

Exam 1

ARE 012, Spring 1995

Answer the six (6) 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.

Student's Signature

1. Please illustrate the "consumption-production model" in equilibrium, and label each parameter 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 pickup truck inventory levels were to begin **decreasing**, what would you conclude about current consumption relative to current production? (5 points)
 - b. Assume pickup truck 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, truck inventory continues to **decrease**, what other option(s) does the manager have? (5 points)
2. If the real interest rate is 2%, the expected inflation rate is 2.5%, and the risk premium is 2%, please calculate the nominal interest rate (5 points).
 - a. If the interest rate for one year U.S. Treasury Bills is currently 6.34%, and the real interest rate is 2%, 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 why they might receive different interest rates (5 points).

3. List all the functions of **government** 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)
4. List the functions that must be performed by any economic system (5 points).

Instructions:

Within your chosen major, think of a commodity you would like to produce for sale. Write that commodity down on your answer sheet. Now complete items a, b, and c below.

- a. What basic decisions must you (the manager) make when determining how to organize the production process for the commodity you have specified (5 points)
- b. **ILLUSTRATE and EXPLAIN** how a manager (you) evaluates alternative production technologies, and chooses which one to use (5 points).
- c. President Clinton is proposing an increase in the minimum wage from \$4.25 per hour to \$4.70 per hour the first year after enactment, and to \$5.15 in the next year. Discuss how a profit maximizing manager using minimum wage labor would likely respond to this increase in the price of unskilled labor relative to the price of other inputs used in the production process (5 points)

5. 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 in excess of 2.5% with very low unemployment levels. Please illustrate and explain how you would use Fiscal Policy to help “**cool off**” the economy in an effort to avoid excessive inflation. (5 points)

Use the **Production-Consumption Model** to answer this question.

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

b. What affect will the use of these Fiscal Policy tools likely have on the federal budget deficit ceteris parabis?

Why? (3 points)

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

a. Assume that you are the Federal Reserve Chairman. Assume the actions the President took in 5(a) above

“cooled off” the economy, but just a bit too much. GDP is now increasing at an annual rate of 2.0%, unemployment has increased too slightly above the full employment level, and inventory levels for

major

manufacturing firms are beginning to increase slightly. You are convinced that major inflation has

been

averted, 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 the President in 5(a) above may cause the economy to

stall

if you do not take action. Please illustrate how you would use Monetary Policy to prevent the

economy

from slipping into a recession. (5 points)

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

(Watch out, this one is tricky! Think carefully.)

BONUS QUESTIONS:

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

1. Herman’s gross income is \$40,000 (**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 \$18,750 per year for family living

expenses (Wife, one daughter at home, one daughter 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 \$50,000, 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 do you think Ol'Herm is going to do with this extra money? What will most folks do with this extra money? (5 points)

2. 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)