**Midterm 2 Solutions - Economics 160B - Fall 2012**

**Regrade policy:** If you would like your test regraded, please submit a written statement to explain why. Your entire test will be regraded, so there is a possibility that points could be lost or gained. All regrade requests must be submitted within one week of exams first being returned.

**Multiple Choice:**

| Versions A | 1) b | 2) c | 3) b | 4) a | 5) a | 6) c | 7) b | 8) d |
| Versions B | 1) c | 2) b | 3) a | 4) a | 5) c | 6) b | 7) d | 8) b |

**Question 1a)**

![Graph 1](image.png)

version A: rise, fall, rise, rise, rise
version B: fall, rise, rise, rise, rise

b) A firm will carry out an investment project only if the returns exceed the firm's cost of borrowing, which is the interest rate. For example, if the firm needs to get a loan from a bank in order to buy equipment or build a factory, a lower interest rate makes the loan cheaper, so the firm is more likely to take the loan and make the investment expenditure.

If investment were constant, the IS curve would get steeper (a drop in $i$ would lead to a smaller rise in $Y$), because we are shutting down the ability of the interest rate to raise investment demand. (Note that we still have the channel by which the drop in interest rate causes a currency depreciation and raises foreign demand in the form of the trade balance, which can also raise output. So the IS curve would not be perfectly vertical.) All this means the rise in the equilibrium level of output from a money supply increase would be smaller.
Question 2a)

Version A: fall, fall, rise, rise
Version B: rise, rise, fall, fall

b)

Version A: fall, no change, no change, fall
Version B: no change, fall, fall, no change

c) The fall in output is larger under a fixed exchange rate regime than under a flexible exchange rate. So it is harder to balance the budget here under the fixed exchange rate because it creates a worse recession. The reason is that a flexible exchange rate allows the interest rate to fall and the currency to depreciate, which encourage other categories of demand, investment and foreign demand, to replace the loss of consumption demand created by the tax increase.