ECON110B
Summer II 2007
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Practice Final

PART A: Multiple Choice

1. Which of the following must occur for the nominal interest rate to be equal to the real interest rate?
   a) Expected inflation is equal to zero. b) The nominal and real interest rates can never be equal.
   c) Expected inflation is equal to the nominal interest rate.
   d) Expected inflation is negative.

2. The present discounted value of a future payment becomes smaller when:
   a) the payment itself decreases. b) the nominal interest rate decreases.
   c) the payment is made sooner rather than later d) all of the above.

3. A downward-sloping yield curve suggests that financial market participants expect short-term interest rates will
   a) fall in the future. b) be equal to zero in the future.
   c) rise in the future. d) not change in the future.

4. For this question, assume that there is perfect arbitrage in the stock market. Given this assumption, economists believe that:
   a) movements in stock prices are largely unpredictable.
   b) the rate of return on stocks will be equal to the rate of return on bonds.
   c) most stocks will diverge from their fundamental value.
   d) stocks will generally earn a lower rate of return than bonds.

5. Which of the following represents human wealth?
   a) the sum of financial and housing wealth b) total wealth minus housing wealth
   c) financial wealth minus housing wealth
   d) the present discounted value of expected future after-tax labor income.

6. Assume the following: (1) the real cost of a unit of capital is one; (2) the unit of capital is expected to increase a firm's real profit by $10,000 each year, and depreciate by 12% each year (d = .12); and (3) The real interest rate is 3% (r = .03). What is the "user cost" or "rental cost" of this unit of capital?
   a) 0.03 b) 0.09 c) 0.12 d) 0.15

7. Which of the following will NOT cause aggregate private spending to decrease?
   a) an increase in expected future real interest rates
   b) an increase in future taxes
   c) a decrease in government spending
   d) all of the above

8. A permanent reduction in the money supply, with no other policy change implemented or anticipated, will cause which of the following shifts in the IS and/or LM curves in the current period?

a) IS right; LM down
b) IS left; LM down
c) no shift in IS; LM up
d) IS left; LM up

9. Which of the following best defines the real exchange rate?

a) the price of domestic currency in terms of foreign currency
b) the price of foreign currency in terms of domestic currency
c) the price of domestic goods in terms of foreign goods
d) the price of foreign bonds in terms of domestic bonds

10. Assume that the interest rate in a foreign country is 7% and that the foreign currency is expected to depreciate by 3% during the year. For each dollar that a U.S. resident invests in foreign bonds, he/she can expect to get back an approximate total of:

a) $0.93.
b) $0.96
c) $1.04
d) $1.07

11. Which of the following occurs when the goods market is in equilibrium?

a) Y equals the domestic demand for goods.
b) Domestic output (Y) equals the demand for domestic goods.
c) Y equals the domestic demand for domestic goods.
d) Demand for domestic goods equals the domestic demand for goods.

12. Which of the following would make the spending multiplier smaller?

a) a larger marginal propensity to import
b) a real depreciation
c) a marginal propensity to save
d) a small initial trade deficit

PART B: CONCEPT AND KNOWLEDGE

B.1 Briefly explain following terminologies:

B1.a. Rational expectations
B1.b. Uncovered interest parity condition
B1.c. Marshall-Lerner condition

B.2. "When account is taken of its effect on expectations, the decrease in government spending need not lead to a decrease in output." Explain this statement.

PART C: ALGEBRAIC AND GRAPHICAL ANALYSIS

C1. Consider two bonds, one issued in Pounds in United Kingdom and one issued in dollars in the United States. Assume that both government securities are one-year bonds—paying the face value of the bond one year from now. The exchange rate, *E*, stands at 1 dollar = 0.55 pounds. The face values and prices on the two bonds are given by

		Face Value	Price
United States	1-year bond	$10,000	$9,433.96
United Kingdom	1-year bond	£10,000	£9,615.38

C1.a. Compute the nominal interest rate on each of the bonds.
C1.b. Compute the expected exchange rate next year consistent with uncovered interest parity.
C1.c. If you expect the dollar to appreciate relative to the pound, which bond should you buy?

C2. Suppose the open economy is characterized as follows:

$C = 10 + 0.8(Y - T)$
$I = 10; G = 10; T = 10$
$IM = 0.3Y; X = 0.3Y^*,$

where the real exchange rate is fixed and equal to one and Y^* denotes foreign output.

C2.a. Solve for equilibrium output in the domestic economy, given Y^*. What is the multiplier in this economy? If we were to close the economy—so exports and imports were identically equal to zero—what would the multiplier be? Why would the multiplier be different in a closed economy?

C2.b. Assume that the foreign economy has the same equations as the domestic economy (with asterisks reversed). Use the two sets of equations to solve for the equilibrium output of each country. What is the multiplier for each country now? Why is it different from the open economy multiplier in part a)?

C2.c. Assume the domestic government has a target level of output of 125. Assuming that the foreign government does not change the G^*, what is the increase in G necessary to achieve the target output in the domestic economy? Solve for net exports and the budget deficit in each country.

C2.d. Suppose each government has a target level of output of 125, and that each government increases government spending by the same amount. What is the common increase in G and G^* necessary to achieve the target output in both country? Solve for net exports and the budget deficit in each country.

C3. Explain why the multiplier in an open economy is different from the multiplier in a closed economy.

PART D: APPLICATION

D1. Suppose a country is experiencing a situation where output is above the full employment level of output and a trade deficit. Further assume that the policy makers' goals are to achieve full employment output and balanced trade. Given this information, what type of exchange rate and/or fiscal policy can be used to achieve simultaneously these two goals? Explain.