

ECO 209Y
MACROECONOMIC THEORY AND POLICY

Term Test #3

LAST NAME _____

FIRST NAME _____

STUDENT NUMBER _____

Circle the section of the course in which you are registered:

L0101
M – 2-4

L0301
W – 2-4

L0401
R – 2-4

INSTRUCTIONS:

1. The total time for this test is 1 hour and 50 minutes.
2. Aids allowed: a simple, non-programmable calculator.
3. Use pen instead of pencil.

DO NOT WRITE IN THIS SPACE

Part I 1. _____/10

Part II _____/18

2. _____/10

Part III _____/42

3. _____/10

4. _____/10

TOTAL _____/100

PART I (40 marks)

Instructions: Indicate whether each of the following statements is true, false or uncertain. Marks will be given entirely for your explanation. All questions are of equal weight.

1. Determine whether the following statement is true, false, or uncertain: *“In a fixed-price, open economy with flexible exchange rates and imperfect capital mobility, an increase in government expenditure will lead to an increase in equilibrium income, a rise in the equilibrium rate of interest, a deterioration in the current account, and an improvement in the capital account.”* (Show your answer with the help of a diagram and explain the economics.)

2. Determine whether the following statement is true, false, or uncertain: *“Under the assumption of perfect capital mobility and flexible exchange rates, expectations of domestic currency depreciation will cause domestic output to fall, the capital account to improve, and the current account to deteriorate.”* (Show your answer with the help of a diagram and explain the economics.)

3. Determine whether the following statement is true, false, or uncertain: *“If money wages are fully flexible, expansionary fiscal policy will be effective with respect to income only if workers suffer from money illusion.”* (Show your answer with the help of a diagram and explain the economics. An analysis of the supply adjustment would be sufficient.)

4. The U.S. is experiencing significant macroeconomic imbalances: the federal government is running a record budget deficit while the current account deficit is at an all time high. The data also show that the U.S. trade deficit with China accounts for a significant portion of this current account deficit, while China's purchases of U.S. treasury bills account for a significant portion of the capital account surplus the U.S. is also experiencing. Some economists and policy advisers suggest that, in order to eliminate the current account deficit, the U.S. government should continue pressuring China to revalue its domestic currency.

In your view, what impact would a significant revaluation of the Chinese currency have on the U.S. economy? In your answer you should clearly explain the expected effect on GDP, the interest rate, the current account, and the capital account of the U.S. as well as on the value of the U.S. dollar. [Note: You do not need to use a diagram to answer this question.]

PART II (18 marks)

Consider the following model of the economy:

Aggregate Demand:	$P = 150 / Y$
Labour Demand:	$W = 10 P / N^{1/2}$
Labour Supply:	$W = 3 N^{1/2} / 5$
Production Function:	$Y = 20 N^{1/2}$

where P is the price level, Y is real output, W is nominal wage, and N is the level of employment.

a) Derive the expression for the Aggregate Supply (AS) curve. **(4 marks)**

b) Find the equilibrium values of Y and P . **(2 marks)**

c) Find the equilibrium values of N , W , and W/P . **(3 marks)**

d) Suppose now that AD changes to $P = 216 / Y$ at the same time that the government freezes wages at $W = 3$.

i) Derive the expression for the new AS curve. **(4 marks)**

ii) What are the new equilibrium levels of P , Y , N , and W/P ? **(5 marks)**

PART III (42 marks)

Instructions:

- Multiple choice questions are to be answered using a **black pencil** or a **black or blue ball-point pen** on the separate **SCANTRON sheet** being supplied.
- **Be sure to fill in your name and student number on the SCANTRON sheet!**
- Each question is worth 3.5 marks. **No deductions will be made for incorrect answers.**
- **Write your answers to the multiple choice questions ALSO in the table below.** You may use this question booklet for rough work, **and then transfer your answers to each multiple choice question onto the separate SCANTRON sheet.** Your answers **must be** on the SCANTRON sheet. In case of a disagreement, **the answer to be marked is the one on the SCANTRON sheet.**

1	2	3	4	5	6	7	8	9	10	11	12

1. Consider the fixed-price model of an open economy with perfect capital mobility and a flexible exchange rate. Which of the following best expresses how policy could affect aggregate output in the short-run?
 - A) Monetary policy is effective and fiscal policy is ineffective.
 - B) Monetary policy and fiscal policy are both effective.
 - C) Monetary policy is ineffective and fiscal policy is effective.
 - D) Monetary policy and fiscal policy are both ineffective.
 - E) Monetary and fiscal policy must be coordinated.

2. In an open economy with fixed prices, flexible exchange rates, and perfect capital mobility, all other things equal a decrease in the foreign interest rate would cause
 - A) the exchange rate to appreciate and equilibrium income to fall.
 - B) the exchange rate to appreciate and equilibrium income to increase.
 - C) the exchange rate to depreciate and equilibrium income to fall.
 - D) the exchange rate to depreciate and equilibrium income to increase.
 - E) the exchange rate to appreciate with no change in equilibrium income.

3. In an open economy IS-LM-BP model with imperfect capital mobility and flexible exchange rates, restrictive monetary policy causes
 - A) the LM-curve to shift to the left with a subsequent shift of both the IS-curve and the BP-curve to the right due to a currency depreciation.
 - B) the LM-curve to shift to the left with a subsequent shift of both the IS-curve and the BP-curve to the left due to a currency appreciation.
 - C) the LM-curve to shift to the left with a subsequent shift of the IS-curve to the left and of the BP-curve to the right due to a currency depreciation.
 - D) the LM-curve to shift to the left with a subsequent shift of both the IS-curve and the BP-curve to the left due to a currency depreciation.
 - E) the LM-curve to shift first to the left and then back to the right due to a currency appreciation.

4. Consider a model of an open economy with fixed prices, flexible exchange rates, and perfect capital mobility. Given an increase in the level of U.S. income, which one of the following statements is true with respect to its impact on the Canadian economy?
- A) Exports will increase, the Canadian dollar will appreciate but the balances in both the current and the capital accounts will remain unchanged.
 - B) Net exports and equilibrium income will both increase.
 - C) Net exports will increase, the Canadian dollar will appreciate, and the balance in the capital account will deteriorate.
 - D) Exports will increase while imports will decrease, and thus the balance in the current account will improve while the balance in the capital account will deteriorate.
 - E) Net exports will increase, the Canadian dollar will depreciate, and the balance in the capital account will deteriorate.
5. Under a system of imperfect capital mobility and flexible exchange rates, which of the following would be the most likely outcomes following the implementation of expansionary fiscal policy?
- A) Lower interest rates, outflow of capital, currency depreciation.
 - B) Higher interest rates, inflow of capital, currency depreciation.
 - C) Higher interest rates, inflow of capital, currency appreciation.
 - D) Lower interest rates, outflow of capital, currency appreciation.
 - E) Lower interest rates, outflow of capital, currency depreciation.
6. Consider a model of an open economy with fixed prices, flexible exchange rates, and imperfect capital mobility. If the government wishes to reduce interest rates without reducing the value of the Canadian dollar, it should
- A) increase its spending and cut the money supply.
 - B) lower its spending and cut the money supply.
 - C) raise its spending and raise the money supply.
 - D) lower its spending and raise the money supply.
 - E) cut the money supply and leave spending unchanged.
7. Which of the following is NOT reflected in a shift of the AD-curve?
- A) A change in real money balances due to a change in nominal money supply.
 - B) A change in the interest sensitivity of the demand for real balances.
 - C) A change in government transfer payments.
 - D) A change in real money balances due to a change in the price level.
 - E) A change in autonomous investment.
8. The concept of “diminishing marginal product of labour” suggests that the slope of the short-run production function
- A) increases as the quantity of labour decreases.
 - B) decreases as the quantity of capital increases.
 - C) increases as the quantity of labour increases.
 - D) equals zero for all quantities of labour.
 - E) is negative.

9. A profit-maximizing firm will hire additional units of labour
- A) as long as the nominal wage rate is greater than the value of the marginal product of labour.
 - B) as long as the nominal wage rate is smaller than the marginal product of labour.
 - C) as long as the value of the marginal product of labour is greater than the nominal wage rate.
 - D) as long as the real wage rate is greater than the marginal product of labour.
 - E) up to the point where the marginal product of labour is equal to the nominal wage rate.
10. Which of the following assumptions is NOT included in the Classical model of the economy?
- A) Wages and prices are fully flexible.
 - B) The supply of labour is a function of the nominal wage rate.
 - C) Firms do not suffer from money illusion.
 - D) The labour market is always in equilibrium with full employment.
 - E) Aggregate demand shocks might change the composition but not the level of GDP.
11. You have read Jim Stanford's article on "What's stimulus, anyway. A simple user's guide" published in the *Globe and Mail* on January 19, 2009. Which of the following statements is correct according to Stanford's views?
- A) The new Tax Free Savings Accounts are stimulus because they "leave more money in peoples' pockets."
 - B) A corporate tax cut is a good stimulus because it rewards profitable companies.
 - C) Handing out \$100 gift certificates for Wal-Mart to low income consumers is a good stimulus because it increases spending.
 - D) Permanent tax cuts are best because they continue stimulating the economy even after the recession is over.
 - E) None of the above is correct.
12. "We Chinese are the biggest savers in the world" says Hung Huang in an article he recently published in the *New York Times* (December 17, 2008). Indeed, the Chinese had "a personal savings rate of 25 percent and a national savings rate (which includes corporate savings) of 47 percent in 2005, compared with a personal rate of 0.5 percent and a national rate of 12 percent in the United States that year." Which of the following statements, in Huang's views, helps to explain China's high savings rate?
- A) Most Chinese are now able to save more because their incomes are much higher than a few years ago.
 - B) Many Chinese are trying to save a lot in order to live in luxury during their retirement years.
 - C) In general, Chinese consume little (and save a lot) to generate a substantial surplus for exports.
 - D) Many Chinese need to save a lot due to the insufficient safety net provided by the government.
 - E) All of the above help to explain China's high savings rate.