

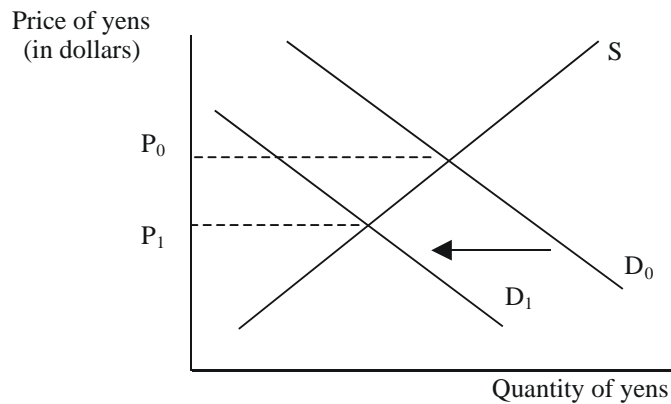
PRACTICE QUESTIONS FINAL EXAM

Question 1)

Demonstrate graphically and explain verbally the effect of a decrease in demand for Japanese yen on the exchange rate for yens.

Answer:

The diagram:

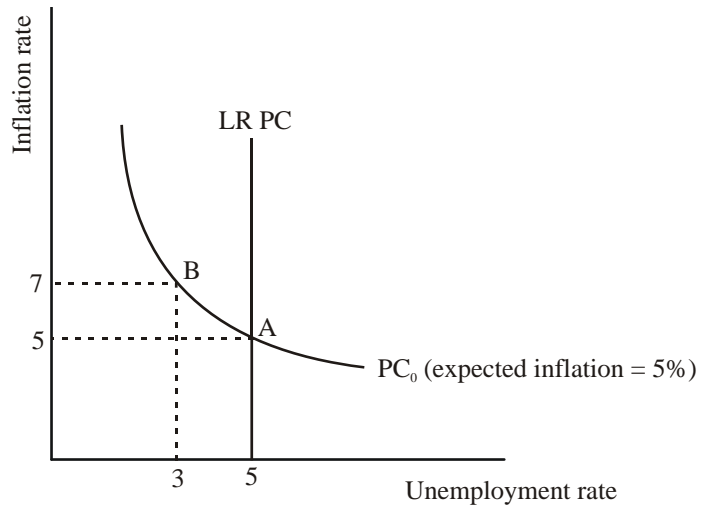


The explanation:

When the demand for yens decreases from D_0 to D_1 the price of yens in terms of dollars falls from P_0 to P_1 . That is, the yen depreciates.

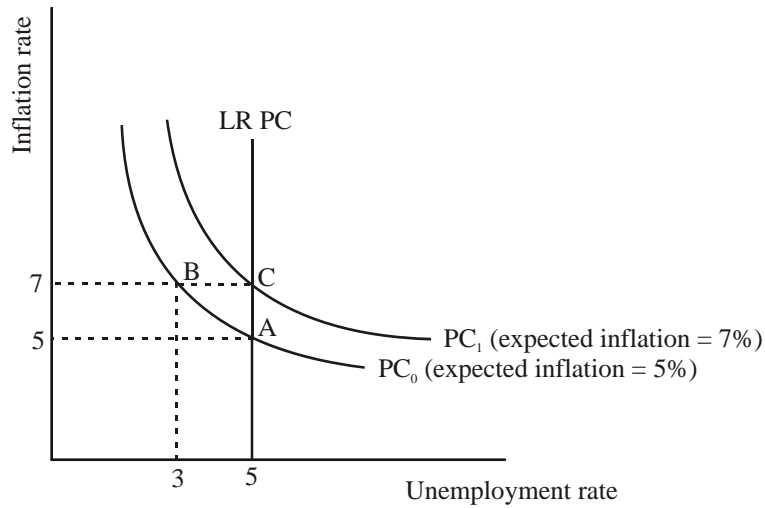
Question 2)

Consider the following Phillips curve diagram:



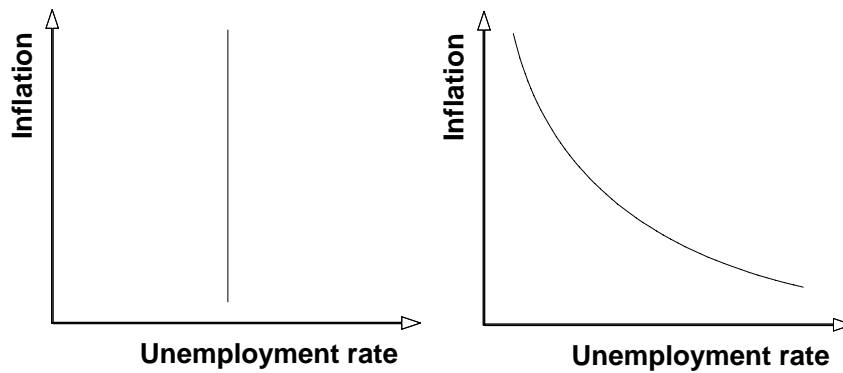
Suppose an expansionary monetary policy has moved the economy from point A to point B. Is point B a long-run equilibrium? If yes, explain why. If no, explain how the economy will get to new long-run equilibrium.

Answer:
The diagram:



The explanation:

Point B is not a long-run equilibrium because expectations of inflation are lower than actual inflation. Only points on the long-run PC are long-run equilibrium points. Adjustment takes place in the AS/AD model through shifts in the SAS curve. The economy will move from point B on PC_0 to point C on PC_1 . Point C is a new long-run equilibrium point.



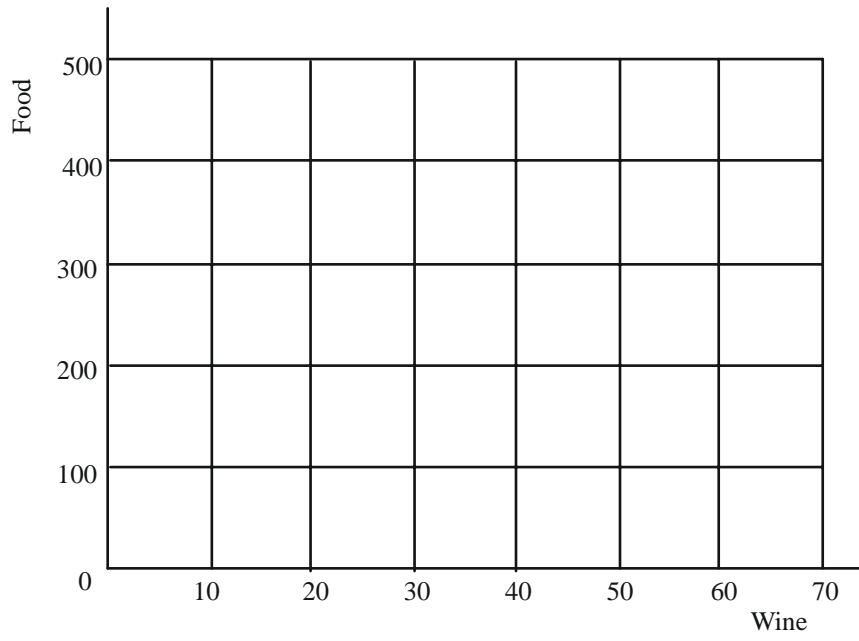
Question 3)

Consider the following information about production of wine and food in England and France:

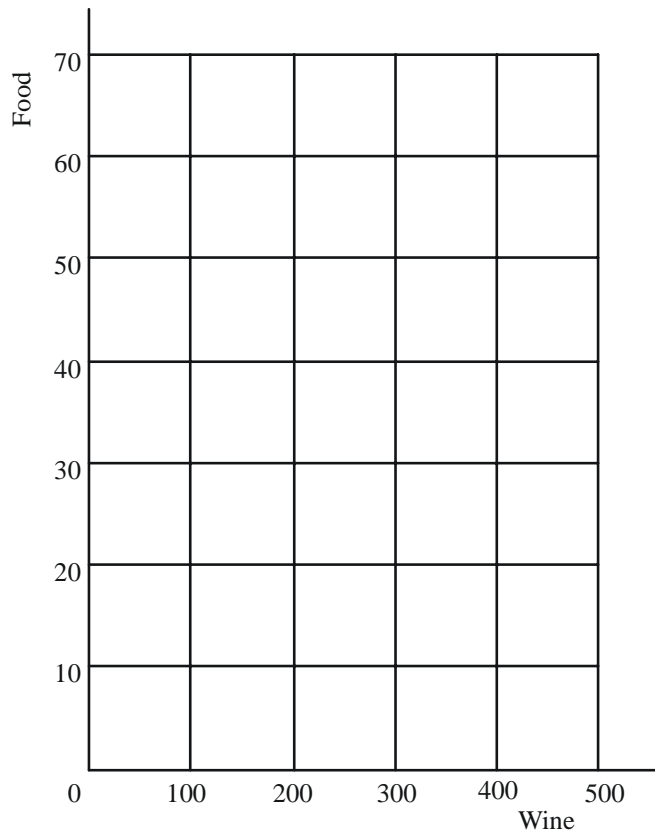
Percentage of resources devoted to food	England		France	
	Food Produced (tons)	Wine Produced (gallons)	Food Produced (tons)	Wine Produced (gallons)
100	500	0	50	0
80	400	10	40	100
60	300	20	30	200
40	200	30	20	300
20	100	40	10	400
0	0	50	0	500

(a) Using the grids below, plot each country's production possibilities curve.

England



France

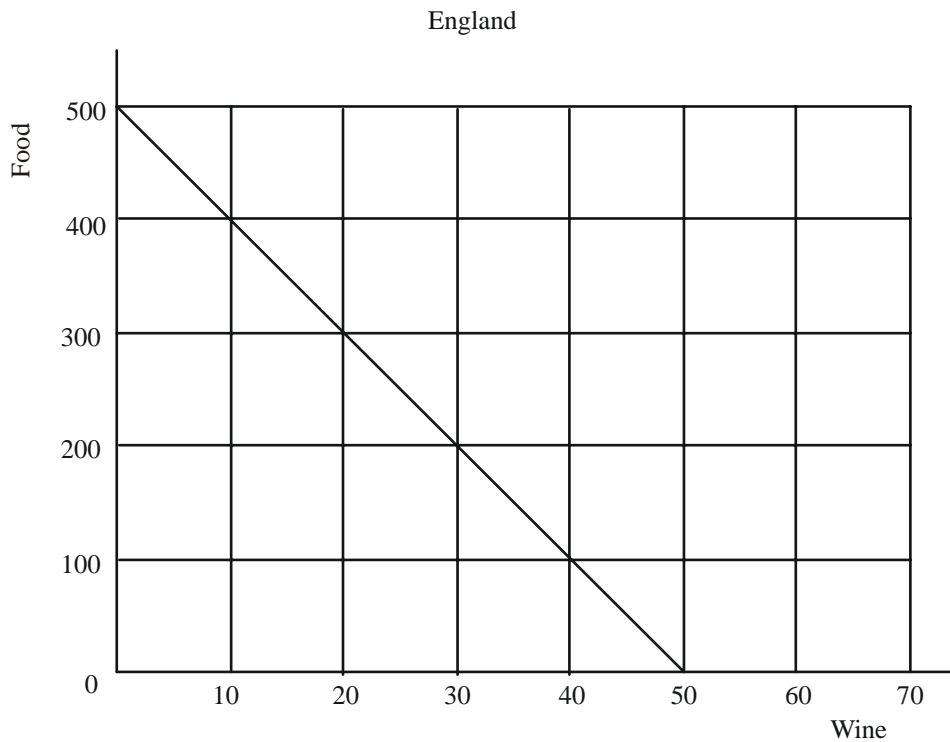


(b) Which country has a comparative advantage in the production of food? Of wine? Explain.

(c) Suppose that currently England and France are not trading with each other. England is producing (and consuming) 200 tons of food and 30 gallons of wine. France is producing (and consuming) 30 tons of food and 200 gallons of wine. As an international trader, how could you take advantage of this situation and make the big bucks?

Answer:

(a) The production possibilities curves:



(b) England has a comparative advantage in the production of food and France has a comparative advantage in the production of wine. To see this, examine the opportunity cost of producing food and wine in each country.

Focus on the production of food. In England, if all resources are transferred away from food to wine, there is a loss of 500 tons of food and a gain of 50 gallons of wine. Thus giving up 1 ton of food results in a gain of $1/10$ of a gallon of wine. Hence, the opportunity cost of one ton of food in England is $1/10$ gallons of wine. Now look at France. If all resources are transferred away from food to wine, there is a loss of 50 tons of food and a gain of 500 gallons of wine. Thus giving up 1 ton of food results in a gain of 10 gallons of wine. Hence, the opportunity cost of one ton of food in France is 10 gallons of wine. Since England has a lower opportunity cost of food than France, England has a comparative advantage in the production of food.

A similar analysis will allow you to discover that France has a comparative advantage in the production of wine because its opportunity cost is $1/10$ whereas England's is 10.

(c) As a trader, you can make a proposal that will allow each country to consume at a point beyond their current production possibility curve by specializing in the production of the good they have a comparative advantage in, and then trading with you for some of the other good. There are many trades you can propose that will allow you to make money. Here is one possibility.

To England: Rather than producing (and consuming) 200 tons of food and 30 gallons of wine, produce 500 tons of food. Then, give me 250 tons of food and I will give you 60 gallons of wine. Thus you now get to consume more of both goods (250 tons of food and 60 gallons of wine) than before!

To France: Rather than producing (and consuming) 30 tons of food and 200 gallons of wine, produce 500 gallons of wine. Then give me 250 gallons of wine and I will give you 60 tons of food. Thus you can consume more of both goods (60 tons of food and 250 gallons of wine) than before!

How do you make money? Compare the total production levels with the total consumption levels. England produces 500 tons of food but only 310 tons are consumed in England and France. France produces 500 barrels of wine but only 310 barrels are consumed in England and France. This leaves you with 190 tons of food and 190 barrels of wine to sell!

Question 4)

The BLS estimates that in 2002, the number of working-age adults was 212.9 million, labor force was 142.8 million, and the total number of employed was 133.1 million. Calculate the following:

- (a) Labor force participation rate
- (b) Unemployment rate.
- (c) Employment rate.

Answer:

- (a) Labor force participation rate = $(\text{Labor force}/\text{working-age population}) * 100 = (142.8/212.9) * 100 = 67.1\%$
- (b) Unemployment rate = $(\text{Total unemployed}/\text{labor force}) * 100 = (9.7/142.8) * 100 = 6.8\%$
- (c) Employment rate = $(\text{Total employed}/\text{labor force}) * 100 = (133.1/142.8) * 100 = 93.2\%$.

Question 5)

For each of the following “quotes” from *The Wall Street Journal*, draw a picture to show how the AD curve will shift. Label your original curve AD_0 and your new curve AD_1 .

- (a) “The value of the US dollar rose about 50% against the yen and 20% against the mark.”
- (b) “The Dow Jones Industrials closed above 11,000 for the first time”
- (c) “Federal investment in civilian capital and infrastructure, education, and research and development is falling.”

Answer:

NOTE: All of the pictures should indicate that the shift from AD_0 to AD_1 is due to the shift factor described in the quote **AND** the multiplier effect.

(a) The increase in the value of the dollar relative to the yen and the mark means that US demand for German and Japanese goods increases while Japanese and German demand for US goods decreases. Both of these occurrences will cause the AD curve to shift leftward.

(b) The impact that this has on the AD curve is through its impact on businesspeople's expectations and wealth. Many see the DJIA rise above 11,000 as a sign that good times will continue in the US. This would result in a rightward shift of the AD curve. Others are worried that the US is currently experiencing a speculative bubble that will soon burst and bring about a "correction" that will signal the beginning of a recession. This would result in a leftward shift of the AD curve. The overall impact of the rising stock market on the AD curve is difficult (if not impossible) to judge, as it depends upon the relative size of the optimistic and pessimistic groups.

(c) The drop in federal government spending will cause the AD curve to shift leftward. Federal government expenditures are a component of aggregate expenditures.

Question 6)

Answer parts (a) - (e) below on the basis of the following table.

Income (Y)	Change in Income (ΔY)	Aggregate Expenditures (AE)	Change in Aggregate Expenditures (ΔAE)
0		500	
500		900	
1000		1300	
1500		1700	
2000		2100	
2500		2500	
3000		2900	

(a) Fill in columns (2) and (4).

(b) What is the value of autonomous expenditures?

(c) What is the mpe?

(d) What is the AE equation?

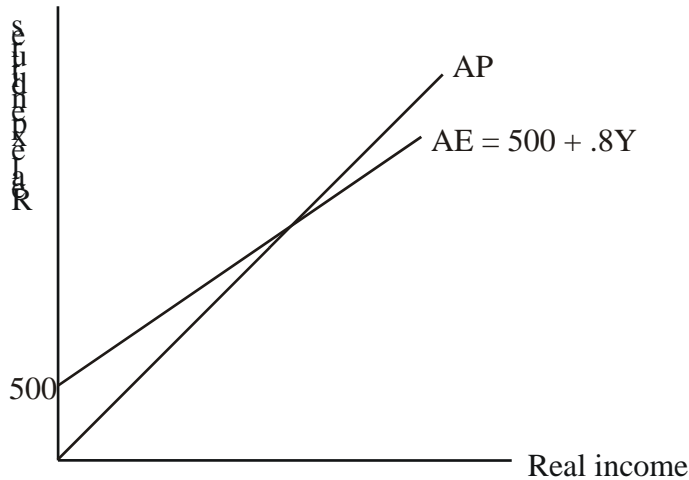
(e) Draw a picture of the AE curve.

Answer:

(a) The completed table:

Income (Y)	Change in Income (ΔY)	Aggregate Expenditur es (AE)	Change in Aggregate Expenditur es (ΔAE)
0		500	
500	500	900	400
1000	500	1300	400
1500	500	1700	400
2000	500	2100	400
2500	500	2500	400
3000	500	2900	400

- (b) Autonomous expenditures are 500.
- (c) The mpe = $400/500 = 0.8$
- (d) The AE equation is $AE = 500 + .8Y$
- (e) The diagram:



Question 7)

Imagine you are a Federal Reserve board governor and you are examining the economy. You discover that the money supply is currently \$2,000,000, that banks have \$1,000,000 in reserves. You want to increase the money supply by \$500,000 using an open market operation. What would you do?

Answer:

To increase the money supply using open market operations involves a Fed purchase of government securities. To increase the money supply by \$500,000 you need to recommend a purchase of \$250,000 in securities. Why this amount? By studying the original information you discover that the money multiplier is 2 (\$1,000,000 reserves supporting \$2,000,000 in money). Thus, to increase the money supply by \$500,000 the Fed needs to increase reserves by \$250,000. The increase in reserves is then multiplied to create a total of \$500,000 more money in the economy.

Question 8)

In Chapter 9 of his book ‘The Roaring Nineties’ Joseph Stiglitz addresses a number of problems resulting from increased trade and financial integration of the world economy (Globalization). Explain three of these problems.

You have many possibilities here, some include:

International financial crises

Push for open markets

Unfair trade treaties
Problem of bailouts
Washington consensus etc.