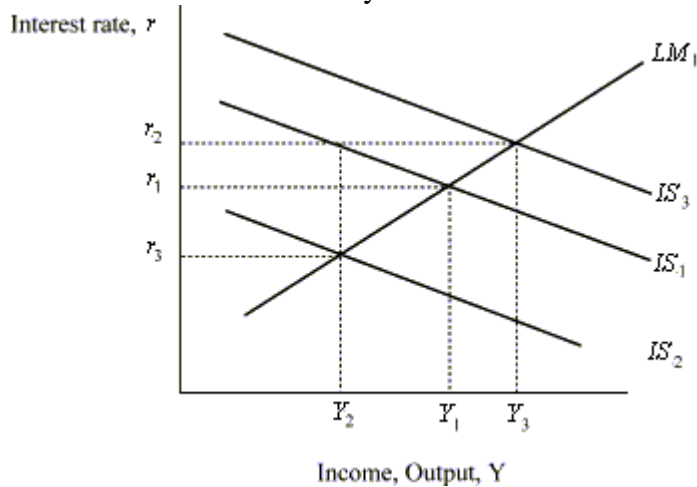


Name: _____ Date: _____

Use the following to answer question 1:

Exhibit: *IS-LM* Fiscal Policy



1. (Exhibit: *IS-LM* Fiscal Policy) Based on the graph, starting from equilibrium at interest rate r_1 and income Y_1 , a decrease in government spending would generate the new equilibrium combination of interest rate and income:
A) r_2 , Y_2
B) r_3 , Y_2
C) r_2 , Y_3
D) r_3 , Y_3
2. In the *IS-LM* model, a decrease in government purchases leads to a(n) _____ in planned expenditures, a(n) _____ in total income, a(n) _____ in money demand, and a(n) _____ in the equilibrium interest rate.
A) decrease; decrease; decrease; decrease
B) increases; increase; increases; increase
C) decrease; decrease; increase; increase
D) increase; increase; decrease; decrease
3. The increase in income in response to a fiscal expansion in the *IS-LM* is:
A) always less than in the Keynesian-cross model.
B) less than in the Keynesian-cross model unless the LM curve is vertical.
C) less than in the Keynesian-cross model unless the LM curve is horizontal.
D) less than in the Keynesian-cross model unless the IS curve is vertical.

4. The reason that the income response to a fiscal expansion is generally less in the *IS-LM* model than it is in the Keynesian-cross model is that the Keynesian-cross model assumes that:
- A) investment is not affected by the interest rate whereas in the *IS-LM* model fiscal expansion raises the interest rate and crowds out investment.
 - B) investment is not affected by the interest rate whereas in the *IS-LM* model fiscal expansion lowers the interest rate and crowds out investment.
 - C) investment is autonomous whereas in the *IS-LM* model fiscal expansion encourages higher investment, which raises the interest rate.
 - D) the interest rate is fixed whereas in the *IS-LM* model it is allowed to vary.
5. If the money supply increases, then in the *IS-LM* analysis the _____ curve shifts to the _____.
- A) *LM*; left
 - B) *LM*; right
 - C) *IS*; left
 - D) *IS*; right
6. In the *IS-LM* model when M/P rises, in short-run equilibrium, in the usual case, the interest rate _____ and output _____.
- A) rises; falls
 - B) rises; rises
 - C) falls; rises
 - D) falls; falls
7. If Congress passed a tax increase at the request of the president to reduce the budget deficit, but the Fed held the money supply constant, then the two policies together would generally lead to _____ income and a _____ interest rate.
- A) lower; lower
 - B) lower; higher
 - C) no change in; lower
 - D) no change in; higher
8. An increase in investment demand for any given level of income and interest rates--due, for example, to more optimistic "animal spirits"--will, within the *IS-LM* framework, _____ output and _____ interest rates.
- A) increase; lower
 - B) increase; raise
 - C) lower; lower
 - D) lower; raise

9. The aggregate demand curve generally slopes downward and to the right because, for any given money supply M a higher price level P causes a _____ real money supply M/P , which _____ the interest rate and _____ spending:
- lower; raises; reduces
 - higher; lowers; increases
 - lower; lowers; increases
 - higher; raises; reduces
10. A shift in the aggregate demand curve, starting from long-run equilibrium, which increases output in the short run, will _____ in the long run, as compared to a short-run equilibrium.
- increase both output and the price level
 - decrease output but increase prices
 - increase output but decrease the price level
 - decrease both output and the price level
11. If the demand function for money is $M/P = 0.5Y - 100r$ and if M/P increases by 100, then the LM curve for any given interest rate shifts to the:
- left by 100.
 - left by 200.
 - right by 100.
 - right by 200.
12. Other things equal, a given change in money supply has a larger effect on demand the:
- flatter the IS curve.
 - steeper the IS curve.
 - smaller the interest sensitivity of expenditure demand.
 - smaller the income sensitivity of expenditure demand.
13. If the IS curve is given by $Y = 1,700 - 100r$ and the LM curve is given by $Y = 500 + 100r$, then equilibrium income and interest rate are given by:
- $Y = 1,100$, $r = 6$ percent.
 - $Y = 1,200$, $r = 5$ percent.
 - $Y = 1,000$, $r = 5$ percent.
 - $Y = 1,100$, $r = 5$ percent.

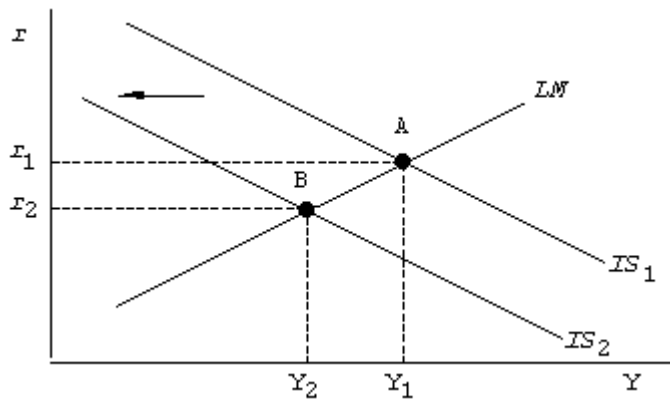
14. Assume that an economy is described by the *IS* curve $Y = 3,600 + 3G - 2T - 150r$ and the *LM* curve $Y = 2 M/P + 100r$ [or $r = 0.01Y - 0.02(M/P)$]. The investment function for this economy is $1,000 - 50r$. The consumption function is $C = 200 + (2/3)(Y - T)$. Long-run equilibrium output for this economy is 4,000. The price level is 1.0 and $M = 1,200$.
- Assume that government spending is fixed at 1,200. The government wants to achieve a level of investment equal to 900 and also achieve $Y = 4,000$. What level of r is needed for $I = 900$? What levels of T and M must be set to achieve the two goals? What will be the levels of private saving, public saving, and national saving? (*Hint: Check $C + I + G = Y$.*)
 - Now assume that the government wants to cut taxes to 1,000. With G set at 1,200, what will the interest rate be at $Y = 4,000$? What must be the value of M ? What will I be? What will be the levels of private, public, and national saving? (*Hint: Check $C + I + G = Y$.*)
 - Which set of policies may be referred to as tight fiscal, loose money? Which set of policies may be referred to as loose fiscal, tight money? Which “policy mix” most encourages investment?
15. Suppose Congress wishes to reduce the budget deficit by reducing government spending. Use the *IS-LM* model to illustrate graphically the impact of the reduction in government spending on output and interest rates. 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.
16. Suppose Congress passes legislation that reduces taxes. Use the *IS-LM* model to illustrate graphically the impact of the tax reduction on output and interest rates. 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.
17. How can the Fed keep the economy from falling into a recession if the budget deficit is reduced? Use the *IS-LM* model to illustrate graphically the impact of both the fiscal policy reducing the deficit and the monetary policy, which prevents output from falling. 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.
18. Use the *IS-LM* model to illustrate graphically the impact on output and interest rates of a one-time increase in the price level due to a large increase in oil prices. 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.

Answer Key

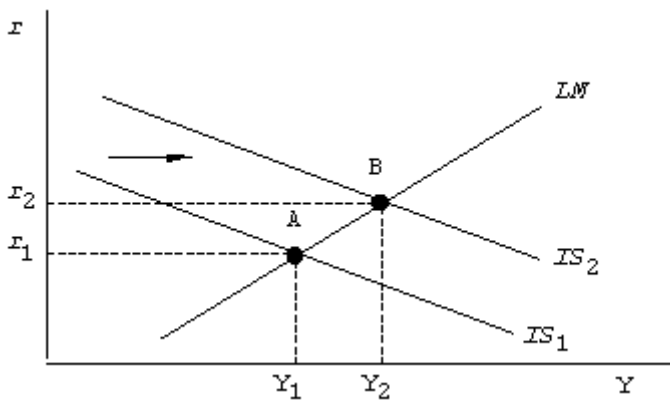
1. B
2. A
3. C
4. A
5. B
6. C
7. A
8. B
9. A
10. B
11. D
12. A
13. A

14. a. $r = 2$; $T = 1,450$; $M = 1,900$. Private saving = 650; public saving = 250; national saving = 900.
 b. $r = 8$; $M = 1,600$; $I = 600$; private saving = 800; public saving = -200; national saving = 600.
 c. The policy under part a is tight fiscal, easy money. The policy under part b is loose fiscal, tight money.
 The policy under part a most encourages investment.

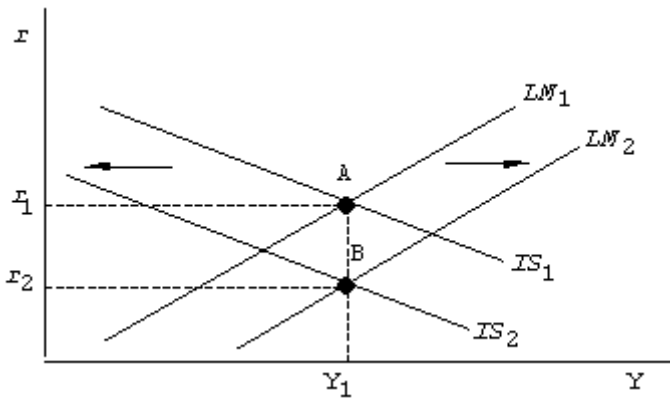
15.



16.



17.



18.

