UNIVERSITY OF TORONTO
Faculty of Arts and Science

April/May Examinations 2014

ECO 209Y

Duration: 2 hours

Examination Aid allowed: Non-programmable calculator only

To be answered only by students in Prof. G. Indart's Sections L0101, L0201, L0301, and L0401

LAST NAME ____

FIRST NAME ____

STUDENT NUMBER ________________________________

DO NOT WRITE IN THIS SPACE

Part I ________/30

Part II 1. ________/10 x 7/6

2. ________/10 x 7/6

3. ________/10 x 7/6

4. _________/10 x 7/6

5. _________/10 x 7/6

6. _________/10 x 7/6

TOTAL: ___________.

PART I (30 marks)

Instructions: Enter the best possible answer to each question in the table below. Only answers entered in the table will be marked. Each correct answer is worth 3 marks.

1	2	3	4	5	6	7	8	9	10

1. Suppose that initially government regulations do not allow banks to pay interest on chequing accounts. If a change in government regulations allows now banks to start paying interest on chequing accounts this will
   A) increase the demand for money.
   B) decrease the demand for money.
   C) have no effect on the demand for money.
   D) increase the demand for currency but decrease the demand for chequing accounts.
   E) leave the demand for currency unchanged but decrease the demand for chequing accounts.

2. Assume that a war breaks out abroad, and foreign investors choose to invest more in a large safe country, the United States. Then, according to the basic open-economy model, in the U.S. the real interest rate
   A) and net exports will both fall.
   B) will fall and net exports will rise.
   C) will rise and net exports will fall.
   D) and net exports will both rise.
   E) will remain unchanged but net exports will fall.

3. In the basic model of a small open economy, if consumer confidence falls and consumers decide to save more, then the real value of the domestic currency
   A) rises and net exports fall.
   B) and net exports both rise.
   C) falls and net exports rise.
   D) and net exports both fall.
   E) is not affected and neither is net exports.

Use this space for rough work.

4. According to the *IS-LM* model, when the government increases autonomous taxes and government purchases by equal amounts, which one of the following statements would be true?
   A) Income, the interest rate, consumption, and investment are unchanged.
   B) Income and the interest rate rise, whereas consumption and investment fall.
   C) Income and the interest rate fall, whereas consumption and investment rise.
   D) Income, the interest rate, consumption, and investment all rise.
   E) None of the above is true.

5. In a small open economy, if exports equal $20 billion, imports equal $30 billion, and domestic national saving equals $25 billion, then capital flow equals
   A) –$25 billion.
   B) –$10 billion.
   C) $10 billion.
   D) $25 billion.
   E) $15 billion.

6. Assume that the currency-deposit ratio is 35%, the desired reserve-deposit ratio is 10%, and total money supply is $2,400 billion. What is the amount of high-powered money if there are no excess reserves in the banking system?
   A) $650 billion.
   B) $800 billion.
   C) $850 billion.
   D) $900 billion.
   E) None of the above.

7. Consider a closed economy with a fixed price-level and a balanced government budget at the initial equilibrium situation. A drop in government purchases will cause
   A) the level of private saving and the level of consumption to fall, and a government budget surplus.
   B) the level of private saving to rise and a government budget surplus, but no change in the level of consumption.
   C) both the level of private saving and the level of consumption to fall, but no change in the government budget balance.
   D) the level of consumption to fall, the level of private saving to rise, and a government budget surplus.
   E) none of the above.

Use this space for rough work.

8. Consider a small 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 would be true?
   A) The domestic currency would appreciate, the balance in the current account would improve, the rate of interest would rise, and income would increase.
   B) The domestic currency would appreciate, the balance in the current account would deteriorate, the rate of interest would rise, and income would increase.
   C) The domestic currency would depreciate, the balance in the current account would improve, the rate of interest would rise, and income would increase.
   D) The domestic currency would depreciate, the balance in the current account would improve, the rate of interest would fall, and income would increase.
   E) None of the above are true.

9. Consider a closed economy with a fixed price-level and unemployment. The effect of a tax increase on real *GDP* will be neutralized if
   A) the central bank loosens monetary policy, which shifts the *LM* curve down to the right and lowers interest rates.
   B) the central bank tightens monetary policy, which shifts the *IS* curve to the left and raises interest rates.
   C) the central bank tightens monetary policy, which shifts the *LM* curve up to the left and raises interest rates.
   D) the central bank loosens monetary policy, which shifts the *IS* curve to the right and raises interest rates.
   E) the central bank loosens monetary policy, which shifts the *LM* curve down to the right and raises interest rates.

10. The expectations-augmented Phillips curve predicts that if inflation is higher than it was expected, then
   A) the Phillips curve will shift up.
   B) the Phillips curve will shift down.
   C) unemployment will be above the natural rate.
   D) unemployment will be below the natural rate.
   E) unemployment will be at the natural rate regardless of the inflation rate.

Use this space for rough work.

PART II (70 marks)

<u>Instructions</u>: Answer <u>all</u> six questions in the space provided. All questions are of equal weight.

1. Comment on the following statement: *"A sale of gold by the commercial banks to the Bank of Canada, a transfer of the Government of Canada's deposits from the Bank of Canada to the commercial banks, a sale of bonds by the general public to the commercial banks, and an increase in the Bank Rate will all result in a decrease in the money supply."* In your analysis, assume a fixed currency-deposit ratio of the public and a fixed desired cash-reserve ratio of the commercial banks.

(Continue on pages 11-12 if necessary)

2. Comment on the following statement: *"Argentina is currently suffering from significant inflation (near 20% per year). The Argentinean central bank should not implement contractionary monetary policy in order to reduce inflation because in doing so the unemployment rate in Argentina will permanently increase."* Show your answer with the help of a diagram and explain the economics. Consider the dynamic *AD-AS* model of a closed economy where the short-run aggregate supply curve is given by the expression: $\pi = \pi_{-1} [1 + \lambda(Y - Y^*)]$. Assume that the Argentine economy is initially at full employment.

(Continue on pages 11-12 if necessary)

3. Comment on the following statement: *“A decrease in consumers’ preference for vacationing abroad will lead to an increase in domestic income, an increase in the domestic interest rate, an improvement in the capital account, and a deterioration in the current account.”* Show your answer with the help of a diagram and <u>explain</u> the economics. Consider the fixed-price model of an open economy with <u>fixed</u> exchange rates and <u>imperfect</u> capital mobility. Assume that this economy was initially below full employment.

(Continue on pages 11-12 if necessary)

4. Critically assess William Robson's and Stephen Roach's contrasting views regarding the pros and cons of using monetary and fiscal policy to restore full-employment during the Great Recession.

(Continue on pages 11-12 if necessary)

5. There is an ongoing debate about the pros and cons of inflation targeting. Some economist (e.g., Pierre Fortin and Olivier Blanchard) argue about the benefits of a higher target for the rate of inflation, others (e.g., Angelo Melino) call for a lower target, while others (e.g., Joseph Stiglitz) consider that inflation targeting should be abandoned altogether. What is your position in this debate? In your discussion comment on the views expressed by Fortin, Blanchard, Melino, and Stiglitz.

(Continue on pages 11-12 if necessary)

6. Before the Great Recession, Mark Carney suggested that the Bank of Canada's inflation target might have been too high at 2 percent. What would have been then the short-run and long-run impact of the Bank of Canada reducing the target rate of inflation to 0 percent? Using the dynamic AS model developed in class, show your answer with the help of graphs and **explain** the economics. Assume that Canada was at full employment at that time.

(Continue on pages 11-12 if necessary)

(Continue on this page if necessary)

(Continue on this page if necessary)