Practice Questions for Midterm 2

AD-AS model and the Phillips curve

How do each of the following affect real GDP, prices and unemployment in the short run and the long run?

1. The average age of the population is getting older, so a larger number of people are retired than before.
2. Apple unveils a new product that is extremely popular for a short time.
4. The government starts a long term spending program in building new hospitals.
5. A new computer program increases worker efficiency permanently.
6. International oil prices temporarily increase.

Answers: short run real GDP / prices / unemployment ; long run …

1. Permanent lower AS: down / up / up ; down / up / up
2. Temporary higher AD: up / up / down; same/same/same
3. Temporary lower AD: down / down / up ; same/same/same
4. Permanent higher AD: up / up / down; same / higher / same
5. Permanent higher AS: up / down / down ; up / down /down
6. Temporary lower AS: up / down / down ; same/same/same

AD-AS and Stabilization Policy

Use graphs to show the effect of government intervention in response to each of these shocks. What are the costs and benefits to each type of government response?

1. Because of a government shutdown, government spending temporarily decreases.
2. Better-than-expected weather causes productivity in the agricultural industry to increase temporarily.
3. A short term boom in Canada causes net exports to increase temporarily.
4. The Panama canal is temporarily closed, making shipping more difficult and disrupting business operations.
Answers:

1. Shock: AD goes down temporarily; Response: AD goes up
   a. Pro: Recession shortened
   b. Con: higher prices in the short run
2. Shock: AS goes up temporarily; Response: AD goes down
   a. Pro: Permanently lower prices
   b. Con: shortens an economic boom
3. Shock: AD goes up temporarily; Response: AD goes down
   a. Pro: Prices don’t increase
   b. Con: Shortens an economic boom
4. Shock: AS goes down temporarily; Response: AD goes up
   a. Pro: Shortens recession
   b. Con: Permanently higher prices

Questions from Lectures

a. What are the long term effects of the government’s response to the most recent recession?
b. What is “moral hazard”?
c. What does “too big to fail” mean in the context of banking?
d. How do banks benefit from taking correlated risks?
e. What are the three functions of money?
f. What are the benefits and risks when comparing fiat and commodity money?
g. What items make up M1? M2?
h. Are credit cards money? Why?
i. What is the money multiplier effect?
j. What are open market operations?
k. What is the federal funds rate?
l. Why does changing reserve requirements change the money supply?
m. What are bank runs?
n. Why does a bank run reduce the money supply?
o. Which parts of GDP change the most during recessions?
p. Why is SRAS upward sloping?
q. What is the government spending multiplier? How is it related to the marginal propensity to consume?

r. What is the crowding out effect?

s. What are automatic stabilizers?

t. What are implementation lags?

u. What is the zero lower bound?

v. Why does a reduction in government spending have a particularly strong effect at the zero lower bound?

w. Why is the Phillips curve downward sloping in the short run?

x. Does the Phillips curve offer a menu of outcomes to policymakers?