ECO 209Y
MACROECONOMIC THEORY AND POLICY

Term Test #2

December 13, 2017

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SURNAME (LAST NAME):

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INSTRUCTIONS:

- The total time for this test is ***2 hours***. Manage your time properly!
- The only aid allowed is a ***non-programmable*** calculator.
- ***Write your name and identifying information above but keep this test paper and the Supplement closed until the start of the test is announced.***
- There are three parts to the test: ***Part I*** consists of 14 multiple-choice questions (35 points); ***Part II*** is one numerical problem (10 points); and ***Part III*** includes 4 short-answer questions (40 points). The ***total*** point-value of the test is ***85 points***.
- This test includes ***8 pages*** plus the *Supplement*. The *Supplement* contains the multiple-choice questions but you must record your answers to each multiple-choice question in the table provided on the next page. ***Anything written on the Supplement will not be graded.*** We will only collect the test papers, not the *Supplement*.
- In Parts II and III, write your answers clearly and concisely in the space provided immediately after each questions. ***Your entire answer must fit in the designated space.*** No extra space/pages are possible. You cannot use blank space for other questions nor can you write answers on the *Supplement*.
- ***It is best to write in PENCIL and use an ERASER as needed.*** This way you can make sure to fit your final answer in the appropriate space.
- ***Please write legibly.*** If I can't read your handwriting, I can't award you any marks!

PART I (35 points)

Instructions:

- Enter your answer to each of the 14 multiple-choice questions (see the ***Supplement***) in the table below.
- Each correct answer is worth ***2.5 points***.
- ***Note that a deduction of 0.5 point will be made for each incorrect answer.*** Table cells left blank will receive zero points (i.e., no deduction).
- **Do NOT guess your answers! Manage your time properly!**

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

PART II (10 points)

Consider an open economy with exogenous money supply and flexible exchange rates. This economy is characterized by the following behavioural equations:

$C = 100 + 0.75\ YD$	$X = 200 + 50\ e$
$I = 100 - 20\ i$	$Q = 300 - 50\ e + 0.1\ Y$
$G = 300$	$CF = 10\ (i - 5)$
$TA = 0.2\ Y$	$L = 0.5\ Y - 20\ i$
$TR = 0$	$M/P = 400$

a) What is the equation for the *IS* curve? **(2 points)**

b) What are the equations for the *LM* and *BP* curves? **(2 points)**

c) What are the equilibrium values of Y, i and e? **(6 points)**

PART III (40 points)

Instructions: Answer the following four questions in the space provided. Each question is worth a maximum of 10 points.

1. **Critically comment on the following statement:** *"Fiscal austerity has emerged from the debate on the euro crisis as the main strategy to restore growth and employment. According to this view, decreasing fiscal deficits reduces interest rates and injects confidence in the private sector, freeing the basic instincts to invest and consume."*

2. **Critically evaluate the following statement:** *"If the U.S. drops out of NAFTA and imposes tariffs on Canadian goods, Canada's equilibrium income will fall, its equilibrium interest rate will rise, its capital account will improve, and its current account will deteriorate."* **(Show your answer with the help of**

a diagram and <u>explain</u> the economics. Consider the fixed-price level model of an open economy with <u>fixed</u> exchange rates and <u>imperfect</u> capital mobility.)

3. **Critically evaluate the following statement:** *"If, due to greater uncertainty, Canadian investors choose to invest more in the U.S., then Canada's output will fall, its rate of interest will decrease, the balance in its capital account will improve, and the balance in its current account will deteriorate."* **(Show your answer with the help of a diagram and <u>explain</u> the economics. Consider the**

model of an open economy with a fixed-price level, flexible exchange rates, and imperfect capital mobility.)

4. Consider a small open economy with a fixed-price level, flexible exchange rate, and imperfect capital mobility. Suppose that an increase in government spending resulted in a large budget deficit. What difference would it make if this government deficit were financed either entirely by domestic investors or entirely by foreign investors? **(In you answer you must <u>compare</u> and <u>explain</u> the likely short-**

run impact that these two alternative ways of financing a government deficit would have on the rate of interest, level of output, current account balance, and capital account balance.)

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SUPPLEMENT

INSTRUCTIONS:

- ***Read these instructions but keep this Supplement closed until the start of the test is announced.***
- This *Supplement* contains the test's multiple-choice questions but you must record your answers to each of the 14 multiple-choice questions in the table provided on page 2 of the test paper. ***Anything written on this Supplement will not be graded.*** We will only collect the test papers, not the *Supplement*.
- 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!**
- The only aid allowed is a ***non-programmable*** calculator.

1. Consider the fixed-price-level model of a closed economy. The short-run impact of an increase in autonomous investment will be to
   A) lower the interest rate and increase savings.
   B) raise the interest rate and increase savings.
   C) lower the interest rate and decrease savings.
   D) raise the interest rate and decrease savings.
   E) raise the interest rate but leave savings unchanged.

2. Consider an open economy with a fixed price level, fixed exchange rates and perfect capital mobility. Which of following events will cause the position of the *LM* curve to change in the new equilibrium?
   A) An increase in foreign income.
   B) A rise in the foreign rate of interest.
   C) The Central Bank sells bonds.
   D) A revaluation of the exchange rate.
   E) The government cuts its spending.

3. Consider an open economy with a fixed price level, flexible exchange rates and perfect capital mobility. If government purchases decrease, which one of the following best describes the impact on the equilibrium values of output, interest rate, and exchange rate?
   A) Output, interest rates, and the exchange rate will all decrease.
   B) Output and interest rates will decrease, but the exchange rate will rise.
   C) The exchange rate and the level of output will fall, but the interest rate will remain unchanged.
   D) Output will rise and the exchange rate will fall while the interest rate will remain unchanged.
   E) The exchange rate will rise, but the level of output and the interest rate will both remain unchanged.

4. Consider an open economy with a fixed price level, flexible exchange rates and imperfect capital mobility. If the money supply decreases, which one of the following best describes the impact on the equilibrium values of output, interest rate, and exchange rate?
   A) Output, the interest rate and the exchange rate will all fall.
   B) Output and the exchange rate will both fall, while the interest rate will rise.
   C) Output will fall, while the interest rate and the exchange rate will both rise.
   D) Output, the interest rate and the exchange rate will all rise.
   E) Output will rise while the exchange rate and the interest rate will both fall.

5. China has been accused by Western countries of setting the value for its domestic currency too low in the past. 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) Inflationary pressure would be reduced 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.

6. Suppose the domestic interest rate is 15%, the foreign interest rate is 11%, and the exchange rate is expected to appreciate by 3%. All else equal, what is the investors' expected rate of return differential?

- **A)** 7% in favour of the home country.
- **B)** 4% in favour of the foreign country.
- **C)** 1% in favour of the foreign country.
- **D)** 1% in favour of the home country.
- **E)** Need more information to answer this question.

7. Consider an open economy with a fixed price level, fixed exchange rates, and imperfect capital mobility. If the central bank revalued the exchange rate (i.e., devalued the domestic currency), which one of the following would be true in the new equilibrium?

- **A)** Both the *IS* and *BP* curves would shift up, while the *LM* curve would shift down.
- **B)** Both the *IS* and *BP* curves would shift down, while the *LM* curve would shift up.
- **C)** The *IS* curve would shift up, while the *LM* and *BP* curves would shift down.
- **D)** The *IS*, *LM* and *BP* curves would all shift up.
- **E)** None of the above is true.

8. Consider an open economy with a fixed price level, fixed exchange rates, and perfect capital mobility. Which one of following events will cause a positively-sloped LM curve to shift down in the new equilibrium?

- **A)** A decrease in foreign income.
- **B)** A rise in the foreign rate of interest.
- **C)** The Central Bank buys government bonds in the open market.
- **D)** A devaluation of the exchange rate.
- **E)** An increase in government spending.

9. Suppose that average income per capita in Argentina is 48,000 pesos per year and that the nominal exchange rate for Argentine pesos is 0.30. Further suppose that a given consumption basket of goods and services costs $3,500 in the Canada and 8,750 pesos in Argentina. Using the *PPP* exchange rate, income per capita in Argentina is:

- **A)** $14,400.
- **B)** $19,200.
- **C)** $35,250.
- **D)** $120,000.
- **E)** none of the above.

10. 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 horizontal.
- **B)** The *BP* curve is vertical.
- **C)** The *BP* curve is downward sloping.
- **D)** The *BP* curve is upward sloping if the international rate of interest is greater than the domestic rate.
- **E)** Not enough information to determine the shape of the *BP* curve.

11. In an *IS-LM-BP* model with flexible exchange rates and perfect capital mobility, contractionary fiscal policy will cause:

- **A)** a depreciation of the exchange rate.
- **B)** the *IS* curve to shift down and then the *LM* curve to shift up.
- **C)** a decrease in investment.
- **D)** an increase in net exports.
- **E)** output to fall while leaving the interest rate unchanged.

12. Consider a small open economy with a fixed price level, fixed exchange rates, and no capital mobility. If the government imposes an import quota, which one of the following describes its impact in the new equilibrium?

- **A)** Net exports, the money supply, and income will all remain unchanged.
- **B)** Net exports, the money supply, and income will all decrease.
- **C)** Net exports, the money supply, and income will all increase.
- **D)** Net exports will remain unchanged, but the money supply and income will both increase.
- **E)** Net exports will remain unchanged, the money supply will decrease, and income will increase.

13. Third-quarter data recently released by Statistics Canada shows a significant increase in Canada's current account deficit as a result of a fall in net exports. At the same time, the data shows an increase in the capital account surplus due to greater foreign investment in Canadian securities. Which one of the following statements best explains these outcomes?

- **A)** A current account deficit needs to be financed with foreign savings – which explains the surplus in the capital account.
- **B)** A greater inflow of capital causes the currency to appreciate – which explains the decrease in net exports.
- **C)** The Bank of Canada's increase in the overnight rate of interest caused exports to fall – which explains the increase in the current account deficit.
- **D)** The increase in the rate of interest caused the domestic production of goods and services to contract, thus fueling imports – which explains the decrease in net exports.
- **E)** The rapid expansion of Canadian income caused imports to rise – which explains the increase in the current account deficit.

14. The U.S. senate recently approved a cut in the corporate tax rate from 35 to 20 percent. Which one of the following statements best describes the likely impact of such a tax cut?

- **A)** It will encourage businesses to hire more workers and offer higher wage.
- **B)** It will increase corporate after-tax profits and thus investment will rise.
- **C)** It will increase aggregate demand and thus investment will rise.
- **D)** It will increase shareholders' income and management compensation but will not stimulate investment.
- **E)** Both A) and B) are correct.