EE432 - Practice Questions for Final Exam

Short Essay Questions

1. Fixed exchange rates are sometimes implemented through a currency board or dollarization. What is the difference between the two approaches?
2. According to the Keynesian view, why is it better to target the federal funds rate rather than money supply?
3. Define sterilized and unsterilized foreign exchange interventions. What are the differences between the two approaches in terms of how it affects the market of exchange rates?
4. Explain how the International Monetary fund (IMF) was established. What were its original objectives? How have these objectives changed over time?
5. High capital mobility is forcing emerging market nations to choose between free floating regimes and currency board or dollarization regimes. What are some considerations from the perspective of emerging market nations in choosing between which regimes to adopt?

Applied Questions

Question 1

Consider the following closed economy:

$C = 2000 – 100 r + 0.9 (Y-T)$

$T=2000$, $G = 1000$

$I = 900 + 0.03Y – 100 r$

a) Solve for equilibrium condition in the goods market. What is the size of the multiplier?
b) Suppose T increases from 2000 to 2500. Solve for the new equilibrium. Is the multiplier effect present? Explain.
c) Derive the IS curve from the equations above (Hint: Pick arbitrary values of r and solve for Y). Graph your answer.

Question 2

Let P be the GDP deflator in the US and P* be the GDP deflator in the UK. Suppose $P = 1.1$ and $P^* = 1.6$.

a) Calculate the real exchange rate for each of the following dollar/pound nominal exchange rates: 1.2, 1.4 and 1.6.
b) What happens to the real exchange rate as E increases?
c) What happens to the price of US goods in terms of UK goods as E increases? Briefly explain.
d) Given that P and P* are fixed, does an increase in E cause a real appreciation or depreciation of the dollar?
e) If the real exchange rate remains constant following an increase in E, what must have happened to the inflation rates in the US and UK? Explain.

<u>Question 3</u>

Suppose an economy is in a recession.

a) Without policy intervention and without further demand or supply shocks, explain and illustrate on a graph how the economy will adjust over time.
b) Now suppose the economy had adjusted to the long run equilibrium. Then, suppose there is an increase in government spending. Show and explain how the AS-AD model as well as IS-LM is affected in the short and long run (align the two graphs vertically as we have done in class). With this fiscal expansion, what is the effect on aggregate output, the aggregate price level, interest rates, consumption and investment in the long run?
c) Is the crowding out effect present in part b)? Explain

<u>Question 4</u>

French Guyana, the only country in South American which is not independent, has a very low inflation rate. It was 1.5% in 2005 and 2.5% in 2004. The following modified Phillips curve has been estimated.

$\pi_t = \pi_{t-1} + 3.0 - 0.2u_t$

a) What is the expected inflation rate for 2005? What is the actual unemployment rate in 2005?
b) What is the natural rate of unemployment in 2005? Make sure you explain the conditions that need to hold when calculating for the natural rate of unemployment.
c) Rewrite the modified Phillips curve $\pi_t = \pi_{t-1} + (\mu+z) - \alpha u_t$, such that the change in the inflation rate is a function of the actual and natural unemployment rates. Show all steps in your derivation.
d) Using the Phillips curve as derived in part c), explain what will have to happen to the inflation rate in 2006 if the French Guyana president wants to maintain the same 2005 unemployment rate for the year 2006. Name three policy measures that can be carried out to achieve this task.
e) What will be the inflation rate in year 2006 if the French Guyana president wants to maintain the 2005 unemployment rate for the year 2006. Draw the Phillips curves for year 2005 and 2006 and illustrate the corresponding equilbriums on a graph.
f) Suppose however, that before the end of the year 2005, there is a sudden decrease in the expected rate of inflation (this could happen through a decrease in the exogenous parameter θ). Given that the expected rate of inflation is now lower, will the actual inflation rate for year 2006 be less than, greater than, or equal to the inflation rate for year 2006 that you calculated in part e)? Explain why this is the case.

<u>Note: this practice exam is to give you an idea of the style of questions you may encounter in the final exam. However, it is not meant to be comprehensive so I would encourage you to do a careful review of all topics.</u>