

Exam 2

Econ. 61
Spring 1991
Prof. Mark Pernecky

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 :

Read each question carefully. Assume all curves are normally sloped unless otherwise indicated or implied. Label all axes, curves, and equilibrium values. Relax.

1. Given the equation for the LM curve

$$M = c_0 + c_1 Y - c_2 r, \text{ where } c_1 > 0 \text{ and } c_2 > 0 \text{ and } M \text{ is the money supply, } Y \text{ is real income, and } r \text{ is the interest rate,}$$

(a) what is the slope of the LM curve?

(b) Why is the slope of the LM curve positive? (Explain how the LM curve is generated in your answer.)

(c) Discuss the differences between the Monetarists and Keynesians concerning the slope of the LM curve. Be sure to include their point of disagreement and their views concerning why the LM curve slopes as it does.

(d) Discuss the implications of differences concerning the slope of the LM curve for the effectiveness of monetary policy according to the Keynesians and Monetarists.

2. Given the equation for the IS curve

$$S + T = I + G$$

where $S = -a + (1 - b)(Y - T)$

$$I = I - i_1 r$$

$$G = G$$

$$T = T$$

S: Savings

T: Taxes

G: Government Spending

I: Investment

a: autonomous consumption

b: marginal propensity to consume

Y: real income

i_1 : coefficient

(a) what is the slope of the IS curve?

(b) Why is the slope of the IS curve negative? (Explain how the IS curve is generated in your answer).

(c) Discuss the differences between the Monetarists and Keynesians concerning the slope of the IS curve. Be sure to include their point of disagreement, and their views concerning why the IS curve slopes as it does.

(d) Discuss the implications of differences concerning the slope of the IS curve for fiscal policy effectiveness according to the Keynesian and Monetarist schools.

3. Policy makers currently tend to support lower government spending, higher taxes, and looser money. Graphically depict the results of these policies in the Keynesian: (a) injections leakages diagram, (b) money market, and (c) IS/LM diagram. Be sure to include the primary impacts, including the price effects in all 3 diagrams.

(d) Briefly describe how effective these policies will be in getting us out of the current recession according to these diagrams.

4. What 2 reasons does Keynes give for the upward slope of the (short run) AS curve?

5. Graph the results of an increase in the (nominal) money supply in the Keynesian: (a) IS/LM diagram and (b) AS/AD diagram. Be sure to show the price effects in both diagrams.

6. (a) Graph what the short-run Phillips Curve would look like for the Classical model.

(b) How would the Rational Expectations (New Classical) short-run Phillips Curve differ from (or be similar to) this Classical short-run Phillips Curve?

7. Identify two criticisms of Rational Expectations (New Classical) theories.