TOPIC: Answer Key Sample Problems

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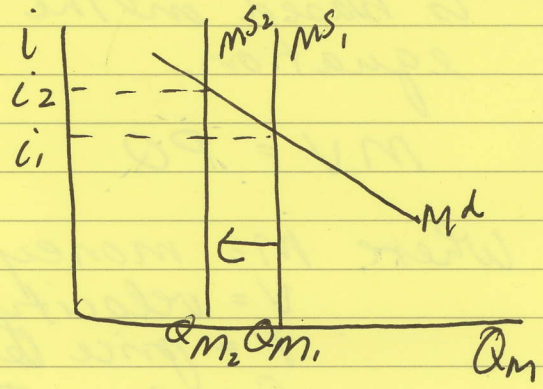
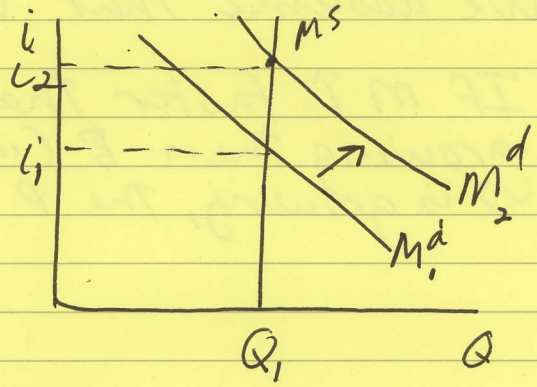
1a. Fed sells Treasury bonds.



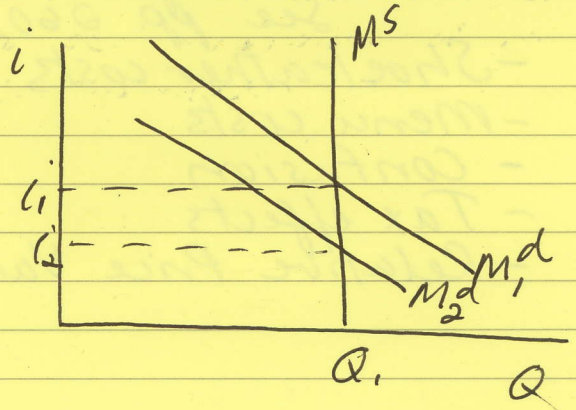
$i \uparrow$; $Q_m \downarrow$

b. An increase in income



$i \uparrow$ $Q_m \rightarrow$

c. A reduction in the price level



2. The quantity theory of money is based on the following equation.

$$MV = PQ$$

Where M = money supply
V = velocity of money
P = price level
Q = quantity of goods + services

We assume that V is constant.

If M ↑ faster than the economy is growing then P (in other words than Q is growing, the P must be rising.

3. Real costs of anticipated inflation
See pp. 260-266
- Shoeleather costs
- Menu costs
- Confusion
- Tax effects
- Relative Price Variability

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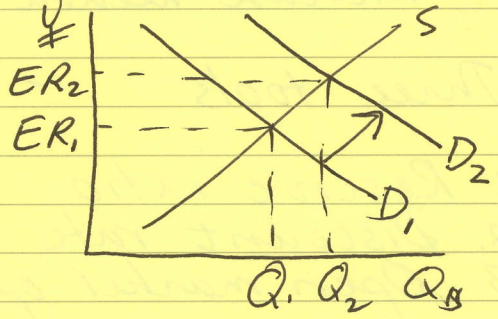
4. Nominal interest rate - The current published interest rate

Real interest rate - The interest rate adjusted for inflation

Real interest rate = Nominal interest rate − rate of inflation

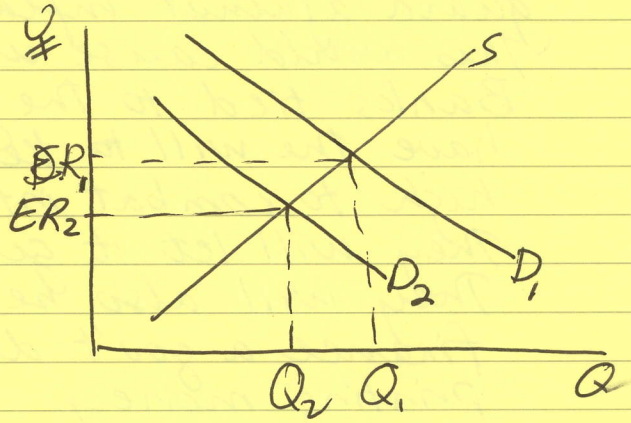
5. Exchange rate ¥ to $

a. interest rate rises in U.S. relative to Japan



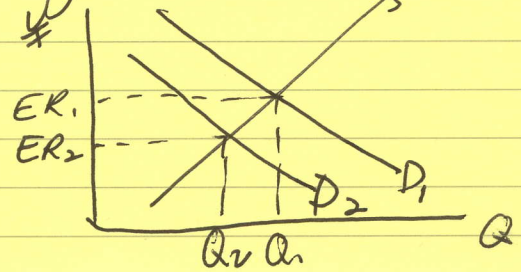
Q↑; ER↑

b. Incomes in Japan fall



Q↓ ER↓

c. Higher tariffs on American goods



6. a)

Assets	Liabilities
Reserves 50,000	Deposit 500,000
Loans 450,000	

b) Money multiplier = $1/RR = 1/.1 = 10$
Overall change = $500,000 \times 10 = 5,000,000$

c) Increase in deposits $\times$ 10 = 1,000,000

Increase needed = 100,000

7. Three tools - Expansionary

1. Reserve ratio ↓
2. Discount rate ↓
3. Open market operations Buy bonds

8. Independent central banks will guard against inflation even if this would cause unemployment. Banks tied to the gov't will not have the will to keep unemployment high to combat inflation and they will let it get out of hand. They will also be more likely to finance a gov't deficit through printing money.

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9. U.S. net capital outflow

a. American co establishes office in Czech Republic NCO ↑

b. Honda expands its factory in Marysville, Ohio NCO ↓

10. U.S. Real exchange rate =

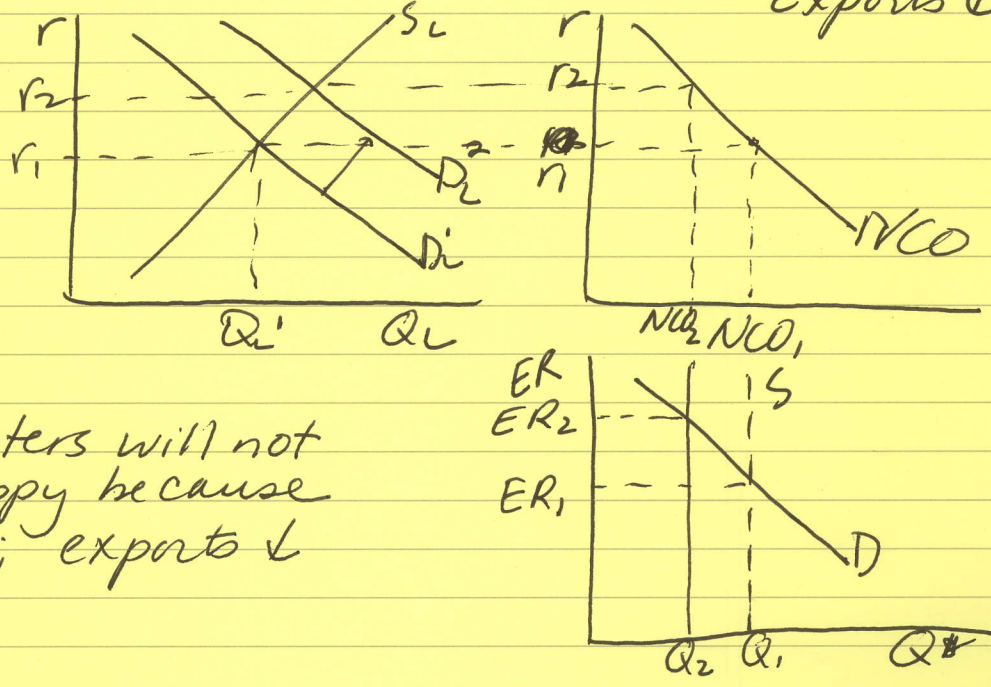
$$\frac{\text{Nominal ER} * \text{Domestic price}}{\text{Foreign Price}}$$

a. Real exchange rate ↑

b. Real exchange rate ↓

11. Investment tax credit to subsidize domestic investment

NS ↑ Domestic investment ↑ Net capital outflow ↓ i ↑, ER ↑ trade balance ↓ Exports ↓



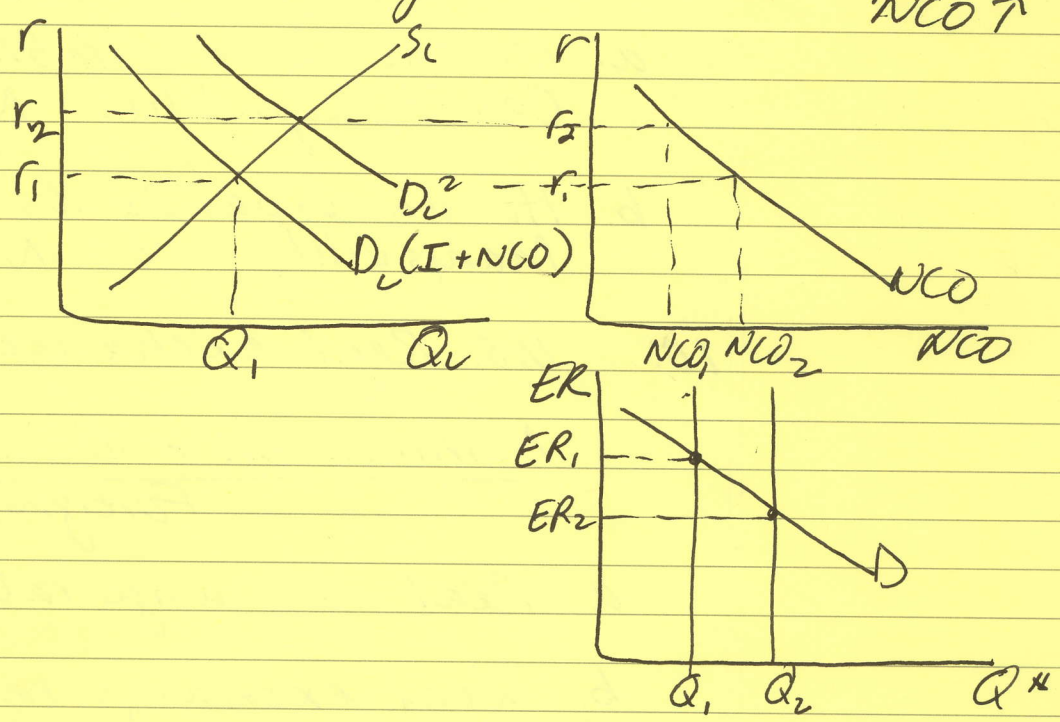
b. Exporters will not be happy because ER ↑, exports ↓

(12)

Chinese saving don't want to buy U.S. assets

NCO ↑

a.



b. The exchange rate ↑