Examination:

Principles OF Economics II (5017)

Winter Semester 2003 / 2004

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You are allowed to use a non-programmable calculator (in accordance with the instructions given by the examination office) and a translating dictionary from your native language to English (without any notes written into it). **All** of the **five** (5) exam questions must be answered (the estimated time to spend on each question is provided). This examination consists of **two** (2) pages and must be completed within sixty (60) minutes.

Question 1 (5 Minutes)

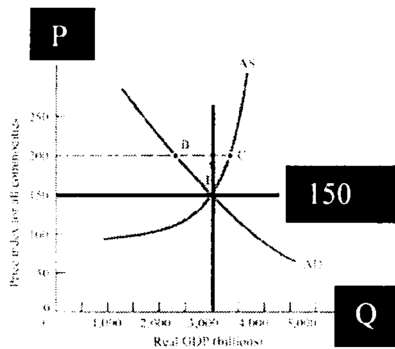
Most governments in the world today consider "management" of macroeconomic activity in their countries to be part of their responsibility.

(a) What are the Macroeconomic goals that these economic policymakers are trying to achieve?

(b) Explain the term Fiscal Policy and explain how it is used to achieve the goals mentioned in part (a) of this question.

(c) What does the term "Political Business Cycle" mean and why does the possibility of its existence create skepticism among many economists concerning the effectiveness and appropriateness of Fiscal Policy?

Question 2 (10 Minutes)



Assume that you are an economic policymaker at the central bank of your country. The economy is presently at an equilibrium where output is at potential GDP = 3000 and the price level, P = 150. You want to keep the price level constant at P = 150, no matter what happens to output. You can use monetary policy to affect aggregate demand, but you cannot affect aggregate supply in the short run. What would you recommend if:

(a) There is a sudden decrease in consumer spending.

(b) There is a sharp increase in the cost of production due to a big price increase in imported crude oil.

Question 3 (5 Minutes)

In most countries the Central Bank is responsible for Monetary Policy.

(a) Explain how the Central Bank can affect the money supply and thus overall economic activity in a country.

(b) What role does the Federal Funds Rate play in the day-to-day conduct of monetary policy?

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Question 4 (30 Minutes)

The following are short answer questions. Sometimes only a formula is required, but if you are requested to explain something, one paragraph will suffice.

(a) When an economy is already at its full employment output level, a substantial increase in government spending will have what effect upon the economy?

(b) Explain the difference between "movements along" an Aggregate Demand Curve and "shifts in" the Aggregate Demand Curve. What causes these things to occur?

(c) Write the formulas for the Expenditure Multiplier and the Tax Multiplier. If you add these two multipliers together what is your answer?

(d) Name the two methods that can be used by government statistical agencies to calculate Gross Domestic Product. Briefly explain how each method arrives at its answer.

(e) In 1957 Milton Friedman proposed the Permanent Income Hypothesis to explain consumer behavior. Explain how this theory differs from the explanation of consumption given by John Maynard Keynes in his book published in 1936.

(f) How does the Federal Reserve's Open Market Committee in the United States conduct monetary policy? The committee meets eight times a year (the next meeting is scheduled for March 16, 2004) and what do they do in order to effect the economic conditions in the United States?

(g) What is the difference between the Federal Funds Rate and the Discount Rate?

Question 5 (10 Minutes)

Consider an economy where the Marginal Propensity to Save has been estimated to be: 0.15

(a) Explain how the concept of Macroeconomic Equilibrium is defined?

(b) Assume that this economy is currently in equilibrium at a GDP = 10,000. Now assume that gross private domestic investment, I, is increased from its previous level by $\Delta I = 115$. What is the new resulting level of equilibrium GDP?

(c) Now assume that the economy is currently at equilibrium at the new level of GDP that was calculated in part (b) of this question. The government says, "We need some additional tax revenue to pay for the cost of the *War on Terror*." As a result the congress approves a tax increase $\Delta T = 64$. What is the resulting equilibrium level of GDP?

This is the End of the Examination.

GOOD LUCK!