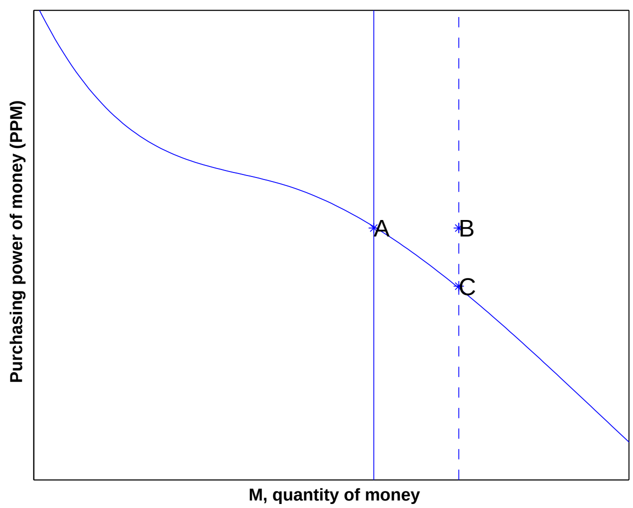
ECON 135 midterm

Answers to last 3 questions.

(These are more elaborate answers than I expected from you.)

36. The diagram shows the demand for money as the usual downward-sloping line, but the supply of money is shown as a vertical line, suggesting that it is issued by a government central bank.



(a) The vertical axis is labeled "The price of money," What is the price of money? Write the correct phrase on the vertical axis.

(b) Mark point "A" on the graph where there was an equilibrium between people's demand to hold money and the supply of it prior to the shift.

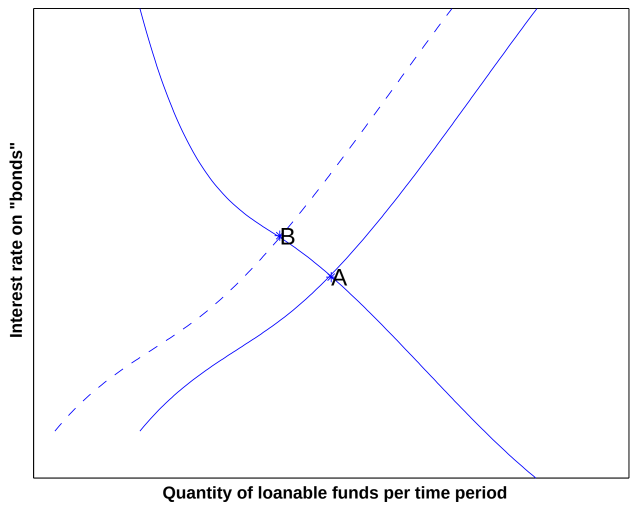
(c) Now suppose the government increases the money stock as shown by the shift to the dashed line. Before there has been any change in the purchasing power of money, there will be a surplus of money relative to the quantity demanded. Mark this as point "B."

(d) The market will move toward a new equilibrium where the quantity demanded once again matches the supply. Mark this as point "C."

In a few sentences, describe the process by which people modify their spending and money-holding actions and thereby bring about the movement from A to B to C.

The price of money is its purchasing power. The new money stock is greater than the total amount people want to hold (Point B on the graph). But since money is not destroyed, every dollar must be in someone's possession. This could be called a "hot potato" situation. People spend faster in order to keep their money holdings down to their preferred levels. When people spend faster, the purchasing power of money declines. We move toward point C where the PPM has fallen enough to induce people to hold the new larger money stock, because they need it to pay higher prices.

37. This diagram depicts the market for loanable funds. Suppose income tax rates are raised on highly productive people, who tend to save more than less productive people.



(a) The vertical axis is labeled "Price of loanable funds," What is the price of loanable funds? Write the correct phrase on the vertical axis.

(b) Which curve shifts, and in which direction? Draw a shifted curve on the diagram.

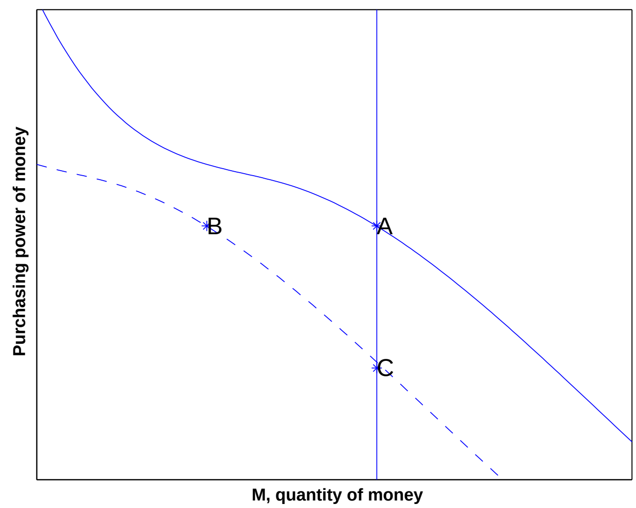
(c) Mark the new equilibrium point.

(d) Describe briefly the effect of this change in terms of the amount of investment, the interest rate, and future prosperity.

High-income people will have less income left after tax and will thus supply less to the loanable funds market. The supply curve shifts left, as shown, resulting in fewer "bonds" being sold at a higher interest rate. This results in less investment, lower future productivity, and lower future prosperity than would otherwise occur.

38. The diagram shows the demand for money as the usual downward-sloping line, but the supply of money is shown as a vertical line, suggesting that it is issued by a government central bank.

Suppose people begin to fear future price inflation, and everything else is unchanged. How will they change their spending and money-holding patterns and what will be the consequences? Explain in a few sentences. Also draw a shifted curve on the graph showing these consequences.



Fearing future price inflation, people will want to hold less money, since they believe its purchasing power will decline (dashed line). Since money is not destroyed, and every dollar is always in someone's possession, we have a "hot potato" situation. People spend their money faster trying to get rid of it. This increase in velocity leads to price inflation (with other things, particularly the money stock, being unchanged). Price inflation means reduced purchasing power. As the purchasing power drops, people realize they need to hold more to match higher prices, moving from B toward a new equlibrium at C where people's desired money holdings match the existing (unchanged) stock.