

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. With the real money supply held constant, the theory of liquidity preference implies that a higher income level will be consistent with:
 - A) no change in the interest rate.
 - B) a lower interest rate.
 - C) a higher interest rate.
 - D) first a lower and then a higher interest rate.

2. According to the quantity equation, if velocity is *not* assumed to be constant and the money supply is held constant, then an increase in the interest rate _____ velocity and _____ income.
 - A) increases; increases
 - B) increases; decreases
 - C) decreases; decreases
 - D) decreases; increases

3. According to the theory of liquidity preference, the supply of nominal money balances:
 - A) is chosen by the central bank.
 - B) depends on the interest rate.
 - C) varies with the price level.
 - D) changes as the level of income changes.

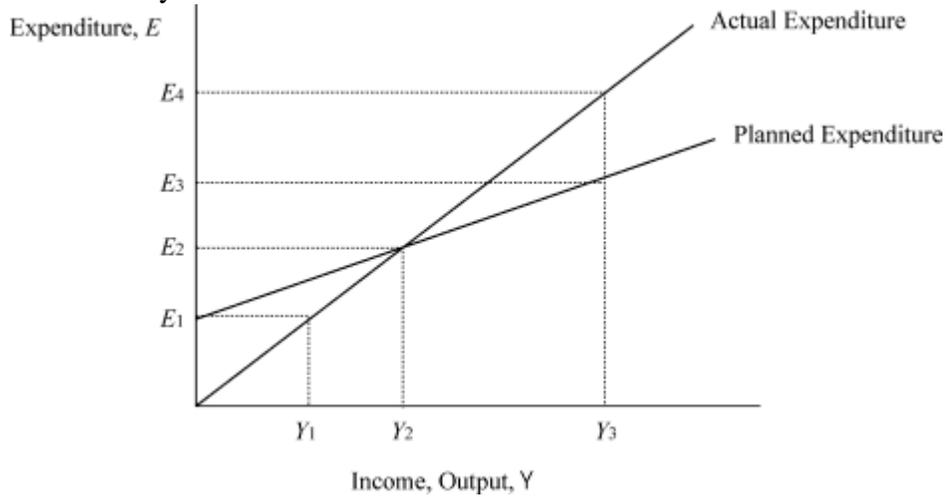
4. Assume that the equilibrium in the money market may be described as $M/P = 0.5Y - 100r$, and M/P equals 800.
 - a. Write the *LM* curve two ways, expressing Y as a function of r and r as a function of Y . (*Hint: Write the *LM* curve only relating Y and r ; substitute out M/P .*)
 - b. What is the slope of the *LM* curve?
 - c. If r is 1 percent, what is Y along the *LM* curve? If r is 3 percent, what is Y along the *LM* curve? If r is 5 percent, what is Y along the *LM* curve?
 - d. If M/P increases, does the *LM* curve shift upward and to the left or downward and to the right?
 - e. If M increases and P is constant, does the *LM* curve shift upward and to the left or downward and to the right?
 - f. If P increases and M is constant, does the *LM* curve shift upward and to the left or downward and to the right?

5. a. As an economy moves into a recession, income falls. Illustrate graphically the impact of a decrease in income on the equilibrium interest rate using the theory of liquidity preference and the market for real money balances. 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 interest rate as a result of the open-market purchase.
6. An increase in government spending generally shifts the *IS* curve, drawn with income along the horizontal axis and the interest rate along the vertical axis:
A) downward and to the left.
B) upward and to the right.
C) upward and to the left.
D) downward and to the right.
7. An increase in income raises money _____ and _____ the equilibrium interest rate.
A) demand; raises
B) demand; lowers
C) supply; raises
D) supply; lowers
8. According to the theory of liquidity preference, tightening the money supply will _____ nominal interest rates in the short run, and according to the Fisher effect, tightening the money supply will _____ nominal interest rates in the long run.
A) increase; increase
B) increase; decrease
C) decrease; decrease
D) decrease; increase
9. The *LM* curve generally determines:
A) income.
B) the interest rate.
C) both income and the interest rate.
D) neither income nor the interest rate.

10. Assume that the money demand function is $(M/P)^d = 2,200 - 200r$, where r is the interest rate in percent. The money supply M is 2,000 and the price level P is 2. If the price level is fixed and the supply of money is raised to 2,800, then the equilibrium interest rate will:
- A) drop by 4 percent.
 - B) drop by 2 percent.
 - C) drop by 1 percent.
 - D) remain unchanged.
11. The *IS-LM* model is generally used:
- A) only in the short run.
 - B) only in the long run.
 - C) both in the short run and the long run.
 - D) in determining the price level.
12. According to the theory of liquidity preference, the supply of real money balances:
- A) decreases as the interest rate increases.
 - B) increases as the interest rate increases.
 - C) increases as income increases.
 - D) is fixed.
13. According to the theory of liquidity preference, if the supply of real money balances exceeds the demand for real money balances, individuals will:
- A) sell interest-earning assets in order to obtain non-interest-bearing money.
 - B) purchase interest-earning assets in order to reduce holdings of non-interest-bearing money.
 - C) purchase more goods and services.
 - D) be content with their portfolios.
14. Both Keynesians and supply-siders believe a tax cut will lead to growth:
- A) and both agree it works through incentive effects.
 - B) but Keynesians believe it works through incentive effects whereas supply-siders believe it works through aggregate demand.
 - C) but Keynesians believe it works through aggregate demand whereas supply-siders believe it works through incentive effects.
 - D) and both agree it works through aggregate demand.

Use the following to answer question 15:

Exhibit: Keynesian Cross



15. (Exhibit: Keynesian Cross) In this graph, the equilibrium levels of income and expenditure are:
- A) Y_1 and E_1
 - B) Y_2 and E_2
 - C) Y_3 and E_3
 - D) Y_3 and E_4