### CHAPTER 19
Disputes over Macro Theory and Policy

<table>
<thead>
<tr>
<th>Topic</th>
<th>Question numbers</th>
</tr>
</thead>
<tbody>
<tr>
<td>2. Mainstream view of instability</td>
<td>10-14</td>
</tr>
<tr>
<td>3. Monetarism/equation of exchange</td>
<td>15-53</td>
</tr>
<tr>
<td>4. Real-business cycle view</td>
<td>54-60</td>
</tr>
<tr>
<td>5. Coordination failures</td>
<td>61-64</td>
</tr>
<tr>
<td>6. New classical view of self-correction</td>
<td>65-83</td>
</tr>
<tr>
<td>7. Mainstream view of self-correction</td>
<td>84-88</td>
</tr>
<tr>
<td>8. Efficiency wages; insider-outsider theory</td>
<td>89-100</td>
</tr>
<tr>
<td>9. Policy rules; critiques of stabilization policy</td>
<td>101-116</td>
</tr>
<tr>
<td>10. Defense of discretionary stabilization policy</td>
<td>117-122</td>
</tr>
<tr>
<td>11. Absorption into the mainstream</td>
<td>123-126</td>
</tr>
<tr>
<td>Consider This</td>
<td>127-128</td>
</tr>
<tr>
<td>Last Word</td>
<td>129-133</td>
</tr>
<tr>
<td>True-False</td>
<td>134-152</td>
</tr>
</tbody>
</table>

### Multiple Choice Questions

#### Classics vs. Keynes: AD/AS

Type: A  Topic: 1  E: 340  MA: 340
1. In its simplest form, Keynesian theory views the aggregate supply curve as being:
   Answer: B

Type: A  Topic: 1  E: 340  MA: 340
2. In its simplest form, Keynesian theory holds that a decline in aggregate demand will:
   A) increase the price level, but lower output and employment.
   B) reduce output and employment but not the price level.
   C) reduce both the price level and the levels of output and employment.
   D) reduce the price level, but not the levels of output and employment.
   Answer: B

Type: A  Topic: 1  E: 338  MA: 338
3. Classical theory sees the aggregate supply curve as being:
   A) upsloping, but quite flat.  B) downsloping.  C) vertical.  D) horizontal.
   Answer: C
In classical theory a decline in aggregate demand will:
A) increase the price level, but lower output and employment.
B) reduce output and employment but not the price level.
C) reduce both the price level and the levels of output and employment.
D) reduce the price level, but not the levels of output and employment.
Answer: D

The classical aggregate supply curve suggests that:
A) real output is unrelated to the price level.
B) businesses must receive higher prices to produce more output.
C) real output can be increased without affecting the price level.
D) idle capital goods and unemployed workers are available in the economy.
Answer: A

Refer to the above diagrams. Classical theory is best portrayed by:
A) Figure A. B) Figure B. C) Figure C. D) none of the above.
Answer: A

Refer to the above diagrams. Keynesian theory is best portrayed by:
A) Figure A. B) Figure B. C) Figure C. D) none of the above.
Answer: B

Classical theory views the aggregate demand curve as being:
Answer: C
9. If there is full employment, and a decline in aggregate demand occurs:
   A) Keynesian analysis would predict a decline in prices and wages.
   B) Keynesian analysis would predict a decline in real output and employment.
   C) Classical analysis would predict a decline in real output and employment.
   D) Classical analysis would predict declines in both real GDP and the price level.
   Answer: B

Mainstream view of instability

10. The equation underlying the mainstream view of macroeconomics is:
    A) $MV = PQ$.  B) $C_a + I_g + X_n + G = GDP$.  C) $S = a - bY$.  D) $GDP = P \times Q$.
    Answer: B

11. The mainstream view is that macro instability is caused by:
    A) erratic growth of the nation's money supply.  C) significant changes in investment spending.
    B) government interference in the economy.  D) consumption "booms" and "busts."
    Answer: C

12. The mainstream view of macroeconomic instability is based mainly on:
    A) Keynesian ideas.  C) the theory of rational expectations.
    B) monetarist ideas.  D) the equation of exchange.
    Answer: A

13. According to mainstream macroeconomists, U.S. macro instability has resulted from:
    A) investment "booms" and "busts" and, occasionally, adverse aggregate supply shocks.
    B) adherence by the Fed to a monetary rule.
    C) government's attempts to balance its budget.
    D) wide fluctuations in net exports.
    Answer: A

14. The mainstream view of macro instability is that:
    A) changes in the money supply directly cause changes in aggregate demand and thus cause changes in
       real GDP.
    B) changes in investment shift the aggregate demand curve and thus cause changes in real GDP.
    C) bursts of innovation put the economy on an unsustainable growth path, eventually producing recession.
    D) changes in technology and resource availability are the two main sources of fluctuations of real GDP.
    Answer: B
Monetarism/equation of exchange

15. Economist Milton Friedman is most closely associated with:
   A) Keynesian economics.    C) supply-side economics.
   B) the rational expectations theory.    D) monetarism.
   Answer: D

16. The intellectual roots of monetarism are based on:
   A) the idea that prices and wages are inflexible or sticky.
   B) the idea that both product and resource markets are monopolistic.
   C) classical economics.
   D) Keynesian economics.
   Answer: C

17. According to monetarists:
   A) changes in the money supply are the primary cause of changes in real output and the price level.
   B) an expansionary fiscal policy will lower interest rates and overstimulate the economy.
   C) changes in the velocity of money are more important than changes in the money supply in causing the level of economic activity to change.
   D) the supply of money changes in response to changes in the levels of real output and prices.
   Answer: A

18. The basic equation of monetarism is:
   A) \( MV = PQ \).    B) \( S_a + T + M = I_g + G + X_n \)
   C) \( V = M/PQ \).    D) \( C_a + I_g + X_n + G = GDP \).
   Answer: A

19. The equation of exchange indicates that:
   A) \( MV = PQ \).
   B) other things equal, an increase in the demand for money will increase \( P \) and/or \( Q \).
   C) the velocity and the supply of money vary directly with one another.
   D) \( MP = VQ \).
   Answer: A

20. If \( M \) is $300, \( P \) is $4, and \( Q \) is 200, then \( V \) must be:
   Answer: B

21. In the equation of exchange the level of aggregate expenditures is indicated by:
   A) \( MV \).    B) \( MV/Q \).    C) \( PM \).    D) \( MP \).
   Answer: A
Chapter 19: Disputes over Macro Theory and Policy

According to the equation of exchange, changes in the money supply can affect:

A) only the velocity of money.  
B) both the price level and real output.  
C) only real output and employment.  
D) only the price level.

Answer: B

The velocity of money is the:

A) relationship between the money supply and the price level.  
B) number of times per year the average dollar is spent on final goods and services.  
C) relationship between asset and transactions demands for money.  
D) price level divided by aggregate supply.

Answer: B

If a certain household earns and spends $24,000 per year and, on the average, holds a money balance of $6,000, then the velocity of money for this household is:

A) 6.  
B) 1/6.  
C) 4.  
D) 1/4.

Answer: C

Which of the following is a component of the equation of exchange?

A) consumption  
B) the interest rate  
C) investment  
D) the velocity of money

Answer: D

The velocity of money measures the:

A) proportion of the money supply held as an asset.  
B) ratio of the transactions demand to the asset demand for money.  
C) average annual rate of increase in the money supply.  
D) number of times per year the average dollar is spent on final goods and services.

Answer: D

In the equation of exchange $V$ indicates the:

A) value or purchasing power of the dollar.  
B) number of times per year the average dollar is spent.  
C) quantity of real output.  
D) reciprocal of the price level.

Answer: B

The velocity of money:

A) is defined as the number of times per year the average dollar is spent on final goods and services.  
B) is defined as the multiple by which a final increase in GDP exceeds an initial increase in spending.  
C) is equal to the reciprocal of the monetary multiplier.  
D) has been nearly constant during the past several decades.

Answer: A
Type: A  Topic: 3  E: 341  MA: 341
29. At the equilibrium level of GDP:
   A) \( MV = \text{nominal } C_d + I_g + X_n + G \).
   B) \( MV = \text{real GDP} \).
   C) \( M = \text{nominal GDP} \).
   D) \( V = 1/MPS \).
Answer: A

Type: A  Topic: 3  E: 341  MA: 341
30. If the price level does not change from one period to the next:
   A) the money supply must have been constant during the period.
   B) velocity must have been constant during the period.
   C) nominal GDP must have remained constant during the period.
   D) none of the above responses are valid.
Answer: D

Type: A  Topic: 3  E: 342  MA: 342
31. The velocity of money is equal to:
   A) \( 1/MPS \).
   B) \( \text{nominal GDP}/M \).
   C) \( 1/\text{reserve ratio} \).
   D) \( \text{nominal GDP}/P \).
Answer: B

Type: A  Topic: 3  E: 341  MA: 341
32. The velocity of money is equal to:
   A) \( 1/MPS \).
   B) \( 1/\text{reserve ratio} \).
   C) \( M/GDP \).
   D) none of the above responses are valid.
Answer: D

Type: A  Topic: 3  E: 341  MA: 341
33. The equation of exchange suggests that, if the supply and velocity of money remain unchanged, an increase in the physical volume of goods and services produced will cause:
   A) the unemployment rate to rise.
   B) the Federal Reserve Banks to sell securities in the open market.
   C) a decline in the price level.
   D) an automatic budget deficit.
Answer: C

Type: A  Topic: 3  E: 341  MA: 341
34. If the amount of money in circulation is $180 billion and the value of the economy's total output is $540 billion, then the:
   A) circulation period of money must be one-fourth of a year.
   B) velocity of money is 4.
   C) average price per final good sold is $3.
   D) velocity of money is 3.
Answer: D
Use the following to answer questions 35-37:

Answer the next question(s) on the basis of the following information for a hypothetical economy. All values are in nominal terms.

\[ M = \$100 \]
\[ V = 2 \]
\[ C_a = \$160 \]
\[ X_n = \$10 \]
\[ G = \$10 \]

35. Refer to the above information. Nominal GDP is:
   A) $100.  B) $200.  C) $180.  D) $50.
   Answer: B

36. Refer to the above information. If the price level \( P \) is 4, \( Q \) is:
   A) 50.  B) 100.  C) 200.  D) 500.
   Answer: A

37. Refer to the above information. In equilibrium, \( I_g \) is:
   Answer: A

38. Most monetarists would say that:
   A) the MV = PQ equation provides a better understanding of the macroeconomy than does the \( C_a + I_g + X_n + G = GDP \) equation.
   B) most changes in the price level are explainable by changes in the money supply.
   C) the velocity of money is quite stable.
   D) all of the above are true.
   Answer: D

39. Monetarist say that the relationship between the amount of money which households and businesses want to hold and the level of national output and income:
   A) has decreased historically because of increased accessibility to credit.
   B) rises during recession and falls during periods of full employment.
   C) falls during recession and rises during periods of full employment.
   D) is relatively stable.
   Answer: D
Chapter 19: Disputes over Macro Theory and Policy

40. Monetarists say:
   A) that, because $P$ is stable, a change in $M$ will change $Q$ proportionately in the opposite direction.
   B) a change in the money supply will change aggregate demand and therefore the nominal GDP.
   C) a change in the money supply will change velocity, which in turn will change nominal GDP.
   D) a change in the money supply will change the interest rate, which will change investment spending and
   nominal GDP.
   Answer: B

41. To determine the velocity of money you would need to know:
   A) nominal GDP and real GDP.
   B) the money supply and the price level.
   C) nominal GDP and the money supply.
   D) nominal GDP and the interest rate.
   Answer: C

42. In a full-employment economy a rise in $M$ will cause inflation unless:
   A) $V$ rises in proportion to the increase in $M$.
   B) the quantity of goods produced declines proportionately.
   C) tax reductions accompany the increase in the money supply.
   D) the velocity of money diminishes.
   Answer: D

43. As monetarists view the equation of exchange:
   A) $V$ changes erratically and unpredictably.
   B) $V$ is quite stable.
   C) $V$ usually changes in the same direction of any given change in $M$.
   D) $V$ usually changes in the opposite direction of any given change in $M$.
   Answer: B

44. The velocity of money may be stated as:
   A) $PM/V$.
   B) nominal GDP/$M$.
   C) $QM/P$.
   D) $PM/Q$.
   Answer: B

45. Monetarists believe the private economy is inherently:
   A) unstable and the public sector should be small.
   B) unstable and the public sector should be large.
   C) stable, but that the public sector should be large.
   D) stable and that the government sector should be small.
   Answer: D

46. In the equation of exchange the nominal GDP is designated by:
   A) $PQ/M$.
   B) $MV/P$.
   C) $PQ$.
   D) $MV$.
   Answer: C
47. The term $V$ in the equation of exchange is equal to:
   A) $M/nominal\ GDP$.  
   B) nominal GDP/$M$.  
   C) the reciprocal of the price level.  
   D) nominal GDP/$Q$.
   Answer: B

48. If the money supply is constant when both nominal and real GDP are rising, we can conclude that:
   A) tax rates have been increased.  
   B) the velocity of money is rising.  
   C) interest rates are falling.  
   D) the unemployment rate is rising.
   Answer: B

49. If the nominal GDP is $477$ billion and the velocity of money is $4.5$, then the money supply is:
   A) $122$ billion.  
   B) $98$ billion.  
   C) $106$ billion.  
   D) $477$ billion.
   Answer: C

50. According to monetarists, a change in the money supply changes:
   A) the velocity of money which in turn changes the nominal GDP.  
   B) investment spending which in turn changes the nominal GDP.  
   C) the interest rate which in turn changes the nominal GDP.  
   D) aggregate demand which in turn changes the nominal GDP.
   Answer: D

51. Assume monetary equilibrium exists—i.e., the desired and the actual supply of money are equal—when nominal GDP equals $480$ billion and the money supply is $160$ billion. According to a strict monetarist view, an increase in the money supply of $10$ billion will increase the nominal GDP by:
   A) $30$ billion.  
   B) $25$ billion.  
   C) $20$ billion.  
   D) $10$ billion.
   Answer: A

52. According to monetarists, the Great Depression in the United States largely resulted from:
   A) contractionary fiscal policy.  
   B) excessive imports relative to exports.  
   C) significant changes in technology and resource availability.  
   D) inappropriate monetary policy.
   Answer: D

53. The view that inappropriate monetary policy was a main reason for the depth of the Great Depression in the United States is most closely associated with:
   A) monetarism.  
   B) Keynesianism  
   C) the rational expectations theory.  
   D) the real-business-cycle theory.
   Answer: A
Chapter 19: Disputes over Macro Theory and Policy

Real-business cycle view

54. The real-business-cycle theory holds that business fluctuations are caused by:
   A) factors affecting aggregate demand.
   B) incorrectly anticipated government stabilization policies.
   C) factors affecting aggregate supply.
   D) "stop-and-go" monetary policies.
   Answer: C

55. According to real business cycle theory:
   A) monetary factors affecting aggregate demand cause macroeconomic instability.
   B) recessions result from declines in long-run aggregate supply, rather than decreases in aggregate demand.
   C) when real wages fall during recessions, "real" unemployment rates rise.
   D) the net long-run costs of business fluctuations are severe.
   Answer: B

56. In the real business cycle theory:
   A) declines in real output cause declines in the money supply and thus aggregate demand.
   B) decreases in long-run aggregate supply are fully anticipated and therefore do not reduce real output.
   C) technology is constant.
   D) economic instability results from inappropriate monetary policy.
   Answer: A

Use the following to answer questions 57-58:

57. Refer to the above diagram. A decline of aggregate supply from \( AS_{LR1} \) to \( AS_{LR2} \), followed by a decline of aggregate demand from \( AD_1 \) to \( AD_2 \), would best describe the:
   A) direct relationship between aggregate supply and aggregate demand.
   B) real-business-cycle view of recession.
   C) monetarist view of recession.
   D) mainstream, Keynesian-based, view of recession.
   Answer: B
58. Refer to the above diagram. The real-business cycle view of recession would best be described by:
   A) a decrease of aggregate demand from AD1 to AD2, followed by a decrease in aggregate supply from ASLR1 to ASLR2.
   B) an increase in aggregate demand from AD1 to AD2, which in turn caused a decrease in aggregate supply from ASLR1 to ASLR2.
   C) a decrease in aggregate supply from ASLR1 to ASLR2, followed by a decrease in aggregate demand from AD1 to AD2.
   D) a decrease in aggregate supply from ASLR1 to ASLR2, followed by an increase in aggregate demand from AD2 to AD1.
Answer: C

59. The real-business-cycle theory:
   A) is a monetarist view of the business cycle.
   B) is a Keynesian-view of the business cycle.
   C) assumes that the supply of money is constant.
   D) says that macro instability results from shifts in the long-run aggregate supply curve.
Answer: D

60. Which of the following is *not* an aggregate-demand-side explanation of business cycles?
   A) the real-business-cycle theory
   B) the idea of coordination failures
   C) mainstream (Keynesian-based) macroeconomics
   D) monetarism
Answer: A

**Coordination failures**

61. When most consumers and firms reduce spending only because they expect other consumers and firms to reduce spending, and a recession results:
   A) a self-correction has occurred.
   B) an adverse aggregate supply shock has occurred.
   C) a coordination failure has occurred.
   D) a real-business-downturn has occurred.
Answer: C

62. A coordination failure:
   A) is a real-business-cycle event.
   B) is a self-fulfilling prophesy.
   C) results from the spending-income multiplier.
   D) is a direct outcome of inappropriate fiscal policy.
Answer: B
63. The idea that an economy can get stuck in either an unemployment equilibrium or an inflation equilibrium is most closely associated with:
   A) new classical economics.  C) monetarism.
   B) the real-business-cycle theory.  D) the idea of coordination failures.
   Answer: D

64. Assume that many households and businesses reduce their spending only because they expect other households and consumers to reduce their spending. Also suppose that all households and consumers would be better off if they did not reduce their spending. This situation best describes the:
   A) real-business-cycle theory.  C) idea of coordination failures.
   B) rational expectations theory.  D) adaptive expectations theory.
   Answer: C

New classical view of self-correction

65. New classical economists:
   A) stress the importance of federal budget deficits in stimulating aggregate demand.
   B) hold that, left alone, the economy gravitates to its full employment level of output.
   C) emphasize tax cuts as means of increasing aggregate supply.
   D) advocate active use of monetary policy to stabilize the economy.
   Answer: B

66. Rational expectations theory is based on the assumption that:
   A) wages and prices are flexible upward, but inflexible downward.
   B) both product and resource markets are very competitive.
   C) product markets are competitive, but resource markets are monopolistic.
   D) both product and resource markets are monopolistic.
   Answer: B

67. Rational expectations theory implies that the:
   A) aggregate demand curve is vertical.  C) long-run aggregate supply curve is horizontal.
   B) long-run aggregate supply curve is vertical.  D) long-run aggregate supply curve is quite flat.
   Answer: B
Use the following to answer questions 68-70:

Type: G Topic: 6 E: 344 MA: 344
68. Refer to the above diagram. Rational expectations theory say that a fully anticipated shift in aggregate demand from AD$_1$ to AD$_2$ will:
   A) move the economy from a to b to c.
   B) move the economy directly from a to c.
   C) move the economy from a to new equilibrium at b.
   D) shift the AS curve to the right.
   Answer: B

Type: G Topic: 6 E: 344 MA: 344
69. Refer to the above diagram. Rational expectations theory says that a fully anticipated decrease in aggregate demand from AD$_2$ to AD$_1$ will:
   A) move the economy from a to b to c.
   B) shift the AS curve to the left.
   C) move the economy from c to new equilibrium b.
   D) move the economy directly from c to a.
   Answer: D

Type: G Topic: 6 E: 344 MA: 344
70. Refer to the above diagram. Suppose that, as expected, aggregate demand declines from AD$_2$ to AD$_1$. A direct move of the economy from c to a would best reflect:
   A) new classical economics.
   B) mainstream (Keynesian-based) economics.
   C) the real-business-cycle theory.
   D) a coordination failure.
   Answer: A

Type: F Topic: 6 E: 344 MA: 344
71. The rational expectations theory assumes that:
   A) people behave rationally and that all product and resource prices are flexible both upward and downward.
   B) firms pay above-market wages to elicit work effort.
   C) markets fail to coordinate the actions of households and businesses.
   D) markets are dominated by monopolistic firms.
   Answer: A
Chapter 19: Disputes over Macro Theory and Policy

72. According to new classical economists, the:
   A) short-run demand for labor curve is vertical.  
   B) short-run aggregate demand curve is vertical.  
   C) long-run aggregate supply curve is horizontal.  
   D) long-run aggregate supply curve is vertical.  
   Answer: D

73. New classical economist say that an *unanticipated* increase in aggregate demand first:
   A) increases the price level and real output, and then reduces short-run aggregate supply such that the economy returns to the full-employment level of output.  
   B) increases the price level and real output, and then increases long-run aggregate supply.  
   C) increases long-run aggregate supply, and then increases the price level and real output.  
   D) reduces short-run aggregate supply, and then reduces long-run aggregate supply.  
   Answer: A

74. New classical economists say that an *unanticipated* decrease in aggregate demand first:
   A) decreases the price level and real output, and then decreases long-run aggregate supply.  
   B) decreases long-run aggregate supply, and then decreases the price level and real output.  
   C) reduces short-run aggregate supply, and then reduces long-run aggregate supply.  
   D) decreases the price level and real output, and then increases short-run aggregate supply such that the economy returns to the full employment level of output.  
   Answer: D

75. New classical economists say that a fully anticipated increase in aggregate demand:
   A) shifts the long-run aggregate supply curve to the right.  
   B) shifts the long-run aggregate supply curve to the left.  
   C) moves the economy up along its vertical long-run aggregate supply curve.  
   D) eventually results in a self-correcting decrease in aggregate demand.  
   Answer: C

76. New classical economist say that a fully *anticipated* decrease in aggregate demand:
   A) shifts the long-run aggregate supply curve to the right.  
   B) shifts the long-run aggregate supply curve to the left.  
   C) moves the economy down along its vertical long-run aggregate supply curve.  
   D) eventually results in a self-correcting increase in aggregate demand.  
   Answer: C
Use the following to answer questions 77-80:

77. Refer to the above figure and assume the economy initially is in equilibrium at point a. In the new classical theory, an *unanticipated* increase in aggregate demand from AD_2 to AD_1 would move the economy:
   A) directly from a to d.  B) from a to b to d.  C) from a to e to d.  D) directly from a to f.
   Answer: C

78. Refer to the above figure and assume the economy initially is in equilibrium at point a. In the new classical theory, a fully *anticipated* increase in aggregate demand from AD_2 to AD_1 would move the economy:
   A) directly from a to d.  B) from a to b to d.  C) from a to e to d.  D) directly from a to f.
   Answer: A

79. Refer to the above figure and assume the economy initially is in equilibrium at point a. In the new classical theory, an *unanticipated* decrease in aggregate demand from AD_2 to AD_3 would move the economy:
   A) directly from a to h.  B) from a to g to h.  C) directly from a to d.  D) from a to c to h.
   Answer: D

80. Refer to the above figure and assume the economy initially is in equilibrium at point a. In the new classical theory, a fully *anticipated* decrease in aggregate demand from AD_2 to AD_3 would move the economy:
   A) directly from a to h.  B) from a to g to h.  C) directly from a to d.  D) from a to c to h.
   Answer: A

81. In new classical economics, "a price-level surprise":
   A) has no effect on the economy.  B) causes a temporary change in real output.  C) causes a permanent change in real output.  D) can never occur since people correctly anticipate the future.
   Answer: B
82. In new classical economics, the change in output caused by a "price-level surprise":
A) is shown as a shift of the long-run aggregate supply curve.
B) does not alter the rate of unemployment, even in the short-run.
C) is soon reversed through a shift of the short-run aggregate supply curve.
D) permanently reduces the rate of unemployment.
Answer: C

83. Suppose that, as expected, aggregate demand in the economy sharply declines. New classical economists say that the price level will ___________ and real output will ___________.
A) fall; remain constant.  B) rise; remain constant.  C) remain constant; fall.  D) remain constant; rise.
Answer: A

Mainstream view of self correction

84. Mainstream economists question the new classical assumption that:
A) excessive growth of the money supply is a cause of inflation.
B) the price level is determined by aggregate demand and aggregate supply.
C) demand creates its own supply.
D) wages and prices are equally flexible upward and downward.
Answer: D

85. Suppose aggregate demand in the economy sharply declines. Mainstream economists say that the price level (at least for a time) will _______ and real output will _______.
A) decrease; remain constant.  C) remain constant; decrease.
B) increase; remain constant.  D) remain constant; increase.
Answer: C
Use the following to answer questions 86-87:

86. Refer to the above diagram and assume the economy initially is in equilibrium at point $a$. In the mainstream view, a decline in aggregate demand from $AD_1$ to $AD_2$ would likely move the economy:

A) directly from $a$ to $d$.  
B) directly from $a$ to $b$.  
C) from $a$ to $c$, then quickly from $c$ to $d$.  
D) from $a$ to $c$, then eventually from $c$ to $b$.

Answer: B

87. Refer to the above diagram and assume the economy initially is in equilibrium at point $a$. Suppose the aggregate demand declines from $AD_1$ to $AD_2$ and the economy moves from $a$ to $c$. In the mainstream view, the resulting decline in the price level need not shift the short-run aggregate supply curve from $AS_1$ to $AS_2$ because:

A) supply creates its own demand.  
B) nominal wages are (at least for a time) inflexible downward.  
C) firms misperceive the price-level decline as being permanent.  
D) deflation reduces the purchasing power of the dollar.

Answer: B

88. If prices and wages are inflexible downward, a decrease in aggregate demand will:

A) reduce the price level but not real output.  
B) increase short-run aggregate supply.  
C) decrease short-run aggregate supply.  
D) reduce real output but not the price level.

Answer: D

**Efficiency wages; insider-outsider theory**

89. An efficiency wage is:

A) a below-market wage.  
B) an above-market wage.  
C) a "wage" that contains a profit-sharing component.  
D) a wage that is free to rise or fall from day to day, depending on labor supply and demand.

Answer: B
90. An efficiency wage is:
A) a wage payment necessary to compensate workers for risk of injury on the job.
B) a "wage" that contains a profit-sharing component as well as traditional hourly pay.
C) an above-market wage that minimizes a firm's labor cost per unit of output.
D) a wage that automatically rises with the national index of labor productivity.
Answer: C

Use the following to answer questions 91-92:

<table>
<thead>
<tr>
<th>Hourly wage rate</th>
<th>Output per hour of work</th>
</tr>
</thead>
<tbody>
<tr>
<td>$10</td>
<td>6</td>
</tr>
<tr>
<td>9</td>
<td>6</td>
</tr>
<tr>
<td>8</td>
<td>4</td>
</tr>
<tr>
<td>7</td>
<td>2</td>
</tr>
<tr>
<td>6</td>
<td>1</td>
</tr>
</tbody>
</table>

91. Refer to the above table. At the $8 wage, labor cost per-unit of output is:
A) $1.25. B) $1.50. C) $2.00. D) $1.67.
Answer: C

92. Refer to the above table. The efficiency wage is:
Answer: B

93. A higher wage could result in a lower labor cost per unit of output than a lower wage if the higher wage:
A) brings forth greater work effort. C) increases job turnover.
B) increases supervision costs. D) increases worker absenteeism.
Answer: A

94. A higher wage could result in a lower labor cost per unit of output than a lower wage if the higher wage:
A) is accompanied by an offsetting decline in fringe benefits.
B) increases supervision costs.
C) reduces job turnover.
D) increases worker absenteeism.
Answer: C

95. If firms are paying efficiency wages, they:
A) may be reluctant to increase nominal wages when aggregate demand increases.
B) are highly vulnerable to import competition.
C) may be targeted for takeover by firms paying market wages.
D) may be reluctant to cut wages when aggregate demand declines.
Answer: D
96. In the insider-outsider theory:
   A) insiders are workers who retain employment during recession.
   B) insiders are managers who have more information about their firm's performance than outsiders.
   C) insiders are "principals" and outsiders are "agents."
   D) outsiders are foreigners.
   Answer: A

97. In the insider-outsider theory:
   A) outsiders are workers who retain employment during recession.
   B) insiders are managers who have more information about their firm's performance than outsiders.
   C) insiders are "principals" and outsiders are "agents."
   D) outsiders are laid off workers and other qualified unemployed workers.
   Answer: D

98. Suppose laid off workers and other qualified unemployed workers offer to work for less than the wages being paid existing employed workers, but employers do not hire these workers for fear that existing workers will refuse to cooperate with them. This situation best describes the:
   A) efficiency wage theory.
   B) theory of compensating wage differentials.
   C) insider-outsider theory.
   D) rational expectations theory.
   Answer: C

99. The insider-outsider theory implies that:
   A) wages are flexible both upward and downward.
   B) unemployment quickly reduces market wages.
   C) agents pursue their own agendas, sometimes at the expense of principals.
   D) wages may be inflexible downward.
   Answer: D

100. Which of the following pairs help explain why self-correction from a decline in aggregate demand in the economy may be slow rather than rapid?
    A) theory of compensation wage differentials; theory of derived demand for labor.
    B) efficiency wage theory; insider-outsider theory.
    C) insider-outsider theory; principle-agent problem.
    D) externalities; efficiency wage theory.
    Answer: B
Chapter 19: Disputes over Macro Theory and Policy

Policy rules; critiques of stabilization policy

101. The traditional monetary rule is the idea that:
   A) the annual rate of increase in the money supply should be equal to the potential annual growth rate of real GDP.
   B) the annual rate of increase in the money supply should be equal to the long-term increase in the price level.
   C) an expansionary fiscal policy should always be accompanied by an easy monetary policy.
   D) monetary policy only affects the economy 6 to 9 months after the money supply is changed.
   Answer: A

102. Adherents of the traditional monetary rule advocate that the:
   A) functional finance approach to fiscal policy be adopted.
   B) money supply should be increased by a constant rate year after year.
   C) money supply should be reduced during inflation and increased during recession.
   D) money supply should be increased during inflation and reduced during recession.
   Answer: B

103. Adherents of the traditional monetary rule say that the supply of money should be:
   A) increased at a constant rate each year.
   B) decreased during recession and increased during inflation.
   C) held constant over time.
   D) increased during recession and decreased during inflation.
   Answer: A

Use the following to answer question 104:

![Graph](image)

104. Answer this question on the basis of the above diagram and the equation of exchange. Assume that the velocity of money is constant at 4. Suppose that the increase of aggregate supply from AS₁ to AS₂ indicates the economy's average increase in real output per year. According to monetarists, the proper monetary rule for price stability would be to increase the money supply by:
   A) zero percent per year.  B) 4 percent per year.  C) 10 percent per year.  D) 30 percent per year.
   Answer: D
105. Monetarists and rational expectations theorists generally agree that:
   A) the Federal Reserve should adhere to a monetary rule.
   B) the rate of interest and the price of bonds are positively or directly related.
   C) the money supply cannot be measured and therefore cannot be controlled by the Federal Reserve.
   D) prices and wages are inflexible downward.
   Answer: A

106. According to monetarists, an expansionary fiscal policy:
   A) will be ineffective because the interest rate will rise and crowd out private investment spending.
   B) should not be permitted so long as a public debt exists.
   C) should be used only when unemployment exceeds 6 percent of the labor force.
   D) will be effective, provided the money supply is held constant.
   Answer: A

107. The crowding-out effect refers to the possibility that:
   A) when used simultaneously, expansionary fiscal and monetary policies are counterproductive.
   B) the asset demand for money varies inversely with the interest rate.
   C) deficit financing will increase the interest rate and reduce investment.
   D) an increase in the supply of money will result in a decline in velocity.
   Answer: C

108. According to monetarists, an expansionary fiscal policy is a weak stabilization tool because:
   A) the asset demand for money varies inversely with the rate of interest.
   B) government borrowing to finance a deficit will raise the interest rate and reduce private investment.
   C) government borrowing will reduce the supply of money in circulation and depress the GDP.
   D) government borrowing to finance a deficit will lower interest rates, increase money balances, and lower velocity.
   Answer: B

109. Assume there is an increase in government spending and a reduction in net taxes. With a specific money supply, the consequent:
   A) contractionary impact might be lessened by the resulting increase in the interest rate.
   B) expansionary impact might be lessened by the resulting increase in the interest rate.
   C) contractionary impact might be enhanced by the resulting decline in the interest rate.
   D) expansionary impact might be enhanced by the resulting decline in the interest rate.
   Answer: B

110. According to monetarists, a fiscal deficit will be associated with an increase in real output:
   A) regardless of the character of accompanying changes in $M$ or $V$.
   B) only if it is accompanied by an increase in the demand for money.
   C) only if it is accompanied by an increase in the supply of money.
   D) only if it is financed by selling government bonds to the public.
   Answer: C
111. The rational expectations perspective suggests that:
A) fiscal policy is more powerful than monetary policy.
B) monetary policy is more powerful than fiscal policy.
C) fiscal and monetary policy are not likely to achieve their stated aims.
D) fiscal policy works only to the extent that it is accompanied by fully anticipated changes in the money supply.
Answer: C

112. The theory of rational expectations concludes that:
A) the public's expectations can influence the outcome of monetary policy, but not of fiscal policy.
B) the public's expectations can influence the outcome of fiscal policy, but not of monetary policy.
C) the public's expectations as to the effects of economic policies tends to reinforce the effectiveness of those policies.
D) by reacting in its self-interest to the expected effects of stabilization policy, the public tends to negate the impact of those policies.
Answer: D

113. In comparing monetarism and rational expectations theory we find that:
A) both favor policy rules and for the same reasons.
B) both favor policy rules, but for different reasons.
C) both favor discretionary policies.
D) the former favors discretionary policy, while the latter favors policy rules.
Answer: B

114. Over recent years, economists holding monetarist views have replaced their call for a monetary rule with a call for:
A) artful Fed management of interest rates.  
B) inflation targeting. 
C) nominal GDP targeting. 
D) inflationary and recessionary gap analysis.
Answer: B

115. Proponents of inflation targeting generally think that:
A) the economy will have fewer, shorter, and less severe business cycles if the Fed holds the rate of inflation to low, targeted levels from year to year.
B) low interest rates are inflationary and high interest rates are deflationary.
C) fiscal policy is more effective in stabilizing the economy than monetary policy.
D) the Fed should strive to achieve zero inflation.
Answer: A

116. Which of the following groups of economists is most likely to favor annually balanced Federal budgets?
A) Keynesians  
B) Supply-side economists. 
C) Rational expectations economists. 
D) Functional finance economists.
Answer: C
Defense of discretionary stabilization policy

117. According to mainstream economists, the Fed's adherence to a traditional monetary rule rather than to discretionary monetary policy is likely to:
   A) reduce the severity of business cycles.
   B) increase the amount of instability in the economy.
   C) increase the rate of inflation.
   D) crowd out much needed investment spending during times of rapid inflation.
   Answer: B

118. According to mainstream economists, a tight money policy might be frustrated, wholly or in part, by:
   A) Treasury sales of gold bullion.
   B) a Treasury surplus.
   C) the desire of households and businesses to hold smaller money balances.
   D) a decrease in $V$.
   Answer: C

119. Mainstream economists favor:
   A) the use of discretionary monetary policy and fiscal policy.
   B) a monetary rule.
   C) a balance-budget amendment.
   D) wage and price controls.
   Answer: A

120. Mainstream economists contend that, as stabilization tools:
   A) discretionary fiscal policy is effective, but discretionary monetary policy is not.
   B) discretionary monetary policy is effective, but discretionary fiscal policy is not.
   C) both discretionary fiscal policy and monetary policy can be effective if appropriately used.
   D) discretionary fiscal policy and discretionary monetary policy cause more instability than they cure.
   Answer: C

121. Most mainstream macroeconomists oppose a strict requirement to balance the Federal budget annually because they conclude that such a requirement would:
   A) increase real interest rates and drive out investment spending.
   B) eliminate monetary policy as a stabilization tool.
   C) force government to undertake expansionary fiscal policy during inflation and contractionary fiscal policy during recession.
   D) expand the size of the Federal government.
   Answer: C
Chapter 19: Disputes over Macro Theory and Policy

122. Since 1946:
   A) the U.S. economy has been more stable than in the 1895-1945 period.
   B) the U.S. economy has been less stable than in the 1985-1945 period.
   C) fiscal policy has largely replaced monetary policy as the United States' main stabilization tool.
   D) new classical economics has replaced Keynesian-based economics as the mainstream macroeconomic view.
   Answer: A

Absorption into the mainstream

123. Which of the following ideas of the rational expectations theory has been absorbed into mainstream macroeconomics?
   A) the monetary rule  
   B) the idea that "money doesn't matter"
   C) the monetary multiplier
   D) the idea that "expectations are important."
   Answer: D

124. The view that excessive growth to the money supply over long periods leads to inflation:
   A) is accepted by the monetarists but not by mainstream macroeconomists.
   B) is the main contribution of the rational expectations theory.
   C) had been absorbed into the mainstream of macroeconomics.
   D) is known as the monetary rule.
   Answer: C

125. Mainstream macroeconomics has embraced the:
   A) rational expectations view that stabilization policy is totally ineffective.
   B) monetarist view that the Fed should increase the money supply at a fixed annual rate.
   C) rational expectations view that expectations can shift the aggregate demand and aggregate supply curves.
   D) monetarist view that an increase in government spending crowds out an equal amount of investment spending.
   Answer: C

126. Modern mainstream macroeconomists agree with the monetarists that:
   A) the Fed should increase the money supply at a fixed annual rate.
   B) velocity is highly stable.
   C) fiscal policy is largely ineffective.
   D) "money matters" in the macroeconomy.
   Answer: D
Consider This Questions

127. (Consider This) According to economist Abba Lerner (1903-1982), fiscal and monetary policy is analogous to:
   A) automobile brakes.  C) a string that can be pushed or pulled.
   B) a steering wheel in an automobile.  D) highway guard rails.
   Answer: B

128. (Consider This) According to economist Milton Friedman (b. 1912), the source of instability in the economy could be thought of as a:
   A) baseball manager (the Fed) that removes his starting pitcher too soon and sees a 5-run lead evaporate in a single inning.
   B) duck hunter (the Fed) who starts shooting at ducks well before they fly over.
   C) a camp counsellor (the Fed) who is wearing a baseball cap that has two bills and says "I am the leader, which way did they go?"
   D) backseat car passenger (the Fed) who occasionally leans over the front seat and abruptly jerks the steering wheel to the left or to the right.
   Answer: D

Last Word Questions

129. (Last Word) The proposed monetary rule that would specify how the Fed should respond to changes in GDP and inflation rates is called the:
   Answer: C

130. (Last Word) The key policy target in the Taylor rule is the:
   Answer: B

131. (Last Word) According to the Taylor rule, if real GDP rises 1 percent above potential GDP, the Fed should raise the Federal funds rate, relative to the current rate of inflation, by:
   A) .5 percentage points.  B) 1 percentage points.  C) 1.5 percentage points.  D) 2 percentage points.
   Answer: A

132. (Last Word) According to the Taylor rule, if inflation rises 1 percent above a target rate of 2 percent, the Fed should raise the Federal funds rate, relative to the current rate of inflation, by:
   A) .5 percentage points.  B) 1 percentage point.  C) 1.5 percentage points.  D) 2 percentage points.
   Answer: A
Chapter 19: Disputes over Macro Theory and Policy

Type: D E: 351 MA: 351

133. (Last Word) Suppose that real GDP falls to 2 percent below potential GDP. Then, according to the Taylor rule, the Fed should reduce the Federal funds, relative to the current rate of inflation, by:
   A) 1/2 percentage point.  B) 1 percentage point.  C) 2 percentage points.  D) 4 percentage points.
   Answer: B

True/False Questions

Type: A E: 339 MA: 339

134. In classical theory, the full-employment output is determined by the location of the aggregate supply curve while the price level is determined by the location of the aggregate demand curve.
   Answer: True

Type: F E: 340 MA: 340

135. In its simplest form, Keynesian theory views the aggregate demand curve as stable and the aggregate supply curve as vertical.
   Answer: False

Type: A E: 341 MA: 341

136. Monetarists say the velocity of money is highly variable and there is no close link between the money supply and the level of economic activity.
   Answer: False

Type: F E: 341 MA: 341

137. According to monetarists, discretionary monetary policy has been a major source of economic instability.
   Answer: True

Type: F E: 341 MA: 341

138. The equation of exchange is \( MV = PQ \).
   Answer: True

Type: F E: 346 MA: 346

139. Mainstream macroeconomists see two main sources of macroeconomic instability: changes in investment spending and, occasionally, adverse aggregate supply shocks.
   Answer: True

Type: F E: 343 MA: 343

140. In the theory of coordination failures, shifts of the nation's long-run aggregate supply curve are the main cause of business cycles.
   Answer: False

Type: A E: 342-343 MA: 342-343

141. The real-business cycle theorists see aggregate supply as the "active" factor in causing business cycles and aggregate demand as a "passive" factor.
   Answer: True
142. The "real" factors in the real-business cycle theory include resource availability and technology.
   Answer: True

143. The idea of coordination failures suggests the possibility of less-than-desirable price-level and real-output equilibriums in the economy.
   Answer: True

144. The idea that the economy will "self-correct" when confronted with changes in aggregate demand is associated with new classical economics.
   Answer: True

145. In the new classical theory, a fully anticipated change in aggregate demand and the price level will temporarily change real output, but an unanticipated change will not.
   Answer: False

146. Mainstream economists say the recessions are unlikely to occur today because prices and wages are highly flexible downward.
   Answer: False

147. Efficiency wage theory says that an above-market wage can reduce labor costs per unit of output by eliciting greater work effort, lowering supervision costs, and reducing job turnover.
   Answer: True

148. In the insider-outsider theory, insiders are agents and outsiders are principals.
   Answer: False

149. Nearly all modern economists support the idea of a monetary rule.
   Answer: False

150. Monetarist say that fiscal policy, such as a tax cut, will only affect the level of real GDP if it entails a change in the supply of money.
   Answer: True
Mainstream economists contend that use of stabilization policy has helped increase macro stability in the U.S. economy over the past 40 years.
Answer: True

Mainstream macroeconomics has incorporated some aspects of monetarism and rationale expectations theory.
Answer: True