Prof. Mark Pernecky
Econ 261
Fall 1991

Final Exam

Pledge: "I pledge my honor that during this examination I have neither given nor received assistance, and that I have seen no dishonest work."

Signed
Name

Circle the best answer on multiple choice questions.

Draw all curves normally sloped, ie. without vertical or horizontal segments, except for the money supply curve, unless otherwise implied or expressed.

Also, specifically label all relevant variables, as well as equilibrium values, axes, and curves.

The first 3 questions deal with the following statements.

John Galbraith notes how Richard Nixon was devastating for the economics profession; he tried every economic theory in practice and showed that none of them worked.

1. Specifically, in 1969 he cut (the rate of growth of) government spending in order to fight inflation. Meanwhile, the Federal Reserve Board cut the (rate of growth of) the money supply. However, inflation rose and a recession occurred.

Graphically depict the theoretical impact of a reduction in government spending, coupled with a reduction in the money supply for: (a) the money market, (b) the income/expenditure diagram, (c) the IS/LM diagram, and (d) the aggregate supply/aggregate demand diagram.

(e) What economic theory or theories were being attempted with this Fiscal/Monetary policy mix? Explain.

2. In 1971 and '72, Nixon increased government spending, reduced tax rates, and "leaned on" the Federal Reserve Board to dramatically increase the money supply (which it did). Nixon was concerned about getting reelected and wanted to boost the economy near election day. However, the unemployment rate fell only slightly (from 5.8% in 1971 to 5.5% in 1972), while (the rate of growth) of real GNP and income rose.

Graphically depict the impact of an increase in government spending, a reduction in personal income tax rates, and an increase in the money supply, in: (a) the money market, (b) the injections/leakages diagram, (c) the IS/LM diagram, and the (d) aggregate supply/aggregate demand diagram.

(e) Identify and explain which theory or theories were being "put to the test" by Nixon and the Fed with this fiscal/monetary policy mix.

3. From 1971-1974, Nixon used mandatory wage and price controls to reduce inflation. The inflation rate did decline, but according to Peterson, this was due to the recession in 1970 and not to these controls.

Which school of thought supports this type of policy of controls? Explain their support for controls to fight inflation theoretically. Include an aggregate supply/aggregated demand diagram in your explanation, as well as any relevant formulae.

4. Which of the following is a true statement concerning the current "credit crunch"?

a. Banks are lending to credit worthy firms but not to firms with a large amount of debt.
b. The Federal Reserve Board has targeted the money supply to enhance output because the money supply has been growing slow.
c. Interest rates have been rising, in conjunction with Minsky's theory, because of an increase in the probability of loan defaults.
d. None of the above is a true statement about the current credit crunch.

5. Which of the following is a true statement which also lends support to the idea that the Federal Reserve Board should be less independent from the "body politic"?

a. The Federal Reserve Board has not been to tightenned the money supply during periods of inflation.
b. The Federal Reserve Board has not been influenced by a President to loosen the money supply near an election.
c. The Federal Reserve Board has been influenced by a President to loosen the money supply near an election.
d. None of the above is a true statement which also lends support to the idea that the Federal Reserve Board should be less independent from the "body politic".

6. (a) Identify which school of thought supports an "intermediate" targeting of the money supply and explain their views as to how and why it should be targeted.

(b) Identify a time period in the last 20 years when such a Monetary Policy in (a) was attempted and assess its success or failure.

7. According to the article "The Bush Plan is No Cure for the S&L Insurance Malady" identify two reasons why the S&Ls weren't closed several years earlier than they were.

8. (a) Graphically depict how the aggregate supply curve is generated under the assumptions of sticky wages and perfect information.

(b) Why could the unemployment associated with sticky wages be considered involuntary?

(c) Identify and explain two efficiency wage rationales offered by New Keynesians for sticky wages.

9. Graphically depict the impact of rising oil prices in the '70s for: (a) the aggregate supply/aggregate demand diagram, and (b) the short-run Phillips Curve.

10. Identify two reasons why the inflation rate has tended to slow down recently according to the article, "Mon, What's Inflation"?

11. Identify two empirical trends (or sets of empirical trends) from the 1980s which contradict Monetarism and explain why they contradict Monetarism.

12. Graphically depict a short-run Phillips Curve for Rational Expectations economists if, due to the normal distribution of unanticipated money shocks, money supply changes are anticipated in the aggregate.

13. Which of the following is a correct statement concerning Rational Expectations economists' views about monetary policy?

a. Any monetary policy could be pursued because individuals have perfect information.
b. Individuals must know how changes in the money supply affect prices in order to have rational expectations about prices.
c. The Federal Reserve Board should pursue unanticipated money supply changes in order to increase output.
d. None of the above is a correct view of Rational Expectations economists concerning monetary policy.

14. There are Republicans and Democrats now who, reflecting the views of supply-siders and Keynesians respectively, support tax cuts to stimulate the economy. (a) Graphically depict, utilizing the labor market and the production function, the impact of personal income tax rate cuts according to supply-siders. (b) Graphically depict, utilizing the aggregate supply/aggregate demand diagram and the labor market, the impact of personal income tax rate cuts according to Keynesians.