Review for Midterm 3

Practice questions

For the next midterm, it is essential that you are able to manipulate the AS/AD and associated IS and LM curves to determine how changes in exogenous variables affect the equilibrium output, price and interest rate levels.

For the IS/LM model, use

\[
\text{LM: } \frac{M}{P} = m + l(r + \pi) + dY, \ l < 0, \ d > 0
\]

\[
\text{IS: } Y = A + cY + br + G + NX, \ c > 0, \ b < 0
\]

Note: \( A, G, M, P, NX \) and \( \pi \) are exogenous. There are no taxes.

1. Suppose that \( G \) decreases. Which of the following best describes the equilibrium effects of the change, using the AD/AS model with flexible prices and flexible nominal wages?

a. \( Y \) will increase, \( r \) will increase, \( P \) will increase.

b. \( Y \) will not change, \( r \) will increase, \( P \) will increase.

c. \( Y \) will increase, \( r \) will not change, \( P \) will not change.

d. \( Y \) will not change, \( r \) will decrease, \( P \) will decrease,
2. For the aggregate production function \( Y = AF(K, L) \), suppose that \( A \) is increased. (Recall that \( K \) is exogenous in the short run). Which of the following best describes the equilibrium effects of the change, using the AD/AS model with flexible prices and fixed real wages? Assume the real wage level is fixed at a high enough level that it is above the market clearing level both before and after the change in \( A \)

a. \( Y \) will increase, \( r \) will decrease, \( P \) will decrease.

b. \( Y \) will decrease, \( r \) will decrease, \( P \) will decrease

c. \( Y \) will increase, but one cannot tell whether \( r \) and \( P \) will increase or decrease.

d. \( Y \) will not change, \( r \) will decrease, \( P \) will increase,

**Concepts**

The following are among the concepts you will want to understand for the midterm; if a concept is associated with a formula, you should know the formula as well. (Note: I do not expect you to be able to remember the formulas for the expected value, variance and covariance, however, I do expect you to understand what these mean and how to interpret formulas such as CAPM that employ them).

Aggregate demand

Aggregate production function

Aggregate supply

Capital Asset Pricing Model (CAPM)

Classical unemployment

Covariance

Dividends

Expectations-based term structure of interest rates

Expected return

Expected value
Exports
Holding return
Imports
Keynesian unemployment
K-period bond
Law of one price
Long term interest rates
Net Capital Outflows
Nominal exchange rates
Nominal wage flexibility
Nominal wage rigidity
Price flexibility
Price rigidity
Purchasing power parity
Random walk theory of stock prices
Real Exchange Rates
Real wage flexibility
Real wage rigidity
Risk free asset
Risk neutrality
Risk premium
Short side rule
Stock price
Term structure of interest rates
Variance
Yield
Yield curve