Name: ____________________ (Last name, first name)
SID: ____________________

UGBA 101B
Macroeconomic Analysis for Business Decisions
Professor Steven Wood
Summer 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 5:00 p.m. on June 29, 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, 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. (3 points each; total of 30 points.)

1. Suppose we have a small open economy has fixed exchange rates. If unemployment is below the NAIRU, then to stabilize the economy a good policy would be to:
   a. A fiscal contraction.
   b. A monetary contraction.
   c. A fiscal expansion.
   d. A monetary expansion.
   e. Indeterminate.

2. Suppose an economy with fixed exchange rates accumulated reserves of 100 last year. Then, if the current account was 30, we know that:
   a. There was no sterilization.
   b. The balance of payments was 70.
   c. The balance of payments was 30.
   d. The capital account was 70.
   e. The country devalued its exchange rate.

3. Suppose a country that starts in joint equilibrium with flexible exchange rates experiences a permanent and large fall in foreign demand for their goods. This will ultimately lead to:
   a. Higher interest rates.
   b. A weaker exchange rate.
   c. Lower interest rates.
   d. A stronger exchange rate.
   e. Unemployment below the NAIRU.

4. A prime objective of sterilization policy would be to:
   a. Reduce unemployment.
   b. Increase potential output.
   c. Prevent inflation from rising.
   d. Keep the exchange rate fixed.
   e. Raise the monetary base.
5. The US has most of its foreign assets denominated in foreign currency terms; hence a weaker dollar can effectively make the US richer. So, given this observation, if the dollar fell in value:

   a. The BP curve would shift outwards.
   b. The shift in the BP curve is indeterminate.
   c. The IS curve would shift to the right more.
   d. The LM curve would shift outwards.
   e. The shift in the IS curve is indeterminate.

6. Suppose unemployment is at the NAIRU. Then, all of the following would permanently reduce inflation EXCEPT:

   a. A fall in the NAIRU.
   b. A rise in labor force participation.
   c. A fall in the price of oil.
   d. Contractionary monetary policy.
   e. A rise in productivity due to the internet.

7. Suppose that rising inflation induces a permanent rise in precautionary savings as people now face more uncertainty. If there is a sudden increase in the price of oil, then, compared to the standard case, in the long run:

   a. Inflation is now higher.
   b. There is deflation.
   c. The interest rate is higher.
   d. Inflation is lower.
   e. Investment is lower.

8. Suppose there is a sudden increase in capital flows into the US, leading initially to a dramatic appreciation of the dollar. Then, the best description of what happens initially is:

   a. The DAD curve would shift in.
   b. The DAD curve would shift out.
   c. The SAS curve would move upwards.
   d. The SAS curve would move downwards.
   e. Both a. and c.
   f. Both a. and d.
9. None of the following developments would lower the standard of living of an economy in the long run EXCEPT:

   a. Expansionary fiscal policy.
   b. Contractionary fiscal policy.
   c. Expansionary monetary policy.
   d. Contractionary monetary policy.
   e. Both b. and c. together.
   f. Both b. and d. together.

10. Suppose that interest rates became more sensitive to inflation. Then, an unfavorable oil shock would:

    a. Cause a deeper recession.
    b. Permanently reduce potential output.
    c. Raise inflation more.
    d. Raise inflation less.
    e. Reduce the NAIRU.

1. In 2005 the U.S. economy was at potential but the government’s budget was in substantial deficit. In 2006, oil prices increase to over $70 per barrel. As a result, many energy-intensive businesses had to permanently change their production processes to less efficient techniques. Also in 2006, there was a big increase in imports as consumers bought more fuel efficient Japanese and German automobiles instead of less fuel efficient American ones. In addition, the government reduced personal income tax rates. The effect of the change in taxes in income was smaller than the effect of imports. Finally in 2006, the FED changed monetary policy to keep the unemployment rate steady at its 2005 level. (35 points.)

   a. Based only on this information, use a DAD – SAS Model diagram to clearly show the effects of these events on the output ratio and the rate of inflation during 2006, 2007, and 2008. Also, be sure to identify where the economy and inflation settle at the end of the adjustment process.
b. Provide a brief economic explanation for what happened to the output ratio and inflation in 2006, 2007, and 2008. Also, be sure to discuss where economic output and inflation finally settle at the end of the adjustment process.
2. China has a large open economy that is currently at potential output. In addition, China now has a large current account surplus, a small capital account surplus, a fixed exchange rate, and relative capital immobility. The Peoples Bank of China (China’s central bank) never sterilizes its foreign exchange intervention. (35 points.)

a. Based only on this information, use an IS-LM-BP Model diagram to clearly show what will then happen to equilibrium income, interest rates, and the balance of payments in China.
b. Provide a brief economic explanation for what then happens to China’s equilibrium income, interest rates, the central bank’s foreign exchange reserves, and the balance of payments.
c. Begin again with the initial conditions stated in 2. Now suppose that the Chinese government relaxes capital controls on its citizens. As a result, there is a significant increase in capital outflows as Chinese residents diversify their financial holdings into foreign currency denominated financial assets. Based only on this information, use a new IS-LM-BP Model diagram to clearly show what will then happen to equilibrium income, interest rates, and the balance of payments in China.
d. Provide a brief economic explanation for what then happens to China’s equilibrium income, interest rates, the central bank’s foreign exchange reserves, and the balance of payments.