Chapter 8 The Self-Regulating Economy

1. The classical economists believed
   a. that intervention by government in the economy is highly desirable.
   b. in Say’s Law.
   c. that prices and wages are inflexible.
   d. that demand creates its own supply.

ANS:
   a. Incorrect. They believed that the economy is inherently stable and that government’s role should be very limited.
   b. Correct.
   c. Incorrect. They believed that prices and wages are flexible such that markets quickly adjust to a new equilibrium in the direction of long-run equilibrium, ultimately achieving the Natural Real GDP level.
   d. Incorrect. They believed that supply creates its own demand.

2. According to the classical economists, if society wishes to save more, the following sequence of events will occur
   a. interest rates will rise causing the amount of investment to fall.
   b. interest rates would fall causing investment to rise until it matched the new higher level of saving.
   c. imports would rise until imports match exports.
   d. interest rates would fall causing investment to fall resulting in an ever-larger gap between society’s saving and investment.

ANS:
   a. Incorrect. Interest rates would tend to fall, causing investment to rise until investment matched saving.
   b. Correct.
   c. Incorrect. Interest rates would tend to fall, causing investment to rise until investment matched saving.
   d. Incorrect. Interest rates would tend to fall, causing investment to rise until investment matched saving.

3. A recessionary gap is defined as a situation such that
   a. actual Real GDP is greater than Natural Real GDP.
   b. actual Real GDP equals Natural Real GDP.
   c. actual Real GDP is less than Natural Real GDP.
   d. none of the above

ANS:
   a. Incorrect. A recessionary gap occurs when actual Real GDP is less than Natural Real GDP.
b. Incorrect. A recessionary gap occurs when actual Real GDP is less than Natural Real GDP.
c. Correct.
d. Incorrect. The correct answer is C.

4. Assuming the economy is initially in long-run equilibrium, a leftward shift in the aggregate demand curve will cause
a. a short-run equilibrium characterized by a drop in Real GDP and a decline in the price level with the result that Real GDP is below its Natural level.
b. a new long-run equilibrium characterized by an increased price level and Real GDP.
c. a short-run equilibrium characterized by a rise in Real GDP and a rise in the price level.
d. none of the above

ANS:
a. Correct.
b. Incorrect. The new long-run equilibrium will involve the same Natural Real GDP level coupled with a lower price level. But in the meantime, there will be a short-run equilibrium involving a lower Real GDP and price level.
c. Incorrect. The short-run equilibrium will be characterized by a drop in both Real GDP and the price level with the result that Real GDP is below its Natural level.
d. Incorrect. Answer A is correct.

5. When the level of Real GDP the economy is producing is less than its Natural Real GDP, the economy is said to be in
a. an inflationary gap.
b. a recessionary gap.
c. long-run equilibrium.
d. none of the above

ANS:
a. Incorrect. When the economy’s Real GDP is less than its Natural Real GDP, the economy is said to be in a recessionary gap.
b. Correct.
c. Incorrect. When the economy’s Real GDP is less than its Natural Real GDP, the economy is said to be in a recessionary gap.
d. Incorrect. Answer B is correct.

6. What aspect of a self-regulating economy can work to remove an inflationary gap?
a. Wages will fall in the labor market, causing the short-run aggregate supply curve to shift to the right until the economy has returned to long-run equilibrium.
b. Wages will rise in the labor market, causing the short-run aggregate supply curve to shift to the left until the economy has returned to long-run equilibrium.
c. The Federal Reserve will increase interest rates, reducing aggregate demand until the economy has returned to long-run equilibrium.
d. The Federal Reserve will decrease interest rates, increasing aggregate demand until
the economy has returned to long-run equilibrium.

ANS:
a. Incorrect. Wages will rise in the labor market, causing the short-run aggregate supply
curve to shift to the left until the economy has returned to long-run equilibrium.
b. Correct.
c. Incorrect. If the Federal Reserve takes action to raise or lower interest rates, the
economy is, by definition, no longer self-regulating.
d. Incorrect. If the Federal Reserve takes action to raise or lower interest rates, the
economy is, by definition, no longer self-regulating.

7. When the economy is in a recessionary gap, a _______________ exists in the labor
market which will put _______________ pressure on wages.
a. shortage; downward
b. surplus; downward
c. shortage; upward
d. surplus; upward

ANS:
a. Incorrect. In a recessionary gap the unemployment rate is greater than the natural
unemployment rate, resulting in a surplus of labor, thus putting downward pressure on
wages.
b. Correct.
c. Incorrect. In a recessionary gap the unemployment rate is greater than the natural
unemployment rate, resulting in a surplus of labor, thus putting downward pressure on
wages.
d. Incorrect. In a recessionary gap the unemployment rate is greater than the natural
unemployment rate, resulting in a surplus of labor, thus putting downward pressure on
wages.

8. Suppose that wages and prices are completely flexible and that actual Real GDP
exceeds Natural Real GDP. This gap between actual and Natural Real GDP will be
corrected, according to the classical economists
a. by a rightward shift of the SRAS curve along the aggregate demand curve.
b. by a leftward shift of the aggregate demand curve along the SRAS curve.
c. by a leftward shift of the SRAS curve along the aggregate demand curve.
d. by a rightward shift of the aggregate demand curve along the SRAS curve.

ANS:
a. Incorrect. The economy would be in an inflationary gap, which would raise wages and
other resources prices, causing the SRAS curve to shift leftward.
b. Incorrect. The economy would be in an inflationary gap, which would raise wages and
other resources prices, causing the SRAS curve to shift leftward.
c. Correct.
d. Incorrect. The economy would be in an inflationary gap, which would raise wages and other resources prices, causing the SRAS curve to shift leftward.

9. According to the classical economists, if the labor market is not in equilibrium, then
a. the economy may or may not be at full employment.
b. inflexible wages will prevent the market from achieving an equilibrium in the labor market.
c. workers feel that they are working too many hours.
d. flexible wages adjust so that the market regains a balance and the quantity of labor demanded equals the quantity of labor supplied.

ANS:
a. Incorrect. The economy would not be at long-run full employment unless there was equilibrium in the labor market.
b. Incorrect. Wages are not rigid; they are completely flexible according to classical economists.
c. Incorrect. The economy would not be at long-run full employment unless there was equilibrium in the labor market.
d. Correct.

10. Assuming that wages and prices are completely flexible, if the economy is in short-run equilibrium where actual Real GDP is less than Natural Real GDP, the gap between the actual Real GDP and Natural Real GDP will be corrected by
a. a leftward shift of the aggregate demand curve along the short-run aggregate supply curve.
b. a rightward shift of the short-run aggregate supply curve along the aggregate demand curve.
c. a leftward shift of the short-run aggregate supply curve along the aggregate demand curve.  
d. a rightward shift of the long-run aggregate supply curve.

ANS:
a. Incorrect. This would expand the gap between actual Real GDP and Natural Real GDP
b. Correct.
c. Incorrect. This would expand the gap between actual Real GDP and Natural Real GDP
d. Incorrect. This would expand the gap between actual Real GDP and Natural Real GDP.