Name: ____________________
(Last name, first name)

SID: ____________________

Lecture (1 or 2): ____________________

UGBA 101B
Macroeconomic Analysis for Business Decisions
Professor Steven Wood

Fall 2005

Exam #3

Please sign the following oath:

The answers on this test are entirely my own work. I neither gave nor received any aid while taking this test. I will not discuss the questions on this test until after 11:00 a.m. on December 20, 2005.

____________________
Signature

Any test turned in without a signature indicating that you have taken this oath will be assigned a grade of zero.

Graph Instructions

When drawing diagrams, the following rules apply:

a. Completely, clearly and accurately label all axis, lines, curves, and equilibrium points.

b. The original diagram and equilibrium points must be drawn in black.

c. The first shift of any line(s) and the new equilibrium points must be drawn in red.

d. Any subsequent shifts in curves and new equilibrium points must be drawn in another color, first blue and then green.

Do NOT open this test until instructed to do so.
A. **Multiple Choice Questions.** Circle the letter corresponding to the best answer. (30 points.)

1. Suppose that the government increases expenditure and prints money to finance it. However, this makes foreigners nervous about investing in the country. We could analyze the effects of these events by:
   
   a. A shift out of the IS curve.
   b. A shift out of the LM curve
   c. A shift in of the BP curve
   d. Both b. and c.
   e. a. and b. and c.

2. Suppose there is a sudden and permanent rise in foreign demand for American goods. Then:
   
   a. The IS curve shifts out.
   b. The BP curve shifts in.
   c. The BP curve shifts out.
   d. Both a. and b.
   e. Both a. and c.

3. In the Fleming-Mundell model with flexible exchange rates, expansionary fiscal policy is ineffective because:
   
   a. Interest rates rise which leads to a fall in net exports.
   b. Of sterilization.
   c. The central bank has to contract the money supply.
   d. Of an immediate exchange rate depreciation.

4. Suppose a country has a large persistent balance of payments surplus. Then all of the following are true EXCEPT:
   
   a. Foreign exchange reserves are rising over time.
   b. The central bank is reducing the value of the domestic currency.
   c. The country has a capital account surplus.
   d. Without sterilization, the money supply is rising over time.
5. According to real business cycle theory, prices are completely flexible. Then a large fiscal expansion in year one would:

   a. Have no effect on inflation.
   b. Not shift the DAD curve.
   c. Have no effect on output.
   d. Both a. and c.

6. Suppose that some development causes interest rates to rise less in response to a rise in inflation. Then:

   a. Output will be less variable.
   b. Output will be more variable.
   c. Inflation will tend to be lower than before.
   d. Shifts out in the DAD curve will be smaller than before.

7. In the late 1990s, the US economy went above potential, but inflation didn’t rise. This might have been due to all of the following EXCEPT:

   a. An appreciation of the dollar.
   b. A fall in the price of oil.
   c. Mismeasurement of potential.
   d. Increased globalization.
   e. A rise in the NAIRU.

8. Suppose that the economy is at potential output. The government then engages in a contractionary fiscal policy that the central bank immediately and fully offsets with an expansionary monetary policy. These actions will cause output:

   a. To rise in the short run, to not change in the medium term, and to fall in the long run.
   b. To fall in the short run, to not change in the medium term, and to rise in the long run.
   c. To not change in the short run, to not change in the medium term, and to rise in the long run.
   d. To not change in the short run, to not change in the medium term, and to fall in the long run.
   e. To not change in the short run, to not change in the medium term, and to not change in the long run.
9. Many economists believe that rising inflation causes uncertainty leading to lower investment. If this is the case:

   a. The SAS curve and DAD curve move simultaneously.
   b. The classical dichotomy holds in the long run.
   c. Inflation has no effect on potential output.
   d. The sum of consumption and net exports is lower in the long run.

10. According to supply side economics tax cuts lead to more innovation and employment. So, in this case, if the economy is initially at potential a large tax cut will, in the long run, lead to:

    a. Higher inflation.
    b. Lower inflation.
    c. Shift the DAD curve in.
    d. Lower investment.
    e. Either a. or b.
B. **IS-LM-BP and DAD-SAS Models.** Answer BOTH of the following questions.

1. In the late 1990’s Chile’s economy was in joint equilibrium with an unemployment rate that was below its NAIRU. Because Chile imposes a transactions tax on all international capital inflows and outflows, its international capital flows are relatively immobile, i.e., its BP curve is steeper than its LM curve. (35 points.)

   a. Based only on this information, use a standard IS-LM-BP model to clearly show what the Chilean central bank would do to return the economy to potential output if the country had **fixed** exchange rates.
b. Provide a brief economic explanation of what happens to economic output, interest rates, and the exchange rate, including any challenges that the central bank may encounter.
c. Based only on the initial information, use a new standard IS-LM-BP model to clearly show what the Chilean central bank would do to return the economy to potential output if the country had flexible exchange rates.
d. Provide a brief economic explanation of what happens to economic output, interest rates, and the exchange rate, including any challenges that the central bank may encounter.
2. Suppose the economy is at potential output and the inflation rate is steady. In year 1, a new technology is developed that permanently increases productivity and also causes a big increase in autonomous investment. (35 points.)

   a. Based only on this information, use a standard DAD-SAS model to clearly show what happens to the output ratio and inflation during the first 3 years of the adjustment process. Also, clearly show the economy’s final equilibrium position.
b. Provide a brief economic explanation for what happens to the output ratio and inflation during the adjustment process. Be sure to discuss where economic output and inflation finally settle at the end of the adjustment process.
c. Begin again but now assume that the central bank has an inflation target at the initial inflation rate. Also assume that the central bank can only react to changes in the economy with a one year lag. Use a new standard DAD-SAS model to clearly show what the central bank must do to maintain its inflation target.
d. Provide a brief economic explanation for what is happening to the output ratio and inflation. Be sure to discuss where economic output and inflation finally settle at the end of the adjustment process.