

## Exam 2 Sample Questions

**Identify and explain the significance of:**

Inventory adjustment mechanism

GDP gap

Excess Reserves

Three types of unemployment

inventory adjustment mechanism

Quantity theory of money

Frictional unemployment

effects of unanticipated inflation on creditors

Three functions of money

Default risk

Consumer Wealth

how inflation affects creditors

1. Use the Quantity Theory of Money to explain inflation.

2. If you were a member of the Federal Reserve Board of Governors, what *three* policies would you suggest to combat inflation? Why? Explain *carefully*.

3. Using money *and* bond market diagrams, illustrate and briefly explain effects the effects of your suggested open market operation.

4. **Assume:** (a) the economy is initially in equilibrium at noninflationary full-employment GDP ( $Y^*$ ) (b) due to terrorist attacks, the consumption function shifts downward by \$100 billion and (c) the marginal propensity to consume is 0.8. Using a Keynesian total expenditure (TE)/aggregate supply ( $AS_K$ ) diagram, illustrate and explain the probable macroeconomic effects of the decline in consumer spending.

5. How big a tax cut would be needed to restore full-employment under the circumstances outline above? Show your calculations.

6. First, use the Quantity Theory of Money and the standard assumption of constant velocity to explain the hyper inflation experienced by the Confederate states during the American Civil War. Now, suppose that velocity is *not necessarily constant*. How do you think velocity may have changed due to the extremely high wartime inflation? Why? Would the change in velocity tend to reduce or intensify the inflationary pressure in the economy? Why?

7. Suppose that the Fed's policy objective is to keep the nominal interest rate ( $i$ ) constant. How would a Fed with this policy objective respond to an increase in money demand? Why? Illustrate your answer with diagrams of the money and bond markets.

8. Suppose that there is an initial GDP gap of \$20 billion. Now suppose that  $MPC = .8$  and government spending ( $G$ ) is increased by \$2 billion *and at the same time* taxes ( $T$ ) are decreased by \$2 billion. Will this combination of policies restore noninflationary full-employment GDP ( $Y^*$ )? Why or why not? Show your calculations and illustrate your answer graphically.

9. **Assume:** (a) the economy is initially in equilibrium at noninflationary full-employment GDP ( $Y^*$ ) (b) government spending ( $G$ ) is cut by \$8 billion (c) taxes ( $T$ ) are cut by \$10 billion and (d) the marginal propensity to consume ( $MPC$ ) = 0.8

9a Using your knowledge of the government spending and tax multipliers, calculate the change in  $Y$  caused by the decrease in government spending then calculate the change in  $Y$  caused by the decrease in taxes.

9b Using a Keynesian Total Expenditure (TE)/aggregate supply ( $AS_K$ ) and aggregate injections (J)/aggregate withdrawals diagram (W), illustrate and briefly explain the combined effects of the spending and tax cuts. What, if any, problem would the economy be experiencing after these fiscal policy changes?

10. Use a consumption function diagram and brief verbal descriptions to explain: "From 1927 to 1929, the Federal Reserve fueled the prosperity of the "Roaring Twenties" by repeatedly lowering interest rates. When the market crash wiped out consumer wealth in 1929, however, the Fed reacted by raising interest rates. Many economists believe this credit "tightening" made the decline in overall economic activity even worse."

11. Suppose initially that: velocity ( $V$ ) is constant and there is no inflation. Now suppose that velocity ( $V$ ) increases. If the policy objective is to prevent inflation, how would the Fed respond to this exogenous change in velocity? Use the Quantity theory of Money to explain your answer.

12. What are the three major economic effects of inflation? Be sure to carefully explain the effects of inflation on debtors and creditors.

13. Congressional Republicans recently proposed a \$25 billion tax cut. Congressional Democrats recently proposed a \$50 billion increase in government spending.

13a Assuming  $MPC = .8$ , calculate the combined effects of these actions on nominal GDP ( $Y$ ). Show your calculations.