Print your name: _____

Final Examination

Econ 712 Fall 2005
Macro II Page Total = 2

DIRECTIONS: Obey page limits. If a question has multiple parts, indicate exactly where you answer each part. This exam has three (3) sections; be sure to follow the directions for each section. Allocate your time carefully: many students spend too much time on the short answer questions.

1. VERY SHORT ANSWERS:

ANSWER ALL OF THESE. Carefully define and briefly discuss the following terms. Whenever possible, supplement your verbal definition with **both** a mathematical definition and an example.
Allocated time: 3 minutes each.
Page limit: one page per definition.

primary fiscal deficit	spurious regression
Euler equation	Tobin's q
gross substitutes (among assets)	open market purchase
Okun's Law	Ricardian equivalence

2. SHORT ANSWERS:

DO THE FIRST QUESTION AND ONE MORE FOR A TOTAL OF TWO (2) OF THE FOLLOWING QUESTIONS. ALL QUESTIONS ARE EQUALLY WEIGHTED. Allocated time: 30 minutes each.

Suggested page limit: three pages per question.

SA1. What was Sargent's (1971) critique of popular approaches to the estimation of the Phillips curve? Give a *detailed* account of his analysis.

SA2. Explain what is meant in the consumption literature by "excess sensitivity" and by "excess smoothness". Be careful and detailed. How supportive is the empirical literature of the permanent-income-life-cycle-hypothesis? Give a brief but very precise account of at least one important empirical study.

SA3. Provide graphs and intuition for an increase in "animal spirits" in the Friedman (1948) deficit finance model (100% money finance). What do you think of Friedman's claim that his proposal will stabilize an economy that is subject to aggregate demand shocks? Provide a precise intuitive discussion, including a brief verbal presentation of the model and its graphical representation. Be sure to discuss in detail all slopes and shifts for *each* curve. **(No algebra, please.)**

3. LONGER ANSWERS:

ALL STUDENTS MUST ANSWER ONE (1) OF THE FOLLOWING QUESTIONS.
Allocated time: 1 hour.

LA1. Consider the following "term-structure" model of a simple fix-price economy.

$$M = L(i, R, Y) \qquad DY = \phi(Y, Y_{ss}, R, F) \qquad i = R - DR/R$$

Here D is the differential operator, i is the short-rate, R is the coupon rate of return on a perpetuity, Y is real income, Y_{ss} is the steady-state level of real income, M is the exogenous money supply, and F is a "fiscal stance" variable. Give an intuitive explanation of each of the "structural" equations, including an explanation of the sign of each of the partial derivatives. Be sure to think carefully about any deviations of this model from the textbook version, and carefully consider the influence of Y_{ss} on aggregate demand. (NO CREDIT if you ignore this!) Then consider the effects of a one-time, permanent, *anticipated* tax cut in the short run, intermediate run (i.e., dynamic adjustment, including full adjustment dynamics algebra), and long run (including full long-run comparative statics algebra). Note that two sets of algebraic results are required. Include a complete intuitive discussion supported by detailed graphs. You should assume that the combined marginal propensity to spend out of current (Y) plus "permanent" (Y_{ss}) income is less than unity.

LA2. Suppose an infintely lived consumer is choosing consumption and portfolio shares, where wealth may be allocated to a risk-free asset or one of two risky assets (for a total of THREE assets). Derive the asset pricing relationships implied by the consumption CAPM model. Be sure to provide *detailed* economic intuition at *every* step of your derivation, with particular attention to the interpretation of the first order and envelope conditions.

END OF EXAM