

Midterm 2 Exam

This exam is worth 60 points, although you have 70 minutes to complete it. Part I is multiple choice, Part II is a short answer. The points are allocated in proportion to the time you should spend on each problem.

PART I: Multiple Choice [30 minutes total, 3 points each]. Do NOT explain. Answers go into the bluebook.

1. The Trilemma, also known as the Impossible Trinity:
 - a. Posits fiscal policy is ineffective is capital mobility is zero and exchange rates are fixed.
 - b. Indicates that only two out of three policy objectives (exchange rate stability, financial openness, monetary autonomy) can be fully achieved simultaneously.
 - c. Must be true for all countries.
 - d. Implies that when exchange rate stability and financial openness are selected, a country's interest rate must follow that of the country to which the currency is pegged to.
 - e. (b) and (d) above.

2. In the IS-LM-BP=0 model, under fixed exchange rates, in the short-term, a fiscal contraction will lead to
 - a. decreased income, lower interest rates and a balance of payments deficit.
 - b. decreased income, lower interest rates and a balance of payments surplus.
 - c. decreased income, lower interest rates and an ambiguous effect on the balance of payments.
 - d. decreased income, higher interest rates and an ambiguous effect on the balance of payments.
 - e. increased income, lower interest rates and an ambiguous effect on the balance of payments.

3. In the aggregate demand-aggregate supply framework
 - a. the price level adjusts in response to the output gap.
 - b. fiscal policy is completely ineffective in affecting the level of output in the long run.
 - c. monetary policy is completely ineffective in affecting the level output in the long run.
 - d. all of the above.
 - e. none of the above.

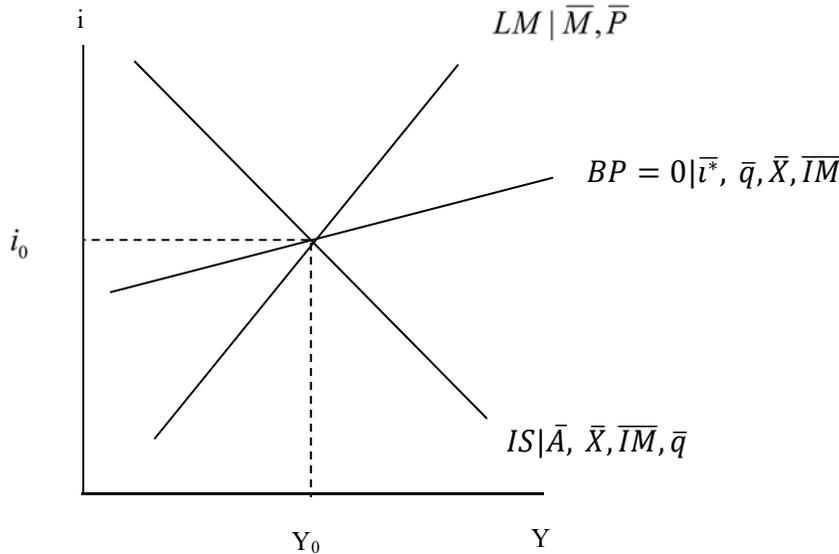
4. Suppose financial capital mobility is perfect.
 - a. Under fixed exchange rates, monetary policy is perfectly effective.
 - b. Under floating exchange rates, monetary policy is perfectly effective.
 - c. Under fixed exchange rates, fiscal policy is perfectly effective.
 - d. Under floating exchange rates, fiscal policy is perfectly effective.
 - e. (b) and (c) above.

5. A central bank wishes to sterilize a reserve outflow. Which of the following achieve this goal?
 - a. Expand net domestic assets at the same rate as the reserve outflow is contracting the money supply.
 - b. Reduce net domestic assets at the same rate as the reserve outflow is expanding the money supply.
 - c. Use open market operations to sell treasury securities on the private market.
 - d. Use open market operations to reduce domestic money supply
 - e. Enlist the help of the fiscal branch to create expenditure switching activities.

6. In a two-country Keynesian model,
- The effect of a fiscal expansion is larger than that in a single economy model.
 - The effect of a fiscal expansion is smaller than that in a single economy model.
 - Some of the leakage of spending power via imports returns via higher export demand.
 - (a) and (c) above.
 - None of the above.
7. How does increasing the mobility of capital change the effectiveness of fiscal policy under fixed and floating exchange rate regimes?
- Under fixed exchange rates, more capital mobility leads to more effective fiscal policy. Under floating exchange rates, more capital mobility leads to less effective fiscal policy.
 - It increases the effectiveness of fiscal policy under both exchange rate regimes.
 - It decreases the effectiveness of fiscal policy under both exchange rate regimes.
 - Under fixed exchange rates, more capital mobility leads to less effective fiscal policy. Under floating exchange rates, more capital mobility leads to more effective fiscal policy.
 - The effect is ambiguous.
8. In an aggregate demand-aggregate supply framework, a one time positive value of z (z goes from zero to a positive number and then returns to zero):
- results in an immediate increase in the price level.
 - necessarily results in an output reduction regardless of policy.
 - will necessarily cause consistent and continuing inflation.
 - will cause persistent inflation if the authorities keep output at full employment and expectations are adaptive.
 - will result in none of the above.
9. Uncovered interest rate parity
- implies that interest rates are equalized.
 - requires that the expected rate of return expressed in dollars of saving in dollar and foreign currency denominated assets must be equal
 - requires that returns denominated in bundles of consumption goods be equalized.
 - requires that the forward rate and the expected spot rate be equal.
 - both (b) and (d).
10. Under fixed exchange rates, an increase in the sensitivity of capital flows to interest rate differentials is likely to result in
- a larger balance of payments deficit following a fiscal expansion.
 - small losses in reserves following a monetary expansion.
 - a more substantial capital outflow following a monetary expansion.
 - a lower long-run increase in income following a fiscal expansion.
 - none of the above.

PART II: Short Answer (30 minutes total)

1. (15 minutes) Suppose you are given a standard IS-LM-BP=0 model for a small country operating under a fixed exchange rate regime:



1.1 (5 minutes) Show what happens to output and the interest rate if the lump sum taxes are decreased, using a graph (show the curve shifts clearly). Assume for the moment the central bank sterilizes flows.

1.2 (5 minutes) Show what happens over time the curves, and the money base, if the central bank does not sterilize flows. Explain clearly the mechanics and economics of what happens.

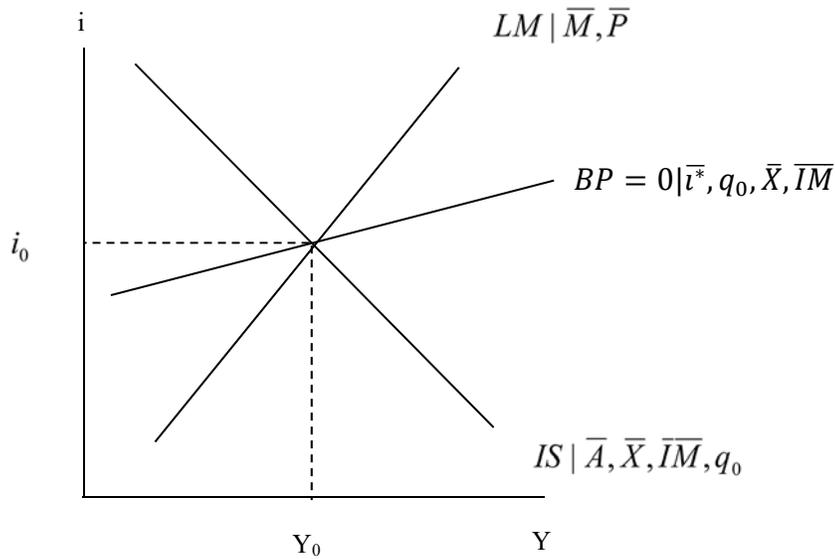
1.3 (5 minutes) Returning to equilibrium (before questions 2.1, 2.2), suppose that the fixed exchange rate is not perfectly credible, so even under a fixed exchange rate regime, financial flows behave as follows:

$$FA = \bar{FA} + \kappa(i - i^* - \Delta s_{+1}^e)$$

That is, financial flows respond to interest differentials after accounting for expected depreciation.

Show what happens if the markets start doubting the credibility of the exchange rate peg, and ascribe a 50% probability that the peg will remain in place, and 50% probability of a 20% depreciation. Also show what must the central bank do, if anything, to do to prevent reserve decumulation.

2. (15 minutes) Suppose you are given a standard IS-LM-BP=0 model for a small country operating under a floating exchange rate regime:



2.1 (5 minutes) Suppose the rest of the world's economy slows down, such that autonomous exports fall. Show what happens *immediately* to the relevant curve(s), indicating with arrows (marked [1]) the shift(s). Be sure to indicate what variables are changing, by labeling the curves (changes in autonomous exports, changes in real exchange rate, etc.) Explain the economics of what is happening, referring to the graph and specific shifts.

2.2 (5 minutes) Show what secondary shift(s) occur(s). Mark these arrows with a [2]. Be sure to indicate what variables are changing, by labeling the curves (changes in autonomous exports, changes in real exchange rate, etc.) Explain the economics of what is happening, referring to the graph and specific shifts.

2.3 (5 minutes) Suppose the central bank increases the money supply. Show what happens, using a graph with arrows (marked [2] for the second set, and [3] for the third set). Be sure to indicate what variables are changing, by labeling the curves (changes in autonomous exports, changes in real exchange rate, etc.) Explain the economics of what is happening, referring to the graph and specific shifts.