1. Suppose that Tommy Hilfiger’s marginal cost of a jacket is a constant $100 and at one of the firm’s shops, total fixed cost is $2,000 a day. The profit-maximizing number of jackets sold in this shop is 20 a day. When the shops nearby start to advertise their jackets, this Tommy Hilfiger shop spends $2,000 a day advertising its jackets, and its profit-maximizing output jumps to 50 jackets a day.

(1) What is this shop’s average total cost of a jacket sold before it starts to advertise? (10%)
(2) What is its average total cost of a jacket with advertising? (10%)
(3) Can you say what happens to Tommy’s markup and its economic profit? Why or why not? (10%)

2. What is the cause of the high unemployment rate? One side says more government spending can reduce it. The other says it’s a structural problem - people who can’t move to take new jobs because they are tied down to burdensome mortgages or firms that can’t find workers with the requisite skills to fill job openings.


(1) Which business cycle theory would say that the rise in unemployment is cyclical? (10%)
(2) Which business cycle theory would say it is an increase in the natural rate? Why? (10%)

3. A donut store caters to its retirement population by selling over 10,000 donuts each week. To produce that many donuts weekly, the donut store uses 1,000 pounds of flour, which must be delivered by 5:00 AM every Friday morning. How would the manager of this donut store acquire flour? Explain. (10%)

4. You are the bargaining coordinator for a manufacturing company. At present you are renegotiating the labor contract with the union representative. You are bargaining over an expected 20 percent increase in earnings over the next three-year contract period. You are trying to decide whether to offer one-third, one-half, or all of the increase in earnings to the union. The union rules are such that all contracts must be voted on. The additional earnings are contingent on getting started on the new contract next week. If an agreement isn't reached on the first round of negotiations, the firm will go out of business. The union representative tells you that if you do not give the union all of the additional profits, the union members will not vote for the agreement.

(1) Show the extensive form of this game. (10%)
(2) What will you offer the union? Explain. (10%)

5. Describe the effects of contractionary monetary policy by the domestic central bank on output, the real interest rate, and net exports in both the domestic and foreign country, using a Keynesian model in the short run. (12%) What happens in the long run? (8%)