

UNIVERSITY OF TORONTO
Faculty of Arts and Science

August Examination 2015

ECO 209Y

Duration: 2 hours

Examination Aids allowed: Non-programmable calculators only

LAST NAME _____

FIRST NAME _____

STUDENT NUMBER _____

DO NOT WRITE IN THIS SPACE

Part I _____/50

3. _____/10

Part II 1. _____/10

4. _____/10

2. _____/10

5. _____/10

TOTAL _____/100

PART I (50 marks)

Instructions: Enter your answer to each question in the table below. Only the answers recorded in the table will be marked. Table cells left blank will receive a zero mark for that question. Each question is worth 2.5 marks. No deductions will be made for incorrect answers.

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|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|
| 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |
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| 11 | 12 | 13 | 14 | 15 | 16 | 17 | 18 | 19 | 20 |
| | | | | | | | | | |

- If investment exceeds private saving by \$22 billion and government spending exceeds tax revenues by \$34 billion, then
 - the trade deficit is \$56 billion.
 - the trade surplus is \$56 billion.
 - the trade deficit is \$12 billion.
 - the trade surplus is \$12 billion.
 - we cannot say anything about the international trade balance.
- Suppose exports receipts are 100, imports payments are 110, income from assets receipts are 20, income from assets payments are 30, and net gifts and grants are nil. Which of the following is true?
 - There is a Current Account surplus and GDP is greater than GNP.
 - There is a Current Account surplus and GDP is less than GNP.
 - There is a Current Account deficit and GDP is greater than GNP.
 - There is a Current Account deficit and GDP is less than GNP.
 - The Current Account is balanced and GDP is greater than GNP.

Use this space for rough work.

3. A reduction in savings at each level of disposable income
 - A) increases the slope of the IS curve.
 - B) shifts the IS curve to the left.
 - C) shifts the IS curve to the right.
 - D) shifts the LM curve down.
 - E) shifts the LM curve up.

4. Consider an open economy with a fixed-price level, fixed exchange rates, and perfect capital mobility. If the central bank revalued the exchange rate (i.e., devalued the domestic currency), which one of the following would be correct?
 - A) The IS curve would shift down.
 - B) The LM curve would shift up.
 - C) The BP curve would shift down.
 - D) Both the IS and BP curves would shift up.
 - E) None of the above is correct.

5. Consider an open economy with a fixed-price level, flexible exchange rates, and perfect capital mobility. If autonomous exports increased, which one of the following would be true in the new equilibrium?
 - A) The rate of interest would increase.
 - B) The balance in the capital account would improve.
 - C) The balance in the current account would improve.
 - D) Both the rate of interest and the level of income would remain unchanged.
 - E) None of the above is true.

6. Consider a closed economy with a fixed-price level. If investors expect the rate of interest to fall, which one of the following would be a likely outcome?
 - A) The demand for money would increase.
 - B) The demand for bonds would decrease.
 - C) The IS curve would shift to the left.
 - D) The LM curve would shift to the right.
 - E) None of the above.

Use this space for rough work.

7. Consider an open economy with a fixed-price level, flexible exchange rates, and imperfect capital mobility. An increase in the money supply will cause
- A) output, interest rate, and exchange rate to increase.
 - B) output and interest rate to increase, and exchange rate to decrease.
 - C) output and exchange rate to decrease, and interest rate to increase.
 - D) output and exchange rate to increase, and interest rate to decrease.
 - E) output to decrease, and exchange rate and interest rate to increase.
8. Consider an open economy with a fixed-price level, flexible exchange rates, and imperfect capital mobility. In the short run, a lower tariff on imports will
- A) raise exports but leave imports unchanged.
 - B) raise imports but lower exports.
 - C) raise both imports and exports.
 - D) lower both exports and imports.
 - E) raise imports but leave exports unchanged.
9. According to the General AS-AD (upwards sloping AS) model developed in class, which of the following statements is true in the short run?
- A) A decrease in the price level shifts the short-run AD curve to the right.
 - B) The nominal wage is fixed.
 - C) If the nominal wage increases, the quantity supplied of labour increases.
 - D) If the real wage increases, the quantity supplied of labour necessarily increases.
 - E) Both C) and D) are correct.
10. Consider an economy with the following features: the production function is $F(N) = 10 N^{1/2}$, the marginal product of labour function is $MP_N = 5 / N^{1/2}$, and the equation for the supply of labour is $W = N^{1/2}$. What is the equation for the AS curve in this economy?
- A) $Y = 10 (5P)^{1/2}$
 - B) $Y = 50 P^{1/2}$
 - C) $Y = 50 P$
 - D) $Y = 50$
 - E) None of the above.

Use this space for rough work.

11. The stickier (i.e., more rigid) nominal wages in an economy are,
- A) the steeper the IS curve is.
 - B) the more effective fiscal policy is.
 - C) the flatter the AD curve is.
 - D) the flatter the LM curve is.
 - E) the flatter the IS curve is.
12. Consider the Classical AS-AD model discussed in class where workers do not suffer from “money illusion”. If workers decide to supply less labour at any real wage, which of the following statements is correct?
- A) The real wage increases while the price level stays constant.
 - B) The real wage increases and the price level decreases.
 - C) The real wage decreases and the price level increases.
 - D) Both the real wage and the price level decrease.
 - E) Both the real wage and the price level increase.
13. Consider an economy described by the dynamic AS-AD model where the AS curve is given by $P = P_{-1} + \lambda(Y - Y^*)$. Suppose that upon experiencing a temporary negative supply shock, the government increases aggregate demand to offset any loss of output. According to the discussion in class, which of the following would be true immediately following both actions?
- A) The real wage remained unchanged.
 - B) The real wage increased.
 - C) The nominal wage decreased.
 - D) The nominal wage remained unchanged.
 - E) None of the above.

Use this space for rough work.

14. Consider an economy described by the dynamic AS-AD model where the AS curve is given by $P = P_{-1} + \lambda(Y - Y^*)$. What is the long-run impact of an increase in autonomous taxation?
- A) Both the real and nominal wage decrease.
 - B) The real wage decreases and the nominal wage increases.
 - C) The real wage remains unchanged and the nominal wage decreases.
 - D) The real wage decreases and the nominal wage remains unchanged.
 - E) Both the real and nominal wage increase.
15. The Bank of Canada wishes to implement an expansionary monetary policy. What actions can it take to achieve this?
- A) Buy government of Canada bonds.
 - B) Increase the band of the bank rate.
 - C) Withdraw government of Canada deposits from the commercial banks.
 - D) Sell foreign currency in the exchange market.
 - E) Increase the bank rate.
16. Consider an economy currently in equilibrium. The public likes to hold 0.25 fraction of their money holdings (M) as cash (Cu_p). Banks like to hold 0.2 fraction of deposits (D) as reserves (R) and currently hold \$12 as reserves. Which of the following statements is correct?
- A) The money multiplier (mm) is 2.78
 - B) The money supply is \$180.
 - C) The quantity of cash held by the public (Cu_p) is \$20.
 - D) The monetary base (B) is 12.
 - E) None of the above is correct.

Use this space for rough work.

17. Which of the following may help maintain a Central Bank's credibility with respect to sustaining a constant inflation rate?
- A) A high degree of independence from the federal government.
 - B) The use of "seignorage" to finance government spending.
 - C) The use of the "expectations augmented Phillips curve" to boost economic activity.
 - D) Multiple policy targets in addition to inflation control.
 - E) None of the above.
18. Which of the following best explains the collapse of oil prices?
- A) Increased supply from non-traditional sources.
 - B) A high short-run price elasticity.
 - C) A low long-run price elasticity.
 - D) Decreased demand from China and the developing world.
 - E) Both A) and C).
19. A popular 2010 paper by Rogoff-Reinhart was used to justify "austerity" in Europe. Which of the following best describes the paper's conclusion?
- A) Austerity was crucial to recovery during "The Great Depression".
 - B) There is a negative correlation between debt-to-GDP ratios and economic growth.
 - C) There is a positive correlation between debt-to-GDP ratios and "confidence".
 - D) Government spending cuts allow for lower taxes.
 - E) None of the above.
20. Which of the following are potential drawbacks to a less-developed country joining the Eurozone?
- A) The loss of the ability to use both fiscal and monetary policy.
 - B) High inflation due to the Greece bailouts.
 - C) Increased transaction frictions with the rest of Europe.
 - D) Increased borrowing costs.
 - E) None of the above.

Use this space for rough work.

PART II (50 marks)

Instructions: Answer all five questions in the space provided. All questions are of equal weight.

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 policies during balance-sheet recessions.

2. Suppose that an increase in government spending results in a large budget deficit. What difference would it make if this government deficit is financed either entirely by domestic investors or entirely by foreign investors? In your answer you must compare and explain the likely short-run impact that these two alternative ways of financing a government deficit may have on the economy, particularly on the rate of interest, level of output, current account balance, and capital account balance.

3. **Critically evaluate the following statement:** “An increase in the international rate of interest will cause domestic output to increase, the rate of interest to rise, 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 explain the economics. Consider the model of an open economy with a fixed-price level, flexible exchange rates, and imperfect capital mobility.)**

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4. **Critically evaluate the following statement:** *“The relationship between unemployment and inflation is stable so that in the long-run policymakers can trade off a stable higher inflation rate for a lower unemployment rate.”* **(Consider the expectations augmented dynamic AS-AD model, where the equation for the short-run AS curve is $\pi = \pi^e + \lambda (Y - Y^*)$. In your answer, explain the short- and long-run effects of such a policy, including the associated costs.)**

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5. Considering an open economy with a flexible-price level and perfect capital mobility, critically evaluate the following statement: “With a flexible exchange rate, in the long run fiscal policy is effective but monetary policy is ineffective.” (Answer the question with the help of IS-LM-BP and AS-AD diagrams and explain the economics. In your answer, clearly indicate what happens to e^{real} , e^{nominal} , NX, Y, and P in both situations.)

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