ECO 209Y MACROECONOMIC THEORY AND POLICY

Term Test #2							
I	LAST NAME						
I	FIRST NAME		50				
	STUDENT NUMBER						
<u>Indica</u>	ate your section of the cours						
	sday, 10-12 – L0101	□Tuesday, 2-4	□ Tuesday, 2-4 – L0201				
Wed	dnesday, 2-4 – L0301	☐ Thursday, 2-	☐ Thursday, 2-4 – L0401				
INSTR	UCTIONS:						
	 The total time for this test is 2 Aids allowed: a <u>simple</u>, non-pr Use <u>pen</u> instead of <u>pencil</u>. 	hours. ogrammable calculator.					
	DO NOT WRITE	IN THIS SPACE					
Part I	/25	Part III	1/10				
Part II	/15		2/10				
		:	3/10				
TOTAL	/80		4/10				

PART I (25 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
									7
Correct:			Inco	orrect:		E	Blank:	C	

- 1. In a fixed-price *IS-LM* model, if we assume that money demand is totally interest insensitive, then
 - A) fiscal policy is ineffective.
 - B) the liquidity preference curves are horizontal.
 - C) the IS curve is vertical.
 - D) interest rates cannot be lowered by fiscal or monetary policy.
 - E) the *LM* curve is horizontal.
- 2. Consider the model of a closed economy with a fixed price-level. If the interest-sensitivity of investment increased, which one of the following statements would be correct with respect to income?
 - A) Fiscal policy would become more effective and monetary policy would become less effective.
 - B) Fiscal policy would become less effective and monetary policy would become more effective.
 - C) Both fiscal and monetary policy would become more effective.
 - D) Both fiscal and monetary policy would become less effective.
 - E) Fiscal policy would become less effective and monetary policy would become neither more nor less effective.

Use this space for rough work.

- 3. If consumption, investment, and imports are all completely insensitive to changes in the rate of interest, which one of the following statements will be true?
 - A) The *LM* curve is vertical.
 - B) The *IS* curve is horizontal.
 - C) The *IS* curve is vertical.
 - D) The *BP* curve is horizontal.
 - E) None of the above is true.
- 4. If imports are completely insensitive to changes in the level of income, which one of the following statements will be true?
 - A) The BP curve is vertical.
 - B) The BP curve is horizontal.
 - C) The IS curve is vertical.
 - D) The IS curve is flatter than the BP curve.
 - E) None of the above is true.
- 5. Consider a closed economy with a fixed price-level. If consumption demand declines as the interest rate increases, which one of the following statements will be true?
 - A) If the interest sensitivity of consumption is equal to the interest sensitivity of investment, then the *IS* curve will be horizontal.
 - B) If the interest sensitivity of consumption is equal to the interest sensitivity of investment, then the *IS* curve will be vertical.
 - C) The larger the interest sensitivity of consumption, the flatter the *IS* curve.
 - D) The larger the interest sensitivity of consumption, the steeper the IS curve.
 - E) None of the above is true.
- Consider a small open economy with a fixed price-level, fixed exchange rates, and no capital mobility. Assume that BP = 0 at the initial equilibrium. If the central bank devalues the exchange rate, in the new equilibrium
 - A) net exports, the money supply, and income will all be lower.
 - B) net exports and the money supply will decrease, but income will remain unchanged.
 - C) net exports, the money supply, and income will all be higher.
 - D) net exports will remain unchanged, the money supply will be lower, and income will be higher.
 - E) net exports will remain unchanged, but the money supply and income will both be lower.

Use this space for rough work.

- 7. Consider an open economy with a fixed price-level, fixed exchange rates, and perfect capital mobility. An increase in government expenditure will cause
 - A) output to increase and the money supply to fall.
 - B) the money supply to rise and the interest to fall.
 - C) output and interest rate to fall.
 - D) output to increase and the current account to deteriorate.
 - E) output and interest rate to rise.
- 8. Consider a small open economy with a fixed-price level, fixed exchange rates, and **no** capital mobility. If the government decreases autonomous taxes, in the new equilibrium:
 - A) net exports, the money supply, and income will all be lower.
 - B) net exports, the money supply, and income will all be higher.
 - C) net exports will remain unchanged, but the money supply and income will both be higher.
 - D) net exports, the money supply, and income will all remain unchanged.
 - E) net exports and income will remain unchanged, but the money supply will be lower.
- 9. The Japanese economy has been stagnant for a number of years now. After implementing aggressive fiscal and monetary policy, Japan's government is now considering:
 - A) a reduction in corporate taxes in order to increase profits and investment expenditure.
 - B) a reduction in sales taxes in order to increase consumption expenditure.
 - C) a reduction in wages in order to increase profits and investment expenditure.
 - D) an increase in minimum wages in order to increase consumption expenditure.
 - E) a reduction of protectionist measures in order to increase competition in the economy.

10. Which one of the following characterizes a balance-sheet recession?

- A) Due to greater uncertainty, commercial banks reduce their lending.
- B) Households try to increase the value of their assets.
- C) Consumers do not spend because interest rates are too high.
- D) Over optimistic expectations create excess capacity in the economy.
- E) Concerned with inflation, central banks raised interest rates.

Use this space for rough work.

PART II (15 marks)

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

C = 100 + 0.6 Y	L = 0.2 Y - 10 i
I = 200 - 20 i + 0.1 Y	<i>M</i> / <i>P</i> = 200
G = 300	
NX = -150 + 300 e - 0.1 Y	<i>CF</i> = 10 <i>i</i> – 60

a) What are the equations for the IS, LM, and BP curves in this model? (3 marks)

b) If the economy has achieved external balance, what are the values of Y, i and e? (6 marks)

c) What are the balances in the current and capital accounts in the above equilibrium? (1 mark)

d) Suppose now that the central bank changes the exchange rate to *e* = 1. What are the new equilibrium values of Y and *i* in this economy? **(3 marks)**

e) What is the level of the real supply of money in this new equilibrium? (2 marks)

PART III (40 marks)

Instructions: Answer the following four 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: "An increase in autonomous exports will cause the level of income to increase, the rate of interest to rise, and the balance in the current account to improve." Show your answer with the help of a diagram and <u>explain</u> the economics. Consider an economy characterized by a fixed-price level, a fixed exchange rate, and <u>no</u> capital mobility. Assume a recessionary gap and external balance at the initial equilibrium.

2. Critically evaluate the following statement: "An open market purchase (of government bonds) by the Bank of Canada will cause income to increase, the rate of interest to fall, the balance in the current account to deteriorate, and the balance in the capital account to improve." Show your answer with the help of a diagram and <u>explain</u> the economics. Consider an economy characterized by a fixed-price level, a fixed exchange rate, and <u>imperfect</u> capital mobility. Assume a recessionary gap and external balance at the initial equilibrium.

3. Critically evaluate the following statement: "The imposition of a tariff on all imports will cause the level of income to increase, the rate of interest to fall, the balance in the current account to improve, and the balance in the capital account to deteriorate." Show your answer with the help of a diagram and <u>explain</u> the economics. Consider an economy characterized by a fixed-price level, a fixed exchange rate, and <u>imperfect</u> capital mobility. Assume a recessionary gap and external balance at the initial equilibrium.

4. Critically evaluate the following statement: "An increase in the international rate of interest will cause the equilibrium income of a small economy to fall, its money supply to decrease, the balance in its current account to improve, and the balance in its capital account to deteriorate." Show your answer with the help of a diagram and <u>explain</u> the economics. Consider an economy characterized by a fixed-price level, a fixed exchange rate, and <u>perfect</u> capital mobility. Assume a recessionary gap and external balance at the initial equilibrium.

(Continue on this page if necessary)

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