UNIVERSITY OF TORONTO
Faculty of Arts and Science

April/May Examinations 2015

ECO 209Y

Duration: 2 hours

Examination Aid allowed: Non-programmable calculator only

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

LAST NAME ________________________________________

FIRST NAME _______________________________________

STUDENT NUMBER __________________________________

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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. If a country chooses to have free capital flows and to conduct an independent monetary policy, then it must:
   A) live with exchange-rate volatility.
   B) restrict its citizens from participating in world financial markets.
   C) give up the use of monetary policy for purposes of domestic stabilization.
   D) have a fixed exchange rate.
   E) have a managed exchange rate.

2. Under the policy of inflation-rate targeting adopted by the Bank of Canada, the money supply is:
   A) increased at a constant rate.
   B) decreased at a constant rate.
   C) held constant.
   D) allowed to fluctuate.
   E) defined as M1 (narrowly defined).

3. In Canada, the money supply is determined:
   A) only by the Bank of Canada.
   B) only by the behaviour of individuals who hold money and of banks in which money is held.
   C) jointly by the Bank of Canada and by the behaviour of individuals who hold money and of banks in which money is held.
   D) according to a constant-growth-rate rule.
   E) by the Minister of Finance.

*Use this space for rough work.*

4. The use of fiscal policy, including automatic stabilizers, to stabilize output over a business cycle is not consistent with:
   A) rational expectations.
   B) inflation targeting.
   C) the natural-rate hypothesis.
   D) a strict balanced-budget rule.
   E) monetary policy.

5. Large drops in house prices may generate widespread insolvency of financial institutions by:
   A) reducing the value of collateral assets.
   B) reducing the value of liabilities.
   C) increasing the value of assets.
   D) increasing capital.
   E) lowering demand for mortgages.

6. 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) Both fiscal and monetary policy would become more effective.
   B) Both fiscal and monetary policy would become less effective.
   C) Fiscal policy would become less effective and monetary policy would become neither more nor less effective.
   D) Fiscal policy would become more effective and monetary policy would become less effective.
   E) Fiscal policy would become less effective and monetary policy would become more effective.

7. Assume that the currency-deposit ratio is 32%, the desired reserve-deposit ratio is 7%, the excess reserve-deposit ratio is 1%, and total money supply is $1,320 billion. What is the amount of high-powered money?
   A) $132 billion.
   B) $165 billion.
   C) $330 billion.
   D) $400 billion.
   E) None of the above is correct.

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*Use this space for rough work.*

8. Consider an open economy with a fixed price-level, flexible exchange rates, and infinitely elastic capital flows (i.e., perfect capital mobility). An increase in government expenditure will cause
   A) output and interest rate to increase, and domestic currency to depreciate.
   B) output and interest rate to increase, and domestic currency to appreciate.
   C) domestic currency to appreciate, while output and interest rate will remain unchanged.
   D) domestic currency to appreciate, output to rise, but interest rate will remain unchanged.
   E) domestic currency to appreciate, interest rate to rise, but output will remain unchanged.

9. In using the expenditure approach to measure GDP, consumption includes
   A) both the domestically and internationally (foreign) produced final and intermediate goods consumed by households and firms.
   B) both the domestically and internationally (foreign) produced final goods consumed by households and firms.
   C) the domestically produced but not the internationally (foreign) produced final and intermediate goods consumed by households and firms.
   D) the domestically produced but not the internationally (foreign) produced final goods consumed by households.
   E) both the domestically and the internationally (foreign) produced final goods consumed by households.

10. Consider a closed economy with a fixed price-level and a balanced government budget at the initial equilibrium. A drop in government purchases will cause
   A) consumption to fall, business inventories to rise, and a government surplus.
   B) business inventories to rise and a government surplus, but no change in consumption.
   C) both consumption and business inventories to fall, but no change in the government budget balance.
   D) both consumption and business inventories to fall, and a government surplus.
   E) a government surplus but no change in either consumption or business inventories.

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*Use this space for rough work.*

## PART II (70 marks)

**<u>Instructions</u>:** Answer <u>all</u> six questions in the space provided. You may continue your answers on pages 11-12 if additional space is required (***but clearly indicate that your answer continues on pages 11-12***). All questions are of equal weight.

1. **Critically evaluate the following statement:** *“Adjusted for inflation, the price of oil increased from about $30 a barrel in 2002 to about $100 a barrel in 2008 and (except for 2009-10) remained around that level until mid-2014. Being Canada an oil exporter, some observers concluded that this dramatic increase in the price of oil was ‘unambiguously good’ for Canada.”*



*(Continue on pages 11-12 if necessary)*

**2. Critically evaluate the following statement:** *"If, due to greater uncertainty in the world economy, foreign investors choose to invest more in a safe country such as Canada, then Canada's output will rise, its rate of interest will fall, 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.)**



*(Continue on pages 11-12 if necessary)*

**3.** As a result of the quantitative easing program implemented since the start of the Great Recession, the Federal Reserve holdings of treasury security increased to about $4.5 trillion. What were the main impacts of this program on the U.S. economy? **(In your answer, <u>explain</u> any possible changes to the U.S. money supply, rate of interest, level of output, and the balances of the capital and current accounts.)**



*(Continue on pages 11-12 if necessary)*

**4. Critically evaluate the following statement:** *"Before rewriting rulebooks and cranking up government spending, Canadians need to recall that central banks are far and away our best hope to cushion the downturn and hasten the recovery."* (William Robson, *The Globe and Mail*, 25/09/2008)



*(Continue on pages 11-12 if necessary)*

**5. Critically evaluate the following statement:** *"In the absence of an active government policy, the long-run effect of a negative supply shock will be a higher price level, a lower output level, and a higher real wage rate."* **(Show your answer with the help of a diagram and <u>explain</u> the economics. Consider the model where the short-run aggregate supply curve is $P = P_{-1} [1 + \lambda(Y - Y^*)]$ and assume that, prior to the supply shock, the economy was in long-run equilibrium.)**



*(Continue on pages 11-12 if necessary)*

**6.** 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)*

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