ECO 209Y
MACROECONOMIC THEORY AND POLICY

Term Test #2

December 6, 2018

U of T E-MAIL: ______________________________@MAIL.UTORONTO.CA

SURNAME (LAST NAME):

GIVEN NAME (FIRST NAME):

UTORID (e.g., LIHAO118):

INSTRUCTIONS:

- The total time for this test is ***1 hour and 45 minutes***.
- The only aid allowed is a ***non-programmable*** calculator.
- ***Write your name and identifying information above but keep this test paper closed until the start of the test is announced.***
- There are three parts to the test: ***Part I*** consists of 10 multiple-choice questions (25 points); ***Part II*** consists of one quantitative problem (10 points); and ***Part III*** includes 3 short-answer questions (30 points). The ***total*** point-value of the test is ***65 points***.
- The answers to the 10 multiple-choice questions of ***Part I*** must be recorded in the ***bubble sheet*** provided on **page 10** of this test paper. Only the answers recorded in the bubble sheet will be marked. Cells left blank will receive a zero mark for that question. No deductions will be made for incorrect answers.
- In ***Parts II and III***, write your answers clearly and concisely in the space provided immediately after each question. ***Your entire answer must fit in the designated space.*** No extra space/pages are possible and you cannot use blank space for other questions.
- ***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 (25 points)

Instructions:
Enter your answer to each of the 10 multiple-choice questions in the ***bubble sheet*** provided on **page 10** below. Each correct answer is worth ***2.5 points***. ***Note that no deduction will be made for incorrect answers.*** Table cells left blank will receive zero points. **Do NOT guess your answers! Manage your time properly!**

1. Consider a fixed price level model of a closed economy. An increase in savings at each level of disposable income will
- **A)** shift the *LM* curve down.
- **B)** shift the *LM* curve up.
- **C)** shift the *IS* curve to the left.
- **D)** shift the *IS* curve to the right.
- **E)** leave both the *IS* and the *LM* curves unchanged.

2. In a fixed-price level model of the economy, expansionary fiscal policy is very effective in increasing national income when
- **A)** money demand is very responsive to income changes.
- **B)** money demand is very responsive to interest rate changes.
- **C)** consumption is very responsive to interest rate changes.
- **D)** the marginal propensity to import is very large.
- **E)** investment is very responsive to interest rate changes.

3. In a fixed-price level model of the economy, expansionary monetary policy is very effective in increasing national income when
- **A)** investment is very responsive to interest rate changes.
- **B)** money demand is very responsive to income changes.
- **C)** the marginal propensity to import is very large.
- **D)** money demand is very responsive to interest rate changes.
- **E)** the income tax rate is very high.

4. Suppose that income per capita in Brazil is 42,000 reals and that the nominal exchange rate for Brazilian reals is 0.35. Further suppose that a given consumption basket of goods and services costs $2,250 in Canada and 5,000 reals in Brazil. Using the PPP exchange rate, income per capita in Brazil is
- **A)** $14,700.
- **B)** $16,100.
- **C)** $17,600.
- **D)** $18,900.
- **E)** None of the above.

5. In an IS-LM-BP model with fixed exchange rates and perfect capital mobility, expansionary fiscal policy will cause:
- **A)** a depreciation of the exchange rate.
- **B)** both the IS and the LM curves to shift up.
- **C)** output and the interest rate to increase.
- **D)** a decrease in investment.
- **E)** a decrease in net exports.

6. 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)** The balance in the capital account would improve for China.
- **E)** None of the above is correct.

7. If capital mobility is imperfect and import demand is completely insensitive to changes in the level of domestic income, 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 of interest.
- **E)** The slope of the *BP* curve is not determinable.

8. Consider a small open economy with a fixed price level, 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, the money supply, and income will all remain unchanged.
- **B)** net exports, the money supply, and income will all be lower.
- **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 higher.

9. If Trump follows through on his threats to impose a 25% tariff to all imports from China, which one of the following would best describe its impact on the U.S. economy?

- **A)** Exports would increase while imports would fall.
- **B)** The current account deficit would be significantly reduced.
- **C)** The rate of inflation would increase.
- **D)** Real wages would rise.
- **E)** All of the above are correct.

10. Late last year, President Trump signed into law a $1.5 trillion tax overhaul, reducing corporate and income taxes for the rich. Which of the following has materialized since the tax cuts?

- **A)** Most large companies have increased employment.
- **B)** Payouts to shareholders have risen significantly.
- **C)** Real wages have increased considerably.
- **D)** Most companies have changed their investment decisions.
- **E)** All of the above are true.

PART II (10 points)

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

$C = 140 + 0.8YD$	$X = 250 + 200e$
$I = 200 - 20i + 0.1Y$	$Q = 400 - 100e + 0.1Y$
$G = 300$	$L = 0.2Y - 10i$
$TA = 0.25Y$	$i^* = 10$
$TR = 50$	$P = P^f = 1$

NOTE: <u>Although not needed</u>, you might find it helpful to draw a diagram when answering the following questions.

a) What is the equilibrium value of Y when the exchange rate is fixed at $e = 0.9$ and the economy achieves external balance? **(1 point)**

b) What are the balances in the current account and the capital account in the equilibrium of part a)? **(2 points)**

c) What is the size of the real money supply in the equilibrium of part a)? **(1 point)** What is the equation for the *LM* curve? **(1 point)** (*Note: The size of the money supply is expressed in billions of dollars.*)

d) Suppose now that, through an open market operation, the central bank increases the supply of money by \$50 billion. What would be the new rate of interest in the very short run (i.e., before any change in Y could occur)? **(1 point)** What would be the very-short-run impact on the balance of payments (i.e., in both the current and capital accounts)? Briefly <u>explain</u>. **(1 point)**

e) What would be the equilibrium values of Y and i in the short run? **(1 point)** And the balances in the current and capital accounts? **(1 point)** What is the level of money supply in the new equilibrium? **(1 point)** (*Note: Provide a numerical answers and <u>briefly</u> explain the economics.*)

PART III (30 points)

Instructions: Answer the following three questions in the space provided. Each question is worth 10 points.

1. Describe the main characteristics that differentiate a "balance-sheet recession" from a more "typical" recession. Comment on the relative effectiveness of expansionary monetary and fiscal policy during balance-sheet recessions.

2. Assuming <u>fixed</u> exchange rates and <u>no</u> capital mobility, explain the impact of a devaluation of the domestic currency. In your answer, clearly indicate the effect on the equilibrium income, the equilibrium rate of interest, and the balance of the current account. **(Show your answer with the help of *IS-LM-BP* and *X-Q* diagrams and <u>explain</u> the economics. Assume external balance and a recessionary gap at the initial equilibrium.)**

3. **Critically evaluate the following statement:** *"A decrease in the international rate of interest will cause equilibrium income to rise, the equilibrium 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 an *IS-LM-BP* diagram and explain the economics. Consider an open economy with a fixed price level, fixed exchange rates, and perfect capital mobility. Assume external balance and a recessionary gap at the initial equilibrium.)**