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.

__________________________________________
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. (30 points.)

1. If the central bank sterilizes its foreign exchange intervention, then it prevents:
   a. An inward shift of the BP curve.
   b. An outward shift of the BP curve.
   c. An outward shift of the DAD curve.
   d. An outward shift of the IS curve.

2. With a policy of fixed exchange rates, all of the following are true EXCEPT:
   a. Fiscal policy is very effective in combating recessions.
   b. The central bank will raise interest rates in booms to stabilize the economy.
   c. There is no limit to the extent that the central bank can act to prevent a weakening of the currency.
   d. The central bank must have sufficient foreign exchange reserves to prevent a strengthening of the currency.

3. Suppose the domestic economy has a balance of payments surplus of 50 and a current account deficit of 70. Then all of the following are true EXCEPT:
   a. With fixed exchange rates, the central bank’s foreign exchange reserves increase by 50.
   b. There is a capital account surplus of 120.
   c. Private domestic residents are investing 70 abroad.
   d. Without foreign exchange intervention, the domestic currency appreciates.

4. A large increase in interest rates of our trading partners (i.e., the world interest rate) would initially:
   a. Shift the IS curve inward and the BP curve outward.
   b. Shift the IS curve inward and the BP curve inward.
   c. Reduce the slope of the BP curve.
   d. Reduce the slope of the IS curve.
5. Suppose the central bank adopts an inflation target, committing to keeping inflation at a fixed rate and doing whatever is necessary to prevent deviations from it. If there is a sudden temporary fall in productivity, then the central bank should:

   a. Raise interest rates.
   b. Lower interest rates.
   c. Maintain fixed interest rates.
   d. Engage in some expansionary policy to offset the adverse shock.

6. Suppose two countries (A and B) have the same inflation rates and are at their respective potential output levels. Country A lowers interest rates in year 1 while country B doesn’t. Then, according to the DAD-SAS model, all of the following are true EXCEPT:

   a. The output ratio will be higher in A in year 1.
   b. Inflation will be the same in both A and B in year 1.
   c. In the long run, A will have permanently higher inflation than B.
   d. In the long run, A will have a higher output ratio than B.

7. Usually, government expenditures are assumed to be for consumption-type spending. Suppose, however, that government expenditures are used to finance research and development activities. Then, compared to the usual assumption, in the long-run, this will lead to:

   a. Higher potential output and lower inflation.
   b. Higher potential output and the same inflation.
   c. The same potential output and lower inflation.
   d. The same potential output and higher inflation.

8. Suppose that the central bank is unsure of the level of potential output, that there are no supply shocks, and that inflation is falling. Then we know that:

   a. GDP growth is less than potential GDP growth.
   b. GDP growth is greater than potential GDP growth.
   c. GDP is less than potential GDP.
   d. GDP is greater than potential GDP.
9. Suppose there is a sudden increase in the price of oil that reduces consumer confidence. We can best represent this as:

   a. An inward shift of the DAD curve.
   b. An outward shift of the DAD curve.
   c. An inward shift of the DAD curve and an upward shift of the SAS curve.
   d. An inward shift of the DAD curve and a downward shift of the SAS curve.

10. Suppose that the unemployment rate is at its natural rate and there is a permanent increase in productivity. Further suppose that this leads to a surge in consumption as people expect higher wages in the future. Then according to the DAD-SAS model, ultimately:

   a. Inflation will rise.
   b. Inflation will fall.
   c. Deflation will occur.
   d. Disinflation will occur.
   e. Whether inflation rises or falls is indeterminate.
B. IS-LM-BP and DAD-SAS Models. Answer both of the following questions.

1. In the early 1990’s, wealthy British residents borrowed money in the United Kingdom to buy vacation homes in Portugal. This set off a building boom as the number of new homes being constructed soared. Portugal was in joint equilibrium at the beginning of the decade. (40 points.)

   a. Based only on this information, use a standard IS-LM-BP model to clearly show what effects these events had on Portugal’s level of economic output, interest rates, and the exchange rate assuming that Portugal had a flexible exchange rate. Be sure to provide a brief economic explanation of what is happening.
b. Based only on the information given above, use a standard IS-LM-BP model to clearly show what effects these events had on Portugal’s level of economic output, interest rates, and the exchange rate assuming that Portugal had a fixed exchange rate and does not sterilize their foreign exchange intervention. Be sure to provide a brief economic explanation of what is happening.
2. In 1995 the U.S. economy was operating at potential output with a steady inflation rate. In 1996, two major events happened. First, there was a major acceleration in autonomous investment as corporations rushed to invest in the new information technologies. Second, a sharp increase in globalization suddenly and significantly increased international competitive pressures. (30 points.)

   a. Based only on this information, use a DAD-SAS model to clearly show what effects these events would have on the output ratio and the rate of inflation. Be sure to show what happens in 1996, 1997, and 1998. Also, be sure to identify the final equilibrium position.
b. Provide a brief economic explanation of the adjustment process being sure to discuss the role of interest rates.