

REVIEW QUESTIONS FOR CHAPTERS 32, 33, 34, 9, 10
NOTE THAT FINAL EXAM IS COMPREHENSIVE

CHAPTER 32

1. What are three advantages and disadvantages of expansionary fiscal policy?

Answer:

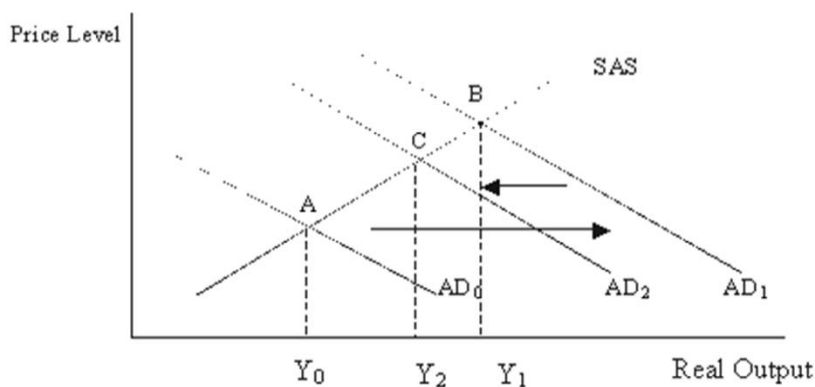
Three advantages of expansionary fiscal policy are: (1) Increases in spending may increase the welfare of those receiving government expenditures, (2) The economy may grow providing increased incomes, and (3) Increased demand may result in decreased unemployment.

Three disadvantages of expansionary fiscal policy are: (1) Government spending and taxes cannot be changed instantaneously, (2) Other goals may conflict with the goals of fiscal policy, and (3) Decision taking process might delay the initiation of the appropriate fiscal policy for months, or years.

2. What is the crowding out effect? Using the AS/AD model, demonstrate graphically and explain in words the impact of expansionary fiscal policy on the crowding out effect.

Answer:

The crowding out effect is the offsetting effect on private expenditures caused by the government's sale of bonds to finance expansionary fiscal policy. The initial equilibrium is point A where AD_0 intersects the SAS curve with an income of Y_0 . The government undertakes an expansionary fiscal policy by increasing spending. This shifts the AD curve outward to AD_1 and brings the multiplier effect into action resulting in a new equilibrium level of income of Y_1 . If the government finances the increase in spending by selling bonds this will drive up interest rates resulting in a drop in business investment. The drop in investment will shift the AD curve inward to AD_2 and result in a third equilibrium point C and an associated level of income of $Y_2 < Y_1$. Thus the amount of income shown by $(Y_1 - Y_2)$ is crowded out of the economy. The upshot: instead of moving from equilibrium point A to equilibrium point B (from Y_0 to Y_1) the economy moves to point C (Y_0 to Y_2); the change in income is smaller than the multiplier story suggests.



3. Explain the difference between *countercyclical* and *procyclical* policies. Provide an example of each.

Answer:

A countercyclical policy is a policy that is designed to offset changes in economic output. That is, if the economy is growing too quickly, a countercyclical policy will slow it. An example is income taxes. A procyclical policy is one that augments changes in economic output. That is, when the economy is growing quickly, this policy will make it grow even more quickly. An example is balanced budget requirements of the government.

4. Give an example of an automatic stabilizer and explain how it works.

Answer:

An automatic stabilizer includes any policy that will counterbalance the business cycle without requiring any new government action, such as welfare payments, unemployment insurance, and the income tax system. Income tax, for example, works as an automatic stabilizer because tax revenue fluctuates as income fluctuates. Therefore, when the economy expands, tax revenues rise to slow the economy and when the economy contracts, tax revenues decline to stimulate the economy.

CHAPTER 33

5. If trend growth is zero and if unemployment falls by 3%, by how much would you expect output to rise? (Use Okun's rule of thumb.)

Answer:

Okun's rule of thumb states that a 1 percentage point change in the unemployment rate will tend to be associated with a 2 percent deviation in output from its trend in the opposite direction. Based on Okun's rule of thumb, if unemployment falls by 3%, you would expect output to rise by 6% relative to its trend. That is, output would be expected to rise by 6%.

CHAPTER 34

6. Who wins and who loses when there is unexpected inflation? Explain and offer an example.

Answer:

When there is an unexpected inflation, those who do not or cannot raise their prices lose and those who do or can raise their prices gain. To see why consider an example. Suppose a worker enters into a contract with a firm to receive a 3% annual wage increase for the next three years. If inflation is greater than 3% in the next 3 years, the worker loses because she cannot change her wage. The firm wins because it can change the price of its output.

7. Explain the difference between the distributional effects of asset inflation from the distributional effects of goods inflation.

Answer:

The winners of any inflation are the people who can raise their price while still selling their goods, and the losers are people who have to pay that higher price. For goods inflation that means that the winners are people who can raise their wages or prices and still keep their jobs

or sell their goods. Because lenders and borrowers often enter into fixed nominal contracts, lenders often lose and borrowers gain in an inflation.

Asset price inflation benefits those people who own the assets whose price is rising, and hurts those who might want to buy that asset in the future. Since the people hurt do not directly experience the hurt, generally asset price inflation is seen as a societal benefit. It allows people to hold the illusion that society is richer when it is in fact, not “really” richer, other than the degree that thinking one is richer makes one richer.

8. Describe three different ways that people form expectations of inflation and give an example of each method.

Answer:

Three different ways that people form expectations of inflation are rational expectations, adaptive expectations, and extrapolative expectations.

Rational expectations are the expectations that the economists' model predicts. Thus if prices increased by 2 percent last year and 4 percent this year and the economists' model predicted a zero percent rate of inflation, then rational expectations would call for a zero percent rate of inflation. Information about past inflation rates would be ignored.

Adaptive expectations are expectations based in some way on information about inflation in the past. Thus if prices increased by 2 percent last year and 4 percent this year and the economists' model predicted a zero percent rate of inflation, then adaptive expectations would call for a 3 percent rate of inflation (or some other weighted average of past rates of inflation). The economists' model would be ignored.

Extrapolative expectations are expectations that a trend will accelerate. Thus if prices increased by 2 percent last year and 4 percent this year extrapolative expectations would predict an increase of greater than six percent rate of inflation since the rate of change will be increasing.

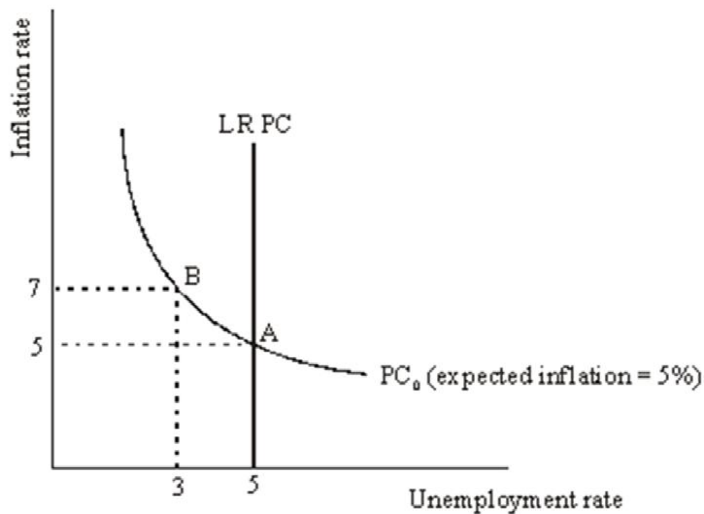
9. How is the quantity theory of money related to the equation of exchange? What are the implications of the quantity theory for dealing with inflation? Why do economists who believe in the quantity theory advocate monetary growth rules?

Answer:

The equation of exchange says that the quantity of money (M) times its velocity (V) equals the price level (P) times the quantity of real goods sold (Q). The quantity theory of money takes the equation of exchange and adds three assumptions to it. These assumptions are 1) velocity is constant; 2) real output is independent of the money supply; and 3) causation goes from MV to PQ. When the equation of exchange is combined with these three assumptions, we get the quantity theory that says that an increase in the money supply will always lead to a proportional increase in the price level.

The quantity theory of money holds that inflation is always and everywhere a monetary phenomenon. Therefore, economists who believe in the quantity theory of money do not favor an activist monetary policy. Instead they advocate monetary growth rules, in order to make certain that monetary policy is conducted without any political interference. They argue that the short-run effects of monetary policy are unpredictable, and the long-run effects of monetary policy are on the price level only, not on real output.

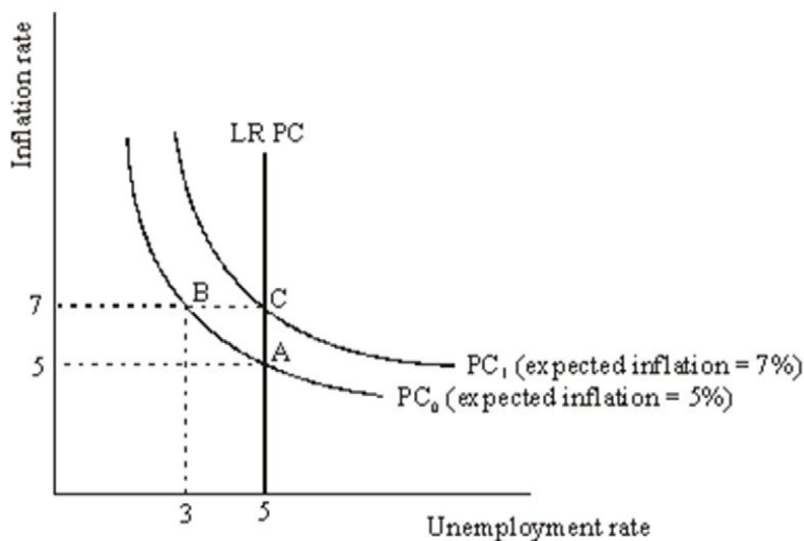
10. Consider the following Phillips curve diagram:



Suppose an expansionary monetary policy has moved the economy from point A to point B. Is point B a long-run equilibrium? If yes, explain why. If no, explain how the economy will get to new long-run equilibrium.

Answer:

Point B is not at long-run equilibrium because expectations of inflation are lower than actual inflation. Only points on the long-run PC are long-run equilibrium points. The key to the story of how the economy moves to a new long-run equilibrium is to recall that whenever actual and expected inflation are different the short run Phillips curve will shift. In this case (at point B on PC_0) expected inflation is 5% but actual inflation is 7%. Whenever actual inflation is greater than expected inflation the short-run PC will shift up. In this case to PC_1 (drawn for expected inflation of 7%). The economy will move from point B on PC_0 to point C on PC_1 . Point C is a new long-run equilibrium point.



CHAPTER 9

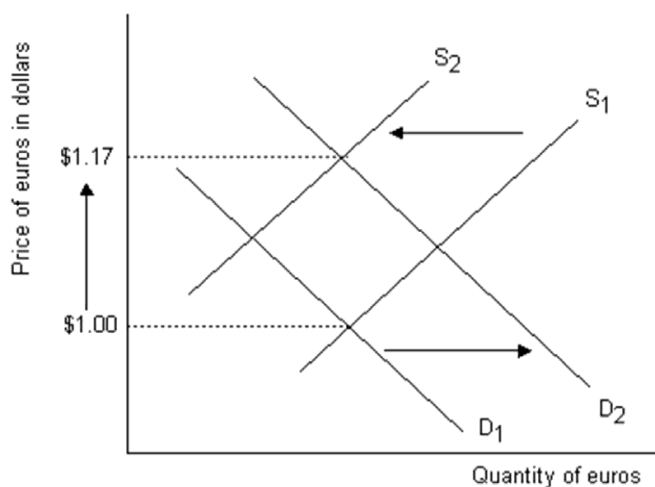
11. What is meant by the dollar-euro exchange rate? In what market is this rate determined? What factors will cause the dollar value of the euro to rise? What factors will cause the dollar value of the euro to fall?

Answer:

The dollar-euro exchange rate is the number of euros one must pay to purchase a dollar or vice versa. That exchange rate is determined in the foreign exchange market. The exchange rate between the dollar and the euro is determined by the demand and supply of both currencies, which in turn are determined by the amount of goods and assets that the U.S. and the EU exchange. For example, if Americans buy more goods from Europe, the demand for euros increases, and the dollar price of euros will rise. If Europeans wish to purchase more American stocks and bonds, the supply of euros will increase and the dollar price of the euro will fall.

12. Suppose as a result of a recession and falling interest rates in the United States, European investors buy fewer U.S. financial assets. Conversely, U.S. investors decide to buy more European stocks. Use supply/demand analysis to show graphically why the value of the euro relative to the dollar increases.

Answer: Europeans who no longer wanted to buy U.S. stocks, decrease their supply of euros from S_1 to S_2 . Americans who are now buying European stocks increased their demand for euros from D_1 to D_2 on the graph. Both forces raise the value of the euro relative to the dollar.



CHAPTER 10

13. Three policies used to restrict trade are: tariffs, quotas, and regulatory trade restrictions. Discuss each of these policies.

Answer:

1. A tariff is a tax imposed by the government on internationally traded goods. Tariffs are also known as custom duties. Tariffs affect the price of imported goods, which then affect the quantity demanded. In the case of a tariff, an increase in domestic demand will result in an increase in imports.

2. Quotas are quantity limits placed on imports. Quotas restrict quantities, which then affect the price. Unlike tariffs, where the government collects revenues, the government collects no revenues on quotas. The benefit of the increase in price due to a quota goes to the importer as additional revenue. In the case of a quota, an increase in domestic demand will not result in an increase in imports. It will simply push up the domestic price.

3. Regulatory trade restrictions refer to government imposed procedural rules that limit imports. For example the government might prohibit the import of vegetables from countries that use certain types of pesticides. Some of these are imposed for legitimate health reasons. Some are simply methods of reducing imports.

14. What are the six main methods used by governments to restrict trade?

Answer:

Governments have six main categories of methods for restricting trade: tariffs, quotas, voluntary restraint agreements, sanctions, regulatory trade restrictions, and nationalistic appeals.

15. Define tariffs and quotas, and explain the similarities and differences between them.

Answer:

A tariff is a tax imposed by the government on internationally traded goods. They are also known as custom duties. Quotas are quantity limits placed on imports. Both methods have the same effect in terms of limiting trade. However, the mechanism of restricting trade differs. Tariffs affect the price of imported goods, which then affect the quantity demanded. Quotas restrict quantities, which then affect the price. The main difference between the two methods is who benefits from the restrictions. In the case of tariffs, the government collects tariff revenues. In the case of quotas, the government collects no revenues. The benefit of the increase in price goes to the importer as additional revenue.