3A

Examination: 5017

Principles of Economics II

Summer Semester 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 **ten** (10) exam questions must be answered (the estimated time to spend on each question is provided). This examination consists of **three** (3) pages and must be completed within 120 minutes.

Question 1 (15 Minutes)

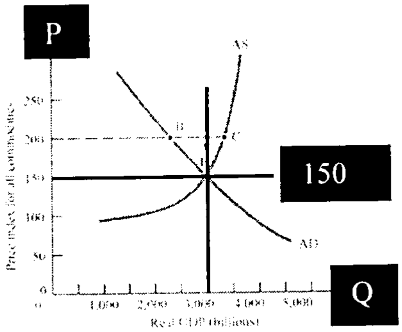
In 1987 Professor Robert Solow of M.I.T. in the United States was awarded the Nobel Prize for Economic Science for his contributions to the theory of economic growth.

(a) Explain the difference between the "Business Cycle" and "Economic Growth." How do these two concepts differ for macroeconomic policy-making purposes?

(b) Describe the Solow Model and explain why technology plays such a central role in it.

(c) Outline some of the public policy measures that a government might undertake to stimulate economic growth.

Question 2 (10 Minutes)



Assume that you are an economic advisor for your government and your job is to provide advice to policy-makers. The economy is presently doing quite well and is at an equilibrium where the output level is at potential GDP = 3000 and the price level is P = 150. Due to a great amount of uncertainty concerning the unstable political situation in Iraq, world crude oil prices begin to rise in a sudden and dramatic manner and the present economic condition begins to change for the worse …

(a) Using the graph above and a comparative statics analysis, explain how the equilibrium position of this economy will likely change as a result of rising oil prices.

(b) What public policy measures would you recommend to the government to improve the economic conditions of this country in light of these current circumstances?

Question 3 (10 Minutes)

Of all the concepts in Macroeconomics the single most important measure of economic performance is gross domestic product.

(a) What is the difference between GDP, GNP, and NNP?

(b) What is included in Gross Private Domestic Investment?

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Question 4 (10 Minutes)

Consider an economy that has balanced trade, X = M, that has no government, there is no consumption of fixed capital, there is no statistical discrepancy, and GDP = GNP = 1240. Furthermore, wages = 860, interest = 220, and rent = 60.

(a) What is the level of aggregate profits in this economy?

(b) If three-fourths of output is consumed, what is the level of savings and investment at equilibrium?

Question 5 (15 Minutes)

Answer the following questions:

(a) Define and explain the difference between the Federal Funds Rate and the Discount Rate?

(b) The Expenditure Multiplier plus the Tax Multiplier equals the Balanced Budget Multiplier. Show mathematically the value of the Balanced Budget Multiplier.

(c) In the 1950's Professor Modigliani formulated the Life-Cycle Hypothesis of consumption behavior. Explain the main elements of this theory.

Question 6 (10 Minutes)

The Central Banks in most major countries of the world conduct monetary policy by utilizing open market operations.

(a) Explain how open market operations are conducted by a central bank and how this affects the money supply.

(b) If a country is experiencing a rather severe increase in inflation, explain the "practical" aspects to consider when suggesting the use of fiscal or monetary policy to combat this problem. How would each of these two macroeconomic policy instruments be applied?

Question 7 (15 Minutes)

The foreign exchange market is the largest financial market in the world with a trading volume of over $1.5 trillion daily. The spot exchange rates are determined in these markets by the interaction of supply and demand.

(a) Explain the concept of the real exchange rate.

(b) Explain the concept of Purchasing Power Parity (PPP) exchange rate. How is this concept related to the "law of One Price" when it is applied to the international marketplace?

(c) Show and explain the relationship between the nominal exchange rate, the real exchange rate, and the purchasing power exchange rate.

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