Some repetition questions and tentative answers in macroeconomics

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1. **Q** Why do saver households not directly lend to borrower households? How can banks help solve this problem? [5.1] **A** There are difficulties with coordinating saving and credits. Savers (=lenders) may not be able to find matching borrowers. There may also be many individual savers with small saving accounts, but few big borrowers who wish to finance major projects. The savers may also wish to keep their assets safely in a tank for some years or even a decade, whereas the borrowers may need their credits fast and wish to pay them back after less than a year. Banks serve as coordinators (=intermediaries).

2. **Q** 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] **A** There is now more than one interest rate, one interest rate for deposits and a higher one for credits. They differ by a banking mark-up. A simplification in the model is to equate the interest on deposits and the policy rate. In fact, all three rates may differ in reality. The only major effect on monetary policy is that the banking mark-up may be affected by the economic shock. If the mark-up increases, the central bank may set their policy rate at a lower value, such that output can return to its equilibrium.

3. **Q** Following an inflation shock, explain why unemployment goes up before the economy returns to its medium-run equilibrium. [3.6] **A** This can best be explained in the diagram with the MR curve and the Phillips curve. The inflation shock pushes the Phillips curve up, as the realized inflation also affects expected inflation, and expected inflation determines the position of the Phillips curve. On the new Phillips curve, there is a point where the curve and the MR curve

intersect. It is to the southwest, as on our slide 3:16. Thus, the central bank increases the interest rate in order to establish a lower output, they create a recession. In this recession, the unemployment rate rises above its 'natural' level. The lower output and inflation at the new target push down the Phillips curve, and the economy returns slowly to the old equilibrium. The medium-run equilibrium has not changed in this experiment.