**Final Exam- Solution Key**
**Economics 160B, spring 2011**

### Multiple Choice:

**Version A:**

1) b 2) d 3) a 4) b 5) d 6) d 7) e 8) a 9) c 10) d 11) b 12) e 13) c 14) d 15) a 16) c 17) a 18) c 19) b 20) d 21) d 22) a

**Version B:**

1) c 2) b 3) d 4) d 5) a 6) b 7) d 8) a 9) b 10) d 11) d 12) e 13) a 14) c 15) d 16) b 17) e 18) c 19) d 20) a 21) c 22) a

**Version C:**

1) b 2) e 3) c 4) d 5) a 6) b 7) d 8) c 9) b 10) d 11) d 12) a 13) b 14) d 15) a 16) b 17) d 18) d 19) e 20) a 21) c 22) d

### Question 1: Parity conditions

**Version A:**

23) d 24) b 25) b 26) d 27) d 28) c

**Version B:**

23) d 24) d 25) a 26) c 27) c 28) d

**Version C:**

23) a 24) c 25) c 26) a 27) a 28) b

### Question 2: ISLM 1:

The rise in taxes reduces consumption expenditure and shifts the IS curve left, lowering the interest rate and causing the dollar to depreciate. The lower interest rate stimulates investment, and the depreciated currency stimulates net exports. But on net output falls. Real money demand does not change due the fall in interest rate and fall in output offset each other. Since the marginal propensity to consume is less than one, consumption falls less than disposable income, so private saving falls.

Under the fixed exchange rate, there is no change in the interest rate or exchange rate, so there is no crowding in of the trade balance or investment. Output falls even more. Reserves fall to defend the exchange rate. Real money demand falls because output is lower but there is no fall in the interest rate to counteract this.

**Version A:**

29) b 30) a 31) a 32) b 33) b 34) a 35) c 36) b 37) b 38) c

**Version B:**

29) a 30) b 31) b 32) a 33) a 34) b 35) c 36) a 37) a 38) c

**Version C:**

29) a 30) a 31) b 32) b 33) a 34) c 35) b 36) b 37) c 38) e

### Question 3: ISLM 2

The rise in the expected future value of the mark relative to the franc raises expected returns of holding the mark, shifting the foreign returns curve right. In order to keep the exchange rate fixed,
the French must let their money supply shrink and interest rates rise to compensate for the capital loss of those holding francs over time. This shifts the LM curve left.

Version A:  42) b  43) a  44) b  45) b
Version B:  42) a  43) b  44) a  45) a
Version C:  42) b  43) a  44) b  45) b

If defending the peg causes a recession, then France might be willing to let the currency depreciate if it is attacked. So even if France has reserves, a speculative attack betting on a franc depreciation could bring about a depreciation.

Question 4: Overshooting
a) The answer is the same as homework #2, problem #3.

b) Time path:

![Diagram showing the money market with the MD curve shifted right, indicating less exchange rate overshooting.]

c) If the money supply increase also raises output, this will raise money demand. This shifts the MD curve right in the graph of the money market. As a result, the US interest rate will fall less, and the exchange rate will move less in the short run. So there is less exchange rate overshooting.

Question 5:

The first paragraph should include the following points:
If California could devalue its currency, it would make its products more competitive and easier to export (even to the rest of the U.S.). It potentially could let it lower interest rates further than the rest of the country (although they are already nearly as low as possible now).
A devaluation would not reduce the size of the debt, as the bonds were issued in dollar not peso terms. A peso devaluation would only make the peso value of these debts larger.

The second paragraph should include the following items:
The fact that the U.S. has high labor mobility allows unemployed Californians to find jobs by relocating to other states.
There is a highly developed fiscal federal system. There would be less taxes collected from California and more distribution of federal government expenditure to California, to help act as insurance against asymmetric recessions.

6/1/11