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 Thursday, 10/3, on Zoom.

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.

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 $Y = \overline{Y} + b(P - P^e)$ should hold. Be able to illustrate the effects on the diagrams.

Chapter 11, Section 11.1: What is meant by **real-wage rigidity** and **nominal wage rigidity**? Which one is the important one? Be able to explain it with the following explanations, and be able to explain the problems with them. How does **the high wage reduce turnover** and/or increase efficiency? Why does the **effort curve** take that shape and why do you want the point of tangency? How does the **efficiency wage** cause high unemployment? What does it do to the FE line?

On the next page is the non-graded Assignment #4A that will be reviewed with Assignment #4.

1) (10 points) The Neo-Classical school believes in the neutrality of money in the short-run. However, if you look at your supplemental text, the AIER uses M1 to forecast while the Conference Board uses M2 to forecast. Explain how money can be neutral and it still be used to predict GDP.

2) (15 points) Explain why the SRAS curve slopes up in the Rational Expectations Model.

3) (20 points) Draw the SRAS/LRAS/AD diagram. Illustrate the effects of a 10% increase in the money supply with people expecting a 15% increase. Explain why the curve(s) moved as drawn. What happens to GDP, inflation, and the unemployment rate?

4) (20 points) Draw the SRAS/LRAS/AD diagram. Illustrate the effects of a 12% increase in government spending with people expecting a 5% increase. Explain why the curve(s) moved as drawn. What happens to GDP, inflation, and the unemployment rate?

5) (15 points) One criticism of the Rational Expectations Model is that it appears to assume that everybody has a Ph.D. in Economics. What is wrong with that criticism? Explain your logic.

6) (20 points) Draw the effort curve. Explain why it takes that shape. What does that imply that about how much a company should pay? That is a microeconomic argument. How can it apply to macroeconomics?