ECONOMICS 102

FINAL EXAM

PLEASE NOTE:

The exam has 4 parts. Each of the 4 parts is of equal value. Total time: 2 hours.

Answer the last part (Part D) on the sheet provided.

For each of the other 3 parts (A through C), PLEASE USE A SEPARATE EXAM BOOK FOR EACH PART; i.e., submit a total of 3 exam books. On the outside of each book please put (a) your name, (b) your TA’s name, and (c) the question (A, B, or C) being answered.

PART A (30 minutes)

Explain the relationship between EACH of the following pairs. In most cases, to explain the relationship you will need to begin by defining the concepts involved.

(1) opportunity cost AND production possibilities curve (or frontier).

(2) economic growth AND gross domestic product (GDP).

(3) Malthusian positive checks AND the law of diminishing returns.

(4) the Keynesian assumption about “sticky wages and prices” AND countercyclical fiscal policy.
PART B (30 minutes)

When Federal Reserve Chairman Alan Greenspan gathers his colleagues in the central bank’s stately boardroom on Oct. 2, there’s no doubt about what they’ll do: cut interest rates. The widely expected cut would be the second in two weeks and would lower short-term rates below 3% for the first time since the 1960s. Normally, that sort of financial firepower would be more than enough to repel a recession. But these are not normal times. The Sept. 11 attacks have shaken America’s psyche, making the future a lot more uncertain than it was just a few weeks ago. That has led to a fundamental reassessment of risk throughout society.

Business Week, October 8, 2001

(1) If the Federal Reserve uses open market operations to cut interest rates, explain what those operations will be, and how they will lead to a reduction in interest rates.

(2) In general, why should a cut in interest rates help “to repel a recession”? If you use causal arrows in your answer, define each variable linked by the arrows and explain the linkage.

(3) In this causal sequence (your answer to (2)), which variables will be affected, and how will those variables be affected, assuming the events of September 11 made all Americans more pessimistic about the possibility of a major recession?

(4) If interest rates in America fall below interest rates abroad:

(a) Which way will the value of the US dollar move in the foreign exchange market (up or down)? Why?

(b) Will this change in the value of the US dollar help or hurt exports? Why?

(c) Will this change in exports be good or bad for the economy?
PART C (30 minutes)

Cautious men are in charge of the economy at the moment, but this attitude can only bring disaster. There no longer is any danger of overdoing fiscal policy; demand-pull inflation is not even a remote threat. The danger, at the moment, is collapse. To avert this, an initial program could be up to three times as large as what has been so far proposed.

Most analysts would consider the above diagnosis of the present economic situation somewhat extreme, but the author believes that the federal government shall pursue a vigorous anti-recession policy.

(1) (a) What is the Keynesian multiplier for a change in government spending?
(b) What is the Keynesian multiplier for a change in taxes?
(c) Explain why these two multipliers are different.

(2) (a) Define or explain “demand-pull” inflation.
(b) Under what circumstances could an increase in government spending lead to “demand-pull inflation”?
(c) What is the relationship between demand-pull inflation and the Phillips Curve? Begin your answer by defining or explaining the Phillips Curve.

(3) (a) What kind of tax cuts are favored by advocates of supply-side economics?
(b) How do those tax cuts differ from the tax cuts advocated by Keynesian economics?