

**ECO 209Y – L0101
MACROECONOMIC THEORY**

Term Test #2

LAST NAME _____

FIRST NAME _____

STUDENT NUMBER _____

INSTRUCTIONS:

1. The total time for this test is 1 hour and 45 minutes.
2. Aids allowed: a simple calculator.
3. Use pen instead of pencil.

DO NOT WRITE IN THIS SPACE

Part I _____/40

Part II _____/10

Part III 1. _____/10

2. _____/10

3. _____/10

TOTAL _____/80

PART I (40 marks)

Instructions:

- Enter your answer to each question in the table below.
- Each correct answer is worth 2.5 marks. **Note that a deduction of 0.5 mark will be made for each incorrect answer.** Table cells left blank will receive a zero mark (i.e., no deduction).
- **Do NOT guess your answers!**

1	2	3	4	5	6	7	8
9	10	11	12	13	14	15	16

1. Suppose that average income per capita in Uruguay is 240,000 pesos per year and that the nominal exchange rate for Uruguayan pesos is 0.04. Further suppose that a given consumption basket of goods and services costs \$3,750 in the Canada and 75,000 pesos in Uruguay. Using the *PPP* exchange rate, income per capita in Uruguay is:
A) \$11,500.
B) \$11,750.
C) \$12,000.
D) \$12,250.
E) none of the above.
2. If capital mobility is imperfect and import demand is completely insensitive to changes in the level of domestic output, which one of the following statements is correct?
A) The *BP* curve is vertical.
B) The *BP* curve is horizontal.
C) The *BP* curve is downward sloping.
D) The *BP* curve is upward sloping.
E) The *BP* curve is not determinable.

Use this space for rough work.

3. China is being accused by Western countries of setting the value for its domestic currency too low. All else equal, which one of the following statements might describe the impact of an undervalued domestic currency on the Chinese economy?
- A) The prices of imported goods would be artificially low for Chinese consumers.
 - B) Inflation pressure would tend to decrease in the Chinese economy.
 - C) The Chinese money supply would tend to increase.
 - D) China will experience greater capital inflows.
 - E) None of the above is correct.
4. In a flexible exchange rate system with perfect capital mobility, which one of the following statements is correct?
- A) Expansionary monetary policy will appreciate the domestic currency.
 - B) Fiscal expansion is very effective in stimulating aggregate expenditure.
 - C) Fiscal expansion causes an appreciation of the domestic currency.
 - D) An increase in exogenous exports will increase net exports.
 - E) None of the above is correct.
5. Consider the model of an open economy with a fixed-price level, fixed exchange rates and perfect capital mobility. Suppose the economy is initially in a situation of internal and external balance and the government now implements contractionary fiscal policy. Which one of the following statements better describes the changes once the new equilibrium is achieved?
- A) The exchange rate will appreciate.
 - B) The balance in the current account will improve.
 - C) The money supply will increase.
 - D) The balance of the capital account will improve.
 - E) Both output and the interest rate will increase.
6. Consider a fixed-price level model of an open economy with flexible exchange rates and imperfect capital mobility. If the government wishes to raise interest rates without increasing the value of the Canadian dollar, the government should
- A) increase its expenditure and cut the money supply.
 - B) raise its expenditure and raise the money supply.
 - C) leave its expenditure unchanged while increasing the money supply.
 - D) lower its expenditure and cut the money supply.
 - E) lower its expenditure and raise the money supply.

Use this space for rough work.

7. Consider the model of an open economy with a fixed-price level, flexible exchange rates and perfect capital mobility. A decrease in government expenditure will cause
- A) output, interest rates, and the exchange rate to increase.
 - B) output and interest rates to increase, but the exchange rate to fall.
 - C) the exchange rate to rise, but the level of output and the interest rate will remain unchanged.
 - D) the exchange rate and the level of output to rise, but the interest rate will remain unchanged.
 - E) output to rise and the exchange rate to fall while the interest rate will remain unchanged.
8. Consider the model of an open economy with a fixed-price level, flexible exchange rates and imperfect capital mobility, where the BP curve is flatter than the LM curve. An increase in the money supply will cause
- A) output, the interest rate, and the exchange rate to increase.
 - B) output and the interest rate to increase, while the exchange rate will decrease.
 - C) output and the exchange rate to increase, while the interest rate will decrease.
 - D) output to decrease while the exchange rate and the interest rate will increase.
 - E) output to increase while the exchange rate and the interest rate will decrease.
9. Consider the model of an open economy with a fixed-price level, flexible exchange rates, and perfect capital mobility. Given an increase in autonomous exports, which one of the following statements is true with respect to its impact on the domestic economy?
- A) The domestic currency will appreciate and imports will rise, leaving net exports and the level of output unchanged.
 - B) The domestic currency will appreciate and the rate of interest will rise, and therefore imports will increase and investment will fall.
 - C) The domestic currency will depreciate and imports will fall, thus increasing both net exports and the level of output.
 - D) The domestic currency will depreciate and the rate of interest will rise, and therefore both imports and investment will fall.
 - E) None of the above are true.
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Use this space for rough work.

10. Consider a small open economy with a fixed-price, fixed exchange rates, and no capital mobility. Assume that $BP = 0$ in the initial equilibrium. If the government imposes an import quota, in the new equilibrium:
- A) net exports will remain unchanged, but the money supply and income will both be higher.
 - B) net exports, the money supply, and income will all remain unchanged.
 - C) net exports, the money supply, and income will all be lower.
 - D) net exports, the money supply, and income will all be higher.
 - E) net exports will remain unchanged, the money supply will be lower, and income will be higher.
11. Suppose money and bonds are the only two assets in the economy. If bond holders attempt to sell bonds in order to increase their money holdings, at the end of the process of adjustment
- A) the money held by individuals and businesses will decrease by the same amount as their bond holdings will increase.
 - B) the money held by individuals and businesses will increase by the same amount as their bond holdings will decrease.
 - C) individuals and business will reduce their bond holdings but will keep their money holdings unchanged.
 - D) individuals and businesses will keep both their total money holdings and their total bond holdings unchanged.
 - E) individuals and business will reduce both their bond holdings and their money holdings by the same amount.
12. If the money multiplier is 2 and the Bank of Canada buys \$1 million of bonds in the open market at the same time that it sells \$1.5 million of foreign exchange, then the M1 money supply will
- A) increase by \$5 million.
 - B) increase by \$2 million.
 - C) increase by \$1 million.
 - D) fall by \$5 million.
 - E) fall by \$1 million.
13. Assume that the currency-deposit ratio is 0.20, the desired reserve-deposit ratio is 0.05, and total money supply is \$3.6 billion. What is the amount of high-powered money if there are no excess reserves in the banking system?
- A) \$500 million.
 - B) \$650 million.
 - C) \$700 million.
 - D) \$750 million.
 - E) None of the above is correct.

Use this space for rough work.

14. You have just learned that the Bank of Canada has bought for \$1 million a collection of painting by the Group of Seven to decorate its boardroom. Once monetary equilibrium is restored, which one of the following statements will be correct?
- A) The monetary base and the money supply will both decrease by \$1 million.
 - B) The monetary base and the money supply will both increase by \$1 million.
 - C) The monetary base will increase by \$1 million but the money supply will increase by more than \$1 million.
 - D) The monetary base will increase by \$1 million but the money supply will not change.
 - E) The money supply will increase by \$1 million but the monetary base will not change.
15. Consider a closed economy with a flexible-price level and currently at full employment. If workers decided to supply more labour at any level of the real wage rate, which one of the following statements would be correct?
- A) Both the real wage and the price level would increase.
 - B) Both the real wage and the price level would decrease.
 - C) The real wage would increase and the price level would decrease.
 - D) The real wage would decrease and the price level would increase.
 - E) The real wage would increase while the price level would remain unchanged.
16. It has recently been reported in the news that Canada's unemployment rate has fallen from 6.9 percent in May to 6.8 percent in June. Which of the following statements best explains this labour market outcome?
- A) The level of employment increased while the participation rate remain unchanged.
 - B) The participation rate decreased while the level of employment rose slightly.
 - C) Both the participation rate and the level of employment decreased.
 - D) The Canadian economy is improving.
 - E) Both A) and D) are correct.

Use this space for rough work.

PART II (10 marks)

Consider an open economy with a fixed-price level, flexible exchange rates, and imperfect capital mobility. This economy is characterized by the following behavioural equations:

$$C = 60 + 0.8 YD$$

$$I = 200 - 20i + 0.1 Y$$

$$G = 300$$

$$TA = 0.25 Y$$

$$TR = 50$$

$$X = 250 + 100 eP^f/P$$

$$Q = 400 - 50 eP^f/P + 0.1 Y$$

$$P^f = 2$$

$$P = 1$$

$$L = 0.2 Y - 10i$$

$$M/P = 200$$

$$CF = 25 (i - i^*)$$

$$i^* = 9$$

a) What is the equation for the *IS* curve in this model? (2 marks)

b) What is the equation for the *LM* curve in this model? (2 marks)

c) What is the equation for the BP curve in this model? **(2 marks)**

d) What are the equilibrium values of Y , i and e ? **(3 marks)**

e) What are the balances in the current account and the capital account in this equilibrium? **(1 mark)**

PART III (30 marks)

Instructions: Answer the following three questions in the space provided. You may continue your answer on page 12 if additional space is required (***but clearly indicate that your answer continues on page 12***). Each question is worth 10 marks.

1. **Critically evaluate the following statement:** *“If a small country unilaterally reduces its import tariffs, its level of income decreases, its rate of interest falls, and the balances in both its current and capital accounts deteriorate.”* **(Show your answer with the help of a diagram and explain the economics. Consider the fixed-price level model of an open economy with imperfect capital mobility and fixed exchange rates.)**

2. Critically evaluate the following statement: *"The more flexible money wages are, the more effective expansionary fiscal policy will be."* (Show your answer with the help of a diagram and explain the economics. Consider a closed economy with a flexible-price level. Assume that there is a recessionary gap at the initial equilibrium.)

3. Describe the main characteristics that differentiate a “balance-sheet-recession” from a more “typical” recession. Comment on the relative effectiveness of both monetary and fiscal policies during balance-sheet-recessions. Clearly describe and explain the most effective type of policy the government could implement to restore the health of the economy in this situation.

(Continue on this page if necessary)

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