Study questions for Midterm

I. Short answers

1. Explain the wage setting and price setting relations. How are they used to define the natural rate of unemployment.

2. Why does an increase in unemployment insurance benefits lead to an increase in the natural rate of unemployment?

3. Explain the importance of expected inflation in the Phillips curve. What is the accelerationist hypothesis?

4. Explain what Okun’s law tells us. What is the growth rate of real GDP when unemployment is at its peak in a recession?

II. Long answers

1. Suppose the economy is in medium run equilibrium and the Fed increases the money supply through an open market purchase.
   a. How does this affect output and interest rates in the short run?
   b. How does the price level respond in the short run?
   c. Do real wages rise in the short run?

2. Consider the adjustment back to the medium run following the short run of Problem 1.
   a. How does the economy adjust back to the medium run in the AS-AD model?
   b. What is different in the new medium run (after the monetary expansion) and the original medium run?
   c. Why do we say that money is neutral in the medium run?

3. Suppose that the economy is in the medium run with money supply growing at 5 percent per year.
   a. What are the inflation rate and unemployment rate?
   b. If the Fed increases the growth rate of the money supply to 6 percent, how do inflation and unemployment change in the short run?
   c. Use the Phillips curve, Okun’s law and the AD relation to explain how the economy adjusts to the increase in the growth rate of the money supply.

4. Suppose the economy is in the medium run with a constant money supply and the world price of oil suddenly doubles.
a. Explain what happens in the short run if fiscal and monetary policies do not change.
b. How does this affect the medium run?
c. Suppose that the Fed responds by increasing the money supply. How does this affect output and the price level in the short run? How does it affect the interest rate and investment in the short run?

5. (short question) Use your answer to problem 4 to consider what happens if the money supply is initially growing at the 5 percent a year. How does the oil price increase affect inflation in the short run? In the medium run?

6. Suppose the economy starts in the medium run and consumer confidence suddenly declines.

a. Explain how output, interest rates and the price level respond in the short run.
b. Explain how a monetary expansion can bring output back to the natural level.
c. Explain how a fiscal expansion can bring output back to the natural level.
d. Compare the effects of a fiscal expansion to a monetary expansion in bringing the economy back to the natural level of output.

7. Repeat questions long answer questions 1 and 2 for a fiscal expansion.