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.

Since nobody attended the last two review sessions, I will only run a review session if somebody requests it.

Chapter 11: Draw only the "modern SRAS" Curve. *The equilibrium is where SRAS and AD cross. If that point is to the right of the LRAS, then the unemployment rate is too low because GDP is above Y_{FE}, so we are producing too much. If that point is to the left of the LRAS, then the unemployment rate is high because GDP is down. Unless I tell you otherwise, start with all three curves crossing at one point.* Chapter 11: What are the four assumptions of the **classical school**? What did **Say say**? How does it relate to the **SRAS curve**? Note that we went into more detail than the book on that explanation. How does it relate to labor supply and labor demand? Why should S = I? What assumptions did **Keynes** make? How did that relate to the SRAS curve? Why do we draw the "**Modern**" SRAS? *Unless I specify otherwise, when I refer to the SRAS, use the "Modern SRAS."* What moves the SRAS? *Notice that the only thing that moves SRAS without moving LRAS is the price of inputs because they do not affect how much could be produced if we are at full employment. Note the book has useful tables on Pages 229 (Chapter 10) and 253, which is slightly misleading in the next to last line. Marginal **business and/or sales** tax rates move the SRAS because it is a cost of production, while marginal **income** tax rates affect aggregate demand because they reduce income, not raising the cost of production. The prices of inputs only temporarily affect the costs of production without any long-term effects. Since expected future price increases will increase wages, which are an input price, it will move only the AD and SRAS curves but not the LRAS curve.* What is meant by **supply shock** and **demand shock**? *Unless specified otherwise, use the "modern" SRAS curve when asked for the SRAS curve. If you are not told that unemployment is high or low, start your graph with LRAS crossing SRAS where it crosses AD.* What are **inflationary and recessionary gaps**? How will they solve themselves if the government takes no actions? What are the demand pull and cost push inflations? How does a change in the value of the dollar on the foreign exchange market affect the SRAS/LRAS/AD diagram? *Note that the book should combine the panels in Figure 11-13. Unless specified otherwise, use the "modern" SRAS curve when asked for the SRAS curve. If you are not told that unemployment is high or low (recessionary gap or inflationary gap respectively), start your graph with LRAS crossing SRAS where it crosses AD.*

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**?

Chapter 14: 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**. What is the difference between **gross public debt** and **net public 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, constrains the budget in the future,** 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 did **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? 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.

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? What is the **Keynesian liquidity trap**? Why might that mean monetary policy won't work?

Homework #10A to be reviewed with Homework #10.

1) (40 points) Draw the MS/MD diagram and the LRAS/SRAS/AD diagram. Illustrate the effects of the Fed buying bonds. Explain why the curves moved as drawn. What happens to interest rates, GDP, inflation, and unemployment rate.

2) (25 points) Draw the MS/MD diagram to show a Keynesian Liquidity Trap. Use the diagram to prove that monetary policy is ineffective for an economy in that situation. Go to the page below and scroll down the page to the table about ½ way down. Do you think Japan was in this situation in 2018-2019? Explain your logic.

3) (15 points) What is *adverse selection*? Explain why it occurs and how banks avoid it.

4) (20 points) Use the MS/MD diagram to explain crowding out. Explain why the (curves) moved as drawn.

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 first half of the final will be the last class (4/25) and the second half is at the time of the final. Section #1 has it Monday, April 28th, 3:00 - 5:00 PM. Section #2 has it Tuesday, April 29th, 3:00 - 5:00 PM. The review sessions for the first half of the final was during the classes on 4/11 and 4/21.

The second half of the final will be just like the second half of the final for the last semester. However, I will change the numbers and 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 sheets 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, supply/demand, and Social Security 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 Test #3, and Test #4. Therefore, much of the material for the first half of the final will be on material from Test #1 & Test #2, with possibly a question or two from Test #3 and Test #4.