Q1 macro 2012 PA

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MACROECONOMICS
Section II
Planning Time—10 minutes
Writing Time—50 minutes

Directions: You have 10 minutes to read all of the questions in this booklet, to sketch graphs, to make notes, and to plan your answers. You will then have 50 minutes to answer all three of the following questions. It is suggested that you spend approximately half your time on the first question and divide the remaining time equally between the next two questions. In answering the questions, you should emphasize the line of reasoning that generated your results; it is not enough to list the results of your analysis. Include correctly labeled diagrams, if useful or required, in explaining your answers. A correctly labeled diagram must have all axes and curves clearly labeled and must show directional changes. Use a pen with black or dark blue ink.

1. Assume that the country of Rankinland is currently in recession.

   (a) Assume that Rankinland produces only food and clothing. Draw a correctly labeled production possibilities curve for Rankinland. Show a point that could represent the current output combination and label it A.

   point below axis

   (b) Assume that the Central Bank of Rankinland pursues an expansionary monetary policy.

      (i) Identify the open-market operation that the Central Bank would use.

      (ii) Draw a correctly labeled money market graph and show the short-run effect of the expansionary monetary policy on the nominal interest rate.

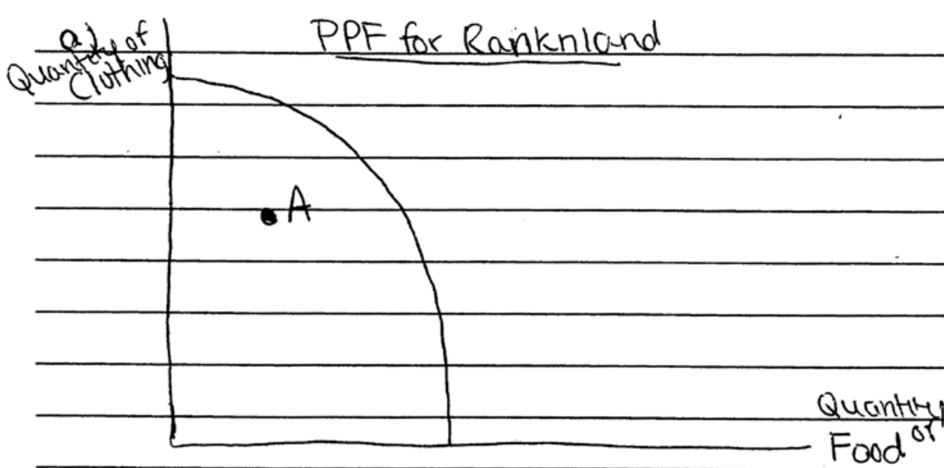
      (iii) Assuming no change to the price level, what happens to the real interest rate as a result of the expansionary monetary policy? Explain.

      (iv) Given your answer to part (b)(iii) regarding the real interest rate, what happens to the real gross domestic product (GDP) in the short run? Explain.

   (c) Suppose Rankinland has a current account deficit. Rankinland's currency is called the bera.

      (i) What will initially happen to the current account deficit in Rankinland solely due to the change in the real GDP from part (b)(iv) ? Explain.

      (ii) What will happen to the international value of the bera solely due to the change in the real GDP from part (b)(iv) ? Explain.



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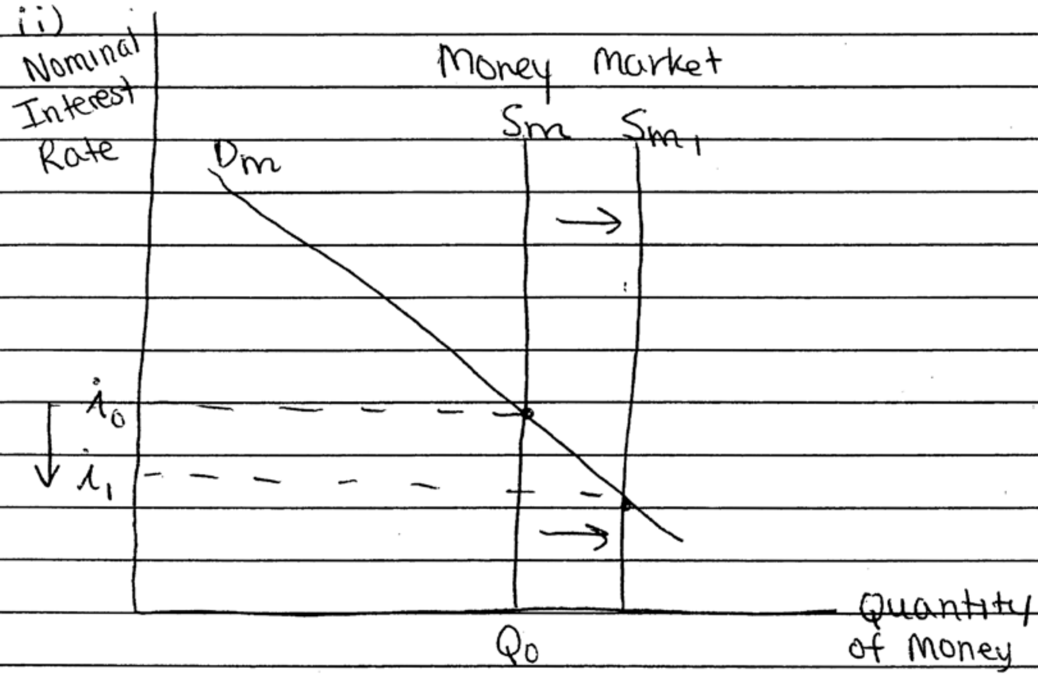
Additional answer page for Question 1.

b) i) The Central Bank would buy bonds on the open market to pursue an expansionary monetary policy.

ii)



The increase in the money supply (Sm to Sm₁) caused by the purchase of bonds causes the nominal interest rate to fall (i_0 to i_1), as shown in the graph.

iii) Because there is no inflation, the fall in the nominal interest rate corresponds to a fall in the real interest rate (Real = Nominal − Inflation → Real = Nominal − 0 → Nominal ↓ = Real ↓).

iv) The fall in the real interest rate causes interest-sensitive expenditures of consumption, investment and net exports to rise, so aggregate demand increases and thus real GDP rises.

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Question 1 is reprinted for your convenience.

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   (b) Assume that the Central Bank of Rankinland pursues an expansionary monetary policy.

      (i) Identify the open-market operation that the Central Bank would use.

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      (iv) Given your answer to part (b)(iii) regarding the real interest rate, what happens to the real gross domestic product (GDP) in the short run? Explain.

   (c) Suppose Rankinland has a current account deficit. Rankinland's currency is called the bera.

      (i) What will initially happen to the current account deficit in Rankinland solely due to the change in the real GDP from part (b)(iv) ? Explain.

      (ii) What will happen to the international value of the bera solely due to the change in the real GDP from part (b)(iv) ? Explain.

c) i) The increase in real GDP means that national real income in Rankinland has risen, so Rankinland's imports of foreign goods and services will rise. Higher imports is counted as a debit in the current account. so the current account deficit increases.

ii) The increase in real GDP will cause Rankinland to buy more goods and services from abroad, so it will supply more bera to do so and thus the bera will depreciate.

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