

Assignment # 2- Due November 23, 2017 in class

Question 1 (10 marks)

- What are rational expectations? Can they influence the outcome of a monetary policy? (5 marks)
- List three reasons why an economy may choose a fixed exchange rate regime. (5 marks)

Question 2 (20 marks)

Start with a closed economy in equilibrium, and use the *IS-LM-FE* model to determine the impact of the following shocks on these real macroeconomic variables: output, the real interest rate, consumption, real wage, employment, investment, and the price level. **Draw a graph for each.**

- A decline in the working-age population. (5 marks)
- Volatility in the prices of stocks and bonds. (5 marks)
- An increase in the corporate tax rate. (5 marks)
- Reduction in transaction costs of non- monetary assets. (5 marks)

Question 3 (10 marks)

The real money demand is $\frac{M^d}{P} = \frac{Y}{4} - 125i$, where Y is the total output and i is the nominal interest rate of non-monetary assets. Assume $Y = 11,700$ and $i = 5\%$. What is the money supply?

Question 4 (20 marks)

Consider the following relationships describing relationships among key economic macro variables in a closed economy:

$$C^d = 500 + 0.75(Y - T) - 200r$$

$$I^d = 150 - 200r$$

$$T = 140 - 0.3Y$$

$$G = 800$$

$$M/P = 0.4Y - 300i$$

$$M = 150,763$$

Assume that in the short run, price level is $P=110$, inflation $\pi =3\%$ and the full employment level of output is $\bar{Y} = 2300$.

- a) Find the equations of the IS and LM curves. *(10 marks)*
- b) Find the short run equilibrium (where IS=LM). *(10 marks)*

Question 5 (20 marks)

Go to Bank of Canada website: <http://www.bankofcanada.ca/>

Look for the currency converter and obtain exchange rate data from Canadian dollar to a currency of your choice (except US dollar). Copy data into an Excel spreadsheet and plot it against time. Comment on the graph. Discuss trends, appreciation, depreciation.

Question 6 (20 marks)

Use *The Economist's* Big Mac index (<http://www.economist.com/content/big-mac-index>) to investigate the characteristics of China's currency.

- a) What is the most recent price of a Big Mac in India?
- b) Does this measure suggest that the Indian Rupee is overvalued or undervalued relative to the dollar? Is this beneficial for the Indian economy? Why or why not?
- c) In your opinion, is this index a good measure of PPP? Why or why not?
- d) List three countries that are most undervalued relative to the U.S. dollar, and two that are overvalued.