Mid Term Exam

Econ. 116
October 17, 2017

75 MINUTES (one point per minute)
ANSWER EACH PART IN A SEPARATE BLUE BOOK—3 BOOKS TOTAL

(24 minutes—6 minutes each)
Part I. Answer each of the following questions.

1. In the Goldsmith story is there a limit on how much the Goldsmith can lend to the public (i.e., lend pieces of non counterfeitable paper that promise that the pieces of paper can be exchanged for gold if desired)? Explain. In modern times, what limits the amount that commercial banks can lend?

2. Labor markets don't always seem to be in equilibrium (i.e., the quantity of labor demanded does not always seem to be equal to the quantity of labor supplied). What are some of the arguments as to why this might be so? In other words, why is the labor market not like the apple market?

3. Say you won a lottery that pays \$10 million five years from now (and nothing before five years). Say you want to sell this promise to someone else today. Explain why the price that the person would be willing to pay you depends on the value of the interest rate. Give the intuition. If the interest rate were zero, what would be the price?

4. What caused the high inflation rates in the 1970's? Why has inflation been low so far in your lifetime?

(28 minutes—7 minutes each)
Part II. Answer each of the following questions.

1. Consider the AS/AD model with the investment equation dropped—I is exogenous. Say there is an increase in the price of imports, PM, which is the exogenous cost shock variable in the model. What effects will this have on the price level, P, the interest rate, r, consumption, C, and output, Y? In other words, will each of these variables increase or decrease and why?

2. Consider the full AS/AD model, but where in the Fed rule the coefficient on output, Y, is zero, but the coeffiient on the price level, P, is not zero. In other words, the Fed does not change the interest rate when output changes, but it does change the interest rate when the price level changes. In this case, when government spending, G, increases, is the increase in Y larger or smaller than it would be in the case where the coefficient on output in the Fed rule is positive (the normal case). In other words, how is the govenment spending multiplier affected when the Fed does not respond to output changes in its setting of the interest rate? Explain.

3. It was announced last Friday that social security benefits will increase by 2 percent next year. (Good news for Professor Fair!) Using the full AS/AD model, what effect will this have on output, Y, consumption, C, the price level, P, and the interest rate r? Explain why each variable will increase or decrease.

4. Given current data on the one year interest rate and the two year interest rate, what main assumption is necessary to allow one to back out the expected one year interest rate a year from now? Under this assumption, if the current two year rate is greater than the current one year rate, how will the expected one year rate a year from now compare to these two? (All interest rates are taken to be at annual rates.)

(23 minutes)
Part III. Answer each of the following questions in the time allowed.

1. (6 minutes) What was the Fed trying to accomplish when it began buying mortgage-backed securities in 2008? What effect does this have on the Fed's balance sheet (both sides)? On the money supply?

2. (7 minutes) What was one of the main causes of the boom in the economy in the last half of the 1990's? What was one of the main causes of the recession of 2008–2009? How are these two related? (Hint: think wealth effects.)

3. (10 minutes) The three agents in macro are households, firms, and the government (inclusive of the Fed). What has this class assumed so far about the behavior of each? Explain briefly the theory behind each behavioral equation (in the AS/AD model).