

Mid Term Exam

Econ. 116b

March 7, 2007

75 MINUTES (one point per minute)

ANSWER EACH PART IN A SEPARATE BLUE BOOK

(28 minutes—4 minutes each)

I. Answer True/False/Uncertain. Explain your answers. No credit without explanation.

1. If the Fed announces today that it is going to raise the short term interest rate three months from now (but do nothing until that time) and if this announcement is a surprise, long term interest rates will rise immediately.
2. The aggregate demand curve is the sum of all market demand curves in the economy.
3. A low ratio of inventories to sales is generally good for the future course of the economy.
4. In terms of increasing real output, fiscal policy is more effective when the AS curve is fairly flat and monetary policy is more effective when the AS curve is fairly steep.
5. Fixed weight price indices, like the consumer price index, are biased upward.
6. A government announcement that the unemployment rate was smaller than the market expected will always lead to an increase in stock prices.
7. In principle the effect on real output of a government spending increase can be made zero if the Fed increases the interest rate enough, thus making the government spending multiplier zero.

(28 minutes—7 minutes each)

II. Answer each of the following questions in the time allowed.

1. Investment of firms fell in 2001 even though the Fed lowered interest rates substantially. How can this happen? Does it mean that interest rates have no effect on investment? The response of investment to output changes varies over the business cycle. Why?
2. If the value of stocks in the United States falls permanently by 2 trillion, what roughly are the likely quantitative effects on the U.S. economy in the future? Assume that people have a horizon of 20 years, that the multiplier is 1.4, and that U.S. GDP is 14 trillion. What would this fall likely do to labor supply in the future and why? What would be the likely response of the Fed to this fall?
3. Discuss three reasons why unemployment beyond frictional and structural unemployment might exist—i.e., cyclical unemployment. Discuss one argument why cyclical unemployment might not exist even though measured unemployment fluctuates substantially.
4. Each point on the AD curve reflects equilibrium in the IS-LM model for the given value of the price level, P . Explain carefully why the (equilibrium) interest rate decreases as one moves down the AD curve. How does M^d , the nominal demand for money, change as one moves down the AD curve and why? How does investment change and why?

(19 minutes)

III. Answer the following question in the time allowed.

1. ASIMO is a small, closed economy defined by the following equations:

$$C = 300 + 0.8(Y - T) - 500r$$

$$I = 400$$

$$T = 100$$

$$G = 80$$

$$\frac{M^d}{P} = 0.5Y - 250r$$

$$M^s = 10000$$

$$M^s = M^d$$

$$Y = C + I + G$$

Throughout the question, we will limit ourselves to short-run analysis and set $P = 10$.

- (a) Find equilibrium Y and r .
- (b) Suppose the central bank of ASIMO decides to perform an open market purchase of 250 in securities. If the reserve requirement ratio is 0.10, what is the new equilibrium Y and r ? (Hint: you only need to redo half of the algebra from part (a).) What happens to the AD curve in this case?
- (c) Going back to the original set of equations in part (a), suppose the government of ASIMO increases its spending by 100. Find the new equilibrium Y and r . This is related to the “crowding-out effect.” Explain the crowding-out effect. Make sure your answer is specific to the model in this problem.