Wilfrid W. Csaplar Jr. Principles of Macroeconomics Review Sheet for Exam 4 and Final Exams

This review sheet is intended to cover everything that could be on the exam; however, it is possible that I will have accidentally left something off. You are still responsible for everything in the chapters covered except anything that I explicitly say you are not responsible for. Therefore, if I left something off of this sheet, it can still be on the exam. There will be no multiple-choice questions. Most of the questions will be like the ones in the homework assignments, and possibly a few definition questions, but I am more likely to ask questions that make you use the definitions rather than recite them. I will probably ask one of the questions from the book at the end of the chapters.

The review session will be at a time to be determined in class, probably 4/27.

Chapter 12: Note we will not be making the Assumption #4 on Page 251. We will assume an open economy. What are C, I, G, and X? What determines them? Know what moves the flatter line on the **45° diagram, a.k.a. the Keynesian Cross diagram**. *We only need the E = Y line and C + I + G + X line and to move it. The other lines, like the C and the C + I lines were just to help you understand the main line. Ignore the savings line and the S = I derivation of the model. It is mathematically the same as what we did and the book does, but it is more complicated to understand.* What are the **MPC, MPS, APC,** and **APS**? *Note that even though our model assumes the MPC is the same for rich and poor, it also concludes that the rich will have a lower APC than the poor. It is easier to notice a person's APC than MPC*. Know what changes C, I, G, and X. Why does consumption depend upon wealth, although not much? Why does investment depend upon interest rates? Ignore the planned versus unplanned investment. What is a lump-sum tax and how does it affect the 45° diagram? What determines net exports? *Note that the AD line is virtually the same as the C + I + G + X line*. Both represent how much is being demanded. However, changes in the price level will move the C + I + G + X line but not AD line. What determines the size of the **government spending multiplier**? What is the economics behind it? How do we see it on the Keynesian Cross diagram? How does our assumptions about prices, interest rates, income taxes, and imports affect its size?

Chapter 13: What is fiscal policy? What should the government do with taxes and spending if there is an **inflationary gap** or **a recessionary gap**? Show those actions on the **LRAS/SRAS/AD diagram**. What are the drawbacks of doing fiscal policy, for example, **crowding out investment, direct expenditure offset,** and **lags**? Why are these problems? What is the **Laffer Curve** and why does it matter? What is Ricardian Equivalence and why should it hold? Note that **Ricardian Equivalence**, the size of crowding out and lags are often debated among economists. What are automatic stabilizers? What determines the size of the **government deficit/surplus**? Why should we know the unemployment rate when considering the desirability or lack of desirability of the deficit? How does a deficit differ from the **debt**? Be able to calculate the **full-employment deficit**. Ignore the appendix, except that it can help you understand the chapter.

Chapter 14: What is the difference between the budget deficit and the government debt? What are the problems caused by them? To what extent are these arguments valid: **high interest payments hurt, future generations must pay the debt, crowding out,** and **we owe foreigners the money**? How is the government deficit related to the **trade deficit**, i.e., the **twin deficits**? Why is it important to know why the deficit is big? How are the short-run and long-run effects of the deficit different? Why is it difficult to reduce the deficit? For example, why are most expenditures tough to cut and why isn't raising taxes a good option? Why does **Paul O'Neill** say that the government owes a lot more than the amount they borrowed?

Chapter 15: Why should money be a good **medium of exchange, unit of account, store of value,** and **standard of deferred payment**? What is meant by **liquidity**? What backs our money? Know what is in **M1** and **M2**, but not M3. You only have to know the items in them that the book mentions. (There are other parts of M2 and M3 that the book leaves out.) Know the properties of each item in them. Know what happens when we move money between them. *Hints: Do not forget that M1 is in M2. Unless you are taking a loan, then M2 doesn't change.* What is **financial intermediation**? What are **adverse selection** and **moral hazard** and why are they a problem? Do not worry about what each organization in Table 15-2 does. What is the **Federal Reserve**? What does it do? What are its tools? How do they affect the money supply? (That is covered in more detail in Chapter 16 after the test.) The map of the Federal Reserve Districts incorrectly has us in the Richmond District. We are in the Cleveland District. Do not worry about the balance sheets or the money multiplier. What is the **FDIC**? How does it result in moral hazard and adverse selection? Ignore the rest of the chapter.

This is the non-graded Assignment #8A that will be reviewed with Assignment #8.

1) (30 points) What are the three tools of the Federal Reserve for doing monetary policy? For each of them, explain how they could be used to increase the money supply.

2) (20 points) What is *adverse selection*? Give an example from banking. What do banks do to reduce the problem? Explain

how that action reduces the problem.

3) (20 points) What is *moral hazard*? Give an example from insurance. What do insurance companies do to reduce the problem? Explain how that action reduces the problem.

4) (10 points each) For each of the following events, determine what happens to M1 and M2. Explain your logic.
A) You transfer $400 from a checking account to a savings account.
B) You pay your tuition with a check.
C) You buy a $400 textbook with a credit card.

Material after Exam #4

Chapter 16: What determines the demand for money? What are transaction, precautionary, and asset demand for money? Be able to move the **MS** and **MD** curves. Ignore the S/D for bonds. Illustrate the effects of **monetary policy** on LRAS/SRAS/AD diagram. Understand why **MV=PY**. Understand why **monetarists** do not like monetary policy. (This is the lags from Chapter 13 again, but they are of different lengths than they were there.) Why can't the Fed choose to set both interest rates and the money supply?

This is the non-graded Assignment #8B that will be reviewed before the final.

1) (40 points) Illustrate the results of the Fed buying bonds on the LRAS/SRAS/AD diagram and on the MD/MS diagram. Explain why the curves moved as drawn. What happened to GDP, interest rates, and the price level?

2) (20 points) Use the supply and demand for money to explain why no central bank can control both interest rates and the money supply. (Of interest, if the central bank wants to control the exchange rate, then it cannot control either the interest rates or the money supply.)

3) (20 points) Use the SRAS/LRAS/AD diagram to explain the neutrality of money.

4) (20 points) Illustrate the effects of an increase in the GDP on the MS/MD diagram. Explain why the curve(s) moved as drawn. What happens to the quantity of money and the interest rate?

Review Sheet for the two parts of the final.

The optional review session for the first part of the final will be determined by group decision. The "review session" for the second part will be in class on 5/2 and 5/5. The review session for the first half of the final will be determined later. The first half of the final will be the last class (5/9) and the second half is Tuesday, May 13th, 1:00 - 3:00.

The two parts of the final will be in the same order as the last few years, which is the opposite order of the first two semesters. **The second half of the final** will be just like the second half of the final for the last semester. (However, I may slightly change the manner which I assign points or improve the wording.) If I were you, I would use a Keynesian, but not extreme Keynesian, approach to solve the problem because it is easier to solve problems in a Keynesian world. (That does not mean that Keynes is right, just easier to deal with.) For the second half of the final, you will probably want to practice showing policy on the SRAS/LRAS/AD diagram, 45° diagram, and the MS/MD diagram **at the same time**. Make sure that GDP goes the same direction in the two diagrams with it on the X-axis. **The second half of the final** is open book and notebook.

The first part of the final will be held during the last class. It will cover the material that is not directly covered by the second half of the final. For example, I will not ask you to show an increase in the money supply on the LRAS/SRAS/AD diagram. Anything on any review sheet that is not explicitly covered in Part 2 of the Final is fair game. This part of the final is closed book and closed notes, just like all other tests.

When I write the final, I look to see what I did not ask about, and what were the major topics. I write questions about those topics. (Obviously, opportunity costs and supply/demand will be on the first half of the final.) I try to get the questions evenly distributed from all the tests. However, the second half of the final covers much of the material for Tests #3 and #4. Therefore, much of the material for the first half of the final will be on material from Tests #1 and #2, with some questions from each of the other tests' material.