INSTRUCTIONS TO CANDIDATES

1. This paper consists of THREE sections.

2. Each section consists of TWO questions. Candidates MUST answer THREE questions, ONE from EACH section.

3. Answers for ALL questions must be written in the answer booklet provided.

4. Candidates may use silent non-programmable calculators.
SECTION I

Answer ONE question from this section.

1. (a) The 'government purchases' component of GDP does not include spending on transfer payments such as social security benefits. Using the definition of GDP, explain why transfer payments are excluded when computing GDP. [4 marks]

(b) State the formula for converting nominal GDP to real GDP. [1 mark]

(c) Use the information in the table below to answer (c) (i) and (c) (ii).

<table>
<thead>
<tr>
<th>Year</th>
<th>Price of Milk ($)</th>
<th>Quantity of Milk (litres)</th>
<th>Price of Honey ($)</th>
<th>Quantity of Honey (quarts)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>1</td>
<td>100</td>
<td>2</td>
<td>50</td>
</tr>
<tr>
<td>2002</td>
<td>2</td>
<td>150</td>
<td>3</td>
<td>100</td>
</tr>
<tr>
<td>2003</td>
<td>3</td>
<td>200</td>
<td>4</td>
<td>150</td>
</tr>
</tbody>
</table>

(i) Using 2001 as the base year, compute for each year

   a) Nominal GDP
   b) Real GDP
   c) GDP deflator.

(ii) Compute the percentage change from 2001 to 2002 and from 2002 to 2003 for

   a) Nominal GDP
   b) Real GDP
   c) GDP deflator. [30 marks]

(d) Explain why economists use real GDP rather than nominal GDP to measure economic well-being. [5 marks]

(e) On Fridays, Barry, the Barber Inc., collects $400 for haircuts. During the day, his equipment depreciates in value by $50. Of the remaining $350, Barry sends $30 to the government for sales tax, takes home $220 in wages and retains $100 in his business to add new equipment in the future. From the $220 that Barry takes home, he pays $70 as income taxes.
Based on the information given on page 2, compute Barry’s contribution to the following measures of income in the economy:

(i) Gross domestic product
(ii) Net national product
(iii) National income
(iv) Personal income
(v) Disposable personal income

Total 50 marks

2. (a) Explain the meaning of the following terms:

(i) Aggregate demand
(ii) Aggregate demand curve
(iii) Aggregate supply
(iv) Aggregate supply curve
(v) Equilibrium price level

(b) Using aggregate demand and aggregate supply curves to illustrate your points, discuss the impacts of the following events on the price level (P) and equilibrium GDP (Y) in the short run.

(i) A tax cut holding government purchases constant, with the economy operating at near full capacity
(ii) An increase in the money supply during a period of high unemployment and excess industrial capacity
(iii) An increase in the price of oil caused by war in the Middle East, assuming that the government attempts to keep interest rates constant by accommodating inflation

(c) Investment is usually regarded as the most unstable component of aggregate spending. Several factors contribute to such instability.

Explain how the variability of profits and expectations contribute to the instability of investment.

Total 50 marks
3. Fiscal policy is one of two policy channels through which the government can affect the macro-economy. Discretionary fiscal policy and automatic stabilizers are two important fiscal policy measures.

(a) (i) Differentiate between ‘discretionary fiscal policy’ and ‘automatic stabilizers’.

(ii) Using examples, explain how discretionary fiscal policy and automatic stabilizers work during periods of recession or inflation in an economy. [12 marks]

(b) Suppose that as Chief Economic Adviser, the Minister of Finance calls you into his office and says the following:

"Unemployment is too high. We need to lower it by increasing both output and income. Right now the equilibrium level of income/output is $900 billion, but perhaps an acceptable unemployment rate could be achieved if aggregate output increases to say, $1100 billion. Note however that the marginal propensity to consume is 0.75, and taxes must remain at the present levels. So, adjusting taxes (T) is out of the question."

(i) Under the circumstances outlined above, explain how the government can use fiscal policy – taxing and spending – to increase the equilibrium level of output from $900 billion to $1100 billion.

(ii) Using a 45° line diagram, graph the original situation and the solution you gave in (b) (i) above. [18 marks]

(c) Suppose that instead of keeping taxes (T) constant, the Minister of Finance decided to finance the increase in government spending with an equal increase in taxes so as to maintain a balanced budget.

Explain what happens to aggregate spending as a result of a rise in both taxes and government spending. [10 marks]

(d) How much a balanced-budget increase in government spending (G) and taxes (T) will raise output depends on the balanced budget multiplier.

(i) What is the balanced budget multiplier?

(ii) Referring to the solution given in (c) above, how large is the balanced budget multiplier? Explain your answer. [10 marks]

Total 50 marks
4. (a) Discuss the following:
   (i) TWO advantages of paper money
   (ii) TWO advantages of cheques as compared to commodity money
   (iii) TWO disadvantages of commodity money

(b) Currency and chequable deposits have no intrinsic value and they are not backed by gold or other precious metals, yet they are regarded as money.

Discuss the role of acceptability and fiat or law in determining the value of money. [12 marks]

(c) (i) Discuss the basic determinant of the transactions demand for money and the speculative demand for money.

(ii) Assume that the money market is initially in equilibrium and that the money supply is increased.

With the use of a diagram, explain the adjustments toward a new equilibrium interest rate. [20 marks]

Total 50 marks
SECTION III

Answer ONE question from this section.

5. The table below shows the hypothetical domestic demand and supply schedules for shirts. Use the information presented to answer the questions that follow.

<table>
<thead>
<tr>
<th>Price ($)</th>
<th>Quantity Demanded (units)</th>
<th>Quantity Supplied (units)</th>
</tr>
</thead>
<tbody>
<tr>
<td>6</td>
<td>800</td>
<td>1100</td>
</tr>
<tr>
<td>5</td>
<td>1000</td>
<td>1000</td>
</tr>
<tr>
<td>4</td>
<td>1200</td>
<td>900</td>
</tr>
<tr>
<td>3</td>
<td>1400</td>
<td>800</td>
</tr>
<tr>
<td>2</td>
<td>1600</td>
<td>700</td>
</tr>
</tbody>
</table>

(a) (i) Using the graph paper supplied, plot the demand and supply curves.

(ii) What are the equilibrium price, $P_e$, and equilibrium quantity, $Q_e$?

Assume that the world price for shirts is $3.

(iii) Show this as $P_w$ on the diagram you have drawn.

(iv) On your diagram, indicate the levels of domestic consumption and domestic production. [17 marks]

(b) In order to preserve employment, local manufacturers of shirts argue successfully that theirs is an infant industry that should be protected. As such, a tariff is imposed that raises the price of shirts to $4.

(i) Show the tariff as $P_t$ on the diagram you have drawn.

(ii) Following the imposition of the tariff, by how much will domestic production increase?

(iii) What is the new level of domestic consumption?

(iv) Following the imposition of the tariff, how many shirts will be imported?

(v) In terms of tax revenues, how much will the tariff yield? [13 marks]
(c) (i) On your diagram, shade in the area representing the net welfare loss (deadweight loss) caused by the tariff.

(ii) Calculate how much is the loss in welfare. [10 marks]

(d) (i) Explain who gains and who loses when a country allows trade and becomes an exporter.

(ii) Explain who gains and who loses when a country allows trade and becomes an importer.

(iii) Considering the circumstances in (d) (i) and (d) (ii) above, do the gains from trade exceed the losses? [10 marks]

Total 50 marks

6. (a) Using appropriate examples, explain EACH of the following terms:

(i) Free-trade area

(ii) Customs union

(iii) Common market [12 marks]

(b) (i) Describe, briefly, EACH of the following:

a) CARICOM

b) CSME

c) FTAA [9 marks]

(ii) Outline THREE objectives of Caribbean integration. [9 marks]

(c) Discuss FOUR advantages to CARICOM member states arising from the free movement of factors of production – goods, services, capital and people – under the CSME. [20 marks]

Total 50 marks

END OF TEST