Name ______________________________

Matrikelnummer ______________________________

Group/Teacher ______________________________

040090 UK Introduction to Macroeconomics

Endterm (29.06.2012)

Exercise	max. points	obtained points
1	30	
2	30	
3	40	
Total	100	

Good Luck!

Important: You have to show the **complete solution path** (i.e. also auxiliary calculations)! Parts you don't want to count must be crossed out clearly.

---

1) (**30 Points**) Question related to the AS-AD model:

   Please answer the following questions within the framework of the AS-AD model discussed in the class. You have to clearly explain your chain of thought. In addition to your discussions, use the graphical analysis.

   For all questions assume that the economy is initially in the medium run equilibrium.

   (a) What happens to the level of investment in an economy, where the government is expanding its consumption? Explain both short-run and long-run changes in the level of investment. Why do changes in the government expenditure influence the level of investment?

   (b) Why does the expected aggregate price level matter and why might workers adjust their expectations of the aggregate price level (for instance, after the government spending shock)?

   (c) Explain the short- and long-run effects of a monetary expansion on the aggregate price level. Explain in detail the dependencies in the AS-AD model that lead to your results.

Important: You have to show the **complete solution path** (i.e. also auxiliary calculations)! Parts you don't want to count must be crossed out clearly.

---

2) (**30 Points**) Consider the open economy IS-LM model (Mundell-Fleming Model).

   (a) (**10 Points**) Assume that the exchange rate is flexible and explain the effects of a decrease in taxes on the equilibrium levels of real GDP Y, the interest rate i, and the exchange rate E using words and diagrams.
   Also explain the effects this policy has on C, I, and net exports NX.

   (b) (**10 Points**) Assume that the exchange rate is flexible and explain the effects of an increase in the money supply on the equilibrium levels of real GDP Y, the interest rate i, and the exchange rate E using words and diagrams.
   Also explain the effects this policy has on C, I, and net exports NX.

   (c) (**10 Points**) Assume that the country is no following a fixed exchange rate regime. Are the policies of exercise (a) and (b) still possible? (Why?/Why not?).
   If one of these policies can also be implemented under a fixed exchange rate regime, analyze its effects on the equilibrium levels of real GDP Y, the interest rate i, and the exchange rate E using words and diagrams.
   Also explain the effects this policy has on C, I, and net exports NX.

Important: You have to show the **complete solution path** (i.e. also auxiliary calculations)! Parts you don't want to count must be crossed out clearly.

---

3) (**40 Points**) Imagine that the following information is known about the Swiss economy:

Domestic Demand: $DD = 62 + 0.8Y$

Exports: $0.1Y^{EURO} - \epsilon$

Imports: $\frac{0.5Y+2\epsilon}{\epsilon}$

where Y is domestic output, $\epsilon = \frac{EP}{P^{Euro}}$ is the real exchange rate vis-a-vis the Euro and Y^{EURO} is the Euro-area output.

(a) Explain the difference between domestic demand and the demand for domestic goods!

(b) Assume that $E = 1$, $P = 1$, $P^{Euro} = 1$ and $Y^{EURO} = 500$. What is the output of the Swiss economy?

(c) Now assume that the nominal exchange rate appreciates against the Euro by 10%, the price levels remain unchanged in the short run and Euroland output decreases by 5%.

i. By how many percent will the real exchange rate worsen?

ii. By how many percent will Swiss output change?

iii. Should the Swiss national bank try to move the exchange rate back to 1?

(d) Imagine now you are a student living in Switzerland. As you like to invest in financial markets, you bought a one-year bond in Germany for a return of 6% paying back at maturity, you could have alternatively bought a Swiss bond with the same risk and maturity paying an interest of 0.75%.

i. Did you invest smartly? Explain your answer by comparing the results!

ii. What degree of appreciation of the Swiss Frank against the Euro would have made you indifferent between the two bonds?