**JHU ECON 602**

**MACROECONOMIC THEORY AND POLICY (Fall 2022)**

**Answers to Practice Quiz 2 for Part B**

1. **True, False or Uncertain.** State whether the following statements are True, False or Uncertain. **For statements that are False, correct the error or errors by writing out the full correct statement.** (N**ote that there may be more than one error and for full credit you have to correct all of them**). For statements that are Uncertain, explain why that is the case.
2. In the open economy IS-LM model, an increase in government spending leads to an increase in output. If the central bank keeps the exchange rate unchanged, the inflation rate also remains unchanged.

False. In the open economy IS-LM model, an increase in government spending leads to an increase in output. If the central bank keeps the interest rate unchanged, the exchange rate also remains unchanged.

1. When expectations are incorporated in the IS-LM model, the IS curve becomes flat, which in turn leads to the flattening of the Phillips Curve.

False. When expectations are incorporated in the IS-LM model, the IS curve becomes steeply sloping.

1. In the open economy IS-LM model, a decrease in domestic demand leads to an increase in domestic output and a deterioration of the trade balance.

False. In the open economy IS-LM model, an increase in domestic demand leads to an increase in domestic output and a deterioration of the trade balance.

1. In the IS/LM model, an increase in the risk premium leads to a shift of the LM curve to the left and an increase in equilibrium output.

False. In the IS/LM model, an increase in the risk premium leads to a shift of the IS curve to the left and a decrease in equilibrium output.

1. In the IS/LM model, equilibrium in the goods market implies that an increase in the interest rate leads to a decrease in output.

True.

1. In the IS-LM model, when account is taken of its effect on expectations, an increase in government spending need not lead to a decrease in output.

False. In the IS-LM model, when account is taken of its effect on expectations, a decrease in government spending need not lead to a decrease in output.

1. Exports are positively related to domestic income and negatively to the inflation rate.

False. Exports are positively related to foreign income and negatively to the real exchange rate.

1. Wholesale funding is a process in which banks rely on borrowing from the Fed through open market operations to finance the purchase of their assets.

False. Wholesale funding is a process in which banks rely on borrowing from other banks or investors to finance the purchase of their assets.

1. Macroeconomists believe that, in the medium run, real GDP increases over time due to the easing of monetary policy.

False. Macroeconomists believe that, in the medium run, real GDP increases over time due to the factors such as technological progress and not by the easing of monetary policy.

1. The National Bureau of Economic Research concluded that the U.S. economy was in a recession between March 2001 and December 2001, triggered by sharp increases in investment, which crowded out consumption.

False. The National Bureau of Economic Research concluded that the U.S. economy was in a recession between March 2001 and December 2001, triggered by sharp declines in investment demand.

1. In the IS/LM model, a decrease in taxes shifts the LM curve down. This leads to a decrease in the equilibrium level of output.

False. In the IS/LM model, an increase in taxes shifts the IS curve to the left. This leads to a decrease in the equilibrium level of output.

1. To counter the recession of 2001, the U.S. government raised interest rates, cut spending and raised tax rates.

False. To counter the recession of 2001, the U.S. government cut interest rates, increased spending and cut tax rates.

1. Macroeconomists believe that in the medium run monetary policy determines what people really care about such as the inflation rate and the trend rate of real GDP.

False. Macroeconomists believe that in the medium run monetary policy determines the inflation rate but not the trend rate of real GDP.

1. In the IS/LM model, a monetary expansion shifts the LM curve down, and leads to higher output.

True.

1. In the IS/LM model, a decrease in the inflation rate shifts the LM curve up, and leads to lower output.

False. In the IS/LM model, an increase in the interest rate shifts the LM curve up, and leads to lower output.

1. In the IS/LM model, a fiscal expansion shifts the IS curve to the left and a monetary expansion shifts the LM curve up. Both lead to lower output.

False. In the IS/LM model, a fiscal expansion shifts the IS curve to the right and a monetary expansion shifts the LM curve down. Both lead to higher output.

1. The fact that fiscal policy does not affect real variables in the short run is referred to as the neutrality of money.

False. The fact that monetary policy does not affect real variables in the medium (or long) run is referred to as the neutrality of money.

1. In the United States, from 2006 on, many home mortgages went underwater because of declines in policy interest rates.

False. In the United States, from 2006 on, many home mortgages went underwater because of declines in house prices.

1. In the United States, the effects of an increase in the oil price are to raise output and lower the price level.

False. In the United States, the effects of an increase in the oil price are to lower output and raise the price level.

1. Movements in output around its trend are called output fluctuations (business cycles)

True.

1. The interest parity condition states that an increase in the domestic interest rate leads to an increase in the exchange rate.

True.

1. In the open-economy IS-LM model, an increase in the interest rate reduces output both directly and indirectly through the interest rate.

False. In the open-economy IS-LM model, an increase in the interest rate reduces output both directly and indirectly through the exchange rate.

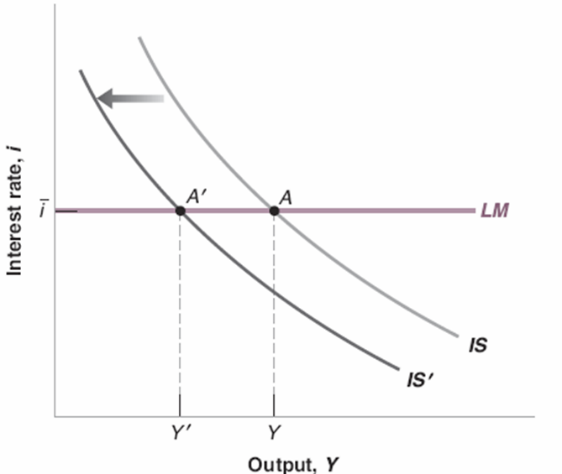
1. Imports are positively related to domestic income and negatively to the exchange rate.

False. Imports are positively related to domestic income and also positively related to the exchange rate.

1. In the open-economy IS model, a higher domestic interest rate leads to a higher exchange rate (an appreciation).

True.

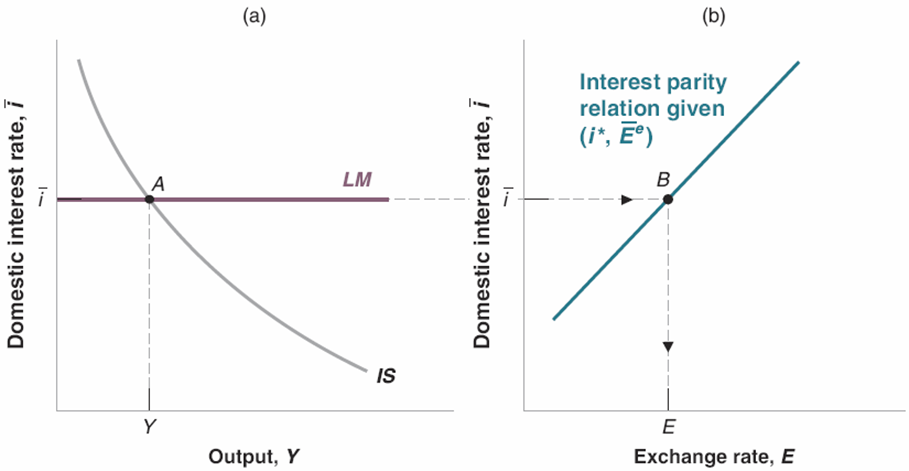
1. **Get the Picture**
2. What are examples of some policies or shocks which can lead to a leftward shift in the IS curve?



Policies: Increase in tax rates; cut in government spending.

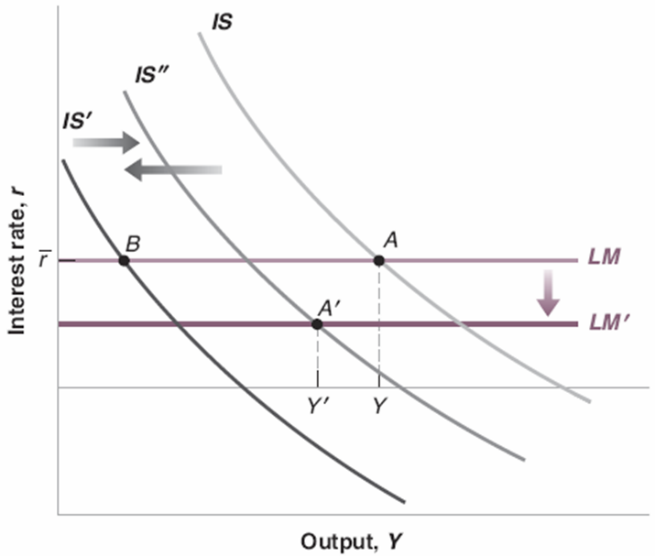
Shocks: increase in risk premium (decline in ‘animal spirits’)

1. What would be the effects in the figures below if there is an increase in government spending?



The IS curve would shift to the right.

1. The picture below depicts the effects of the Great Recession (or Global Financial Crisis) in the United States. Explain what the shifts in the curves are showing.

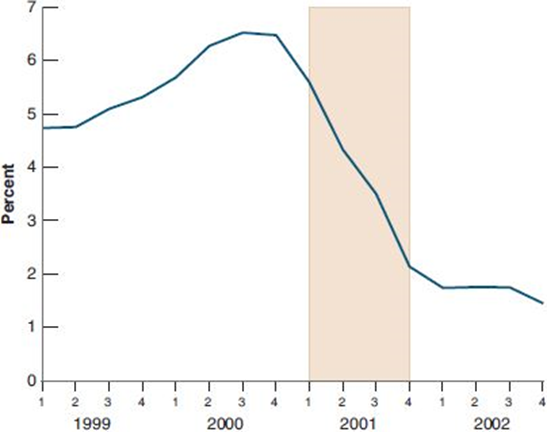


The shift from IS to IS’ shows the effect of the shock, which was the increase in the risk premium due to the effects of the financial crisis.

The shift from IS’ to IS’’ shows the fiscal policy response (increase in government spending) to counter the effects of the shock. Some of the shift is also due to the response of financial policies (provision of liquidity to the financial system and other steps.

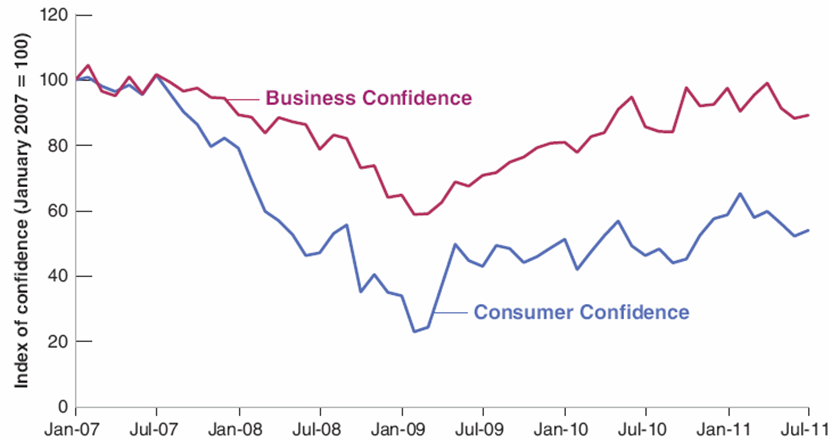
The shift from LM to LM’ is due to the monetary policy response (cut in interest rates by the central bank).

1. Which U.S. macroeconomic variable does the graph below show? (i) U.S. inflation rate; (ii) U.S. exchange rate; (iii) U.S. house prices; (iv) none of the above.



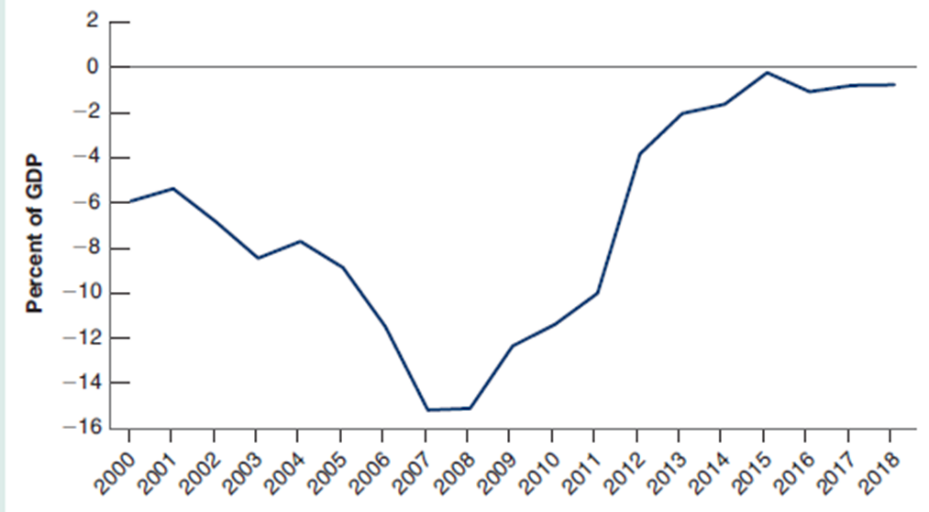
(iv). None of the above. (It is the U.S. federal funds rate).

1. What factors led to the decline in U.S. consumer confidence shown in this picture?



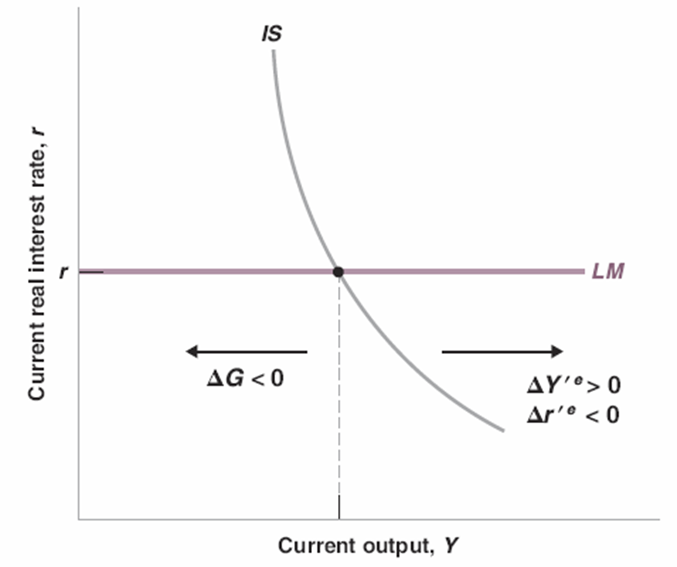
The collapse in U.S. house prices in 2006 triggered a financial crisis which led to a drop in confidence.

1. The current account in Greece improved after 2007. What factors brought about this improvement?



A key factor was the decline in domestic incomes, which led to a sharp decline in imports.

1. What does the picture below depict?



It shows that when account is taken of its effect on expectations, the decrease in government spending need not lead to a decrease in output. The cut in government spending exerts a negative impact on output. But this can be countered by positive effects if people expect that the cut in government spending will boost the economy’s future prospects (e.g., if it addresses the government’s debt problems and hence leads to expectations of lower interest rates in the future; or if the government cuts unproductive spending and improves the economy’s future growth).

1. What is the most interesting thing you have learnt in this part of the course (Part B)?

You tell me!