

JUNE, 13 2008

FINAL EXAMINATION
(Time allowed: 120 mins.)

B

Show ALL your calculations in your answers. Marks will be deducted if you fail to show your solutions.

Part I (50 points)

1. (16 points) You are given the following information about the goods market and money market in a hypothetical open economy, CASELAND. Assume in Caseland, price level is constant.

$$\begin{array}{llll} C = 80 + 0.9 Y_d, & I = 500 - 400 r, & G = 750, & X = 250, \\ M = 0.1 Y, & T = 200, & M_d = Y - 4000 r, & M_s = 1000 \end{array}$$

where

C = planned consumption expenditure, Y_d = disposable income,
 Y = aggregate output (income), I = planned investment expenditure,
 r = the interest rate, G = planned government spending,
 X = planned export expenditure, M = planned import expenditure
 T = autonomous taxes, M_d = money demand and M_s = money supply

a. (6) In this economy;

i. the equilibrium interest rate is _____ %. (Hint: Use the equilibrium condition for national income)

ii. the equilibrium income is _____ CL (Caseland Lira).

iii. the budget _____ (surplus/deficit) is _____ CL. at equilibrium.

iv. the trade (surplus/deficit) is _____ CL. at equilibrium.

For the rest of the question, assume that planned investment expenditure is insensitive to interest rate, i.e. $I = 500$; and the equilibrium level of income is that you have found in (a.ii)

b. (2) The size of simple multiplier is _____.

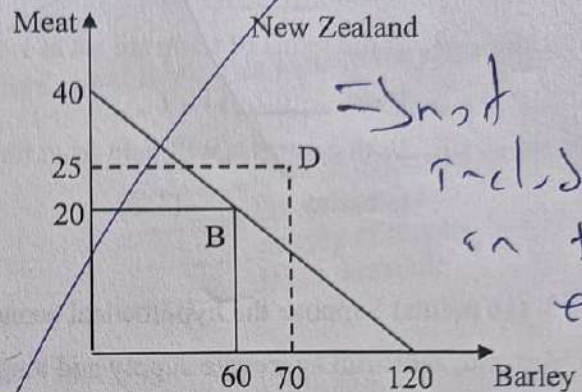
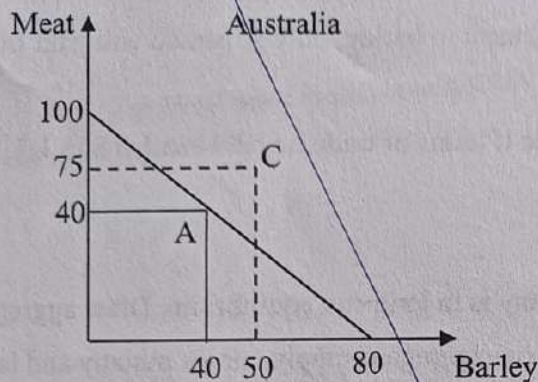
c. (4) Suppose that the government wants to have balanced trade in the economy (no surplus or deficit in the trade balance). For this purpose the government should pursue a(n) _____ (expansionary/contractionary) fiscal policy by _____ (increasing/decreasing) government spending by _____ CL.

d. (5) What is 'crowding-out effect'? Explain briefly. Will there be crowding-out as a result of government policy in (c)?

d. (2) The size of tax multiplier is _____.

e. (2) The size of balanced budget multiplier is _____.

2. (13 points) You are given the production possibilities frontiers (PPF) of Australia and New Zealand in the figures below. Suppose only meat and barley are produced in these two countries where labor is the only factor of production and each country has equal labor force.



⇒ not included in the exam

- (2) New Zealand has comparative advantage in _____ (meat/barley) production, and Australia has comparative advantage in _____ (meat/barley) production. Therefore, New Zealand should specialize in the production of _____ (meat/barley) while Australia should specialize in the production of _____ (meat/barley).
- (2) Before trade, Australia produces at point A on its PPF and New Zealand produced at point B on its PPF. If there were complete specialization total meat production could rise by _____ units and total barley production could rise by _____ units.
- (2) Assume complete specialization occurs in this world. After trade, Australia is consuming at point C and New Zealand is consuming at point D. Therefore, Australia is exporting _____ units of meat and New Zealand is exporting _____ units of barley.
- (7) Indicate whether the following sentences are **TRUE (T)** or **FALSE (F)**. (No explanation is required).
 - New Zealand has absolute advantage in the production of meat; Australia has an absolute advantage in the production of barley. _____ (T/F)
 - In Australia the opportunity cost of one unit of meat is 0.8 units of barley. _____ (T/F)
 - In New Zealand, the opportunity cost of one unit of barley is 1.25 units of meat. _____ (T/F)

- iv. If the terms of trade are set at 1: 1, meat to barley, only New Zealand will gain from trade. _____ (T/F)
- v. If the terms of trade are set at 1: 2, meat to barley, both countries will gain from trade. _____ (T/F)
- vi. If the terms of trade are set at 1: 3, meat to barley, only Australia will gain from trade. _____ (T/F)
- vii. Both countries will gain from trade if terms of trade lie between 1:0.8 to 1:3, meat to barley. _____ (T/F)

3. (16 points) Suppose the hypothetical economy is in long-run equilibrium. Draw aggregate demand, short-run aggregate supply and long-run aggregate supply curves initially and label them as AD_0 , $SRAS_0$ and $LRAS_0$, respectively and corresponding price level as P_0 . How does each of the following events affect output level and price level initially? Show clearly by drawing the relevant movements and/or shifts of the corresponding curve(s). Also indicate by using the letters given in parenthesis if the cited variable will increase (I), decrease (D), remain unchanged (U) or can not be determined (K) in the short-run. Each case is independent from the others and for each case start from the initial long-run equilibrium. (No explanation is required).

a. There is a very hazardous tsunami which destroys all resources of the country significantly.

_____ desired aggregate expenditure.
 _____ the interest rate.
 _____ supply of money.
 _____ labor demand.

b. Households confidence about future is decreased while firms begin to expect greater inflation in the future.

_____ desired aggregate expenditure.
 _____ the interest rate.
 _____ supply of money.
 _____ labor demand.

c. An import tariff (tax) is imposed on foreign goods while the Central Bank tries to keep the interest rate constant.

- _____ desired aggregate expenditure.
- _____ the interest rate.
- _____ supply of money.
- _____ labor demand.

d. The imported oil price is increasing while the Central Bank tries to keep the aggregate output level constant.

- _____ desired aggregate expenditure.
- _____ the interest rate.
- _____ supply of money.
- _____ labor demand.

Part II: Multiple Choice (25*2 =50 points)

1. Which of the following will serve as an automatic adjustment mechanism of the economy with an inflationary gap?
- a. decreasing wages.
 - b. increasing imports.
 - c. declining government spending.
 - d. increasing wages.
 - e. declining taxes.

Refer to the Table 1 to answer questions 1 and 2.

Table 1

International transactions of Country Tradeland in 2007 (billion \$) is given as follows:

Capital inflow	25
Imports of goods.....	30
Tourism Revenues.....	10
Exports of goods.....	20
Interest payments.....	10
Unrequited transfers from abroad.....	5
Interest receipts.....	15
Capital outflow.....	35
Tourism expenditures.....	5

2. For year 2007 Tradeland has:
- a. current account surplus of 10 billion \$ and capital account deficit of 5 billion \$.
 - b. current account surplus of 5 billion \$ and capital account deficit of 10 billion \$.
 - c. current account balance and capital account deficit of 10 billion \$.
 - d. current account deficit of 10 billion \$ and capital account surplus of 5 billion \$.
 - e. none of the above.
3. For year 2007,
- a. total debits exceed total credits and the official financing section (change in reserves) of balance of payments will show a decrease in official reserves of 5 billion \$.
 - b. total debits exceed total credits and the official financing section (change in reserves) of balance of payments will show an increase in official reserves of 10 billion \$.
 - c. total credits exceed total debits and the official financing section (change in reserves) of balance of payments will show an increase in official reserves of 5 billion \$.
 - d. total credits exceed total debits and the official financing section (change in reserves) of balance of payments will show a decrease in official reserves of 10 billion \$.
 - e. none of the above.
4. If there were flexible exchange rates, an economy which uses tight monetary policy to reduce inflation in a period of worldwide inflation, would be likely to experience:
- a. a loss in international reserves
 - b. a fall in the value of its currency
 - c. a gain in the value of its currency
 - d. both (a) and (c)
 - e. both (a) and (b)

5. How does an increase in government transfer payments affect aggregate expenditure (AE)?
- It has the same effect as a tax increase, which lowers AE, but has a greater effect than a decrease in government purchases.
 - It has the same effect as a tax cut, which increases AE, but has a smaller effect than an increase in government purchases.
 - It has the same effect as a spending increase, which increases AE, but has a greater effect than a decrease in government purchases.
 - It has the same effect as a spending decrease, which increases AE, but has a greater effect than government purchases.
6. Which of the following statements about the sources of comparative advantage is CORRECT?
- A country has a comparative advantage in the production of a product if that country is relatively well endowed with the inputs used intensively to produce it.
 - The Heckscher – Ohlin Theorem is inconsistent with the idea of comparative advantage.
 - It is impossible to gather a list of factors that account for comparative advantage as a source to explain most world trade patterns.
 - Evidence suggests that economies of scale in small industries are substantial and accounts for a great part of comparative advantage and world trade patterns.
7. If the price index in Year 1 is P_1 and it is P_2 in Year 2, the inflation rate in Year 2 is:
- $(P_2 - P_1) * 100$
 - $(P_2 / P_1) * 100$
 - $[(P_2 - P_1) / P_1] * 100$
 - $(P_1 / P_2) * 100$
 - $[(P_1 - P_2) / P_2] * 100$
8. Assume there is no leakage from the banking system and that all commercial banks are loaned up. The required reserve ratio is 20%. If the Central Bank sells \$10 million worth of government securities to the public, the change in the money supply will be:
- \$50 million.
 - \$20 million.
 - \$50 million.
 - \$20 million.
9. An increase in the level of aggregate output and the sale of government securities by the Central Bank simultaneously will have:
- no effect on the interest rate.
 - an indeterminate effect on the interest rate.
 - a upward effect on the interest rate.
 - a downward effect on the interest rate.
10. In an imaginary economy, a farmer buys 200 TL. worth of inputs and produce wheat which he sells to the miller for 400 TL. The miller then sells flour to the baker for 700 TL. and the baker later produces 1200 TL. worth of bread. The Gross Domestic Product for this economy is:
- 1000 TL.
 - 2500 TL
 - 1200 TL
 - 2300 TL

11. The policy mix that would cause the interest rate to increase and investment to decrease, but have an indeterminate effect on aggregate output, is a mix of
- expansionary fiscal policy and expansionary monetary policy.
 - contractionary fiscal policy and contractionary monetary policy.
 - contractionary fiscal policy and expansionary monetary policy.
 - expansionary fiscal policy and contractionary monetary policy.
12. Currency depreciation is more likely to improve a country's balance of trade if the _____ for (of) that country's exports is elastic and the _____ for (of) that country's imports is elastic.
- supply; supply
 - demand; demand
 - demand; supply
 - supply; demand
13. Continued growth in the nominal (money) wage together with increasing inflationary expectations will lead to a
- leftward shift in the SRAS and in the Phillips curve.
 - rightward shift in the SRAS.
 - rightward shift in the SRAS and in the Phillips curve.
 - leftward shift in the SRAS and a rightward shift in the Phillips curve.
14. What is the most important difference between inflation generated on the demand side versus inflation generated on the supply side?
- Demand-side inflation is short-lived, while supply side inflation lasts for longtime.
 - Demand-side inflation leads to budget surpluses, while supply-side inflation contributes to budget deficits
 - Supply-side inflation is subject to control of policy makers, while demand side inflation is beyond their reach.
 - Demand-side inflation is normally accompanied by rising real GDP, while supply-side inflation may be accompanied by falling real GDP.
15. Which of the following would NOT be counted in 2003's GDP?
- The 2003 salary of a used car salesperson.
 - The value of a computer manufactured in 2003 but not sold in 2003.
 - The value of a 2001 car you purchased from a car dealer in 2003.
 - The commissions earned by a real state agent in selling houses prior to 2003.
16. The adjustment asymmetry in the economy's aggregate supply behavior refers to:
- prices are sticky but wages are not.
 - booms can persist for a long time without causing large increases in wages and prices.
 - unemployment can persist for a quite long periods without causing large decreases in wages and prices.
 - wages can be sticky but prices typically are not.
 - both (c) and (d).

Refer to the information provided in Figure 1 below to answer the following two questions.

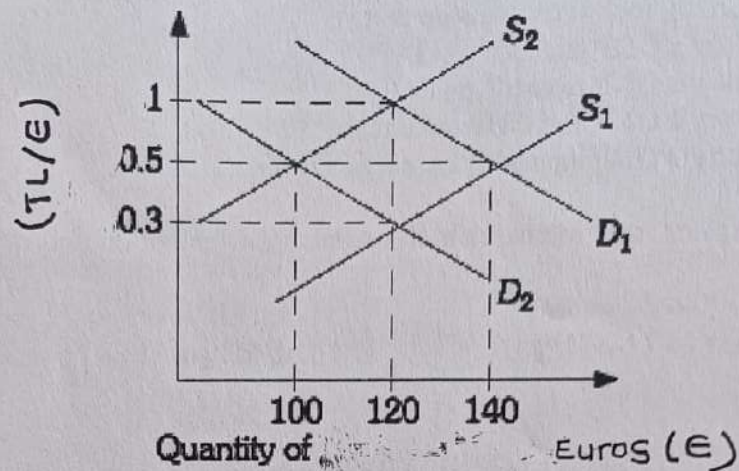


Figure 1

17. Refer to Figure 1. The demand and supply of euros are S_2 and D_2 initially. Which of the following can change the equilibrium exchange rate to 0.3?

- The price level in Europe decreases.
- Income in Europe decreases.
- Europeans purchase of Turkish textiles increases.
- Turkish purchase of European-made cars increases.

18. Refer to Figure 1. The demand and supply of euros are S_2 and D_2 initially. If a group of Turkish tourists go to Austria to watch European Football Championship, the exchange rate will be _____ and this will be recorded as a _____ entry in _____ account.

- 1; debit; current
- 1; credit; current
- 0.3; debit; capital
- 0.3; credit; capital

19. If (Savings + Taxes + Imports) exceeds (greater than), (Investment + Government purchases + Exports), injections _____ leakages and national output will _____ toward its equilibrium level.

- exceed; rise
- exceed; fall
- are less than; fall
- are less than; rise

20. In a business cycle a peak represents the end of _____ and a trough represents the end of _____.

- an expansion; a recession
- a depression; an expansion
- an expansion; a depression
- a recession; an expansion

21. If no foreign companies produce in a country, but many of the country's companies produce abroad, then it can be said that:
- the country's GDP exceeds its GNP.
 - the country's GNP exceeds its GDP.
 - the country's GNP and GDP are equal.
 - the country's GDP equals its domestic income.

22. As the price level increases in the economy, which of the following sequence of events occurs?

- $M^d \uparrow \Rightarrow r \uparrow \Rightarrow I \downarrow \Rightarrow AE \downarrow$
- $M^d \downarrow \Rightarrow r \uparrow \Rightarrow I \downarrow \Rightarrow AE \downarrow$
- $M^d \uparrow \Rightarrow r \uparrow \Rightarrow I \uparrow \Rightarrow AE \downarrow$
- $M^d \downarrow \Rightarrow r \uparrow \Rightarrow I \uparrow \Rightarrow AE \uparrow$

Table 2

	QUANTITY		PRICE (TL.)	
	Year 1	Year 2	Year 1	Year 2
Good X	50	75	1.00	1.00
Good Y	100	100	0.60	0.75

23. Refer to Table 2. Assume that this economy produces only two goods, Good X and Good Y. If Year 1 is the base year, the value of the economy's real GDP and GDP deflator in Year 2 are _____ and _____.

- 135 TL.; 111
- 110 TL.; 136.6
- 175 TL.; 90
- 150 TL.; 11

24. Real GDP is equivalent to:

- the money value of all goods and services produced in an economy plus imports.
- the market value of all goods and services produced in an economy per year.
- personal disposable income plus depreciation.
- the market value of all goods and services produced in an economy per year deflated for price changes.
- the nominal value of GDP multiplied by the GDP deflator.

25. Which of the following statements about investment and investment goods is FALSE?

- An accumulation of inventories counts as current investment.
- The total amount of capital goods in a country is called the capital stock.
- Net investment is equal to gross investment minus depreciation.
- Depreciation refers to funds for investment to increase the economy's total amount of capital goods.
- Housing construction is counted as investment expenditure rather than consumption expenditure.