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.

Use of calculators is not allowed during the exam.

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) the Phillips Curve AND rising structural unemployment in the 1970s.

(2) supply shock AND inflation measured by the Consumer Price Index (CPI).

(3) opportunity cost AND the demand curve to hold money for transactions purposes (or the liquidity preference curve for transactions purposes).

(4) economic growth AND supply-side economics.
PART B (30 minutes)

The Bush tax cut provided the conventional Keynesian remedy for the recent recession. But the growing threat for the future is inflation, fostered by (a) rising total demand for goods and services, (b) rising oil prices, and (c) a fall in the value of the U.S. dollar on foreign exchange markets.

(1) Explain why EACH of the three developments listed under (a), (b) and (c) above can contribute to upward pressures on the general price level.

(2) (a) What are the three types of inflation?

(b) Which of these types can be combated by using countercyclical tools?

(3) Explain how a cut in government spending helps to combat inflation, using a set of causal arrows and symbols. (Be sure to define the symbols you use.) Include in your explanation the initial or first-round effects of the proposed change in government spending on foreign trade and foreign exchange rates.

(4) Justify, qualify, or refute each part of the following: “Tax cuts should never be used to combat a recession (a) because they always result in a larger deficit, (b) government deficits are a form of dissaving (or negative saving), and (c) what is needed in America is more (not less) saving to generate economic growth”. (Hint: recall the arguments advanced in Handout # 13.)
Part C (30 minutes)

Washington, Nov. 10 - The Federal Reserve raised short-term interest rates on Wednesday for the fourth time this year, and suggested that it would continue to raise them gradually through much of next year.

The policy-setting Federal Open Market Committee raised the federal funds rate on overnight loans between banks by a quarter point, to 2 percent, a move that was widely expected.

Saying that monetary policy is still “accommodative,” the central bank, led by Chairman Alan Greenspan, repeated its assertion of the last several months that it would continue to raise short-term rates at a “measured pace” from their historic lows earlier this year. The stock market had little reaction, with the three main gauges trading slightly lower. Bond prices fell on the possibility of further rate increases.

(1) What are the three main tools of the Federal Reserve?

(2) Which of these three is most commonly used to raise interest rates?

(3) Explain how, by raising interest rates, the Federal Reserve can affect real spending in the economy, including spending on exports and imports.

(4) Under what circumstances would a fall in investment spending NOT lead to a fall in national income?