Please answer all questions. Your answers should be concise, yet complete. Be sure to label all graphs clearly (including axes).

Good luck!

1. (30 points) The prices of equities sold in the stock market have recently risen to record high levels. This fact indicates that although the Fed has recently manufactured a recent increase in interest rates, monetary policy may actually be quite loose. If monetary policy is indeed lax, this is cause for concern because it may lead to an overheating of the economy (a level of output above the full-employment level) and eventual inflation.
   a. Explain how loose monetary policy, via its effect on equity prices, could lead to an increase in output in the short run. (Hint: think about Tobin’s q (replacement cost of firm/market value of firm) or wealth effects.)
   b. Assuming the economy was initially operating at a long run equilibrium, depict the events described in part a. graphically, using an IS-LM diagram.
   c. Explain and indicate graphically in an AS-AD diagram and an IS-LM diagram what will happen in the long run.

2. (20 points) If the Fed decides that the US economy is indeed in danger of overheating, it may tighten monetary policy. Interest rates will then rise. Since the US is a large economy, the world interest rate will probably rise as well.
   a. Indicate graphically how output and the exchange rate of a small open economy would be affected by a rise in the world rate of interest.
   b. Explain in words the changes you found in part a.

3. (20 points) In the late 1970s, inflation in the US climbed to the double-digit range. In 1979, the chairman of the Fed, Paul Volker, announced that monetary policy would tighten, aiming to reduce the rate of inflation. The early 1980s saw the largest and quickest reduction in inflation in recent US history.
   a. Indicate the effect of tight monetary policy on interest rates in the short run.
   b. Indicate the effect of tight monetary policy on interest rates in the long run.

4. (20 points) No story for this one.
   a. How do the central bank, the public, and households affect the money supply process?
   b. Suppose that the monetary base is 100 BN dollars, the reserve to deposit ratio is 0.10, the currency to deposit ratio is 0.20, and banks hold no excess reserves. What is the money supply?

5. (10 points) (As promised). Explain to a non-economist why economists like markets so much.