**Econ 1120 – INTRO MACRO – Fall-2012 –November 7, 2012**

**Makeup PRELIM #2 (Wednesday)**

**PRINT YOUR NAME: \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ Your C.U. Netid: \_\_\_\_\_\_\_\_\_\_\_\_\_**

**YOUR C.U. STUDENT NUMBER:** \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

**Check YOUR TA’s NAME**:

\_\_\_\_\_\_\_\_\_\_\_\_\_TA = Naoko Iida (Tuesday sections)

\_\_\_\_\_\_\_\_\_\_\_\_\_TA = Yuzheng Sun (Wednesday sections)

\_\_\_\_\_\_\_\_\_\_\_\_\_TA = Aichatou Fall (Thursday sections)

\_\_\_\_\_\_\_\_\_\_\_\_\_TA = Yijun Pan (Friday sections)

**INSTRUCTIONS:**

**There are two sections in this exam**

* Part I: 15 multiple choice questions @ 3 points each
* Part II: 2 short answer question (22 points) + 2 Newspaper Article questions (33 points)
* **ANSWER ALL QUESTIONS. TOTAL POINTS = 100. TOTAL TIME = 90 minutes.**
* **Prelim2 score counts for 25% of final grade.**

***AGAIN, please….***

**PRINT YOUR NAME: \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ Your C.U. Netid: \_\_\_\_\_\_\_\_\_\_\_\_\_**

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**GRADING**----------------------------------------------------------------------------------------------------------

**\_\_\_\_\_\_\_\_/45 (mc)\_\_\_\_\_\_/10(short essay 1) \_\_\_\_\_\_/12(short essay 2)**

**\_\_\_\_\_\_\_\_\_/18(long essay 1)\_\_\_\_\_\_\_\_/15(long essay 2)**

**TOTAL: \_\_\_\_\_\_\_\_\_\_\_/100
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**Part I: Multiple Choice.**

1. If inflationary expectations decrease, the Phillips curve will

a) shift to the right

b) shift to the left

c) become vertical

d) become upward sloping

1. If there were no time lag between the input and output price changes the \_\_\_\_\_ aggregate supply curve would be almost entirely \_\_\_\_\_\_

a)long-run, horizontal

b)long-run, negatively sloped

c)short-run, vertical

d)short-run, horizontal

1. Which of the following will break down the negative relationship between the unemployment rate and the inflation rate as predicted by the conventional short run Phillips Curve?

a) Demand-pull inflation

b) Cost-push inflation

c) The negative relationship between the unemployment rate and the inflation rate never breaks down

d) None of the above

e) Not enough information to say

1. Which of the following statements is false?

a) Social Security will be unable to make any payments to beneficiaries once its Trust Fund runs out of money.

b) Social Security is the most important program we have for income support for disabled people.

c) More than half of our seniors rely on Social Security for all or most of their income.

d )Social Security benefits depend on how much income you earned during your working years.

e) All of the above

f) None of above

1. A major fall in the housing market which reduces home prices by a large amount might be expected to

a) Cause a compensating increase in housing investment

b) Result in major in government spending cuts to restore balance

c) Cause a drop in consumer spending

d )Reduce the effectiveness of fiscal policy.

e) All of the above.

f) None of above

1. According to the Lucas supply function, when the \_\_\_ price level is greater than the expected price level, production will\_\_
2. Actual; increase
3. Actual; decrease
4. Previous; increase
5. Previous; decrease
6. A major argument against the rational-expectations hypothesis is that
7. It requires households and firms to know too much
8. It is inconsistent with the assumptions of microeconomics
9. It assumes that expectations are formed rather naively
10. It requires the money market to stay neutral.
11. Which of the following factors can lead to a *decrease* in the equilibrium interest rate level?
12. The Fed decreases the required reserve ratio.
13. The Fed increases the required reserve ratio.
14. The Fed sells securities in the open market.
15. The Fed purchases of securities in the open market.
16. People’s income and wealth decreases.
17. Price level increases.
18. I , III, and V.
19. II, IV and VI.
20. I, IV and V.
21. II, IV and V.
22. The crowding out effect associated with expansionary fiscal policy will be relatively *small* when
23. The Fed implements expansionary monetary policy.
24. The Fed implements contractionary monetary policy.
25. Investment is very sensitive to changes in interest rate.
26. Investment is not sensitive to changes in interest rate.
27. I and III.
28. I and IV.
29. II and III.
30. II and IV.
31. The ”Laffer Curve” shows that
32. Sometimes cutting tax rates will increase revenue
33. Sometimes cutting tax rates will decrease revenue
34. There is a point beyond which it makes no sense to increase tax rates
35. There is a point beyond which it makes no sense to decrease tax rates
36. All of the above
37. None of the above
38. An increase in the price level of the economy after an increase in wage rate is an example of \_\_\_\_\_. An increased in the price level of the economy after an increase in government spending is an example of \_\_\_\_\_.

a) Demand-pull inflation; Demand-pull inflation

b) Cost-push inflation; Demand-pull inflation

c) Demand-pull inflation; Cost-push inflation

e) Cost-push inflation; Cost-push inflation

1. When the AS curve has a relatively flat upward slope, in the short-run, a rightward shift of AD curve will result in
2. A small increase in aggregate output and small inflation.
3. A large increase in aggregate output and large inflation.
4. A small increase in aggregate output and relatively large inflation.
5. A large increase in aggregate output and relatively small inflation.
6. Given the life cycle theory, most of a decrease in income taxes will be\_\_\_\_\_\_ if perceived as temporary changes and \_\_\_\_\_\_ if perceived as a permanent change.
7. Spent; spent
8. Spent; saved
9. Saved; saved
10. Saved; spent
11. In terms of the Aggregate Supply curve, the “long-run” refers to
12. a period of time in which wages can be adjusted to changes in other prices.
13. a period of time during which an increase in the cost of production causes inflation.
14. a period of time in which new technology allows the production possibility frontier to expand.
15. a period of time in which an expansionary fiscal policy causes “crowding out effect.”
16. Two people have the same Keynesian consumption function. The one with higher income will have a \_\_\_\_\_\_ average propensity to consume than the one with lower income individuals.
17. higher
18. lower
19. the same
20. it depends

**Part II: Short Essays (22 points)**

**1. “Banks See Mortgage Requests Rising” (10 points)**

By NEIL SHAH, THE WALL STREET JOUNAL, - Oct 31, 2012

**Americans are increasingly asking their banks for mortgages but banks are wary of lending money to buy homes, a trend that could crimp the housing recovery.**

More than 90% of banks said their lending standards for "prime," or low-risk, mortgages were unchanged in the third quarter, according to the Federal Reserve's latest survey of senior bank-lending officers, released Wednesday. The report, which provides a snapshot of the supply of, and demand for, bank loans, had similar findings to the Fed's previous survey in July.

**However, demand for mortgages to buy homes—rather than refinance them—has picked up in the past six months, the Fed data show. Roughly a third of banks surveyed told the Fed that demand for prime residential mortgages was "moderately stronger."** Another 20% said demand for even "nontraditional" mortgages, or higher risk ones, was moderately stronger.

The Fed data reflect a broader problem for the U.S. economy: Banks have eased credit standards for auto loans, student loans and even credit cards, but remain leery of exposing themselves to risks in the still-moribund mortgage market.

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That is a problem because the Fed is hoping to spur the economy by engineering low interest rates aimed at pushing consumers and businesses to borrow and spend more. Most recently, Fed officials relaunched a mortgage-bond buying program to lower mortgage rates and fuel more mortgage-refinancing and home-buying.

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1. The article mentions that the demand for homes has increased. According to the article, which the component(s) of GDP might you expect to increase as a direct result? (3 points)

Investment (To be more specific, residential investment)

1. The article also mentions that banks are still very cautious about lending out the money in the mortgage market. How could monetary policy be used to help improve this situation? How could fiscal policy be used? Which policy – monetary or fiscal – would you expect to be more effective in the short run, in improving the economy and why? (For full credit, you need to draw 3 panel diagrams to illustrate your answer.) (7 points)

The traditional tools of monetary tools, including O.M.O, required reserved ratio and discount rate, are not as effective as before. The following graph depicts the case in which banks are not conservative about lending. The expansionary monetary tools will increase monetary supply to MS1. Interest rate decreases from r0 to r1, resulting in investment increases from I0 to I1. Finally AE shift up to C+I1+G owing to larger investment. Final output increases from Y0 to Y1.

Now banks are still very cautious and thus would hold extra reserve, the whole monetary creation process slows down. Money supply would not shift that much, and the money multiplier hence greatly decreases. As the housing and mortgage market is an very significant market in our economy, we expect the effect of expansionary monetary tools greatly reduces. As show in the following graphs, no matter what monetary tools are applied, the money supply won’t shift to right as much as the previous case. (ro to r2) Interest only decreases a bit, and, in comparison to previous case, magnitude of increases in investment and output also decreases. Therefore, monetary policy is not effective.

Unless the Fed can guarantee no default problem or target at buying mortgage back securities on the market, expansionary monetary policy would not be very effective in stimulate the economy. However, the mentioned method are not traditional tools employed by the Fed.

On the other hand, the government can increase government spending, which directly shifts AE curve up and thus increase output equilibrium. Given previous consideration about banks behavior, we conclude fiscal policy is more effective.

**2. “Sandy Exacts Toll on the Economy?”** By JOSH MITCHELL and SUDEEP REDDY, THE WALL STREET JOUNAL, October 30, 2012 (12 points)

Sandy is delivering a blow to the U.S. economy that will reverberate for weeks, disrupting commerce in the nation's most-populous region, destroying billions of dollars' worth of property and likely boosting gasoline prices.

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**Motorists are likely to feel the pinch of higher gasoline prices. IHS said 70% of East Coast refineries were idled Monday night. That will lead to a shortage of gasoline supplies, which will likely translate into higher prices at the pump.**

Sandy caused the price of gasoline futures to climb 10 cents to 15 cents a gallon, and a similar increase could unfold at the pump, Mr. Daco said, adding that any price spike would last just days. By comparison, Hurricane Isaac earlier this year caused a temporary 45-cent-a-gallon increase in retail gasoline prices, Mr. Daco said. The spike was larger because Isaac hit the Gulf Coast, shutting down not only refineries but also and oil drilling.

Gasoline prices have been political fodder in the presidential campaign and other election races. Candidates could seek to use a storm-related surge in gas prices to score political gains in the final days of the campaign. President Barack Obama and Republican presidential candidate Mitt Romney most recently clashed on gas prices and other energy topics in their presidential debates this months.

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1. Given the information in the article, please use an Aggregate Demand and Aggregate Supply diagram to depict the impact of hurricane Sandy on the economy. (4 points)
2. What would a classical economist suggest for the government to do to offset the effect of the hurricane on the economy? Why? (4 points)
3. Please list two other factors that will shift the short run aggregate supply curve (4 points)

**1.**As shown in the following, the increase of oil price will result in the shift of short run aggregate from SR-AS0 to SR-AS1. Compared to old equilibrium, the output decreases and pirce level increases.

2. A classical economist would suggest government to do nothing. Because he believe the market is very efficient. If the shock is long run, the wage will quickly adjust to a new level where the labor market is full employment. If the shock is short run shock, the short run aggregate supply curve will shift back very soon. Moreover, any policy that would offset the unfavorable movement of output has policy lag. Those policy lags can actually increase the adverse economy fluctuation. Therefore, a classical economist would not suggest government to do anything.

3. Increase of wage or any other prices of input for production.

 Technology change will also shift the aggregate supply curve, while it also shift the long run aggregate supply curve.

**Part III: Long Essay (33 points)**

1. **Monetary Policy and Fiscal Policy (18 points)**

**“Low Interest Rates Alone Won’t Do It”**

By Robert Reich Sep 18, 2012

**With deficit hawks circling overhead, the responsibility for creating jobs has fallen by default to Ben Bernanke and the Federal Reserve. Last week the Fed said it expected to keep interest rates near zero through mid 2015 in order to stimulate employment.**

**…….**

**The problem is, low interest rates alone won’t do it. The Fed has held interest rates near zero for several years without that much to show for it. A smaller portion of American adults is now working than at any time in the last thirty years.**

So far, the biggest beneficiaries of near-zero interest rates haven’t been average Americans. They’ve been too weighed down with debt to borrow more, and their wages keep dropping. **And because they won’t and can’t borrow more, businesses haven’t had more customers. So there’s been no reason for businesses to borrow to expand and hire more people, even at low interest rates.**

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The truth is, low interest rates won’t boost the economy without an expansive fiscal policy that makes up for the timid spending of consumers and businesses. Until more Americans have more money in their pockets, government spending has to fill the gap.

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Yet for purely ideological reasons we’re heading in the opposite direction. The federal government is cutting back spending. It’s not even helping state and local governments — which continue to lay off teachers, fire fighters, social workers, and police officers.

**Worst of all, we’re facing a so-called “fiscal cliff” next year when $109 billion in federal spending cuts automatically go into effect. The Congressional Budget Office warns this may push us into recession – which will cause more joblessness and make the federal budget deficit even larger relative to the size of the economy.** That’s the austerity trap Europe has fallen into.

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Hello? Can we please stop obsessing about the federal budget deficit? Repeat after me: America’s #1 economic problem is unemployment. Our #1 goal should be to restore job growth. Period.

The Federal Reserve Board understands this. And at least it’s trying. But it can’t succeed on its own. Global lenders are giving us a way out. Let’s take advantage of the opportunity.

1. Please use three panel diagrams to illustrate why monetary policy alone hasn’t worked as well as desired to boost the economy. (6 points)
2. Please use a three panel diagram as well as aggregate demand and aggregate supply to explain why, after the “fiscal cliff”, federal spending cuts will cause more unemployment and then worsen budget deficit problem. (6 points)
3. Some mechanisms can be constructed in the federal budget system to reduce adverse fluctuations of the business cycle. Please list two items (or mechanisms/policies) in the federal budget system that can automatically stabilize GDP. Please list at least one item (or mechanism/policy) that would automatically destabilize GDP. (6 points)

(a) As shown in the following graph, the interest rate can’t be lowered because interest rate is 0 now. Therefore, a increase (shifting right) in money supply can’t lower interest rate anymore. As a result, the investment stay at same equilibrium and output is the same.

**(b)**

Owing to spending cut, the AE curve shifts down from AE0 to AE1. The output decreases from Y0 to Y1. (There is a second round effect later. Because lower income shifts monetary demand downward, and hence interest is decreased. Finally the investment may increase to shift AE back a bit. Overall first round effect generally dominates second round effect.)

Given a fixed price level, the shifting of AE curve corresponds to the shifting of aggregate demand curve. The equilibrium output is Y1. The reduced output implies higher unemployment. At the same time, output to overall income, decreased income leads to lower tax. After budget cut and reduced tax, the government may reduce deficit in absolute number. However, what we should care is the relative size between the deficit and income (output). The “deficit to income” ratio can eventually increases after reduced output. (Simple calculation can be shown that we will have increased “deficit to income” ratio under budget balance policy.)

(c) Tax and social welfare systems are auto stabilizers in our economy.

Budget deficit target policy is auto destabilize.

1. **Wage Rigidity (15 points)**

**“ECB: Further Major Labor Market Reforms Are Necessary”**

By Wall Street Journal, October 10, 2012

**The European Central Bank urged euro-zone states on Monday to implement further “major” reforms of their labor markets in order to combat rising unemployment and bolster growth.**

**“Major labor market reforms in euro area countries are essential to foster job creation, bring down unemployment and restore competitiveness, while also lowering the risks of a permanent decrease in potential output growth,” the ECB said in a regular report on structural issues in the currency bloc.**

The central bank said Germany’s “Hartz” reforms to its labor market, introduced in the early 2000s, “may provide a useful example” to other states, although it stressed that country specifics must be taken into account.

Germany’s unemployment rate has fallen to a two-decade low of 6.8% during the crisis, a fact that many economists ascribe to the “Hartz” reforms, which boosted labor market flexibility.

The ECB warned that wages in many euro-zone states have fallen little despite the severity of the crisis.

**“Downward wage rigidities are an impediment to restoring competitiveness (and thus employment), particularly in those euro area countries that had accumulated external imbalances before the crisis,” the ECB said.**

Meanwhile, short-time working schemes may have helped reduce job losses in some countries, but they “might hinder the reallocation of the labor force from declining sectors towards growing ones if they are maintained for too long,” the report said.

It also called for “wide-ranging” reforms of product markets in order to maximize the benefits of labor market reforms.

1. Please list 2 factors which lead to wage rigidity and provide brief explanations for those factors. (4 points)
2. The article mentions that downward wage rigidities are an impediment to restoring competitiveness (and thus employment). Please use a labor supply and labor demand diagram to explain why. (4 points)
3. A change in the wage rate results in substitution and income effects on labor supply. Please briefly explain what substitution effect and income effects are. (7 points)

a) Imperfect information: firms may not have enough information about market clearing wage such that firms can set the wage at wrong level which is above equilibrium prices. It takes time for firms to learn the related information.

Regulation of minimum wage: the government may setup a regulation of minimum wage above equilibrium wage rate. Given this, firms have no way to reduce the wage, and downward rigidity is formed.

(Please check textbook for other factors.)

b)

Assuming before Euro debt crisis, original labor demand Ld0 and labor supply Ls0. The original equilibrium is L0 and W0.

In Euro debt crisis, economy is struggling, and market demand is low. Labor demand shift from Ld0 to Ld1. However, if the wage can adjust quickly to lower level w1, the market reaches a new clearing equilibrium where people, who don’t want to work, are voluntarily. However, wage rigidity, caused by people declining less social security, benefit and wage, results in excess supply. On the other side, the business has higher cost for production, resulting in lower competitiveness on the international market. The labor demand at original wage level is also lower. Given wage is sticky at W0, the supply is L0 and demand is L0’. This is one of reasons why we observe increasing unemployment in Euro. If we can let wage fall, then the quantity of labor demanded will increases along the line Ld1 and labor quantity increase from L0’ to L1. This will help the Euro to revert the increasing unemployment, and the business can produce products with lower costs.

c) substitution effect: The increase of wage rate means the higher opportunity cost of leisure. As a result, we will find people consume leisure less and provide more working hours.

 Income effect: When wage rate increases, the income of a worker increases for working at the same number of hours. Given leisure is a normal good, the higher income makes a worker to consume more leisure and provide working hours.