

Econ 261  
Spring 1993  
Prof. Pernecky

Exam 2

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

Pledge:

Name:

Be sure to label all axes, curves, and beginning and concluding equilibrium values where applicable. Read each question carefully.

Show all of your work.

The number of points that each question is worth out of a total of 300 points is listed in brackets next to each question.

(25) 1. Graphically use the **injections/leakages** diagram (not the income/expenditure diagram) to generate the IS curve diagram. Also, explain what is occurring in your diagrams, and why it is occurring.

(55) 2. Use IS/LM diagrams to show for which school of thought, Monetarism or Keynesianism, will Clinton's proposal for higher energy taxes (not income taxes) be more detrimental to the recovery (ie.

reduce income or output to a greater extent). Also, explain what is occurring in your two IS/LM diagrams, one for each school of thought, and why it is occurring.

(95) 3. Use the AS/AD diagram to depict the cause(s) of recessions (a drop in income or output), and why there is not an immediate recovery (an increase in income or output) according to: (a) Keynesians, (b) Monetarists, (c) the New Classicals (using the Lucas Supply Curve), and (d) New Keynesians. Also, explain what is occurring in your diagrams, and why it is occurring.



(40) 4. Use the labor market diagram and the production function diagram to graphically generate a short run aggregate supply curve diagram assuming flexible wages and prices but "completely imperfect" information on the part of workers as to price changes (ie. price expectations do not change). Also, explain what is occurring in your diagrams and why it is occurring.

(60) 5. Assume that the IS curve is stable (predictable) and the LM curve is unstable (unpredictable) because money demand is unstable.

(a) Graphically depict, using the IS/LM diagram, whether targeting the interest rate or targeting the money supply is more appropriate for targeting income (output). Also, explain what is occurring in your diagram and why it is occurring.

(b) How would a monetarist assess the ideas that money demand is unstable, investment is stable, the policy you've shown superior should be followed, and targeting output should be the ultimate goal of activist monetary policy?

(25) 6. Consider a situation where the demand for money is sensitive to income but almost completely insensitive to the interest rate. (a) Graphically depict the impact of an increase in the money supply in an IS/LM diagram under these circumstances, (b) assess the effectiveness of monetary policy under these circumstances, ie., explain why it is very effective, less effective, or "normal".

**DID YOU REMEMBER TO CONSIDER THE PLEDGE?**