

### **Study Suggestions and Practice Questions for Macro Test One**

Be able to explain the key concepts at the end of each chapter and answer questions using them such as:

1. If a Cobb-Douglas production function describes the economy, what can be said about the relationship between the changes in the marginal product of labor and changes in the share of wages in national income?
2. According to the classical dichotomy, what is the relationship between the money supply and output?
3. According to the theory of purchasing power parity, if our prices rise by ten percent and those abroad rise by three percent, what will happen to a) our real exchange rate and b) our nominal exchange rate?

Be able to explain the slopes (including what are on the axes) of the following curves:

1. The consumption function
2. The demand and supply of a) loanable funds and b) foreign exchange.
3. The demand for money.
4. Aggregate demand and aggregate supply.

Understand the equations:

$$I - S + G - T + X - M = 0$$

$$MV = PY$$

$$BP = K + (X - M)$$

### Some practice questions:

(Except where noted, all questions refer to the classical model.)

(Unless it is otherwise stated, always assume initial equilibrium.)

1. How will an increase in inflation affect a) the demand for money, b) the quantity of money demanded and c) velocity?
2. How do classical and Keynesian models differ in their assumptions about the behavior of prices?
3. If Greece has a budget deficit of 13 percent of GDP, and  $S > I$  by 3 percent, how large will its trade deficit be?
4. a) To reduce its budget deficit to 3 percent of GDP, what does Greece need to do? b) Discuss whether this would be difficult to do politically.
5. a) What has been happening in recent months to the interest rates on Greek government bonds?  
b) Discuss whether you think this has been due more to rational market behavior or due to irrational panic?
6. Under a flexible exchange rate, how will a capital outflow affect a country's a) exchange rate and b) its trade balance?
7. How would an increase in a domestic tariff affect a country's  
a) Trade balance  
b) Nominal exchange rate
8. How is a large increase in a country's minimum wage likely to influence its natural rate of unemployment?
9. a) In a closed economy, how would a tax cut affect domestic investment?  
b) Explain whether this effect would be larger if the MPC is high or low.  
c) What would be the effect on the domestic interest rate?
10. Now consider an open economy. What would be the effect of the cut on:  
a) International capital flows and  
b) the trade balance

- c) Explain how these international effects increase or reduce the effects on domestic investment?
11. If the rate of economic growth fell from 4 to 1 percent, how would the rate of money growth need to be adjusted to avoid inflation?
  12. Explain whether it would be less attractive to lend money at fixed rates of interest if the inflation rate varied, between 4 and 6 percent or 20 to 25 percent.
  13. a) How would an investment boom in the world economy affect world interest rates?  
b) How would this affect domestic investment?
  14. If government spending rises, explain what happens to national savings?
  15. Explain the Fischer effect.

#### Questions from Ch. 9

16. Explain how the quantity theory of money equation can be used as a theory of aggregate demand.
17. Explain whether the AD function is likely to be steeper in the short run or long run.
18. Explain how an increase in AD would affect
  - a) The price level in the short run
  - b) The price level in the long run
  - c) Output in the short run
  - d) Output in the long run
19. Assume the country is initially at full employment and discuss whether the assumption of a horizontal short run AS curve makes more sense for an increase or decrease in AD.
20. With the US unemployment rate so high, discuss whether there is any reason to worry about the large US budget deficit generating substantial inflation a) in the short run and b) in the long run.
21. If economic growth turns out to be slower than is projected in the Obama budget, how would this affect future budget deficits?

22. If the US continues to run a budget deficit, discuss whether it would be possible to keep the ratio of government debt to GDP from rising continuously.
23. Discuss how coordination issues can influence the degree of price flexibility in an industry.
24. Discuss whether you would expect short run price flexibility to be greater in the market for fresh fish or automobiles.
25. Discuss whether it's easier to determine appropriate macroeconomic policy responses in the face of supply or demand shocks.
26. If the economy is overheating, explain how fiscal policy should be adjusted.