Wilfrid W. Csaplar Jr. Business Cycles and Forecasting Review Sheet for Exam 2

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 announced, probably Wednesday, 2/20, in the normal computer lab.

For the laboratories, you will be expected to be able to calculate a **Laspeyres Price Index**, **Paasche Price Index** and the **PCE** with any base year and the resulting inflation. *Note that the PCE is the square root of the product of the Laspeyres and Paasche indices.* You should also be able to do the simple forecasts similar to those in Lab #4. That would be the ***same value, same change, same percent change, n-period moving average,*** **and** ***n-period weighted moving average.*** You should also know what the advantages and disadvantages of each of these methods are. What patterns do they give for the plots over time.

In general, for both chapters, you may be asked to show the effects upon the IS/LM/FE diagram, real MS/MD diagram, NS/ND diagram, and/or the SRAS/LRAS/AD diagram. For the SRAS, generally, draw it upward-sloping with the Misperceptions Theory;. however, in the Keynesian school, you should draw it flat.

Chapter 9: Be able to manipulate the **IS/LM/FE** diagram and the SRAS/LRAS/AD diagram at the same time. Make sure that GDP changes the same on the two diagrams. Know how to manipulate the **real MS/MD**. This diagram is in real terms; therefore, prices do not affect MD/P, they affect MS/P. Understand why the eight curves in this chapter take their shape. Note that in the long-run, SRAS will move back to equilibrium and that causes prices to change. The price level change causes LM and MS/P to change. Why doesn't a change in the money supply have any long-run effects on GDP (a.k.a., **neutrality of money**)? Be able to derive AD from the IS/LM/FE diagram. It may be easiest to draw SRAS with a slight upward slope.

Chapter 10: This chapter is about the ***Classical School*** and the ***Neo-classical School's*** improvements to the theories. Understand the ***Real Business Cycle theory*** of how **real shocks** and **nominal shocks** affect the economy in the *Classical Model*. What are the conclusions of the model? How do they fit the normal business cycle and how do they differ? Are **productivity shocks** the only source of business recessions? What is the **Solow residual**? What would explain **labor hoarding**? What are the short and long-run effects of fiscal policy? Use diagrams to answer the question. Should fiscal policy be used to dampen the cycles? What is meant by **neutrality of money** and why might there be a reverse causation between future changes of GDP and the current money supply? Why might money be non-neutral? How does the ***Neo-classical,*** a.k.a., ***Rational Expectations*** school use the ***Misperceptions Theory*** to explain how money may have real effects if it is not perceived correctly? Understand why $Y = Y_{FE} + b(P - P^e)$ should hold. Be able to illustrate the effects on the diagrams.

This is the non-graded Assignment #4A that will be reviewed with Assignment #4.

1) (10 points) Why should $Y = Y_{FE} + b(P - P^e)$?

2) (45 points) Use the SRAS/LRAS/AD diagram for the Neo-Classical Model and the IS/LM/FE diagram to illustrate an increase in government spending of 1% when a 3% increase was expected. Explain why the curves moved as drawn. What happens to GDP, inflation, and interest rates? Explain your logic.

3) (15 points) Some critics claim the Neo-Classical Model, a.k.a. Rational Expectations Model, requires that everybody understand economics. Why do they say that? What is wrong with that argument?

4) (15 points) What is the difference between real shocks and nominal shocks? Which one has the bigger impact on the economy? Why?

5) (15 points) What is meant by labor hoarding? Why might it occur?