Name:________________

1. Multiple Choice
1. The two cornerstones of classical economics are __.
   A. The Phillips Curve and Say’s Law
   B. Say’s Law and the Quantity Theory of Money
   C. The Quantity Theory of Money and the Liquidity Preference Theory
   D. Say’s Law and the Liquidity Preference Theory

2. Which of the following statements is inconsistent with Say’s Law?
   A. The economy has flexible wages and prices
   B. The economy’s level of investment spending depends solely on the level of income.
   C. The economy will produce at the full-employment level of output.
   D. The economy has an environment of “laissez faire.”

3. In classical theory, interest rates are determined __.
   A. by the price level and unemployment
   B. strictly by the money supply
   C. by the supply and demand for money
   D. by saving and investment

4. In the classical view, the price level is determined by __.
   A. aggregate supply
   B. aggregate demand and supply
   C. supply of money
   D. aggregate demand

5. In an economy operating at full employment with constant velocity of 6, an increase in the money supply of 4% will cause ___.
   A. the price level to rise by 24%
   B. output to rise by 4%
   C. output to rise by 24%
   D. the price level to rise by 4%

6. In the classical model, the aggregate supply curve determines the ___.
   A. money supply
   B. inflation rate
   C. level of output
   D. price level

7. Which of the following ensures full employment in the classical model?
   A. the equation of exchange
   B. wage and price flexibility
   C. a constant velocity
   D. inventory adjustment
8. If the inflation rate is 5% and the real rate of interest is 3%, the nominal interest rate is __.
   A. 15%
   B. 5%
   C. 8%
   D. 3%

9. In the simple Keynesian framework, the price level ___.
   A. varies inversely with wages
   B. is fixed
   C. is indeterminate
   D. varies directly with unemployment

10. In explaining the level of unemployment, Keynes emphasized ___.
    A. changes in technology
    B. aggregate demand
    C. inflationary expectations
    D. lending my financial institutions

11. Assume a consumption function of the following form: \( C = 50 + .8Y \). If income is equal to $1,000, then consumption is ___.
    A. $50
    B. $1,050
    C. $1,000
    D. $850

12. In an economy with $100 taxes, an income level of $600, consumption of $400, and government spending of $25, investment is equal to __.
    A. $75
    B. $175
    C. $100
    D. $200

13. In the Keynesian model, an increase in government spending increases ___.
    A. the money supply by an equal amount
    B. the money supply by a multiple amount
    C. aggregate demand by a multiple amount
    D. aggregate demand by an equal amount

14. In the Keynesian model, liquidity preference refers to the ___.
    A. demand for consumer goods
    B. demand for capital
    C. the supply of money
    D. demand for money
15. An increase in the money supply in the simple Keynesian model causes interest rates to fall because __.
   A. demand for capital goods increases
   B. consumer demand for goods and services increases
   C. demand for bonds increases
   D. demand for bonds decreases

16. In terms of the aggregate demand and supply framework, a decrease in the money supply will shift aggregate ___.
   A. demand to the left
   B. supply to the right
   C. supply to the left
   D. demand to the right

II. Short Answer
17. If, contrary to Classical theory, the interest rate does not fall to eliminate an excess of saving over investment and if prices and wages do not fall as unsold goods pile up, how does the economy adjust to correct for this disequilibrium, according to Keynes? Please include a graph with your explanation.

Output falls as inventories pile up (unplanned investment increases) and it will continue falling until savings equals desired investment (planned investment)

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\begin{align*}
S &< I \\
Y &= Y_{eq} \\
S &= -40 + 0.2Y \\
50 &= -40 + 0.2Y \\
Y &= 450 billion
\end{align*}
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18. Consider a simple economy in which whole investment is constant and equal to $50 billion. There are no government or foreign sectors, and the price level is constant. Assume that consumption behavior can be described as $C = 40 + .8Y$.

A. What is the value of the marginal propensity to consume?
   
   MPC = 0.8

B. What would be the value of consumption if $Y = 500 billion$?
   
   $C = 40 + .8 \times 500 = 440 billion$

C. What is the equilibrium level of GDP in this model? Verify your answer by showing that savings equals investment in equilibrium (include a graph with your explanation please).

$I = 50 so S = 50@equilibrium$

```
\begin{align*}
S &= -40 + 0.2Y \\
50 &= -40 + 0.2Y \\
Y &= 450 billion
\end{align*}
```
D. What is the value of the multiplier in this model? What determines the size of the multiplier?

Multiplier = \frac{1}{1-b}

Determined by size of MPC

E. Suppose that desired investment were to call to $40 billion. What would happen to equilibrium income?

\$40 = I = S

\$40 = \cdot 40 + 0.2Y

\$80 = 0.2Y

Y = \$400 billion

\Delta Y = \$50 billion