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)

(1) Recently the Federal Reserve cut interest rates hoping to simulate the American economy.

(a) Explain why open market operations of the Fed cause interest rates to decline.

(b) Explain how lower interest rates can stimulate the economy.

If you use symbols and causal arrows in any part of your answer, be sure to define the symbols used.

(2) If interest rates abroad do not change, will this lowering of American interest rates help or hurt American exports? Explain your answer.

(3) If the Fed did not use open market operations to lower interest rates in the bond market, what other action might it take that would also lower market interest rates? Explain why that action would cause market interest rates to fall.

(4) If America had a 100% reserve banking system (rather than a fractional reserve banking system), how would this change your answer to 1(a)?
PART B (30 MINUTES)

WITHOUT USING GRAPHS, explain how each of the following 4 causes would be expected to produce the effect noted. Note: marks will be given for being concise and deducted for rambling.

<table>
<thead>
<tr>
<th>CAUSE</th>
<th>EFFECT</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. a 25% increase in government spending for military goods in a fully employed economy</td>
<td>decline in civilian goods available for consumers and investors</td>
</tr>
<tr>
<td>2. a sharp increase in the number of teenagers entering the work force for the first time</td>
<td>rise in the natural rate of unemployment</td>
</tr>
<tr>
<td>3. a sharp increase in consumers' propensity to import (or in the marginal propensity to import)</td>
<td>a decline in the capacity of a given tax cut to stimulate the economy</td>
</tr>
<tr>
<td>4. a fall in savings</td>
<td>reduction in the rate of economic growth</td>
</tr>
</tbody>
</table>

PART C (30 minutes)

"As late as 1971, when President Richard Nixon proclaimed that 'now I am a Keynesian', there was a broad consensus that the government should act to steady the course of the economy. But hardly had Nixon spoken when that consensus was dealt a serious blow. As the inflation rate climbed, unemployment rose as well - in direct contradiction to what Keynes, who died in 1946, had foreseen".

(1) How is "unemployment" measured in America?

(2) Why do economists tend to believe that as unemployment declines, sooner or later inflation will begin to increase? Use the Phillips Curve in explaining your answer.

(3) When an "oil shock" was experienced in the mid-1970s, why did both inflation and unemployment rise at the same time, as indicated in the above quotation? Be concise as you explain the causal mechanisms.

(4) If inflation suddenly becomes worse, what change should be observed:

(a) in nominal (actual) interest rates?

(b) in "real" interest rates?

Explain your answers.