This is a closed book exam. You are required to abide all the rules of the Student Conduct Code of the University of Connecticut.

1. Assume that the economy begins in long-run equilibrium. Then the Fed reduces the money supply. In the short run ______, whereas in the long run prices ______ and output returns to its original level.
   A) output decreases and prices are unchanged; rise
   B) output decreases and prices are unchanged; fall
   C) output and prices both decrease; rise
   D) output and prices both decrease; fall

2. A difference between the economic long run and the short run is that:
   A) the classical dichotomy holds in the short run but not in the long run.
   B) monetary and fiscal policy affect output only in the long run.
   C) demand can affect output and employment in the short run, whereas supply is the ruling force in the long run.
   D) prices and wages are sticky in the long run only.

3. According to the Mundell-Fleming model for a small open economy with flexible exchange rates, if the Federal Reserve cannot alter domestic interest rates, changes in the money supply could still influence aggregate income through changes in the:
   A) exchange rate.
   B) price level.
   C) level of government spending.
   D) tax rates.

4. An economic change that does *not* shift the aggregate demand curve is a change in:
   A) the money supply.
   B) the investment function.
   C) the price level.
   D) taxes.

5. The introduction of a stylish new line of Toyotas, which makes some consumers prefer foreign cars over domestic cars, will, according to the Mundell-Fleming model with floating exchange rates, lead to:
   A) a fall in income and net exports.
   B) no change in income or net exports.
   C) a fall in income but no change in net exports.
   D) no change in income but a fall in net exports.

6. According to the Keynesian-cross analysis, when there is a shift upward in the government-purchases schedule by an amount ΔG and the planned expenditure schedule by an equal amount, then equilibrium income rises by:
   A) one unit.
   B) ΔG.
   C) ΔG divided by the quantity one minus the marginal propensity to consume.
   D) ΔG multiplied by the quantity one plus the marginal propensity to consume.

7. If the Fed reduces the money supply by 5 percent, then the real interest rate will:
   A) rise both in the short run and the long run.
   B) rise in the short run but return to its original equilibrium level in the long run.
   C) rise in the short run but will fall below its original equilibrium level in the long run.
   D) be unaffected both in the short run and the long run.

8. If expected inflation equals 3 percent and monetary policy makers push the nominal interest rate to 1 percent, the real interest rate equals ______ percent.
   A) 4
   B) 1
   C) 0
   D) -2

9. A decrease in the nominal money supply, other things being equal, will shift the *LM* curve:
   A) upward and to the right.
   B) downward and to the right.
   C) downward and to the left.
   D) upward and to the left.

10. For any given interest rate and price level, an increase in the money supply:
    A) lowers income.
    B) raises income.
    C) has no effect on income.
    D) lowers velocity.

11. In a small open economy with perfect capital mobility, if the domestic interest rate were to rise above the world interest rate, then ______ would drive the domestic interest rate back to the level of the world interest rate.
    A) capital inflow
    B) capital outflow
    C) the central bank
    D) a decline in domestic saving

12. a. Use the Keynesian-cross model to illustrate graphically the impact of an increase in the interest rate on the equilibrium level of income. Be sure to label: i. the axes; ii. the curves; iii. the initial equilibrium values; iv. the direction the curve shifts; and v. the terminal equilibrium values.
    b. Explain in words what happens to equilibrium income as a result of the increase in the interest rate.

13. If the demand for money increases, but the Fed keeps the money supply the same, then in the short run output will:
    A) fall and in the long run prices will remain unchanged.
    B) remain unchanged and in the long run prices will fall.
    C) remain unchanged and in the long run prices will remain unchanged.
    D) fall and in the long run prices will fall.

14. In the *IS-LM* model under the usual conditions in a closed economy, an increase in government spending increases the interest rate and crowds out:
    A) prices.
    B) investment.
    C) the money supply.
    D) taxes.

15. John Maynard Keynes wrote that responsibility for low income and high unemployment in economic downturns should be placed on:
    A) low levels of capital.
    B) an untrained labor force.
    C) inadequate technology.
    D) low aggregate demand.

16. In a small open economy with a floating exchange rate, a rise in government spending in the new short-run equilibrium:
    A) chokes off investment, but not by as much as the new government spending.
    B) chokes off an amount of investment just equal to the new government spending.
    C) attracts foreign capital, thus raising the exchange rate and reducing net exports, but not by as much as the new government spending.
    D) attracts foreign capital, thus raising the exchange rate and reducing net exports by an amount just equal to the new government spending.

17. In a small, open economy with a floating exchange rate, the exchange rate will depreciate if:
    A) the money supply is decreased.
    B) import quotas are imposed.
    C) government spending is increased.
    D) taxes are decreased.

18. Suppose you are an economist working for the Federal Reserve when droughts in the Southeast and floods in the Midwest substantially reduce food production in the United States. Use the aggregate demand-aggregate supply model to illustrate graphically your policy recommendation to accommodate this adverse supply shock, assuming that your top priority is maintaining full employment in the economy. Be sure to label: i. the axes; ii. the curves; iii. the initial equilibrium values; iv. the direction the curves shift; and v. the terminal equilibrium values. State in words what happens to prices and output as a combined result of the supply shock and the recommended Fed accommodation.

19. When bond traders for the Federal Reserve seek to decrease interest rates, they ______ bonds, which shifts the ______ curve to the right.
    A) buy; *IS*
    B) buy; *LM*
    C) sell; *IS*
    D) sell; *LM*

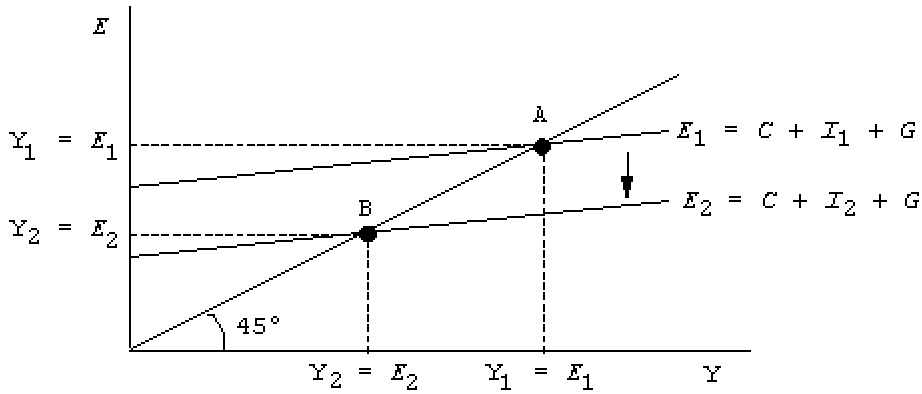
20. In a short-run model of a large open economy with a floating exchange rate, net capital outflow ______ as the domestic interest rate increases and is just equal to ______.
    A) decreases; minus net exports.
    B) decreases; net exports.
    C) increases; minus net exports.
    D) increases; net exports.

21. Other things equal, a given change in money supply has a larger effect on demand the:
    A) flatter the *IS* curve.
    B) steeper the *IS* curve.
    C) smaller the interest sensitivity of expenditure demand.
    D) smaller the income sensitivity of expenditure demand.

22. Those economists who believe that fiscal policy is more potent than monetary policy argue that the:
   A) responsiveness of investment to the interest rate is small.
   B) responsiveness of investment to the interest rate is large.
   C) *IS* curve is nearly horizontal.
   D) *LM* curve is nearly vertical.

Answer Key

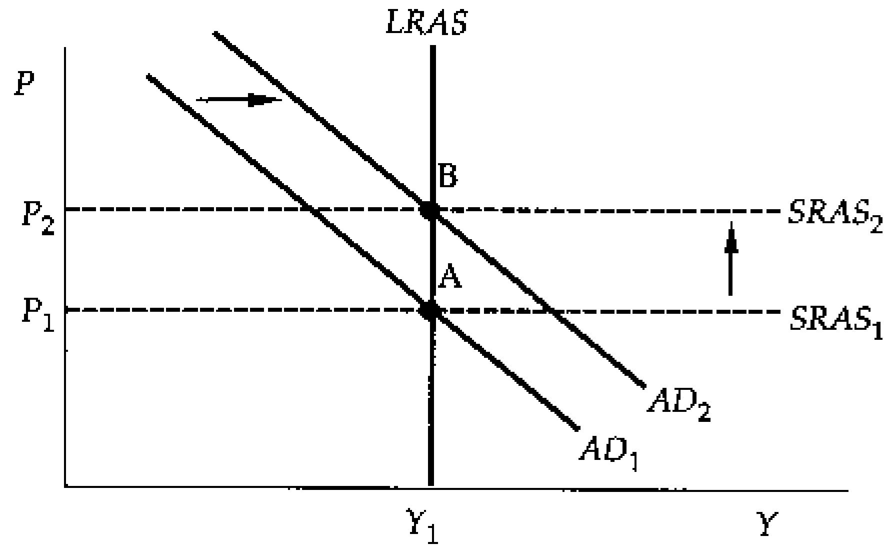
1. B
2. C
3. A
4. C
5. B
6. C
7. B
8. D
9. D
10. B
11. A
12. a.



b. The equilibrium level of income falls.

13. D
14. B
15. D
16. D
17. D

18. The accommodating policy means that the price level is permanently higher, but output is at the full-employment level.



19. B
20. B
21. A
22. A