

Second midterm review questions

Chapters covered: Ch.18, Ch.5, Ch.6, Ch.9, Ch.10, Ch.11, Ch.12
+ Notes on the business cycles (part 1 and 3)

Chapter 18:

- Define money supply.
- What is fractional reserve banking? What is money multiplier?
- Explain how monetary policy is being conducted and what instruments are being used.
- What is portfolio theory of money demand? What is the major drawback of this theory?
- What is the essence of the transaction theory of money demand? (You can answer this by explaining the Baumol-Tobin model)

Chapter 5:

- What is the connection between trade balance, net exports and net capital outflow?
- What does it mean “small open economy”?
- Develop a model of small open economy and explain how different policies (fiscal expansion, monetary contraction and protectionist trade policy) affect the trade balance and exchange rate.
- What is the implication of PPP theory in terms of real exchange rate?

Chapter 6:

- Define natural rate of unemployment using job finding/job loss model.
- Explain the benefits and drawbacks of unemployment insurance.
- Why minimum wage laws can cause unemployment?
- What is the major implication of wage rigidity?

Chapter 9 +Business cycle notes:

- What is a business cycle?
- Why LRAS is vertical why SRAS is horizontal?
- Explain short run equilibrium determination and long run equilibrium determination utilizing AS-AD model
- What are the stylized facts of US business cycle?
- Explain (provide an example) “accommodating monetary policy” its benefits and costs.

Chapter 10-11

- Derive IS-LM model for the closed economy. What are its major assumptions?
- Provide an example of how fiscal policy can affect economy in the short run.
- Provide an example of how monetary policy can affect economy in the short run.
- In case of a shift in fiscal policy an independent central bank can respond (or not) in several ways. What would be the response of the central bank that is targeting interest to fiscal contraction?
- Some economists argue that central bank should be targeting money supply others suggest targeting interest rates. Who is right and why?
- Derive AD from the IS-LM model. Show how changes in fiscal and monetary policy affect AD.
- Application of IS-LM:
 - a. One of the explanations of the Great Depression is titled “spending hypothesis”. How does it relate to “monetary hypothesis”? [The answer is in your textbook pp.295-298]
 - b. Interest rates in Japan are very close to zero. Some economists suggest that Japan is in “liquidity trap”. Explain their argument utilizing IS-LM model. [pp.303]

Chapter 12

- Derive Mundel-Fleming model for a small open economy
- Is monetary policy effective under the fixed exchange rate regime? Show it!
- Under what exchange rate regime restriction of imports will lead to increase in net exports? Show it!
- Why increase in the country risk premium *may not* lead to increase in income?
- What are the benefits and drawbacks of fixed and floating exchange rate regimes?
- One way to show long run equilibrium determination in Mundel-Fleming model is to allow the price level to vary. Show how an adverse shock to the goods market (e.g. exogenous decrease in investment demand) will affect economy in the short run and the long run.

The questions provided are not the COMPLETE LIST of possible questions... These are just guidelines to help you prepare for the midterm.