Midterm 2

The total time for the exam is 60 minutes, although you are given 70 minutes to complete it. Points are allocated proportionally to the time allocations.

Part I: Multiple Choice (30 minutes, 3 minutes each)

1. The term “sterilization” refers to
   a. central bank actions that prevent foreign exchange reserve changes from altering the monetary base.
   b. central bank actions to nullify fiscal policy measures.
   c. making sure nothing ever happens in the economy.
   d. all of the above.
   e. none of the above.

2. Purchasing power parity may fail to hold because of the presence of
   a. imperfect information, contracts and momentum in consumer buying habits.
   b. tariffs and transportation costs.
   c. non-traded goods and services in price indices.
   d. permanent shifts in the terms of trade between traded goods.
   e. all of the above.

3. Along the BP schedule (with imperfect capital mobility), higher income leads to
   a. a trade deficit, a higher interest rate and a capital inflow which leaves the overall balance of payments below zero.
   b. a larger trade deficit (or smaller surplus), a higher interest rate and a capital inflow which leaves the overall balance of payments at zero.
   c. a trade surplus, a higher interest rate and a capital inflow which leaves the overall balance of payments above zero.
   d. a trade surplus, a lower interest rate and a capital outflow which leaves the overall balance of payments at zero.
   e. none of the above.

4. Liberalization of financial markets can be represented as
   a. a steepening of the BP curve.
   b. an increase in the marginal propensity to import.
   c. a rightward shift of the BP curve.
   d. increased sensitivity of capital to interest differentials.
   e. a lessening of interest differentials.
5. With floating exchange rates, a higher degree of international capital mobility implies
a. money comes into the country faster following fiscal expansion to augment the expansion in income.
b. there will be large appreciations following monetary expansion.
c. fiscal expansion may lead to a balance of payments surplus.
d. the exchange rate will adjust to discourage net exports following a fiscal expansion.
e. none of the above.

6. The interest rate in the US is 5 percent and the interest rate in Japan is 3 percent. If the UIP
condition holds, the expected change in the dollar/yen spot rate must then be:
a. 2 percent depreciation of the dollar.
b. 3 percent depreciation of the dollar.
c. 5 percent depreciation of the dollar.
d. 2 percent appreciation of the dollar.
e. 5 percent appreciation of the dollar.

7. If prices are perfectly flexible, then a 10 percent increase in the money supply will
a. increase the demand for real balances by 10 percent.
b. increase income by 10 percent.
c. increase the price level by 10 percent.
d. increase the interest rate by 10 percent.
e. none of the above.

8. If relative PPP holds in growth rates
a. then the nominal rate of depreciation equals the inflation differential.
b. then the price level at home equals the price level abroad adjusted by the exchange rate.
c. then the real exchange rate is constant.
d. then real rate of depreciation equals the inflation differential.
e. both (a) and (c) above are true.

9. In an aggregate demand-aggregate supply framework,
a. the AD curve is downward sloping because people buy more at lower prices.
b. the AD curve is downward sloping because a higher price level, for given level of government
   spending causes more spending.
c. the AD curve is downward sloping because a higher price level, for given level of the nominal
   money stock, is associated with a higher interest rate and hence lower level of investment.
d. the AD curve incorporates equilibrium in both the real and financial sectors of the economy.
e. both (c) and (d) above are true.
10. Covered interest parity
   a. always holds.
   b. is holding if the interest differential equals the forward discount, which is the percentage gap
      between the forward rate and the spot exchange rate.
   c. is the same as uncovered interest parity.
   d. might hold even if uncovered interest parity doesn’t hold.
   e. both (b) and (d) above.

**Part II: Short Answer (30 minutes)**

1. **Mundell-Fleming model.**
   Suppose you are given a standard IS-LM-BP model under floating exchange rates:

   1.1. (6 minutes) Suppose the interest rate in the rest of the world exogenously rises. Show what
       happens both immediately and over time. Clearly label new equilibrium values of output and interest
       rates, and indicate curve shifts with arrows.

   1.2. (4 minutes) Discuss what happens economically, to the composition of output by the end when the
       new equilibrium has been achieved. What happens to the trade balance?

   1.3. (6 minutes) Show what happens, both immediately and over time, if the BP=0 schedule is flat
       because $\kappa=\infty$, and the central bank wishes to keep the exchange rate constant against the rest-of-the
       world. Use a graph. Explain the economics of your answer.

2. **Aggregate Demand and Aggregate Supply**
   Suppose output is below potential, or full employment, GDP in period 1. Further assume the price level
   has been constant at $P_0=P_1$. You can assume expectations are formed in the following fashion:
   $P_t^e = P_{t-1}$.
   2.1 (9 minutes) Discuss what happens if the government and the central bank take no policy actions.
Show specifically what happens in period 2, and over the long run, using an aggregate demand-aggregate supply graph. Be sure to explain the economics of why the economy takes the path it does.

2.2 (5 minutes) Can the government achieve full employment using fiscal policy? Answer your question with the aid of an AD-AS graph.