**ECO 304L Exam 3 Study Guide (11am)**

**You will find questions on the exam relating to the media shown in class and used for Kahoots!**

**Exam:** Tuesday April 23rd, 11am-12:15pm in-class (JESS A121A)

**Please bring a pencil, an eraser and your ID card and arrive by 10:40am.**

**FAQs**

**What is the exam worth?** 240 points (24%).

**What is the exam format?** 32 multiple choice and 8 short answer questions each worth 1 point. You will get a score /40, scaled to a score /240 when grades are uploaded to Canvas.

Partial credit is available for short answer questions if your answer is wrong but you explain your reasoning/working.

**What chapters are covered?** Chapters 16-20.

**What materials are authorised?** This is a closed book, closed notes exam. You may use a physical calculator but may not use a cell phone or any other electronic device during the exam.

**Is there a sample exam?** You will find sample exam files for chapters 16-20 on Canvas, each with approximately 50 questions.

**If you miss exam 3, the final (cumulative) exam becomes mandatory.**

**How does the 3 skips rule work?** Skip any 3 questions – short answer or multiple choice. These are counted as correct. If you don’t skip 3 questions, i.e. choose to answer all 40 questions, they are graded as per normal.

**What’s the best way to prepare for the exam?**

1. Watch the lecture recording for each chapter. Go to Canvas, scroll down to Lectures Online (near the bottom).

2. Take the IQ quizzes in review mode.

3. Attempt the end-of-chapter questions.

4. Attempt the sample exam questions.

5. Attend the Supplementary Instruction sessions

6. Attend office hours if you need help. You can find the days/times for each TA on Canvas (click Modules, click office hours at the top).

My availability is Tuesday 4/16 and Thursday 4/18, 1pm-4pm (BRB 2.102).

**Chapter 16: Fiscal Policy**

**Expansionary fiscal policy**: increases in spending or decreases in taxes to stimulate the economy.

**Contractionary fiscal policy**: decreases in spending or increases in taxes to slow down the economy.

You should be able to illustrate both policies.

Impact of the Great Recession on fiscal policy: massive increases in government spending & increases in budget deficits.

Countercyclical fiscal policy: aim is to minimize business cycle fluctuations.

**Multipliers**: accentuate any increases in spending

* MPC: ∆C / ∆Y
* Spending multiplier: 1/(1-MPC)
* Allows us to determine the effect on spending from an initial change

**Shortcomings of Fiscal Policy**

1. Time lags: recognition, implementation, impact
2. Crowding-out: increase in government spending leads to higher IR & private spending falls

**Automatic Stabilizers**: inbuilt mechanisms that naturally implement countercyclical fiscal policy in response to economic conditions, e.g. progressive income tax (higher revenue during an economic boom); welfare programs (higher spending during a recession).

**Supply-Side Fiscal Policy:** use of government spending & taxes to affect the production (supply) side of the economy. Targets the LRAS.

The concept of the Laffer Curve comes from supply-side fiscal policy.

**Fiscal Policy During COVID-19**

* The recession involved leftward shifts of the SRAS & LRAS and AD.
* The government used demand-side policies, e.g. direct payments & unemployment compensation and supply-side policies, e.g. grants, loans & aid to various small businesses, hospitals, governments & airlines.
* Aim was to shift AD, SRAS & LRAS curves back to the right

**Chapter 17: Money and the Federal Reserve**

Definition of money

Functions of money:

1. medium of exchange
2. unit of account
3. store of value

Fiat (paper) money is backed by trust & confidence

Problems with fiat money: wears out, counterfeiting, hyperinflation from too much printing

**Fractional Reserve Banking**

* Banks hold a fraction of deposits as reserves; the rest is lent out to make money.
* Moral Hazard & the FDIC: 9,000 banks collapsed during the Great Depression.
* 1933: Federal deposit insurance was brought in.
* Aim: increase bank stability, decrease bank runs.
* Created a moral hazard problem: banks have less incentive to guard against risk.
* Case study: collapse of the Silicon Valley Bank.

**How Banks Create Money**

* Simple Money Multiplier: 1/Required Reserve Ratio
* Allows us to work out the maximum impact on money supply.

**Roles of the Federal Reserve**

* Acts as a bank for the banks & a lender of last resort.

**Monetary Policy Tools**

1. Open Market Operations: buying/selling of treasury bonds. Quantitative easing started in 2008
2. Discount window including special lending facilities. Expanded in size & scope since Great Recession
3. Interest on excess reserves. Started in 2008. Fed can stimulate (slowdown) the economy by decreasing (increasing) the IORB.
4. Reserve requirements

**Chapter 18: Monetary Policy**

Changes in interest rates affect 3 components of AD: C, I, NX

**Expansionary Monetary Policy**

* Done through open market purchases: MS rises, IR falls, I rises, AD curve shifts right.
* Be able to illustrate short-run effects: Y rises, U falls, P rises.
* Monetary policy can have real effects on output & employment in the short-run.
* In the long-run, new money devalues the entire money supply through inflation.
* The real effect of monetary policy disappear.
* The only change is higher prices.

**Unexpected Inflation Hurts Some People**

If inflation is **higher** than expected:

1. Input suppliers that have sticky prices
2. Workers who signed wage contracts

If inflation is **lower** than expected:

1. Demanders who signed a fixed-price contract
2. Employers who create wage contracts

**Contractionary Monetary Policy**

* Usually done to curb potential inflation.
* Done through open market sales: MS falls, IR rises, I falls, AD curve shifts left.
* Be able to illustrate short-run effects: Y falls, U rises, P falls.

The huge decline in MS between 1931-33 was a major contributing factor to the Great Depression.

**Shortcomings of Monetary Policy**

1. Diminished effects in the long-run.
2. Effects are reduced by people’s expectations.

**Money neutrality**: money supply does not affect real economic variables (in the long run).

Illustrate expansionary monetary policy in the long-run: no change in Y, no change in U, P rises.

When monetary policy is completed expected, there are no real effects even in the short-run (only effect is inflation).

**Aggregate Supply Shifts**

* During the Great Recession, the LRAS & AD curves both shifted to the left.
* Monetary Policy targeted both curves: crisis era policy focused on targeted lending to specific firms & industries.

**Chapter 19: International Trade**

What do we mean by globalization?

Factors driving globalization.

**Trends in U.S. Trade**

* Goods & Services (typically in deficit); goods (typically in deficit); services (typically in surplus)

**Comparative Advantage**

* Based on opportunity cost; leads to specialization & trade

**Gains From Trade**

* Illustrate gains from trade & calculate opportunity cost
* Other advantages of trade: economies of scale; increased competition

**Protectionism**

* The most common measures are tariffs (taxes on imports) & import quotas (quantity restrictions).
* Explain & illustrate effects of both.

**Reasons Given for Trade Barriers**

1. National security
2. Infant industry argument
3. Retaliation for dumping

**Chapter 20: International Finance**

Define nominal exchange rate.

Explain what is meant by appreciation/depreciation & be able to calculate changes in price.

**Demand for Foreign Currency**

1. Exchange rate (price) of the currency: leads to a movement along the curve.
2. Demand for foreign goods & services (shift).
3. Demand for foreign financial assets (shift).

Be able to illustrate this.

**Supply of Foreign Currency**

* Supply curve is vertical.
* Government can increase or decrease the money supply, leads to shifts of the supply curve.

Be able to illustrate how demand/supply shifts affect the exchange rate.

**Exchange rate manipulation**

* Some countries devalue their currency to make their exports cheaper, to increase AD.

**Purchasing Power Parity**

* Law of one price: define, explain & calculate.

**Balance of Payments**

* Current account: goods & services, current income from investments & gifts. Often in deficit.
* Capital account: payments for real & financial assets between nations. Often in surplus.
* Current account balance + capital account balance must sum to zero.

**What Causes Trade Deficits?**

1. Strong economic growth
2. Lower personal saving
3. Budget deficits