For Exam #2

• Coverage: Chapters 7 – 9, 12.

• Format:
  ➢ 10 multiple choice questions.
  ➢ 1 long question on the IS – LM Model or IS – LM & AD – AS Models.
  ➢ 1 long question on the DAD – SAS Model.

For Exam #2

• Time:
  ➢ Exam will start as close to 3:40 p.m. as possible.
  ➢ The exam will finish promptly at 5:00 p.m.

• Exam Packet is completely self-contained.
  ➢ No blue books are needed.

• No books, notes, or electronic devices.
  ➢ Foreign language dictionaries MUST be examined by me.

For Exam #2

• You will need a set of colored pens or pencils.
  ➢ Black or pencil.
  ➢ Red
  ➢ Blue
  ➢ Green

Point of Clarification

• Wealth Effect and the Demand for Money:
  ➢ Changes in wealth do affect the demand for money.
  ➢ However, statistically the effect is so small that we ignore it.
Topics for the Exam

• Three models:
  - The IS – LM – FE model.
  - The AD – AS – LRAS model.
  - The DAD – SRAS – LRAS model.

Topics for the Exam

• Other topics:
  - Money and asset markets.
  - Business cycles.
  - The Phillips Curve.
  - Costs and benefits of unemployment and inflation.

The IS – LM – FE Model

• Focuses on output and the real interest rate.
  - The IS curve represents equilibrium in the goods market.
  - The LM curve represents equilibrium in the money market.
  - The FE line represents equilibrium in the labor market.

The FE Line

• Factors that shift the FE line:
  - The FE line shifts to the right because of:
    - A beneficial supply shock,
    - An increase in labor supply, and/or
    - An increase in the capital stock.
The IS Curve

- Factors that shift the IS curve:
  - The IS curve shifts to the right because of:
    - An increase in expected future output,
    - An increase in wealth,
    - An increase in government purchases,

The IS Curve

- Factors that shift the IS curve:
  - The IS curve shifts to the right because of:
    - A decline in taxes,
      - If Ricardian equivalence does not hold
    - An increase in the expected future marginal product of capital, and/or
    - A decrease in the effective tax rate on capital.

The LM Curve

- Factors that shift the LM curve:
  - The LM curve shifts to the right because of:
    - An increase in the nominal money supply,
    - A decrease in the price level,
    - An increase in expected inflation,
    - A decrease in the nominal interest rate on money,

The LM Curve

- Factors that shift the LM curve:
  - The LM curve shifts to the right because of:
    - A decrease in wealth (which we will ignore),
    - A decrease in the riskiness of non-money assets,
    - An increase in the liquidity of non-money assets, and/or
    - An increase in the efficiency of payment technologies.
The IS – LM – FE Model

• What you need to know:
  ➢ Factors that shift the curves.
  ➢ The adjustment process.
  ➢ The composition of output.

The AD – AS – LRAS Model

• Focuses on output and the price level.
  ➢ The AD curve represents equilibrium in both the goods market and the money market.
  ➢ The AS curve indicates how the aggregate price level is set in the economy.
  ➢ The LRAS line represents equilibrium in the labor market.

The AD Curve

• Factors that shift the AD curve:
  ➢ The AD curve shifts to the right because of:
    • Any factor that shifts the IS curve to the right, and/or
    • Any factor that shifts the LM curve to the right.

The AS Curve

• Factors that shift the AS curve:
  ➢ The AS curve shifts up because of:
    • Excess demand in the prior time period, and/or
    • Increased costs of production (that cause higher prices).
      – Exogenous increases in wages,
      – Increases in commodity and/or imported goods prices,
      – Decreases in the foreign exchange value of the currency,
        and/or
      – Decreases in productivity.
<table>
<thead>
<tr>
<th>The LRAS Curve</th>
<th>The AD – AS – LRAS Model</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Factors that shift the LRAS curve:</strong></td>
<td><strong>What you need to know:</strong></td>
</tr>
<tr>
<td>➢ The LRAS curve shifts right because of:</td>
<td>➢ Factors that shift the curves.</td>
</tr>
<tr>
<td>➢ Increases in productivity,</td>
<td>➢ The adjustment process.</td>
</tr>
<tr>
<td>➢ Increases in labor supply, and/or</td>
<td>➢ The composition of output.</td>
</tr>
<tr>
<td>➢ Increases in the capital stock</td>
<td></td>
</tr>
<tr>
<td>➢ that increase the full-employment level of output.</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>The DAD – SRAS – LRAS Model</th>
<th>The DAD Curve</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Focuses on output and inflation.</strong></td>
<td><strong>Factors that shift the DAD curve:</strong></td>
</tr>
<tr>
<td>➢ The DAD curve represents equilibrium in both the goods market and the money market.</td>
<td>➢ The DAD curve shifts to the right because of:</td>
</tr>
<tr>
<td>➢ The SRAS curve indicates how inflation is determined in the economy.</td>
<td>➢ Any factor that shifts the IS curve to the right, and/or</td>
</tr>
<tr>
<td>➢ The LRAS line represents equilibrium in the labor market.</td>
<td>➢ Any factor that shifts the LM curve to the right.</td>
</tr>
</tbody>
</table>
The SRAS Curve

- Factors that shift the SRAS curve:
  - The SRAS curve shifts up because of:
    - Excess demand in the prior time period, and/or
    - Increased costs of production (that cause higher prices).
      - Exogenous increases in wages,
      - Increases in commodity and/or imported goods prices,
      - Decreases in the foreign exchange value of the currency, and/or
      - Decreases in productivity.

The LRAS Curve

- Factors that shift the LRAS curve:
  - The LRAS curve shifts right because of:
    - Increases in productivity,
    - Increases in labor supply, and/or
    - Increases in the capital stock
    - that increase the full-employment level of output.

The DAD – SRAS – LRAS Model

- What you need to know:
  - Factors that shift the curves.
  - The adjustment process.
  - The composition of output.

The Phillips Curve

- Focuses on unemployment and inflation.
  - The “simple” Phillips curve versus the “expectations-augmented” Phillips curve.
  - Factors that shift the Phillips curve to the right:
    - A higher expected inflation rate, and/or
    - A higher natural rate of unemployment.