ECON 2002.01 Problem Set 11

Unit 17

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1 (OUP-U17-Q4) The figure shows that central banks reduced interest rates more sharply and kept them lower after the 2008 crisis than they did in the 1930s. But the figure shows nominal interest rates. Bearing in mind that inflation was slightly negative in the early 1930s and approximately zero from 2009, which of the following statements could be true about monetary policy after 1929 and after 2008?

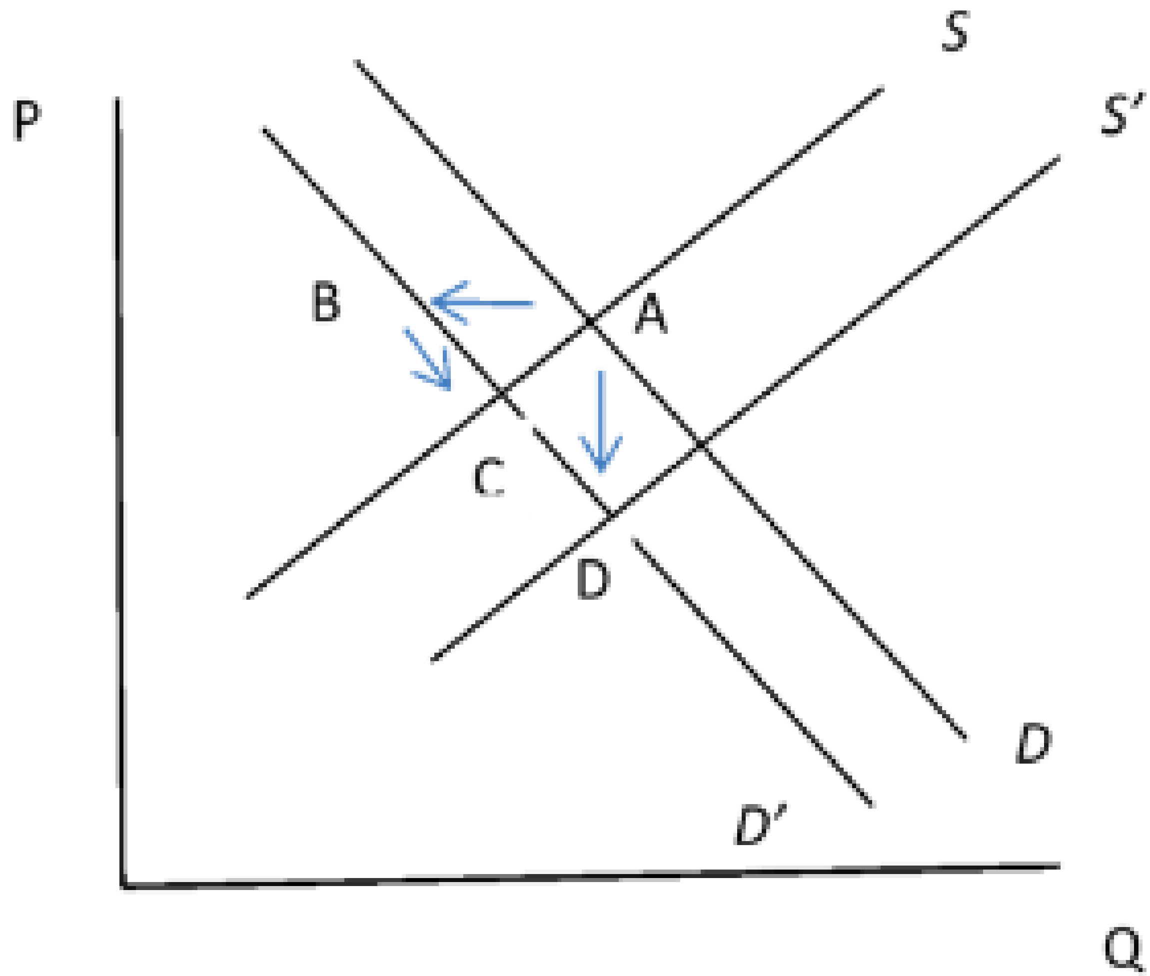
(A) It is real (not nominal) rates that matter, so the figure tells us nothing useful.

(B) Since inflation is roughly zero, the nominal and real rates are the same in both periods.

(C) When we account for inflation, there is little difference in the stance of monetary policy in the two periods.

(D) When we consider real interest rates, monetary policy was even tighter in the 1930s compared with 2008 onwards.

2 (OUP-U17-Q9) In the diagram shown, demand for the industry's goods falls from A to B. In the new equilibrium at C, individual firms are now receiving lower revenue. If they try to restore their earnings by producing more, which of the following is likely to happen in the short run?



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(A) They will not be able to sell the additional output, so the market remains at C.

(B) Producers face a catastrophic fall in prices, partly of their own making.

(C) We cannot predict what will happen.

(D) The direction of price and quantity changes depends on the elasticity of demand.

3 (OUP-U17-Q11) You are given the following information about the short-term nominal interest rate and the rate of inflation over a period of 8 years. In which year was the real rate of interest at its maximum and in which years might we regard monetary policy as having been expansionary?

	Interest (%)	Inflation (%)		Interest (%)	Inflation (%)
Y1	7	0	Y5	3	-5
Y2	6	-1	Y6	2	-2
Y3	5	-5	Y7	2	1
Y4	4	-7	Y8	2	3

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(A) The real rate is at its maximum in Y4, but monetary policy is expansionary in all years since the rate of interest is falling.

(B) Y6 is the earliest point at which we can describe monetary policy as expansionary.

(C) It only becomes negative in Y8, which is the earliest that we can describe policy as expansionary.

(D) The real rate is at its maximum in Y1 (=7%) and monetary policy becomes expansionary in Y3 when the real rate falls to zero (= 5 - 5).

4 (OUP-U17-Q20) According to the original Phillips curve (Unit 15), higher inflation is associated with lower unemployment. The term 'stagflation' was coined to describe the unusual situation in the 1970s where unemployment and inflation both rose together. Which of the following best summarises the underlying causes? _____

(A) Lower profits and a reduced rate of net investment meant a slower increase in productivity.

(B) The lower growth of productivity meant a slower growth in the real wage and in the upward movement of the price-setting curve.

(C) The result is that the wage and price-setting curves intersect at a lower employment (higher unemployment) rate than before.

(D) It also led people, workers especially, to expect inflation and therefore to build it into wage settlements.

5 (OUP-U17-Q22) The leverage ratio is defined as total assets/equity. Assume that a household's sole asset is a house worth \$190,000, which it has bought with a mortgage loan of \$180,000. What is the value of the leverage ratio, and what happens to the ratio if the house value falls to \$185,000? _____

(A) 19; 37.

(B) 19; 18.5.

(C) 0.053; 0.027.

(D) 19; 13.

6 (TEA-U17-Q1) Herbert Hoover was the US President between 1929 and 1933. During this time: (1) President Hoover advocated a balanced budget which remained within the range of -0.6% to +0.8% of GNP in 1929-31, (2) Output was 20% below the full employment level in 1931, (3) The short-term nominal interest rate fell from 5.8% in 1929 to 1.7% in 1933, (4) The CPI decreased from -2.7% in 1930 to -10.3% in 1932 and (5) The US remained on the gold standard while the UK abandoned the regime in 1931. hich of the following statements regarding this period is correct? _____

(A) The government's balanced budget contributed to the stabilisation of economic activity.

(B) Despite the cut in the nominal interest rate, monetary policy was contractionary during this period.

(C) The cut in the nominal interest rate was possible due to the US remaining in the gold standard.

(D) The fact that the UK left the gold standard made it easier for the US to remain in the gold standard.

7 (OUP-U17-Q13) Imagine that you are responsible for policymaking in an economy that is experiencing a deep recession. You and your colleagues announce a

number of measures (like those in Roosevelt's 'New Deal') that you tell everyone will boost demand and output. Why does it matter whether the public believes your announcement? _____

(A) It does not. If the measures are appropriate, aggregate demand will increase, regardless of what anyone thinks.

(B) People will feel more confident about the future and increase their spending, which will reinforce the actions of government.

(C) It might be better if they simply ignored your promises.

(D) You are more likely to be re-elected if people believe that you tried to do something.

8 (OUP-U17-Q24) It is well known that financial transactions frequently involve asymmetric information, because one party to the deal (usually the borrower) has better information about the risk and return to which the borrowed funds will be exposed than the other party (typically the lender). How does the concept of asymmetric information help us understand the particular events described in Section 17.11 (The role of banks in the crisis)? _____

(A) Banks were reluctant to lend to households and firms because they did not know the risks involved.

(B) Central banks were reluctant to provide liquidity because they could not make an accurate assessment of which banks were solvent.

(C) In the credit crunch, banks were reluctant to lend to each other because they knew that risk was widespread because of large holdings of financial assets that were hard to value, and whose distribution amongst banks was unknown.

(D) Households were reluctant to lend to banks because they could not assess their risk.

9 (ECO-U17-Q3) Franklin Roosevelt became the US President in 1933. In the period after he became the president: The federal government deficit increased to 5.6% of GNP in 1934. The short-term nominal interest rate fell from 1.7% in 1933 to 0.75% in 1935. The CPI fell by 5.2% in 1933 and rose by 3.5% in 1934.

The US left the gold standard in April 1933. The New Deal was launched in 1933 and included proposals to increase federal government spending in a wide range of programs and reforms to the banking system. Which of the following statements is correct regarding the years immediately after Roosevelt became the US president? _____

(A) A change in the expectations of consumers of their future earnings, as a result of the New Deal, would have contributed to an expansion in the economy's aggregate demand.

(B) The value of the US dollar increased as the result of the abandonment of the gold standard and allowed the nominal interest rate to be cut to close to zero.

(C) The real interest rate rose after 1933.

(D) Fiscal contraction from the increased government deficit would have contributed to the economy escaping from the Depression.

10 (OUP-U17-Q21) A household owns a house valued at $190,000, which it has bought with a loan of $180,000. It also has financial savings of $10,000. Which of the following shows its net worth at the outset, the minimum amount the value of the house has to fall in order to put the household into negative equity (on the house), and the minimum amount the value of the house has to fall to make the household insolvent? _____

(A) $20,000; £20,000; $20,001.

(B) $200,000; $10,001; $190,000.

(C) $20,000; $10,001; $20,001.

(D) $200,000; $10,001; $20,001.