

Question 1

- 1.1 In the AD-AS model, an increase in net exports would.....
- (a) shift the AS curve to the left;
 - (b) shift the AS curve to the right;
 - (c) shift the AD curve to the left;
 - (d) **shift the AD curve to the right.**
- 1.2 “Supply-side” economists would generally be in favour of.....
- (a) increased government spending, higher taxes and privatization;
 - (b) increased working hours at businesses to increase production;
 - (c) cuts in government spending, higher taxes, and nationalization;
 - (d) **cuts in government spending, lower taxes, and deregulation.**
- 1.3 Which one of the following statements about lags is correct?
- (a) The decision lag is shorter for fiscal policy than for monetary policy.
 - (b) The implementation lag is extremely short for fiscal policy and long for monetary policy.
 - (c) **The recognition lag is the same for fiscal and monetary policy.**
 - (d) The impact lag is shorter for monetary policy than for fiscal policy.
- 1.4 Suppose an economy is experiencing an increase in unemployment. Which policy reaction is most appropriate?
- (a) Encourage households to save a larger proportion of their income.
 - (b) Limit the credit availability by increasing the interest rate.
 - (c) **Raise the demand for domestically produced goods and services and reduce imports.**
 - (d) Raise taxes so that government increases its revenue
- 1.5 In the AD-AS model
- (a) an increase in productivity is shown by a shift of the aggregate supply curve to the left.
 - (b) **a decrease in the interest rate is shown by a rightward shift of the aggregate demand curve.**
 - (c) an increase in the interest rate is shown by a shift of the aggregate supply curve to the left.
 - (d) a decrease in imports is shown by a shift of the aggregate demand curve to the left.

Question 2

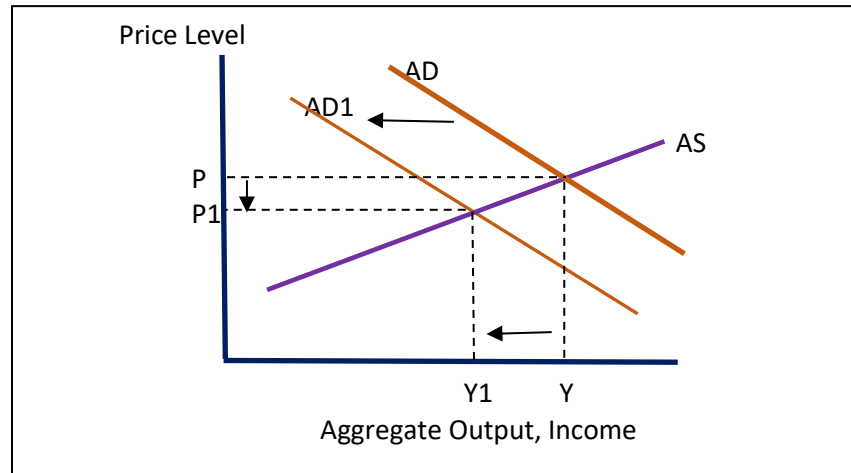
- 2.1 Define the Monetary Transmission Mechanism and explain how it works. (8)

The way in which changes in the monetary sector are transmitted to the rest of the economy.

When the interest rate changes, e.g. decreases, this affects the level of autonomous investment in the economy (1) (2). In the case of a decrease in the interest rate the level of autonomous investment spending will increase (1). This is then transmitted to the rest of the economy through the impact on aggregate spending and aggregate demand (1). In the case of the

Keynesian model, aggregate spending (A) will increase and as a result the equilibrium level of income (Y) will also increase (2). In the case of the AD-AS model, the increase in I will lead to an increase in AD. When AD increase the price level will increase and so will the equilibrium level of income (Y) (2).

- 2.2 Use the aggregate demand-aggregate supply model to explain how an increase in the repo rate will affect the level of production and income in the economy. (Use a graph to aid your explanation).



Explanation: The increase in the repo rate affects aggregate demand in two ways: the level of investment spending will decrease and consumption spending by households will decrease. The AD curve will shift to the left. As a result the level of output in the economy (Y) will decrease and the price level will also decrease.

- 2.3 A number of factors influence aggregate demand and aggregate supply. Use the table below to indicate the effect of each of the variables on AD, AS, Price and Income levels. The first one has been done for you as an example.

Variables	AS	AD	Price Level	Income (Y)
Decrease in investor confidence	-----	Decrease	Decrease	Decrease
A sudden increase in the price of crude oil	Decrease	-----	Increase	Decrease
A decrease in the interest rate	-----	Increase	Increase	Increase
Contractionary fiscal policy	-----	Decrease	Decrease	Decrease
Decrease in the cost of imported intermediate goods	Increase	-----	Decrease	Increase

