Final Exam- Solution Key  
Economics 160B, spring 2012

Multiple Choice:
Version A:
1) d 2) b 3) c 4) b 5) a 6) b 7) c 8) a 9) d 10) c 11) a 12) c 13) b 14) a 15) c
Version B:
1) d 2) c 3) b 4) a 5) b 6) c 7) a 8) d 9) c 10) a 11) c 12) b 13) a 14) c 15) b
Version C:
1) d 2) a 3) a 4) d 5) c 6) a 7) d 8) b 9) a 10) d 11) b 12) a 13) c 14) b 15) a

Question 1: Parity conditions
Version A: 16) b 17) b 18) c 19) e 20) c 21) a
Version B: 16) c 17) a 18) b 19) b 20) c 21) e
Version C: 16) c 17) e 18) c 19) a 20) b 21) b

Question 2: Monetary Approach
Version A: 22) a 23) a 24) b 25) c 26) d 27) b
Version B: 22) e 23) e 24) d 25) c 26) d 27) c
Version C: 22) b 23) b 24) c 25) a 26) d 27) d

Question 3: IS-LM 1:
Graph: LM curve shifts left along IS curve.
Version A: 28) b 29) a 30) b 31) b 32) b 33) b 34) b 35) c 36) a 37) a 38) b 39) b 40) a 41) a 42) a 43) b 44) c 45) b 46) c 47) c
Version B: 28) c 29) b 30) c 31) c 32) c 33) c 34) c 35) a 36) b 37) b 38) c 39) c 40) b 41) b 42) b 43) c 44) a 45) c 46) a 47) a
Version C: 28) a 29) c 30) a 31) a 32) a 33) a 34) a 35) b 36) c 37) c 38) a 39) a 40) c 41) c 42) c 43) a 44) b 45) a 46) b 47) b

The main point is that a fixed exchange rate regime responds poorly to a negative goods market shock, making the fall in output worse, but it responds well to a money market shock, as it automatically accommodates the rise in money demand with a rise in money supply that prevents a fall in output. So if your economy is subject to mainly money market shocks, maybe a fixed exchange rate regime is not so bad for you.

Question 4: IS-LM 2:
Version A: 48) a 49) d 50) c 51) d 52) e 53) c
Version B: 48) b 49) a 50) d 51) a 52) e 53) d
Version C: 48) c 49) b 50) a 51) b 52) e 53) a

Regarding the last part. If you use the fact that here \( Y = C + I + G + NX \), you can write \( Y-C-G = I + NX \). A cut in government spending leads to a rise in investment and a rise in the next exports, so it must raise national saving. A cut in money supply would lower both investment and trade balance, so lower national saving. The negative NX shock (tastes) makes I rise while NX falls.
But you can still figure out the effect on saving by writing it as \( Y - C(Y-T) - G = (1-MPC)Y + MPC*T - G \); since \( Y \) is falling and there is no change in \( G \) or \( T \), we know saving is falling.

**Question 5: Overshooting**

a) The answer is on page 41 of lecture 3

b) Time path: note that \( q \) returns to its original level, but \( E \) does not.

PPP holds in the long run but not the short run. The real exchange rate deviates from 1 in the short run, but returns in the long run.

c) At the time of the shock goods are cheaper in the U.S., so use your $100 to buy goods in the US and resell them for pounds in the UK, then convert the pounds to dollars in the spot exchange market. You will end up with more than $100.

**Question 5:**

An expected currency depreciation shifts the expected foreign returns curve right. If the exchange rate is to stay at \( E \)-bar, then the country must rise the interest rate to compensate investors for the expected currency depreciation. Interest rates on bonds might also be high if investors expect the government to default, so requiring a default or risk premium.

Losing reserves implies a fall in money supply and higher interest rates. This imposes a cost of a recession on a country. So even if the country has sufficient reserves to defend its peg, it might choose not too because the cost in terms of recession is too great. This is the reason that the U.K. decided to exit the EMS and devalue its currency.