

SECOND MIDTERM EXAMINATION
(Time allowed: 120 mins.)

A

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

PART I (60 points)

1. (24 points) There is only one bank in Fairland. The balance sheets of the Central Bank and monopoly bank are given below (All values are expressed in billions of TL.). In Fairland, the bank does not hold any excess reserves and there is no cash drain.

Balance Sheet (T account) of the Central Bank:

Government securities (bonds)	100
Currency in circulation	50
Reserves (deposits of banks)	50

Balance Sheet (T account) of the monopoly bank:

Demand deposits	250
Reserves	50
Loans	200

a. (2) Prepare the balance sheets of the Central Bank and the monopoly bank. Show assets and liabilities and the amount of required reserves and the amount of excess reserves clearly.

Central Bank

Monopoly Bank

b. (2) The money supply (M1) is _____ billion TL. (Show the amounts of its components clearly).

The Central Bank decides to buy 50 billions TL. worth of government securities from the public.

- c. (6) Prepare the initial balance sheets of the Central Bank and the monopoly bank. Show assets and liabilities and the amount of required reserves and the amount of excess reserves clearly.

Central Bank

Monopoly Bank

- d. (6) Prepare the final balance sheets of the Central Bank and the monopoly bank. Show assets and liabilities and the amount of required reserves and the amount of excess reserves clearly.

Central Bank

Monopoly Bank

- e. (2) After this operation of the Central Bank, the money supply (M1) is _____ billion TL. (Show the amounts of its components clearly).

- f. (4) If the Central Bank wants to achieve the money supply in (e) by changing the required reserve ratio, instead of purchase of government securities, (money supply should be changed from the amount in (b) to the amount in (e) by changing the required reserve ratio) the new required reserve ratio should be _____.

- g. (2) What is (are) the other policy instrument(s) that the Central Bank implements to attain the amount of change in money supply from (b) to (e)? How they should be used?

2. (16 points) Explain the two conflicting views expressed below, in the context of elimination of sustained inflation. Use diagrams whenever necessary.
- A rise in interest rate is deflationary, because ending sustained inflation with a tight monetary policy usually requires interest rates rise steeply.
 - A rise in interest rates is inflationary, because interest is a major business cost and as with other costs, a rise in interest rate will be passed on by firms to the market in the form of higher prices.

3. (20 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 , SRA_{S0} and LRA_{S0} and corresponding price level as P_0 . How each of the following events affect output level and price level initially? Show clearly by drawing the relevant movements or/and 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.

a. A decrease in exports of the economy due to recession in the world.

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

b. An increase in government purchases while the Central Bank tries to keep the interest rate constant.

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

c. New environmental pollution standards are implemented which increase the cost of production.

_____ 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.

- e. 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.

PART II. Multiple Choice (2*20 = 40 pts)

1. It is often argued that inflation is a 'monetary phenomenon'. The most accurate interpretation of this phrase is that:
- the price level can not rise without an increase in money supply.
 - only an increase in money supply can start a period of inflation.
 - repeated supply shocks can not drive up prices if there is no monetary validation.
 - a continuous rise in prices is possible only with continually increasing money supply.
2. Suppose in a hypothetical economy the total budget deficit is 5 million dollars in 2005. The Treasury sold 50,000, 10-year government bonds with a face value of 100 dollars each to the public in year 2005. During the same year the Central Bank bought 500,000 dollars worth of outstanding bonds on the open market. In this economy the reserve requirement ratio is 20 percent and banks do not hold any excess reserves. Which of the following sentences are correct?
- The Treasury sale has no effect on money supply.
 - The money supply expand by 2.5 million dollars.
 - The debt of the public sector increases by 5 million dollar in total.
- Only 1
 - Only 2
 - Only 3
 - Only 2 and 3
 - 1, 2 and 3
3. Which of the following statements about 'money' is wrong?
- The term money refers to assets that people regularly use to buy goods and services.
 - As a store of value money provides the way in which prices and other economic values are recorded.
 - Fiat money, like banknotes, is money without intrinsic value.
 - Money eliminates the problems associated with barter because it is a medium of exchange.
4. The amount of money which can be created for a given increase in bank deposits will be the greatest under which of the following circumstances?
- High excess reserves held by banks and high cash drain to the public.
 - Low required reserve ratio and low cash drain to the public.
 - High required reserve ratio and high cash drain to the public.
 - High required reserve ratio and low cash drain to the public.
5. If the SRAS curve were vertical, expansionary fiscal policy would cause all of the following EXCEPT an increase in the:
- demand for money.
 - interest rate.
 - price level.
 - private investment.

6. The Phillips curve demonstrates all of the following EXCEPT:
- a. there is a level of wage inflation associated with each unemployment rate.
 - b. when the unemployment rate is at the natural rate of unemployment, there is no tendency for wages to rise or fall.
 - c. wages increase rapidly when the unemployment rate is below the natural rate.
 - d. wages increase rapidly when the unemployment rate is above the natural rate.
7. In Country A all wage contracts are indexed to inflation i.e. each month wages are adjusted to reflect increases in the cost of living. In country B work force is completely unionized. Unions negotiate 3 year contracts. In which country is an expansionary monetary policy, likely to have a larger effect on aggregate output?
- a. Country A
 - b. Country B
 - c. Country A and Country B
 - d. It can not be determined from the given information
8. If investment spending is relatively insensitive to changes in interest rate, then the most effective expansionary policy would be:
- a. a reduction in required reserves.
 - b. The Central Bank purchases of government bonds.
 - c. an decrease in government spending.
 - d. a tax cut.
9. When there is excess supply of money balances, equilibrium is established in the money market by a process that includes all of the following EXCEPT:
- a. people attempting to sell bonds.
 - b. the price of bonds increasing.
 - c. the opportunity cost of holding money falling.
 - d. people attempting to buy bonds.
10. The steeper the SRAS curve, the:
- a. larger will be the price level rise when government purchases rise and the multiplier effect on output becomes larger.
 - b. smaller will be the price level rise when government purchases rise and the multiplier effect on output becomes larger.
 - c. larger will be the price level rise when government purchases rise and the multiplier effect on output becomes smaller.
 - d. smaller will be the price level rise when government purchases rise and the multiplier effect on output becomes smaller.
11. A change in the stock of human capital will shift:
- a. both the short-run and long-run aggregate supply curves.
 - b. the long-run aggregate supply curve but not the short-run aggregate supply curve.
 - c. the short-run aggregate supply curve but not the long-run aggregate supply curve.
 - d. neither the short-run nor the long-run aggregate supply curves.

12. The level of aggregate output demanded rises when the price level falls, because the resulting:
- a. decrease in the interest rate will lead to higher investment spending and higher consumption spending.
 - b. decrease in the interest rate will lead to lower investment spending and higher consumption spending.
 - c. increase in the interest rate will lead to higher investment spending and lower consumption spending.
 - d. increase in the interest rate will lead to higher investment spending and higher consumption spending.

13. A policy mix of a(n) _____ fiscal policy and a(n) _____ monetary policy would cause output to increase and interest rates to increase, increase or remain unchanged.
- a. expansionary; contractionary
 - b. expansionary; expansionary
 - c. contractionary; expansionary
 - d. contractionary; contractionary

14. If investment depends on the interest rate, an increase in net taxes will cause aggregate output to _____ than if investment does not depend on the interest rate.
- a. increase by more
 - b. increase by less
 - c. decrease by more
 - d. decrease by less

15. Which of the following increases the severity (effect) of the crowding-out effect whenever the government increases spending?
- a. an expansionary monetary policy.
 - b. an expansionary fiscal policy.
 - c. a contractionary monetary policy.
 - d. a contractionary fiscal policy.

16. A major reason why it is so difficult to eliminate a sustained inflation is that inflationary expectations
- a. make it impossible to stop the rightward shift of the AD curve.
 - b. keep shifting the SRAS curve upward.
 - c. make it impossible to reduce aggregate expenditure.
 - d. keep shifting the SRAS curve downward.
 - e. cannot be influenced by monetary policy.

17. Suppose the economy is in long-run equilibrium and real GDP is at its potential level. Suppose there is a demand shock causing the price level to rise in the short-run. If, in the long-run the economy moves back to producing its full employment level of national income, the price level will be:
- a. equal to what it was originally before the demand shock.
 - b. lower than it was originally before the demand shock.
 - c. higher than it was originally before the demand shock.
 - d. lower than it was in the short-run equilibrium, but higher than it was originally.

18. A Central Bank may decide to validate a supply shock because:

- a. there is no other mechanism for returning the economy to full employment.
- b. the economy might suffer a long recession before wages and prices fall enough to restore full employment.
- c. central banks tend to pay little attention to inflation.
- d. by so doing, it can both forestall (prevent) to rise in the price level and the temporary fall in national income.
- e. there are no negative effects from this policy action.

19. Which of the following will serve as an automatic adjustment mechanism of the economy with an inflationary gap?

- a. increasing wages.
- b. increasing imports.
- c. declining government spending.
- d. declining wages.
- e. increasing taxes.

20. In the long-run, fiscal and monetary policies concerning output are:

- a. largely effective.
- b. marginally effective.
- c. ineffective.
- d. completely effective.