Some repetition questions in macroeconomics

Robert M. Kunst

January 23, 2017

1. Explain the difference between the closed and the open economy IS curves. Which curve is steeper? Explain both in words and with reference to equations why this must be the case. [10.1]

2. Explain the sense in which an improvement in price competitiveness (a depreciation) might be considered a 'good thing' for the economy. Might it also be considered a 'bad thing'? [9.1]

3. Answer the following questions about the supply and demand sides in the medium-run model:

   (a) What does the ERU curve represent? What happens to the ERU curve if unemployment benefits are raised? What would you expect to happen to inflation?

   (b) What does the AD curve represent?

   (c) How does a rise in the world interest rate r^* affect the AD curve? What is the effect on the medium-run real exchange rate? [9.2]

4. In a small open economy, is a negative supply shock or a negative demand shock more damaging for medium-run output? Explain in words and using the AD-ERU diagram. In particular, describe the effects of an increase in unemployment benefits (a supply shock) on the real wage, on unemployment and on the real exchange rate. [9.4]

5. Is the following statement true or false? Explain your answer. 'Central banks have to be more aggressive when making interest rate changes in the open economy, as the IS curve is steeper than in the close economy.' (see also question 1) [9.6]

6. Does the problem of moral hazard indicate that insolvent bank should not be rescued? Justify your answer. [6.1]

7. Imagine an investment bank that has equity of 10 and operates in an economy where risk is 0.15, the policy rate is 0, the rate of return on financial assets is 0.05 and the price of financial assets is 1. Use the role model to answer the questions: [6.8]

   (a) How many financial assets does the investment bank hold in period 0? What is their leverage?

   (b) In period 1, risk falls to 0.04 and price of financial assets rises to 1.03. What happens to the investment bank's leverage and holdings of financial assets?

   (c) In period 2, the bank marks to market their financial assets. How much does this increase their equity? How many financial assets do they hold at the end of period 2?

   (d) In the next period, risk rises again to its original level. Calculate how much asset prices have to fall to bankrupt the investment bank.

8. Why do saver households not directly lend to borrower households? How can banks help solve this problem? [5.1]

9. What are the key differences between the way that monetary policy works in the 3–equation model without and with banks? Does this change the policy implemented by central banks following economic shocks? [5.9]

10. Following an inflation shock, explain why unemployment goes up before the economy returns to its medium-run equilibrium. [3.6]