

# Exam 1

## ARE 012, Fall 1995

Answer the seven (7) questions below to the best of your ability. Answer all parts of each numbered question. Use a separate sheet of paper to answer each numbered question, and arrange your answers in numerical order when finished with the exam. Write the number of the question and your name on the top of each sheet of paper you use. You must show all work to receive full credit. The price of all parts of each question (input) is provided so that you may make an informed management decision regarding the production of this exam (output). **DO NOT** write answers on the test sheets. Be thorough and complete in ALL your responses. **RETURN THE TEST SHEET !!!** No test sheet: **F** for the exam.

Please read and sign the Honor Pledge that follows:

*I have neither given or received unauthorized aid on this exam.*

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Student's Signature

1. Please illustrate the "consumption-production model" in equilibrium, and label each component of the model (10 points), then respond to items a, b, and c below.
  - a. Assume you are an executive with Ford Motor Corporation. If Ford Explorer inventory levels were to begin **increasing**, what would you conclude about current consumption relative to current production? (5 points)
  - b. Assume Explorer assembly plants are currently operating at 100% capacity. What action, in the short run, would the "typical manager" take in order to stabilize inventories, and return to equilibrium? (5 points)
  - c. If after the action taken in "b" above, Explorer inventory continues to **increase**, what other option(s) does the manager have? (5 points)
2. Define "**Fiscal Policy**" (2 points)
  - a. Assume you are President of the United States. Assume that the nation 's economy is currently expanding at a rate of 2.0% with unemployment at 5.6% for August, 1995. You are confronted with a Congress that wants to trim government spending significantly. Please illustrate, and explain to Congress how significant government spending cuts will affect the economy during your remaining term of office, ceteris paribus. (5 points)

Please use the **Production-Consumption Model** to **illustrate** an answer to this question, then

**explain.**

For Example:  $\downarrow \uparrow W \implies \downarrow \uparrow X \implies \downarrow \uparrow Y \implies \downarrow \uparrow Z \implies ?$

b. What are the possible affects of reduced government spending on the federal budget deficit, ceteris paribus? **Why?** (3 points). For example, It could decrease if....., or it could increase if.....

3. Define “**Monetary Policy**” (2 points)

a. Assume that you are the Federal Reserve Chairman. Assume Congress was successful at significantly trimming the federal budget. GDP is now increasing at an annual rate of 1.0%, unemployment has increased

slightly and is expected to continue rising due to layoffs from businesses that were dependent upon government spending. Inventory levels for major manufacturing firms are beginning to increase. You are

convinced that inflation is not currently a problem, and the markets are convinced that you will not allow

inflation to raise its ugly head. You are now concerned that the fiscal policy action taken by Congress in 5(a)

above may cause the economy to slump into a recession if you do not take action. Please illustrate how you

would use Monetary Policy to help prevent the economy from slipping into a recession, or at least moderate

the recession. (5 points)

Please use the **Production-Consumption Model** to **illustrate** an answer to this question, then **explain.**

b. What affect would the use of this Monetary Policy tool have on the federal budget deficit? Why? (3 points)

4. If the real interest rate is 2.75%, the expected inflation rate is 2.5%, and the risk premium is 4%, please calculate the

nominal interest rate (5 points).

a. If the interest rate for one year U.S. Treasury Bills is currently 5.26%, and the real interest rate is 2.75%,

please calculate the expected inflation rate for the U.S. economy over the next twelve months (5 points).

b. If two people go to the same bank at the same time to borrow money, explain thoroughly why they might

receive different nominal interest rates (5 points).

5. Herman’s gross income is \$45,000 (**I wish!!!**) per year. After the standard deduction, personal, and

dependent exemptions, the federal and state combined income tax rate is 19.25%. Herman must also pay 7.65% of

his gross income to the Social Security and Medicare systems. Herman spends \$19,250 per year for family living expenses (Wife, two daughters in college ).

a. Calculate Ol' Herm's disposable income for the year (5 points).

b. Calculate Ol' Herm's discretionary income for the year (5 points).

c. If increased government spending for education raises Ol' Herm's gross income to \$55,000, and Herman's

new federal and state combined income tax rate increases to 21.6%, (don't forget the 7.65% Social Security

and Medicare tax) please calculate Herman's new **discretionary** income (5 points)

d. What will Ol'Herm do with this extra money? What will most folks do with this extra money? (5 points)

6. List the characteristics of Pure Capitalism (5 points)

a. List the functions of **PRICE** under Pure Capitalism (5 points)

7. What is the economic meaning of **scarcity**? (2 points)

a. List the four broad categories of resources. (4 points)

b. What "payment" does each factor category receive? (4 points)

### **BONUS QUESTIONS:**

Answer the questions below. Each correctly answered question will add the points indicated to your raw test score.

1. What are the two conditions required for "good" competition to develop? (5 points)

a. List and briefly discuss the market structures we reviewed in class. (5 points)

2. List all the functions of **government** as outlined under pure capitalism (10 points)

a. Why does the government provide **“Public Goods”**? (5 points)

b. Identify the two unique characteristics of **“Public Goods”**, and discuss each characteristic (5 points)

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What “explain” means on one of my exams:

Websters Collegiate Dictionary defines EXPLAIN as:

1. to make plain or understandable
2. to give the reason of or cause of
3. to show the logical development or relationships of

Websters continues by enhancing the definition with the following statement:

"Explain implies a making plain or intelligible what is not immediately obvious or entirely known."