Economics 21 **Spring 2014**

2nd Midterm Exam

This is a **60** minute exam. The exam has **100 points,** use the point totals next to each question to allocate your time.

Part I (36 points): The questions below divide the Perfect Storm that resulted in the world-wide financial meltdown into various components. You need to answer **Two** questions in **each** of the subparts, but you are **Not** supposed to answer all of the questions:

1) Precursors: For **two** of the items below, discuss how they helped lay the foundation for the financial meltdown:

a) The world-wide Savings Glut
b) Securitization of mortgages
c) Financial market deregulation

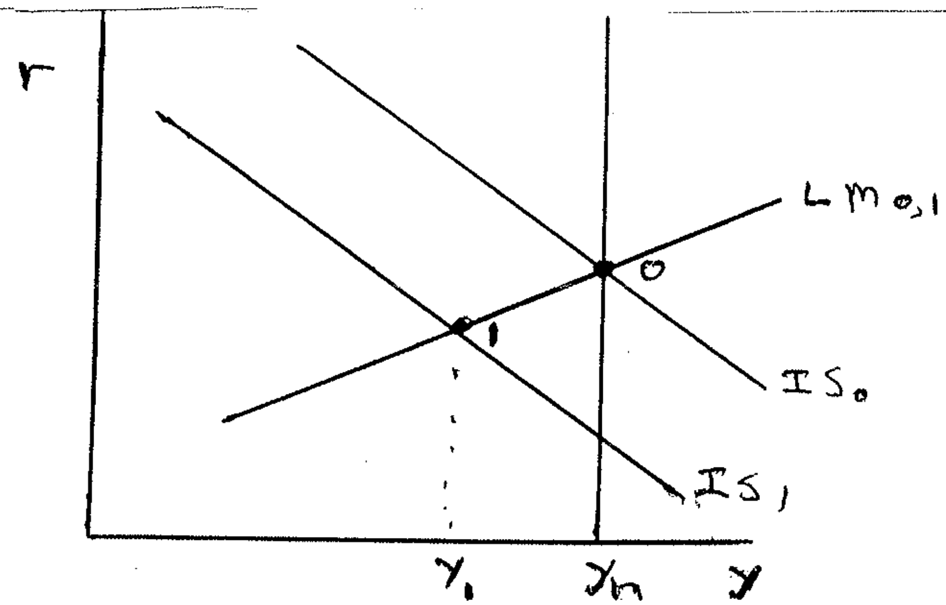
2) Amplification Mechanisms: For **two** of the items below, discuss how they amplified the housing bubble collapse into a world-wide financial meltdown:

a) Leveraging
b) Collateral Calls, Fire Sales and the Financial Market Death Spiral
c) Credit Default Swaps and Increasing Financial Interconnectedness

3) Government Intervention: For **two** of the items below, discuss how they lessened the effects of the financial meltdown and the Great Recession:

a) Quantitative Easing (increasing the monetary base)
b) Qualitative Easing (what Blanchard calls credit easing)
c) The Obama stimulus package

Part II (24 points): The graph below depicts an economy in an ordinary recession:



1) How do you know that in going from Point 0 to Point 1, the economy is entering an ordinary recession and not the Great Recession and a liquidity trap?

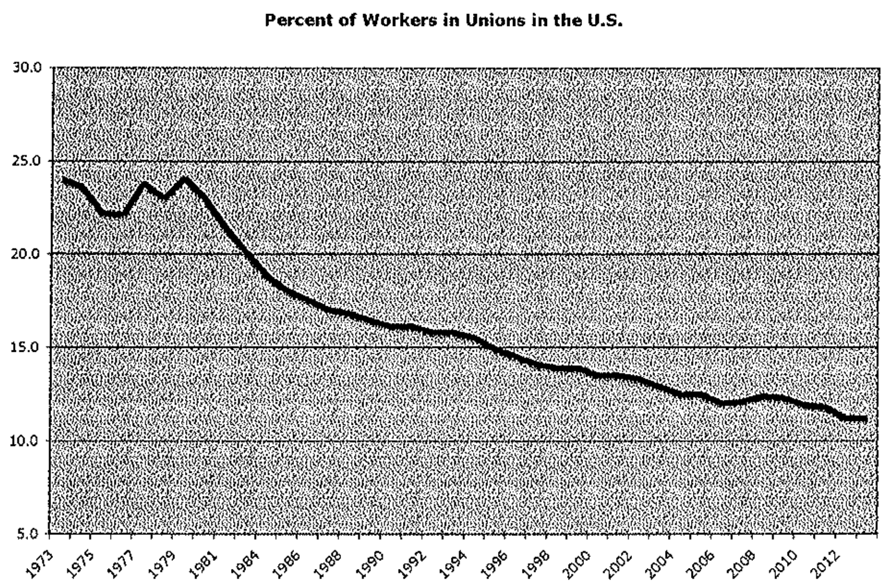
For the remaining questions in this Part assume that the shift back of the IS curve was due to a decline in investment spending (a decline in i_0):

2) What will happen to **the nominal exchange rate** and **NX** as the economy moves from Point 0 to Point 1, Why?

3) If you allow the economy to heal itself, what will happen to the **nominal wage** as the economy moves from Pont 1 to full employment? Why?

4) If you allow the economy to heal itself, what will happen to the **real wage** as the economy moves from Pont 1 to full employment? Why?

Part III (24 points): The chart below gives the percentage of workers in the U.S. that are unionized:



Answer the questions below and provide brief explanations:

1) Over time, what does this graph imply should be happening to the natural rate of unemployment and the real wage?

2) What does this graph imply should be happening to the price level and GDP in the short run?

3) What does this graph imply should be happening to the price level and GDP in the medium run?

(Last Part is on Next Page)

Part IV (16 points):

The central question in All of Economics is "How well do Markets Work and whether Government Intervention can improve things?" Both Milton Friedman and Real Business Cycle theorists are skeptical of government intervention:

1) Why is Milton Friedman skeptical about the effectiveness of government intervention? How does his criticism relate to the timing of government policy?

2) Why are Real Business Cycle theorists skeptical of the effectiveness of government intervention? How does their criticism relate to their belief in the efficacy of markets?