

Exam 1

ARE 012, Spring 1996

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.

Student's Signature

1. Please illustrate the "consumption-production model" in equilibrium, and label each component of the model (5 points), then respond to items a, b, and c below.
 - a. Assume you are an executive with Ford Motor Corporation. You have been given data that shows passenger car inventories on dealers' lots have ballooned to a 76-day supply as of Jan. 1; a 60-to-65-day supply is considered an ideal inventory level. What conclusion would you come to regarding current consumption of passenger cars relative to current production? (5 points)
 - b. Passenger car assembly plants are currently operating at 85% capacity. What action, in the short run, would the "typical manager" take in order to stabilize inventories, and return the market to equilibrium? (5 points)
 - c. If after the action taken in "b" above, passenger car inventory levels on dealer lots are at a 70 day supply, what would you do next? (5 points)
2. Define "**Fiscal Policy**" as it was defined in class (5 points)
 - a. You are the new President of the United States. The previous Congress passed a Balanced Budget Amendment to the Constitution, the previous President signed the Amendment, and the states ratified the Amendment. You are confronted with a national economy with GDP currently expanding at a rate of 1.0%, and an unemployment rate 7.5%. Please illustrate and explain how you and Congress could use fiscal

policy to stimulate the economy, and avoid a recession. Remember, NO DEFICIT is allowed!
(15 points)

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

For Example: $\downarrow \uparrow T \implies \downarrow \uparrow I_D \implies \uparrow ?? \implies \downarrow \uparrow ?? \implies ?$

3. Define “**Monetary Policy**” as it was defined in class. (5 points)

a. You are the Federal Reserve Chairman. GDP is currently increasing at an annual rate of 5.5%, and unemployment is currently at 5.0%. Employers are reporting difficulty in finding skilled labor to expand production, and wages they are having to pay new employees are increasing. Inventory levels for major manufacturing firms are beginning to decrease even though manufacturing facilities are operating at nearly 90% of capacity. What would you expect to happen with inflation? (5 points)

b. Please illustrate and explain what Monetary Policy action you would take to prevent an economic crisis. (10 points)

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

4. If the real interest rate is 2.25%, the expected inflation rate is 2.0%, 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 4.60%, and the real interest rate is 2.25%, please calculate the expected inflation rate for the U.S. economy over the next twelve months (5 points).

b. Farmer Bill is a very successful flue-cured tobacco farmer in Eastern N.C. His operation is very profitable and has expanded from 50 acres of flue-cured tobacco in 1976 to 125 acres of production today. Farmer Wes is a very young, innovative tobacco farmer who graduated from the Agricultural Institute two years ago. Farmer Wes is a much smaller tobacco farmer than Farmer Bill. Due to rising production costs and a bad crop year this past season, Farmer Wes has struggled to pay the bills.

You are a Farm Credit System Loan Officer. Would you offer these two gentlemen the same nominal

interest rate on an operating loan for the coming growing season? (1 point) **Thoroughly explain WHY or WHY not? (4 points)**

5. Mr. Cravens' gross income is \$25,000 per year. After the standard deduction, personal, and dependent exemptions, and itemized deductions; Mr. Cravens' taxable income is \$7,450. His federal and state combined income tax rate is 19.25%. Mr. Cravens' must also pay 7.65% of his gross income to the Social Security and Medicare systems. Mr. Cravens' spends \$19,250 per year for family living expenses (Wife, two sons in grade school, mortgage payment, food, clothing, car payments).
- a. Calculate Mr. Cravens' disposable income for the year (5 points).
 - b. Calculate Mr. Cravens' discretionary income for the year (5 points).

6. What are the two conditions required for "good" competition to develop in a capitalist economic system? (5 points)
7. List all the functions of **government** as outlined under pure capitalism (10 points)

BONUS QUESTIONS:

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

- 1. What is the economic meaning of scarcity? (5 points)
- 2. Thoroughly explain why the government provides **“Public Goods”**? (15 points)

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What “explain” means on one of my exams:

Webster's 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

Webster's continues by enhancing the definition with the following statement:

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