INSTRUCTIONS:

1. Answer ONLY the specified number of questions from the options provided in each section. Do not answer more than the required number of questions. Each section takes one hour.
2. Your answers must be on the paper provided. No more than one answer per page. Do not answer two questions on the same sheet of paper.
3. If you use more than one sheet of paper for a question, write "Page 1 of 2" and "Page 2 of 2."
4. Write ONLY on one side of each sheet. Use only pen. Answers in pencil will be disqualified.
5. Write **------ END -----** at the end of each answer.
6. Write your exam identification number in the upper right-hand corner of each sheet of paper.
7. Write the question number in the upper right-hand corner of each sheet of paper.

Section 2: Macroeconomics and Monetary Theory—Answer One Question.

2A. (Econ 202) Discuss the business cycle by answering *all* of the following. As you answer each part, make sure you identify it with the appropriate letter:

a) Define depressions (or recessions) and mention what characterizes them.
b) What typically happens to employment, output, investment, prices (or inflation), real wages, nominal interest rates, over the business cycle?
c) Relate your answer to the shape of the short-rate aggregate supply curve and the role of expectations in shifting that curve.
d) Discuss stagflation (an inflationary recession). What is it, how does it differ from a typical recession, and why might it arise?
e) Explain why reducing unemployment below its natural rate (or NAIRU) requires accelerating inflation.
f) Identify and describe the two different ways that macroeconomists have modeled expectations.
g) Draw an aggregate-demand, aggregate-supply graph in output-price level space clearly identifying both axes and all three curves.

2B. (Econ 235) Answer all of the following parts completely. Be specific.

a) Does the Federal Reserve (Fed) actually control interest rates? If so, to what extent?

b) What is the short-run impact of an expansionary monetary policy on interest rates? What is this effect called, and why does it occur? Depict this short-run impact on a diagram of the loanable-funds market. Assume you are starting with a constant money stock and that the Fed engages in a one-shot increase in the money stock.

c) After the new money circulates throughout the economy, what happens to interest rates? What is this effect called, and why does it occur? Depict this impact on your diagram of the loanable-funds market.

d) Now assume that the Fed continues expanding the money stock at a constant rate. What is the impact of nominal interest rates? What is the impact on real interest rates? What is this effect called, and why does it occur? (You do not need to graph it.)

e) Why does the difference between short-term and long-term effects of monetary policy that you have described in parts (b), (c,) and (d) create problems for a monetary policy that targets interest rates?

f) Give the equation for the Taylor Rule. Clearly identify all variables and coefficients in the equation. What macroeconomic variables does the Taylor Rule try to stabilize? How does the Taylor Rule deal with the problems you described in part (e)?

(over)