Name: ____________________  
(Last name, first name)

SID: ____________________

Lecture (1 or 2): ____________________

WEIGHT FOR THIS EXAM:  35% _______ or 40% _______

UGBA 101B  
Macroeconomic Analysis for Business Decisions  
Dr. Steven Wood  
Spring 2006  
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 May 19, 2006.

_______________________________________  
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, preferably 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. (3 points each; total of 30 points.)

1. Suppose that there is a sudden fall in the foreign demand for our domestically produced goods. Then:
   a. The BP curve will shift to the left.
   b. The BP curve will shift to the right.
   c. The IS curve will shift to the left.
   d. Either a. or b.
   e. Both a. and c.

2. If an economy has completely flexible exchange rates, then:
   a. The balance of payments is always positive.
   b. The central bank is accumulating foreign exchange reserves.
   c. The sum of the current account and the capital account is zero.
   d. The balance of payments is never zero.
   e. The central bank will always sterilize any foreign exchange intervention.

3. Many developing countries cannot borrow in their own currencies and so have a lot of foreign denominated debt. If such a country has a flexible exchange rate, then a currency depreciation will shift the BP curve to the right and:
   a. Shift the LM curve to the right.
   b. Shift the IS curve to the left.
   c. Shift the IS curve to the right.
   d. Indeterminate, could be either b. or c.
   e. Both a. and c.

4. In the Fleming-Mundell model with fixed exchange rates, fiscal policy is very effective because:
   a. It also causes a monetary expansion.
   b. It causes another fiscal expansion.
   c. The currency depreciates which increases the current account.
   d. It forces the central bank to sterilize its foreign exchange intervention.
   e. It leads to a fall in foreign exchange reserves.
5. Suppose that the government reduces government purchases which causes a decline in the risk premium on the country’s bonds, i.e., investors believe that holding the country’s bonds is now less risky. We could represent these changes as:

   a. A shift of the IS curve to the left.
   b. A shift of the BP curve to the right.
   c. A shift of the LM curve to the left.
   d. Both a. and b.
   e. Indeterminate, could be either a. or c.

6. In the long run, a permanent monetary expansion will lead to all of the following EXCEPT:

   a. A fall in interest rates.
   b. A permanent depreciation of the exchange rate.
   c. No change in consumption.
   d. No change in investment.
   e. Higher inflation.

7. Suppose that interest rates become more sensitive to rising inflation. If the economy is at potential and there is a sudden increase in oil prices, then:

   a. Output will fall by less.
   b. Output will fall by more.
   c. Inflation will rise more.
   d. Inflation will rise less.
   e. None of the above.

8. Suppose that a rise in inflation causes firms to become permanently less efficient because they now have more pricing power. If unemployment is initially at the NAIRU, then a monetary expansion will now (compared to the usual case) lead to:

   a. More inflation.
   b. Less inflation.
   c. Indeterminate, could be either a. or b.
   d. A bigger boom.
   e. Disinflation.
9. Suppose that the introduction of Internet job searches causes the NAIRU to decline substantially. Assuming the DAD curve does not shift, at the long-run equilibrium there will be:

   a. Less output.
   b. Higher inflation.
   c. Lower inflation.
   d. Less employment.
   e. Deflation.

10. Suppose that the economy is at potential output. The government then engages in an expansionary fiscal policy. The central bank’s initial reaction is to immediately increase the money supply in order to keep interest rates at their initial level. These actions will cause output:

   a. To rise in the short run, to not change in the medium run, and to fall in the long run.
   b. To rise in the short run, to not change in the medium run, and to rise in the long run.
   c. To fall in the short run, to not change in the medium run, and to rise in the long run.
   d. To fall in the short run, to not change in the medium run, and to fall in the long run.
   e. To not change in the short run, to not change in the medium run, and to not change in the long run.
B. **IS-LM-BP and DAD-SAS Model Problems.** Answer **BOTH** of the following questions.

1. The country of Hysteria has a balance of payments deficit while unemployment is below its natural rate. In addition, its international capital flows are relatively immobile (i.e., the BP curve is steeper than the LM curve), its exchange rate is fixed, and the central bank sterilizes its foreign exchange intervention. (35 points.)

   a. Based only on this information, use a standard IS-LM-BP Model to **clearly show** the economy’s initial position.
b. Carefully explain how the Hysteria central bank maintains a fixed exchange rate. What are the economic consequences of the central bank’s policy of sterilizing its foreign exchange intervention?

c. In your diagram for part a, clearly show how the Hysteria government can use monetary and/or fiscal policy to achieve joint equilibrium at full employment.

d. Provide an economic explanation of the policies you showed in part c.
2. In 1997, the U.S. economy was at potential output with a steady inflation rate. Because of the Asian economic crisis, oil prices fell significantly while the foreign exchange value of the dollar rose substantially in 1998. Also in 1998, autonomous investment increased considerably because of the advent of the Internet, new telecommunications advances, and in anticipation of the century date change. However, government spending declined, offsetting one-half of the increase in autonomous investment. Finally, in 1999, oil prices rose back to their 1997 level. (35 points.)

   a. Based only on this information, use a standard DAD-SAS Model to clearly show what happened to the output ratio and inflation during 1998, 1999, and 2000.