

## Mid Term Exam

Econ. 116b

March 5, 2008

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. The fact that firms may at times have idle capacity—excess labor and excess capital—implies that productivity fluctuates with output.
2. In the standard AS/AD model, an increase in government spending leads to an increase in output and a decrease in investment.
3. The further down we move along the AD curve, the lower is the equilibrium value of the interest rate.
4. An increase in the price of David Hasselhoff's CDs, which are produced in the United States for export only, will lead to an increase in the GDP deflator but not the CPI.
5. In the National Income and Product Accounts it is always the case that GDP equals consumption plus investment plus government spending plus net exports. So according to these accounts, the economy is always in equilibrium.
6. If taxes go from being proportional ( $T = tY$ ) to being progressive (for example  $T = t_0Y + t_1Y^2$ , where  $t_1 > 0$ ), the multiplier effect on output from a government spending increase will become larger.
7. Consider a consol that pays \$100 per year forever. If people change their expectations about the one year interest rate that will exist five years from now but don't change their expectations about the current one year interest rate, this will not change the current price of the consol.

(30 minutes—6 minutes each)

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

1. If there are no supply shocks, as was roughly the case in the 1960s, why would you expect the Phillips Curve to be fairly stable? What would the Phillips Curve look like if there were only demand shocks, and would it also be fairly stable?
2. If at the next FOMC meeting Bernanke announces an interest rate cut that is larger than expected, saying that he does not think inflation is going to be a problem and he wants to stimulate the economy. Do you expect long term bond rates to go up or down in this case and why? Do you expect stock prices to go up or down and why? Explain carefully. Would this have any effect on the Knicks?
3. If the Federal government wants to run a deficit and does not want the money supply to increase, can this happen and how? Can the Federal government increase its deficit and not have the interest rate increase and how?
4. If you had to explain to your mother or father what the rough effects would be on GDP if the stock-market wealth dropped 5 trillion dollars and this drop was expected to be permanent, what rough calculations would you make? Assume that GDP is 14 trillion dollars. Explain what you are assuming as you answer this. (There is no one right answer. Just be consistent given your assumptions.) What would be the likely effects on the price level and the interest rate?
5. Roughly, how is the unemployment rate measured? Some have said it overestimates true unemployment and some have said it underestimates true unemployment. What are these arguments?

(17 minutes)

III. Answer the following question in the time allowed.

1. At the current time Bernanke is lowering the interest rate and Bush (and Congress) are soon to increase transfer payments. At the same time there are large increases taking place in oil prices and other commodity prices. Answer the following question using the standard AS/AD model we had in class. Assume that  $M$  is increased (Bernanke doing his thing),  $TR$  is increased (Bush doing his thing), and the price of imports  $PM$  is increased (costs shocks from oil and other commodities). Since the AS/AD model is static, we are in effect assuming that these changes are permanent. (So the  $TR$  change is assumed to be permanent even though it will not be in practice.) Using the AS/AD framework, examine the effects on the economy of these three changes all happening at the same time. What are the effects on output  $Y$ , the price level  $P$ , the interest rate  $r$ , consumption  $C$ , investment  $I$ , and the demand for money  $M^d$ ? Explain your answer for each variable. Which effects are unambiguous? Is it possible that stagflation could result from these three changes?