Final Exam, Fall 2010

Part I. Material Since the Second Midterm (67 points total; 45 minutes total)

Question 1 (15 points total; 10 minutes total)
a.   (10 points) Why does the monetary policy reaction function slope up?
b.   (5 points) On November 3, the Fed announced its plan to purchase $600 billion in medium-term Treasury bonds. Will their purchases shift the MPRF, move the economy along the MPRF, or have no effect whatsoever on the MPRF? Briefly explain your answer.

Question 2 (14 points total; 9 minutes total)
a.   (6 points) Why does the Phillips curve slope down?
b.   (2 points) List the 5 aspects of *Animal Spirits* from the book by Akerlof and Shiller. (Just a list, no definitions.)
c.   (6 points) Choose any one aspect of "animal spirits" and discuss how it relates to the Phillips curve.

Question 3 (30 points total; 20 minutes total)
Suppose the economy can be described by the following:

Fed's target inflation rate = 3%	MPE = 0.6	$u^* = 5\%$
initial expected inflation rate = 3%	$A_0 = 4{,}700$	$Y^* = 10{,}000$
	$I_r = 35{,}000$	supply shocks = 0
$r_\pi = 0.8$	$X_\varepsilon \varepsilon_r = 15{,}000$	$\beta = 1/2$
$r_0 = 2\%$		

a.   (10 points) Suppose expectations are static. What are the sticky-price equilibrium values of the inflation rate and the unemployment rate? Show your work, or no points. If you can't solve this without a calculator (tsk tsk), set it up and go as far as you can to get as much partial credit as possible.

b.   (4 points) Now suppose autonomous expenditure drops to 3,800. Will the new equilibrium value of unemployment be higher or lower or the same as your answer in part (a)? Will the new equilibrium value of inflation be higher or lower or the same as your answer in part (a)? (**No need to calculate the new equilibrium values**.) Justify your answers.

c.   (4 points) Draw and label a graph at the right that depicts part (a) and then part (b).

d.   (8 points) Think about the real world and today's economy. Assume there is no further fiscal policy. If parts (a) and (b) describe what happened between 2007 and 2009, would you expect the economy to remain at the new part (b) equilibrium? Or would you expect the unemployment and inflation rates to continue changing? Explain your answer.

Question 4 (8 points; 5 minutes)
Suppose that the MPRF and PC are both non-linear. Prices are much more flexible when unemployment is low than when unemployment is high. When price flexibility is very high, the Fed is very hawkish. When prices are particularly sticky, the Fed is more dovish. Draw these MPRF and PC at the right. Briefly (one sentence for each curve) explain your graph.

Part II. Material From the Entire Course (75 points total; 50 minutes total)
Question 5 (14 points total; 9 minutes total)
Robert Reich recently wrote "This is not a recovery. It's a continuing jobs emergency."
a.   (7 points) What does it mean for the economy to be in recovery?
b.   (7 points) Why doesn't the unemployment rate consistently fall when the economy is in recovery?

Question 6 (20 points total; 13 minutes total)
a.   (7 points) Why is the growth rate of efficiency so very important for long-run economic growth?
b.   (7 points) Give one example of an event (hypothetical or, even better, historical) that can increase efficiency and briefly explain why it affects efficiency.
c.   (6 points) Re-read your answer to part (b). Is your example about increasing efficiency or increasing the growth rate of efficiency? Explain.

Question 7 (12 points; 8 minutes)
Last week President Obama and the Republican Congressional leadership announced a plan to extend the Bush Tax Cuts, adding about $800 billion to federal debt. And also last week, China announced its inflation rate has increased, a development that China's central bank is expected to fight. Why were analysts not at all surprised that long-term interest rates increased after hearing this news?

Question 8 (27 points total; 18 minutes total)
Suppose American consumers embrace a new ethic of thrift, permanently increasing household saving rates.

a.   (10 points) In the long run, what effect will this new consumer behavior have on real interest rates? Why? Supplement your answer with a graph.

b.   (10 points) From generation to generation, what effect will this new consumer behavior have on the standard of living? Why? Supplement your answer with a graph.

c.   (7 points) Will this new consumer behavior help the economy return to full employment? Why?

Part III. Comprehensive Essay Question (60 points total; 60 minutes total)

It's a frustrating time to be an economist. Things that you thought were pretty straightforward – monetary policy is not the same thing as fiscal policy, spending less is not a way to generate jobs – are not agreed-upon basics anymore. Time for someone with a good, strong background in economics – *that'd be you!* – to write a good, clear article that clears everything up. That's your task.

The key question to address in your article is: Will reducing the federal budget deficit help the economy? What *can* help the economy?

Write for an audience of reasonably smart but uninformed people. Your article should help them understand today's economy (so be sure you're not just talking in generalities) but also should help them understand the unique characteristics of today's economy (so be sure you talk about the general norm).

To help you set this up, here's a suggested outline. You can change the outline if you wish. But it's a good idea to at least cover the points below.

- Set the stage. How is the U.S. economy doing? Unemployment? GDP growth? Inflation? Any other indicators you want to mention? Put today in some context historically.

- Give some background. What are the usual ways that fiscal and monetary policies are used to help an economy that's in the shape ours is in?

- Address the primary question. Will reducing the federal budget deficit help the economy?

- Bring in other topics. What about monetary policy? How can it be used to help today's economy? And what is this "QE2"?

- Any other topics you want to discuss?

- Long-run versus short-run considerations. Are the conclusions we draw about the impact of fiscal or monetary policy the same in both the short run and the long run?

- Make a recommendation. End your article with a clear statement of what problem should be solved, why it should be solved, and what steps you recommend be taken to solve the problem. (This should be a logical summary of the analysis in the previous part of your article.)

Once you're done, you can submit your article to your home town newspaper as an op-ed piece. The usual limit for op-ed columns is 750 words, so that's a reasonable length to shoot for. This is your first draft, though, so it might run a bit long.

You may tear this page out of your exam