2. Country Y is experiencing severe and unanticipated inflation.

   (a) Explain the effect of this inflation on each of the following.

      (i) A family with savings in a fixed-interest-rate time deposit account

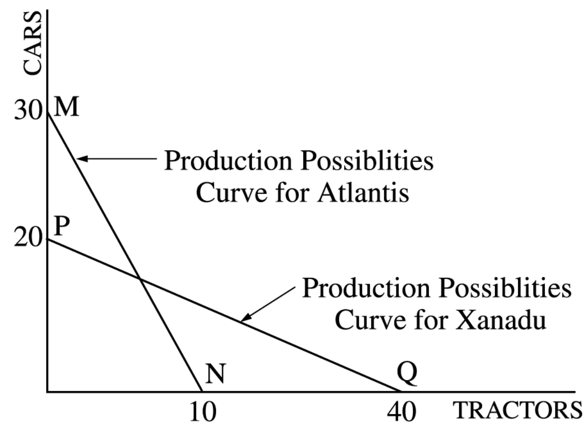
      (ii) A business repaying a long-term, fixed-interest-rate loan

   (b) Identify one fiscal policy action that could be implemented to reduce inflation.

   (c) Identify an open-market operation that could be implemented to reduce inflation.

   (d) Suppose that Country Y continues to experience high inflation in the long run. Indicate the effect of this inflation on the nominal interest rate in Country Y.

   (e) If Country Y's inflation is high relative to that of other countries, explain the effect of this inflation on the international value of Country Y's currency.



3. Assume that two countries, Atlantis and Xanadu, have equal amounts of resources. Atlantis can produce 30 cars or 10 tractors or any combination, as shown by the line MN in the figure above. Xanadu can produce 20 cars or 40 tractors or any combination, as shown by the line PQ in the figure above.

   (a) Which country has an absolute advantage in the production of tractors? Explain how you determined your answer.

   (b) Which country has a comparative advantage in the production of cars? Using the concept of opportunity cost, explain how you determined your answer.

   (c) If the two countries specialize and trade with each other, which country will import cars? Explain why.

   (d) If the terms of trade are such that one car can be exchanged for one tractor, explain how Atlantis will benefit from such trade.

END OF EXAMINATION

Question 2

Correct Answers:

Part a: A family with savings in a fixed-interest rate time deposit will hurt as the real value (or purchasing power) of this deposit will be reduced. A business repaying a long-term loan with a fixed-interest rate will benefit as the business will be repaying the principal with "cheaper" dollars.

Part b: A fiscal policy to reduce inflation would either be an increase in taxes or a reduction in government spending.

Part c: An open market operation to reduce inflation would be a sale of government bonds by the central bank; this sale would reduce bank reserves and the country's money supply.

Part d: With sustained inflation, nominal interest rates will rise in country Y, as lenders will need to be compensated for this inflation with a higher rate of interest.

Part e: Sustained inflation will lead to a reduction in the demand for country Y's goods, reducing demand for the country's currency. As a result, the country's currency will depreciate.

Question 2 (cont'd)

Grading Rubric:

Point allocations: **(7 points: 2 + 1 + 1 +1 + 2)**

a) 2 points: [1 for each explanation OR ½ for each simple assertion without a valid explanation.]

1 point - Family loses as inflation reduces its purchasing power (or real value) or its saving decreases in value / is worth less.

1 point - Business gains as it is paying the creditor using cheaper or inflated dollars.

b) 1 point - Decrease G or Increase T.

c) 1 point - Sell government bonds.

d) 1 point - Nominal interest rate will increase.

e) 2 points: (1 for direction and 1 for explanation)

1 point - The international value of the currency will decrease (depreciates).

1 point - Because the demand for the currency decreases OR supply of the currency increases OR capital outflow.