UNIVERSITY OF TORONTO
Faculty of Arts and Science

April Examination 2016

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 ________/40

Part II 1. ________/10 x 6/5

2. ________/10 x 6/5

3. ________/10 x 6/5

4. _________/10 x 6/5

5. _________/10 x 6/5

TOTAL: __________/100

PART I (40 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.

1	2	3	4	5	6	7	8
9	**10**	**11**	**12**	**13**	**14**	**15**	**16**

1. If investment exceeds private saving by $40 billion and government spending exceeds tax revenues by $30 billion, then
   A) the trade deficit is $10 billion.
   B) the trade surplus is $10 billion.
   C) the trade deficit is $70 billion.
   D) the trade surplus is $70 billion.
   E) we cannot say anything about the international trade balance.

2. Consider an open economy with a fixed price level and a fixed exchange rate regime. Which of following events will NOT cause the LM curve to shift 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 the fixed-price level model of a closed economy. In the short run, a decrease in autonomous investment will
   A) lower the interest rate and increase saving.
   B) raise the interest rate and increase saving.
   C) lower the interest rate and decrease saving.
   D) raise the interest rate and decrease saving.
   E) lower the interest rate but leave saving unchanged.

Use this space for rough work.

4. 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.

5. 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 correct?
   A) The IS curve would shift down and the BP would shift up.
   B) The IS curve would shift up and the BP would shift down.
   C) The IS curve would shift up but the BP curve would remain unchanged.
   D) Both the IS and BP curves would shift down.
   E) Both the IS and BP curves would shift up.

6. If nominal wages are constant while prices are flexible, then the slope of the aggregate supply curve will be
   A) horizontal as in the Keynesian case.
   B) vertical as in the Classical case.
   C) steeper than when nominal wages are fully flexible.
   D) the same as when nominal wages are fully flexible.
   E) none of the above.

7. 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.

8. Consider an open economy with a flexible exchange rate regime and fixed price level. Which of the following incidents will lead to an improvement in the balance of the current account?
   A) A decrease in foreign output.
   B) An increase in consumer's confidence.
   C) An expansionary fiscal policy.
   D) An expansionary monetary policy.
   E) A decrease in foreign interest rates.

9. 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.

10. The more flexible nominal wages 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 steeper the AS curve is.

11. Consider the AD-AS model where the AS curve is given by $P = P_{-1} + \lambda(Y - Y^*)$. Suppose that upon experiencing a negative supply shock, the government increases aggregate demand to offset any loss of output. Which one of the following statements best describes the likely outcome in the short run?
   A) Both the nominal and the real wage will remain unchanged.
   B) Both the nominal and the real wage will increase.
   C) Both the nominal and the real wage will decrease.
   D) The nominal wage will increase but the real wage will remain unchanged.
   E) The nominal wage will remain unchanged but the real wage will decrease.

12. Which of the following best describes the likely impact of the collapse of oil prices in Canada?
   A) The non-tradable sector will expand.
   B) The non-energy tradable sector will contract.
   C) The CPI will increase in the short run.
   D) The energy sector will contract.
   E) Both C) and D).

Use this space for rough work.

13. Consider the Classical AD-AS model where workers do not suffer from “money illusion”. If workers decide to supply more 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.

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 exogenous exports?
    A) Both the real and nominal wage increase.
    B) The real wage decreases and the nominal wage increases.
    C) The real wage remains unchanged and the nominal wage increases.
    D) The real wage increases and the nominal wage remains unchanged.
    E) Both the real and nominal wage decrease.

15. Suppose the Bank of Canada wishes to implement contractionary monetary policy. Which of the following actions would allow it to achieve this objective?
    A) Buy government of Canada bonds in the secondary market.
    B) Widen the band of the overnight rate.
    C) Monetize the government deficit.
    D) Sell foreign currency in the exchange market.
    E) Reduce the bank rate.

16. Consider an economy currently in equilibrium. The public likes to hold 20% of their money holdings (M) in cash (CU_P). Banks like to hold 15% of public’s deposits (D) as reserves (R) and currently hold $30 as reserves. Which of the following statements is correct?
    A) The money multiplier (mm) is approximately 2.75.
    B) The money supply is $200.
    C) The quantity of cash held by the public (Cu_p) is $40.
    D) The monetary base (B) is $80.
    E) None of the above is correct.

Use this space for rough work.

PART II (60 marks)

<u>Instructions</u>: Answer <u>all</u> five questions in the space provided. You may continue your answer on pages 11-12 if additional space is needed (***but clearly indicate that your answer continues on page 11 or 12***). Each question is of equal weight.

1. **Critically comment on the following statement:** *"A central bank's full commitment to inflation targeting helps maintaining output stability at all times."* (**Show your answer with help of an appropriate *AD-AS* diagram and <u>explain</u> the economics. Assume the economy is initially in long-run equilibrium.)**

(Continue on pages 11-12 if necessary)

2. Consider a small open economy with a fixed price level, flexible exchange rate, and imperfect capital mobility. 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 you answer you must compare and explain the likely short-run impact that these two alternative ways of financing a government deficit will have on the rate of interest, level of output, current account balance, and capital account balance.)**

(Continue on pages 11-12 if necessary)

3. **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 given by $P = P_{-1}\,[1 + \lambda(Y - Y^*)]$ and assume the economy is initially in long-run equilibrium.)**

(Continue on pages 11-12 if necessary)

4. Adjusted for inflation, the international price of oil increased from an average of $34/barrel in 2003 to an average of $95/barrel in 2008. What would have been the likely (positive and negative) effects of this price increase on the economy of a small oil-exporting country? Would these effects be different if this country had a fixed instead of a flexible exchange rate system? What could have done the government of this country to reduce some of the negative impacts?

(Continue on pages 11-12 if necessary)

5. The ECB and the central banks of Japan and some European countries are charging interest on the deposits they are taking from commercial banks (i.e., negative rate of interest). What would be the likely impact of this policy? Would negative interest rates help persuade banks to lend more money to their customers? Why or why not? If banks' corporate clients were also charged a negative interest rate on their deposits, would it help persuade them to increase their expenditures on productive investment? Why or why not?

(Continue on pages 11-12 if necessary)

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