

Answer - Midterm 2 ECON 2102J Winter 2011

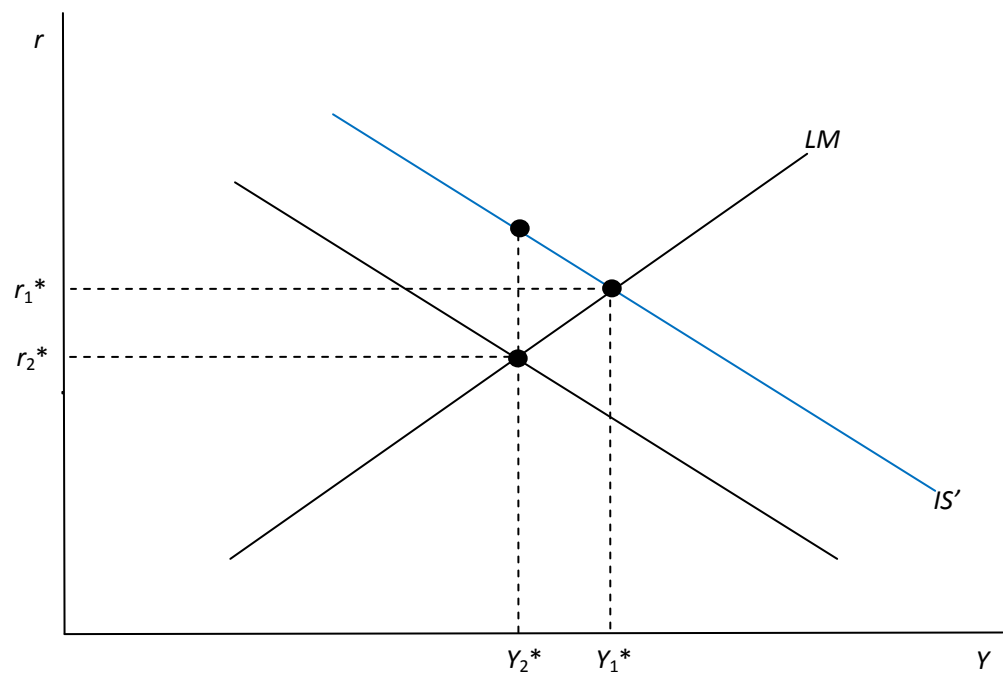
8:35am-10:00am March 16th, 2011

Q1 D D B / C C D

For Q2-Q4, each subquestion has the *same* weight.

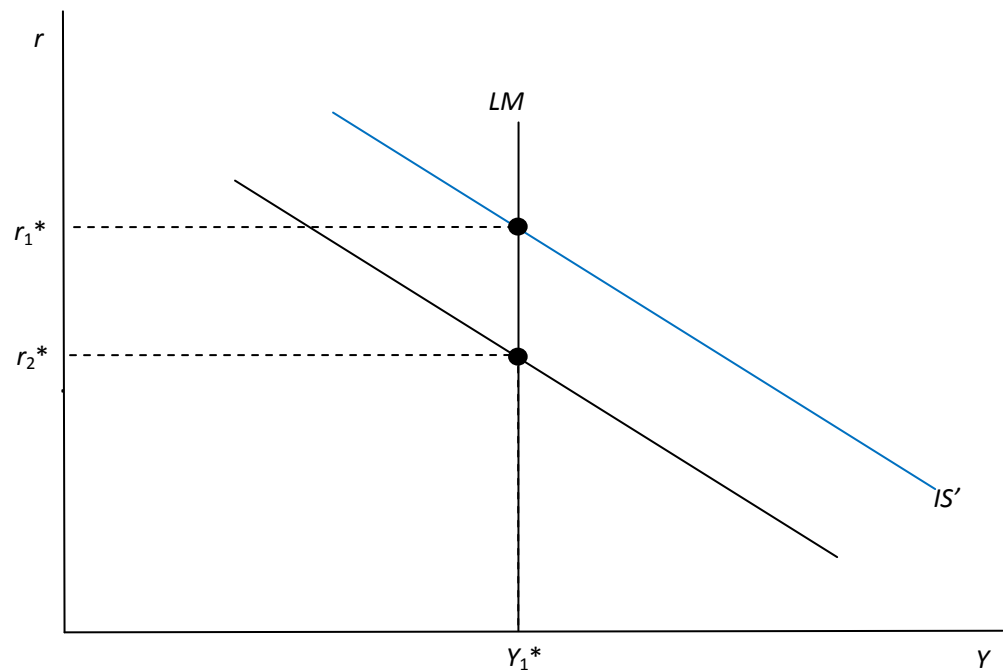
Q2

- A. Since the government multiplier is greater than the tax multiplier (in absolute terms), this policy will overall have a negative effect on planned expenditures E and income. Hence, it will shift the IS-curve to the left.
- B. The leftward shift of the IS-curve leads to a decrease in equilibrium income and interest rate. Investment is higher because of the lower interest rate.



- C. If money demand does not depend on the interest rate, the money demand curve is vertical. Then, nothing behind the LM-curve depends on the interest rate and the LM-curve is vertical, too. The explanation behind this is that with a vertical money demand curve and the standard vertical real money supply curve, the money market will be in equilibrium at only one particular level of income. With a vertical LM-curve, the policy of the government will have no effect on income but just lower the interest rate. This is because in order for the money market to get

back into equilibrium after the decrease in net government spending, the interest rate has to fall sufficiently in order to raise investment to the point that income is back to the initial level. Consequently, output is stabilized at any time and the central bank does not have to respond.



Q3 (using Y-e or Y-r diagram)

- A. Rise.
- B. Output falls, no change in exchange rate or net export. Investment falls.
- C. Output rises, lower exchange rate, more net export and less investment.
- D. Floating exchange rate is better.

Q4

- A. $NX = 50$. $Y = 1200$.
- B. $Y=1400$.

(give full marks if students use $r = 0.1$, then A: $NX= 50$. $Y = 1560$; B: $Y=1760$)

C. Diagram

D. $\Delta Y = \frac{1}{1-MPC} \Delta G = \frac{1}{1-0.75} 10 = 50$. Exchange rate e will rise.

Q5

A. GDP, unemployment, CPI, etc... [1 point]

B. Debt-Deflation [1 point]

C. [3 points]

Debt liquidation and distress selling

Contraction of the money supply as bank loans are paid off

A fall in the level of asset prices

A still greater fall in the net worths of business, precipitating bankruptcies

A fall in profits

A reduction in output, in trade and in employment.

Pessimism and loss of confidence

Hoarding of money

A fall in nominal interest rates and a rise in deflation adjusted interest rates.