Whitman College
Econ 308
Exam 3
April 25, 2011

Write all answers in your blue book. Show **all** of your work. The exam ends at 2:20.

1. (15pts) Over the past twelve months, the Eurozone and the United States both had an inflation rate of 2.7%. Currently, the exchange rate between their currencies is 0.686107 euros per dollar. Twelve months ago the exchange rate was 0.750694 euros per dollar. Did Purchasing Power Parity hold over the past twelve months? Explain your answer.

2. For parts (a) and (b), consider the Keynesian Cross model.

(a) (10pts) Suppose the household savings rate increases. What happens to real aggregate output? Explain your answer, with reference to a Keynesian Cross graph.

(b) (5pts) How could you use the Keynesian Cross model to determine whether the change in output you described in part (a) is good for an economy? Explain your answer.

3. (a) (5pts) The Keynesian fixed-nominal-wage-contracts Aggregate Supply-Aggregate Demand model makes what assumptions about how labor markets work?

(b) (5pts) The Lucas Aggregate Supply-Aggregate Demand model makes what assumptions about how labor markets work?

4. To answer questions (a)- (d), consider the April 16, 2011 Wall Street Journal article "Inflation Hits Gas, Food, but Only Grazes Other Items" (p. A2) in which Mark Whitehouse and Jon Hilsenrath report that in March, the United States Consumer Price Index was up 2.7% from a year earlier. The authors write that the Federal Reserve is

> balancing a desire to provide further stimulus against concerns about soaring prices for oil, cotton and other commodities….For now, senior Fed officials largely expect and hope the commodity-price increase will subside along with inflation expectations, as happened after the last big oil-price spike in 2008. They also think the economy is a long way from overheating, with unemployment at 8.8% and many companies still operating well below capacity. If they are correct, raising interest rates now could cause undue pain for businesses and heavily indebted consumers.

(a) (15pts) Use the Keynesian fixed-nominal-wage-contracts Aggregate Supply-Aggregate Demand (AS-AD) model to explain what the Fed thinks would happen to real aggregate output and the price level if the Fed raised interest rates now. Explain why this model produces the results you describe, with reference to what the model assumes is happening in the labor markets. Refer to an AS-AD graph in your explanation. Be sure to indicate the natural rate of output on your graph.

(b) (15pts) Suppose the Fed is wrong in its expectation that commodity-price increases will subside. Use the Keynesian fixed-nominal-wage-contracts AS-AD model to explain what would happen to real aggregate output and the price level if the Fed raised interest rates now, and the prices of oil, cotton and other commodities continued rising. Explain why this model produces the results you describe, with reference to what the model assumes is happening in the labor markets. Refer to an AS-AD graph in your explanation. Be sure to indicate the natural rate of output on your graph. Use a separate graph from the one in part (a).

(c) (20pts) Suppose the Fed does not raise interest rates and that commodity prices stay constant. Use the Keynesian fixed-nominal-wage-contracts AS-AD model to explain how the economy would automatically adjust back to the natural rate of output. Explain why the economy adjusts, how fast the adjustment occurs, and what the result would be for real aggregate output and the price level. In your explanation, discuss what the model assumes is happening in the labor markets. Refer to an AS-AD graph in your explanation. Be sure to indicate the natural rate of output on your graph. Use a separate graph from those in parts (a) and (b).

(d) (10pts) Explain why using the IS-LM model does not work well for analyzing the situation the Fed currently finds itself in as it balances a desire to provide further stimulus against concerns about soaring commodity prices.