed's bond traders buy bonds in open-market operations. **Shift in the money supply to the right, i.e. decrease in interest rate**
- B) An increase in credit-card availability reduces the cash people hold. **Shift in money demand to the left and decline in interest rate**
- C) The Central bank reduces banks' reserve requirements. **Shift in the money supply to the right, i.e. decrease in interest rate**
- D) Households decide to hold more money to use for holiday shopping. **Shift in money demand to the right and increase in interest rate**
- E) A wave of optimism boosts business investment and expands aggregate demand. **Shift in money demand to the right and increase in interest rate**

Suppose a computer virus disables the nation's automatic teller machine, making withdrawals from bank accounts less convenient. As a result, people want to keep more cash on hand, increasing the demand for money.

- A) Assume the Fed does not change the money supply. According to the theory of liquidity preference, what happens to the interest rate? What happens to aggregate demand? **Shift in money demand to the right causes increase in interest rate. Because of higher costs of borrowing and returns to saving, aggregate demand shifts to the left**
- B) If instead the Fed wants to stabilize aggregate demand, how should it change the money supply? **The Fed should increase money supply. This shift in money supply would offset the change in interest rate.**
- C) If it wants to accomplish this change in the money supply using open-market operations, what should it do? **The Fed should buy government bonds.**

# HW 3 – Problem 1

In Table below are data for the price of Big Macs in several countries. The U.S. price of a Big Mac is \$3.57.

Country	Price of a Big Mac	Predicted Exchange Rate	Actual Exchange Rate
Chile	1,750 pesos	490.20 pesos/\$	549 pesos/\$
Hungary	720 forint	201.68 forints/\$	199 forints/\$
Czech Republic	67.9 korunas	19.02 korunas/\$	18.7 korunas/\$
Brazil	8.03 real	2.25 real/\$	2.00 real/\$
Canada	3.89 C\$	1.09 C\$/\$	1.16 C\$/\$

1. For each country compute the predicted exchange rate of the local currency per U.S. dollar. **Numbers in red in the Table above**
2. According to purchasing-power parity, what is the predicted exchange rate between Hungarian forint and Canadian dollar? What is the actual exchange rate? **The predicted exchange rate is 185.03 forints/C\$ and actual is 171.55 forints/C\$.**
3. How well does the theory of purchasing-power parity explain exchanges rates? **The theory of PPP says that you should buy the same good for the same price everywhere. This is not true always (transaction costs, ...). In the Table, we can see differences between predicted and actual ER that is some countries larger and in other countries only marginal.**

# HW 3 – Problem 2

Over the past decade, some of Chinese saving has been used to finance American investment. That is, the Chinese have been buying American capital assets. Answer the following questions in words and with a diagram.

1. If the Chinese decided they no longer wanted to buy U.S. assets, what would happen in the U.S. market for loanable funds? In particular, what would happen to U.S. interest rates, U.S. saving, and U.S. investment? **In this situation, NCO increases, i.e. demand curve in the market for loanable funds shifts to the right. This induces interest rate to rise, U.S. saving to rise and U.S. investments to fall.**
2. What would happen in the market for foreign-currency exchange? In particular, what would happen to the value of the dollar and the U.S. trade balance?

**The supply curve in the market for foreign currency exchange shifts to the right that causes depreciation. Trade balance, i.e. net export, increases.**

# HW 3 – Problem 3

The economy begins in long-run equilibrium. Then one day, the president appoints a new chairman of the Federal Reserve. This new chairman is well-known for his view that inflation is not a major problem of an economy.

1. How would this news affect the price level that people would expect to prevail? **People expect higher prices.**
2. How would this change in the expected price level affect the nominal wage that workers and firms agree to in their new labor contracts? **They will agree on higher nominal wages (as they expect higher inflation)**
3. How would this change in the nominal wage affect the profitability of producing goods and services at any given price level? **Because of higher wages, the costs of production increase and the profitability decline.**
4. How does this change in profitability affect the short-run aggregate-supply curve? **The short run aggregate supply curve shifts to the left.**
5. If aggregate demand is held constant, how does this shift in the aggregate-supply curve affect the price level and the quantity of output produced? **This shift causes increase in the price level and decline in output.**