EC1010: 2013 Midterm Solutions

March 8, 2013

MCQs

1. D
2. D
3. A
4. E
5. A
6. E
7. E
8. D
9. C
10. C
11. A
12. A
13. A
14. A
15. D
16. A
17. E

18. E

19. A

20. D

Question 1

i.) See Figure 1.

ii.) See Figure 1.

iii.) Figure 1 depicts a situation where the savings rate is low when incomes in an economy are low. This would arise, for example, when poor people have only sufficient income for food and other necessities and therefore have few resources to save.

Question 2

See Figure 2. (*Note that Figure 3 would also receive full credit, if you wished to start from the standpoint of the exchange rate strengthening, and the bank wishing to reduce its value. In this case, there is no need to show the bank reducing the rate to its initial value (as Fig 3 shows); as long as the bank reduces the rate in response to the initial rise, that is sufficient. If you say the central bank has a fixed exchange rate, that is also fine.*)

i.) The central bank wishes to improve the current account and raise domestic economic activity. To achieve this, it must weaken the exchange rate and thereby make domestic goods relatively cheap.

ii.) To weaken the currency, the central bank first prints money.

iii.) Using the printed money, the central bank purchases foreign currencies. This way, it increases the supply of domestic currency, lowers its value, and, in doing so, accumulates foreign exchange reserves.

Question 3

The real interest rate rises over this period. This can be explained by a combination of a *fall* in savings and a *rise* in investment demand. Any three of the following would be sufficient:

i.) Strong economic performance increases the profitability of investment, and thus raises investment demand.

ii.) If an economy is performing well, there is less risk of, say, unemployment. For this reason, *precautionary savings* would fall.

iii.) If an economy is performing well and output is growing, expectations of future income would rise. According to the *permanent income hypothesis*, this would raise consumption today, and could lead to a fall in savings.

iv.) If the U.S. economy was performing well, the rest of the world was likely performing well too. As a result, there would be less of a "flight to quality" to the U.S., thus reducing capital inflows.

v.) If the government engaged in more expenditure over this period, government savings would fall.

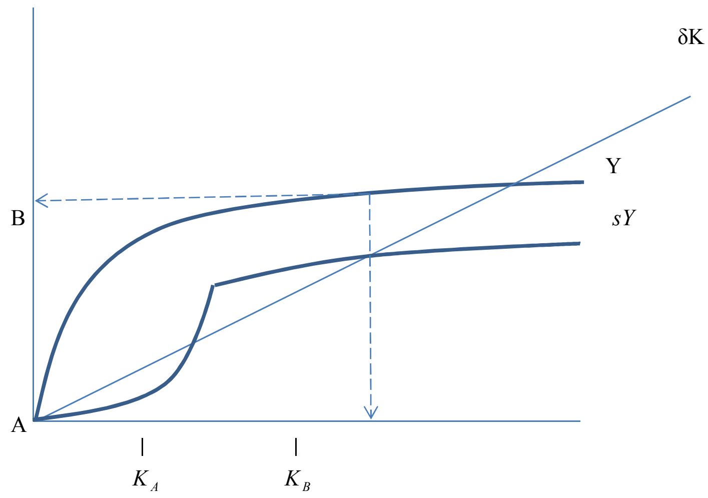

Figure 1: Different savings rates at different levels of development.

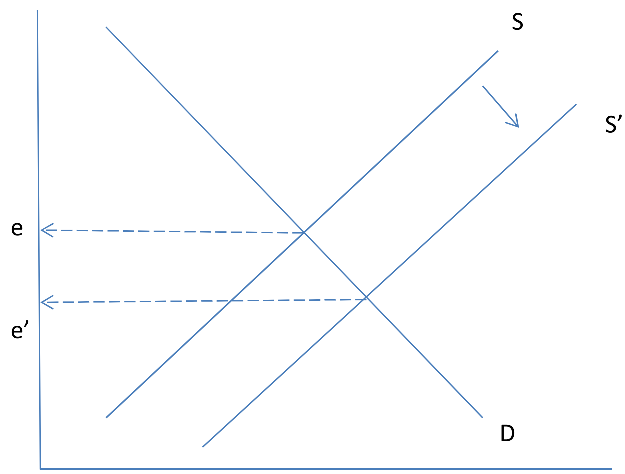

Figure 2: The central bank prints money, which raises the supply of domestic currency.

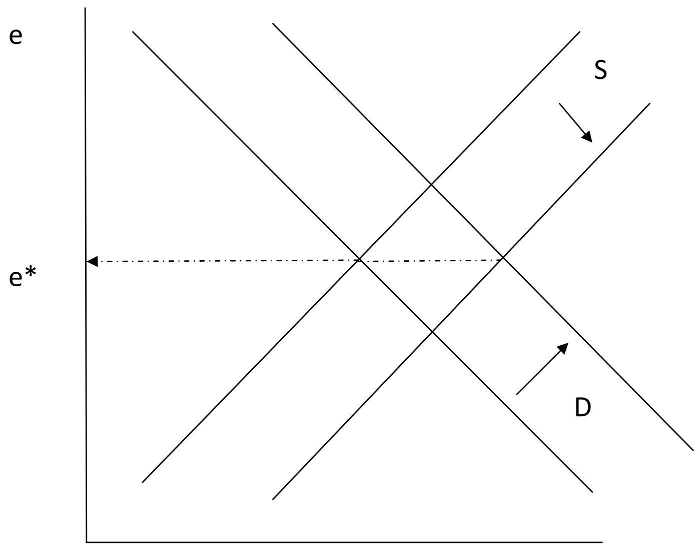

Figure 3: The central bank wishes to weaken the currency in response to an initial rise.

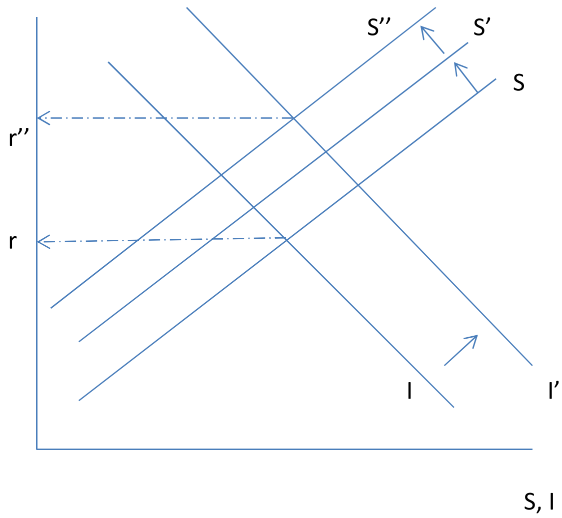

Figure 4: Savings fall and investment demand rises.