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 not gained. You have one week from the time exams are first handed back to request a regrade.

Multiple Choices:
Version A: 1) c 2) b 3) a 4) d 5) a 6) b
Version B: 1) d 2) c 3) b 4) a 5) d 6) c
Version C: 1) a 2) d 3) c 4) b 5) e 6) b

Problem 1:

a) 

b) output rises, interest rate falls, \( E \) rises (home depreciation), investment rises, trade balance rises, total national saving rises because private saving rises (rise in \( Y \) with a \( mpc < 1 \)) and there is no change in government saving.

Version A: 7) a 8) b 9) a 10) a 11) a 12) a
Version B: 7) b 8) c 9) b 10) b 11) b 12) b
Version C: 7) c 8) a 9) c 10) c 11) c 12) c

c) The IS curve is built on the equation that \( Y = C + I + G + CA \), so it must be true that \( CA = S - I \), where \( S \) is defined \( Y - I - G \). However the exchange rate makes the CA move, it must be consistent with the central macroeconomic identity.

We know that \( S \) rises here because private saving rises, while there is no change in government saving. Investment also rises due to the lower interest rate. It must be that investment rises less than saving.

(Note that under the assumptions given for the problem, the current account will be the same as the trade balance here).

Problem 2:

a) 

b) 

(Continued on the next page.)
The rise in government spending shifts the IS curve right. The fixed exchange rate commitment shifts the LM curve right.

b) Output: rise, interest rate: no change, consumption: rise, investment: no change, reserves: rise
   Version A: 13) a 14) c 15) a 16) c 17) a
   Version B: 13) b 14) a 15) b 16) a 17) b
   Version C: 13) c 14) b 15) c 16) b 17) c

c) The twin deficits says that a government budget deficit tends to cause a current account deficit. In the present case the current account cannot change because it is a function of the exchange rate, and policy will make sure that the exchange rate does not change. In this case, although the rise in government spending would tend to make the currency appreciate and create a current account deficit, the money supply will have to increase and restore the exchange rate (and current account) to their original levels.

Problem 3:
The only shock that could cause both investment and trade balance to fall is the rise in money demand. This will shift the LM curve left, raising the interest rate and making the currency appreciate. The interest rate rise lowers investment, and the currency appreciation lowers the trade balance.

   A shock to the trade balance would shift the IS curve left, lowering the interest rate and thus raising investment. So this can’t be the shock we are looking for.

   A shock to investment will also shift the IS curve left, lowering the interest rate and causing the currency to depreciate in value, which raises the trade balance. So this can’t be the shock we are looking for.