Chapter 12
Aggregate Supply and Aggregate Demand

- Multiple Choice Questions

Choose the one alternative that best completes the statement or answers the question.

1. For classical economists, if desired saving exceeds desired investment, at the prevailing interest rate,
   (a) those who want to loan funds will not find borrowers as the interest rate is too low.
   (b) those who want to loan funds will not find borrowers as the interest rate is too high.
   (c) those who want to borrow funds will not find loaners as the interest rate is too low.
   (d) those who want to borrow funds will not find loaners as the interest rate is too high.
   (e) those who want to loan funds are able to find borrowers.
   Answer: B

2. For classical economists, if desired saving exceeds desired investment,
   (a) the interest rate will fall, increasing saving and reducing investment.
   (b) the interest rate will rise, increasing saving and reducing investment.
   (c) the interest rate will fall, decreasing saving and increasing investment.
   (d) the interest rate will rise, decreasing saving and increasing investment.
   (e) the interest rate will remain the same.
   Answer: C

3. For classical economists, if desired saving is less than desired investment,
   (a) the interest rate will fall, increasing saving and reducing investment.
   (b) the interest rate will rise, increasing saving and reducing investment.
   (c) the interest rate will fall, decreasing saving and increasing investment.
   (d) the interest rate will rise, decreasing saving and increasing investment.
   (e) the interest rate will remain the same.
   Answer: B

4. For classical economists, unemployment was caused by
   (a) wages that were too high.
   (b) unions that caused an increase in wages.
   (c) wages that were too low.
   (d) wages that were tied to price increases.
   (e) None of the above caused unemployment according to classical economists.
   Answer: A
5. Money illusion means that
   (a) consumers can be fooled into believing that nominal wage increases don’t affect their spending.
   (b) consumers can be fooled into believing that nominal wage increases affect their spending.
   (c) businesses will not react to changes in prices and wages.
   (d) the government will cause prices and wages to change.
   (e) None of the above.
   Answer: B

6. Money illusion means that
   (a) economic agents will not react to changes in nominal wages and prices.
   (b) economic agents believe changes in nominal prices and wages are changes in real prices and wages.
   (c) economic agents believe changes in nominal prices are changes in real prices but do not affect wages.
   (d) economic agents believe changes in nominal wages are changes in real wages but do not affect prices.
   (e) None of the above.
   Answer: B

7. Money illusion means that
   (a) economic agents will not change production decisions due to changes in nominal wages and prices.
   (b) economic agents will not change production decisions due to changes in real prices and wages.
   (c) economic agents will change production due to changes in nominal prices and wages, though they are not “fooled” into believing that the changes affect real prices and wages.
   (d) economic agents will not change production due to changes in nominal prices and wages, because they are not “fooled” into believing that the changes affect real prices and wages.
   (e) economic agents will change production due to changes in nominal prices and wages, because they are “fooled” into believing that the changes are changes in real prices and wages.
   Answer: E

8. The classical aggregate supply curve is vertical because it assumes
   (a) the money supply is neutral.
   (b) an increase in the money supply increases prices.
   (c) no money illusion.
   (d) wages are affected by unions.
   (e) None of the above.
   Answer: C

9. The aggregate demand curve holds constant all of the following except
   (a) the money supply.
   (b) tax rates.
   (c) the price level.
   (d) real government spending.
   (e) investment demand.
   Answer: C
10. Economists offer three explanations for a downward-sloping aggregate demand curve. Which of the following correctly describes one of these explanations?
   (a) A rising price level raises the purchasing power of consumer assets and increases desired consumption at each income level.
   (b) A rising price level raises nominal interest rates and increases investment spending at each level of income.
   (c) A falling domestic price level, holding foreign prices and dollar exchange rates constant, raises net exports at each income level.
   (d) A rising price level lowers nominal interest rates and increases investment spending at each level of income.
   (e) A rising foreign price level, lowers the relative domestic price level, holding dollar exchange rates constant at each level of income.

Answer: C

11. Economists offer three explanations for a downward-sloping aggregate demand curve. Which of the following correctly describes one of these explanations?
   (a) A rising price level raises nominal interest rates and reduces investment spending at each level of income.
   (b) A rising domestic price level, holding foreign prices and dollar exchange rates constant, raises net exports at each income level.
   (c) A falling domestic price level, holding foreign prices and dollar exchange rates constant, lowers net exports at each income level.
   (d) A falling price level lowers the purchasing power of consumer assets and decreases desired consumption at each level.
   (e) A rising foreign price level, lowers the relative domestic price level, holding dollar exchange rates constant at each level of income.

Answer: A

12. Which of the following is a correct definition of the aggregate supply curve? The aggregate supply curve shows
   (a) the aggregate supply of labor throughout the economy.
   (b) the relationship between aggregate purchases and the price level.
   (c) the amount of real GDP produced by firms at different price levels.
   (d) the effect of real wages on total economic output.
   (e) the amount of labor supplied at various price levels.

Answer: C

13. The aggregate demand curve shows
   (a) the relationship between real income and real wages.
   (b) the aggregate (real) output that people are willing to purchase at different price levels.
   (c) the relationship between price level expectations and aggregate consumption.
   (d) the aggregate (real) consumption at different price levels.
   (e) the aggregate (real) income that people are willing to use at each real wage.

Answer: B
14. The natural rate of unemployment is best defined as
   (a) the rate of unemployment for which the labor market is in balance.
   (b) one for which the labor force grows at a constant rate.
   (c) the rate of unemployment that matches the long-run rate of economic growth.
   (d) a rate of unemployment equal to 6%.
   (e) the unemployment rate consistent with constant real wages.
   Answer: A

15. A positively sloped short-run aggregate supply curve is based on the premise that
   (a) a rising price level will induce businesses to increase production.
   (b) different sectors of the economy expand at different rates.
   (c) wages and prices do not rise at the same rate throughout the economy.
   (d) more output will be produced if investment in the economy exceeds savings.
   (e) prices and wages throughout the economy are perfectly flexible.
   Answer: C

16. If wages and prices are somewhat inflexible, an adverse supply shock will
   (a) not affect real GDP or unemployment but will increase the price level.
   (b) decrease real GDP and unemployment and will reduce the price level.
   (c) decrease real GDP, raise unemployment and increase the price level.
   (d) not affect real GDP, unemployment or the price level.
   (e) decrease real GDP, raise unemployment and reduce the price level.
   Answer: C

17. Macroeconomists believe that the aggregate demand curve is negatively sloped. One explanation for
   this relationship is that
   (a) a rising price level increases the value of the money balances, thus inducing consumers to
       purchase more.
   (b) interest rates and investment spending are inversely related.
   (c) a declining price level increases interest rates, and increases investment spending by businesses.
   (d) an increase in the domestic price level, relative to foreign prices, will reduce exports.
   (e) a falling price level increases the value of real money balances, thus consumers will purchase
       less goods and services.
   Answer: D

18. The short-run production function exhibits
   (a) an inverse relationship between total output and labor demand.
   (b) diminishing returns to labor, given a fixed capital stock and technology.
   (c) the short-run fluctuations in output around the economy’s long-run growth.
   (d) the relationship between real wages and labor supply.
   (e) None of the above.
   Answer: B
19. The short-run aggregate supply curve can be upward-sloping because
   (a) there are no factors held constant.
   (b) a higher price level motivates people to stock up on goods.
   (c) a higher price level can raise interest rates.
   (d) inflation makes people poorer, and they must work harder.
   (e) of inflexible money wages.
   Answer: E

20. Assuming some wage stickiness in the short run, if the aggregate demand curve shifts to the right
   (a) both the price level (P) and real GDP increase.
   (b) P rises, but real GDP remains the same.
   (c) both P and real GDP fall.
   (d) the AS curve also shifts to the right.
   (e) P falls and real GDP rises.
   Answer: A

21. Which of the following is correct? The natural level of real GDP
   (a) is the level prevailing when unemployment is zero.
   (b) is that level toward which equates the supply and demand for labor.
   (c) is a level of GDP that cannot be sustained indefinitely without increasing the rate of inflation.
   (d) depends on the price level.
   (e) None of the above.
   Answer: B

22. The natural rate of unemployment prevails when
   (a) agricultural unemployment equals manufacturing unemployment.
   (b) the AD curve intersects the SRAS curve.
   (c) unemployment is minimized.
   (d) the number of available jobs is matched by the number of unemployed workers.
   (e) unemployment is zero.
   Answer: D

23. If wages and prices are flexible, an adverse demand shock will
   (a) not affect real GDP or unemployment but will reduce the price level.
   (b) decrease real GDP, raise unemployment and reduce the price level.
   (c) decrease real GDP, raise unemployment and leave the price level unchanged.
   (d) not affect real GDP, unemployment or the price level.
   (e) decrease real GDP, raise unemployment and increase the price level.
   Answer: A

24. From a macroeconomic perspective, business decisions to hire more labor are determined by
   (a) nominal wages.
   (b) the price level.
   (c) real wages.
   (d) nominal interest rates.
   (e) real interest rates.
   Answer: C
25. Economists disagree about
   (a) whether demand shocks or supply shocks are the cause of business cycles.
   (b) the long-run rate of economic growth.
   (c) whether supply and demand shocks matter in the long run.
   (d) the factors affecting aggregate demand.
   (e) everything.
   Answer: A

26. The short-run production function shows the relationship between
   (a) savings and investment.
   (b) interest rates and investment demand.
   (c) real and nominal interest rates.
   (d) labor supply and labor demand.
   (e) the economy’s output and employment.
   Answer: E

27. According to classical economics, the aggregate supply curve is
   (a) determined by real wages.
   (b) fixed regardless of the price level.
   (c) a function of consumption and investment.
   (d) upward-sloping, that is, a reduced price level reduces real GDP.
   (e) a function of interest rates.
   Answer: B

28. Which of the following is correct?
   (a) Economists generally agree that the natural rate of unemployment for the U.S. economy is about 4%.
   (b) Economists agree about the causes of business cycles.
   (c) There is evidence that the self-correcting mechanism works.
   (d) The Great Depression disproved the self-correcting mechanism.
   (e) Economists believe that empirical estimates of the natural rate of unemployment are not possible.
   Answer: C

29. The short-run aggregate supply curve is upward-sloping because
   (a) a lower price level increases real money balances.
   (b) lower taxes motivate people to work more.
   (c) wage contracts keep money wages fixed.
   (d) more money motivates people to spend more.
   (e) most business firms operate with long-term contracts for output but not input.
   Answer: C
30. When Professor Friedman says that neither he nor his fellow economists know what the natural rate of unemployment is, the underlying message is that
   (a) macroeconomic data is generally of modest to poor quality.
   (b) even sophisticated models of the economy are not very good at short-run forecasting.
   (c) economists are fundamentally ignorant about forces driving the economy.
   (d) forecasting is as much an art as it is a science.
   (e) the natural rate of unemployment can change from one decade to the next.
   Answer: E

31. Which of the following is one explanation for a negatively-sloped aggregate demand curve?
   (a) The interest-rate effect.
   (b) The foreign-trade effect.
   (c) The real balance effect.
   (d) All of the above.
   Answer: D

32. The natural rate of unemployment can be defined as a rate of unemployment
   (a) equal to 5.5%.
   (b) that results in constant real GDP growth over time.
   (c) equal to the growth rate of investment.
   (d) for which the number of available jobs is equal to the number of unemployed workers.
   (e) that eliminates the business cycle.
   Answer: D

33. Which of the following would increase aggregate demand?
   (a) A decrease in the price level.
   (b) A decrease in government spending.
   (c) An increase in the money supply.
   (d) A decrease in investment spending.
   (e) An increase in real output.
   Answer: C

34. In the short-run, the relationship between total output and the price level (the aggregate supply curve)
   (a) is always positive; a higher price level reduces more real output.
   (b) is a function of aggregate labor supply.
   (c) depends on investment and thus interest rates.
   (d) is determined by the long-run rate of economic growth.
   (e) depends on whether wages and prices are sticky or flexible.
   Answer: E
35. According to data from the 1960s, 1980s and 1990s, the nonaccelerating-inflation unemployment rate
   (a) has increased from about 5% in the 1960s to about 7% in the 1990s.
   (b) is determined by the magnitude of positive demand shocks.
   (c) is approximately 6% in all three decades.
   (d) cannot be explained by macroeconomic theory.
   (e) fluctuates from decade to decade.
   Answer: E

36. Classical macroeconomics has different implications for the effects of demand and supply shocks. For classical macroeconomics, a demand shock
   (a) affects inflation only whereas supply shocks affect inflation and real output.
   (b) affects interest rates and real output whereas a supply shock affects only real output.
   (c) affects inflation and real output whereas supply shocks affect inflation only.
   (d) affects inflation only whereas supply shocks affect real output only.
   (e) affects interest rates, whereas a supply shock affects only real output.
   Answer: A

37. A supply shock that shifts the aggregate supply curve up and leftward
   (a) raises the price level and real GDP.
   (b) raises the price level and lowers unemployment.
   (c) raises the price level and lowers real GDP.
   (d) lowers the price level and raises real GDP.
   (e) lowers the price level and lowers real GDP.
   Answer: C

38. Which of the following would increase aggregate demand at all levels?
   (a) A decrease in tax rates.
   (b) An increase in consumers’ saving rates.
   (c) An increase in government spending.
   (d) A decrease in the money supply.
   (e) An increase in the price level.
   Answer: A

39. If wages and prices are somewhat inflexible, a positive demand shock would
   (a) lower the price level and reduce real GDP.
   (b) lower the price level and raise real GDP.
   (c) increase the price level, and raise the real GDP.
   (d) increase the price level, and lower real GDP.
   (e) None of the above.
   Answer: C
40. Suppose that an adverse demand shock occurs. If the self-correcting mechanism is given time to function, the end result of the changes in aggregate supply and demand will be to
(a) increase real GDP without affecting the price level.
(b) reduce real GDP and the price level.
(c) restore equilibrium at the natural price level.
(d) restore equilibrium at the natural level of real GDP.
(e) increase real GDP and restore the economy to the long run rate of economic growth.
Answer: D

41. Evidence supporting the classical and Keynesian views of the macroeconomy is mixed. Those economists who doubt the classical viewpoint would point to
(a) the long run trend of higher unemployment rates in the nineteenth century (1800–1900).
(b) the various shocks to the nineteenth century economy, such as wars, the railroads and gold discovery in California.
(c) the trend of higher unemployment rates since WWII.
(d) the substantial fluctuations in the price level in Germany, England, and France during the nineteenth century.
(e) the model’s apparent inability to explain the Great Depression.
Answer: E

42. In the classical view, the source of supply shocks was thought to be
(a) trade wars.
(b) ill-timed government policy.
(c) stock market buyers.
(d) the labor market.
(e) advances in technology and increases in productivity.
Answer: E

43. Evidence supporting the classical model of macroeconomics includes
(a) the Bernanke and Parkinson study showing that the self-correcting mechanism had little to do with recovery from the Great Depression.
(b) the increase in fixed contracts as unionism became more important in the early twentieth century.
(c) rising real interest rates in the United States since WWII.
(d) the lack of a strong trend in the price level of industrialized countries in the nineteenth century.
(e) Keynes’ remark that “In the long-run we are all dead.”
Answer: D
44. Which of the following best describes a major difference between classical economists and Keynes?
(a) The classics thought recessions would be self-correcting; Keynes thought the self-correcting mechanism worked slowly.
(b) The classics thought that savings depended on income; Keynes thought savings depended on the nominal rate of interest.
(c) The classics thought that wages were inflexible downward; Keynes thought that unemployment would be eliminated by falling wages.
(d) The classics thought savings equaled actual investment; Keynes thought desired savings equaled desired investment.
(e) None of the above.
Answer: A

45. In the Keynesian view, demand shocks are the most likely cause of business cycles because
(a) savings was determined by changes in personal income, rather than interest rates.
(b) technology does not usually change rapidly and annual productivity growth is low.
(c) there are far more possible causes for demand shocks than for supply shocks.
(d) the self-correcting mechanism does little to offset an adverse demand shock whereas it can correct an adverse supply shock.
(e) supply shocks are an unlikely cause of the large decline in output during the first four years of the Great Depression.
Answer: E

46. In a famous quote, Keynes declared, “In the long run, we are all dead.” What Keynes meant by this quote is that
(a) the classical economists were right - in the long run, interest rates would equilibrate savings and investment.
(b) the self-correcting mechanism of the economy works slowly.
(c) high rates of unemployment could not occur for an extended period of time.
(d) the Great Depression was a long-run phenomenon that was unlikely to repeat itself.
(e) Keynes expected to die, but he thought his macroeconomic theories would outlive him.
Answer: B

47. According to Keynes, wages and prices
(a) are “sticky”, and therefore, cause slow macroeconomic adjustments.
(b) would adjust until the natural rate of unemployment is reached.
(c) were too low for equilibrium.
(d) would equate savings and investments.
(e) tended to be freely-adjusting in the economy.
Answer: A

48. If you believe in classical macroeconomics, then you would expect _____ during a cyclical downturn.
(a) rising real GDP, falling prices, and rising real wages
(b) falling real GDP, falling prices, and rising real wages
(c) rising real GDP, rising prices, and falling real wages
(d) falling real GDP, rising prices, and falling real wages
(e) falling real GDP, rising prices, and rising real wages
Answer: D
49. If you believe in Keynesian macroeconomics, then you would expect _____ during a cyclical upturn.
   (a) rising real GDP, falling prices, and rising real wages
   (b) falling real GDP, falling prices, and rising real wages
   (c) rising real GDP, rising prices, and falling real wages
   (d) falling real GDP, rising prices, and falling real wages
   (e) falling real GDP, rising prices, and rising real wages
   Answer: C

50. The most important difference between the long-run aggregate supply curve and the short-run aggregate supply curve is
   (a) that labor supply determines long-run aggregate supply whereas short-run aggregate supply is a function of investment spending.
   (b) the influence of the aggregate production function in the long-run and role of the price level in short-run aggregate supply.
   (c) that long-run aggregate supply is determined by interest rates and short-run aggregate supply is a function of the price level.
   (d) wages and prices are fully flexible in the long-run whereas the short-run aggregate supply curve exhibits some wage and price rigidities.
   (e) wages and prices are fully flexible in the short-run whereas the long-run aggregate supply curve exhibits some wage and price rigidities.
   Answer: D

51. Three explanations for a downward-sloped aggregate demand curve are listed below. Which of the following correctly summarizes one of these explanations?
   (a) As the price level rises, consumption increases.
   (b) As the price level falls, net exports decline.
   (c) As the price level rises, unintended investment decreases.
   (d) As the price level falls, net exports increase.
   (e) As the price level rises, real money balances rise.
   Answer: D