

UNIVERSITY OF RUHUNA

2016 / 2017 Academic Year, Master of Arts in Economics
First Semester End Examination – September 2017
MAE 5101 – Macroeconomic Theory

Answer **Four** questions only, selecting minimum of **One Question** from sub Sections; A, B and C

Time: 03 Hours

Sub Section A

01.

- (i) One of the theories regarding the income and employment determination was based upon the argument of 'Supply creates its own demand' while another one was on the concept of effective demand' Discuss the similarities and dissimilarities between these two theories.

(10 Marks)

- (ii) Explain the reason for why the second theory is considered to be superior than that of first one with respect to the macroeconomic policy making point of view.

(05 Marks)

02.

- (i) Outline the main issues that are expected to be answered by the alternative theories of international trade.

(03 Marks)

- (ii) Explain how does the Heckscher Ohlin trade theory answer the each of the issues listed above, using an appropriate diagrams and stating Clearly the arguments and assumptions of the H-O theory

(12 Marks)

Sub Section B

03. Suppose you have an IS-LM Model given by:

$$C = 200 + 0.25Y_d$$

$$I = 150 + 0.25 Y - 1000 r$$

$$G = 250$$

$$T = 200$$

$$(M/P)_d = 2Y - 8000 r$$

$$M/P = 1600$$

(i) Derive IS and LM curves and find the equilibrium real output and the interest rate.

(05 Marks)

(ii) What are the levels of private consumption and investment of this economy?

(02 Marks)

(iii.) How does the equilibrium change when the government spending rises to 400? Estimate the crowding out effect if any.

(03 Marks)

(iv.) Now suppose the government gets back to the original level of government spending and increase the real money supply from 1600 to 1840 as an alternative policy. What are the possible implication on output, private investment, and consumption?

(03 Marks)

(v.) With the help of relevant graphical aids, explain the reasons for the increase of interest rate in part (iii) and decrease in part (iv).

(02 Marks)

04.

(i) Suppose BABALAND is a country in which the degree of external capital mobility is not measured and, therefore, not known. It maintains a floating exchange rate regime. The Central Bank is seeking your advice whether to implement expansionary monetary policy or expansionary fiscal policy as the growth engine of this economy. Advice the Central Bank. (Assume IS and LM curves are normal)

(06 Marks)

- (ii) Graphically demonstrate the following scenario. Assuming this economy was initially in equilibrium, explain as to why the balance of payments falls into deficit after implementing the expansionary fiscal policy.

Capital mobility	- not zero but very low
Exchange rate regime	- Fixed with Sterilization
Policy	- expansionary fiscal policy
LM Curve	- upward sloping
IS Curve	- Vertical

(04 Marks)

- (iii) "Exchange rate policy is the typical solution to strike external balance whereas the fiscal policy is the typical solution to strike internal balance. Nevertheless, in certain circumstances we have to interchange these policies." Do you agree with this statement? Explain your answer.

(05 Marks)

Sub Section C

05.

- (i) Explain graphically the possible tradeoff between inflation and unemployment in an economy
- (03Marks)
- (ii) Briefly discuss the Keynesian views on demand for money.
- (03 Marks)
- (iii) Indicate the equation of the Keynesian demand for real balances
- (01 Marks)
- (iv) Show the effect of each of the following events on money demand curve using appropriate diagrams.
- An increase in the level of income of economy
 - A decrease in the inflation of the economy
 - An increase in the credit availability of economy
 - People expect bank runs on major banks.

(08 Marks)

(06)

- (i) Define the concept of “money supply” using the following theoretical views.
- i. The Traditional approach
 - ii. The Chicago approach
 - iii. Gurly and Shaw approach

(06 Marks)

- (ii) What is included in the “ consolidated broad money supply (M2b) in Sri Lanka.

(03 Marks)

- (iii) The following table provides the selected monetary statistics of hypothetical economy for 2016.

Item	End 2016 (Rs. Billion)
a. Net Foreign Assets	
• Monetary Authorities	560.0
• Commercial Banks	-790.0
b. Net credit to the Government	1970.0
c. Credit to public corporations	500.0
d. Credit outstanding	4200.0
e. Currency outstanding	550.0
f. Other Items (Net)	-1030.0

Using the relevant data contained in the above table, calculate the value of consolidated broad money supply (M2b) for 2016

(03 Marks)

- (iv) Compute the Money Multiplier(mm), using the following hypothetical data.

- Currency in circulation Rs. 300 billion
- Total deposits Rs. 600 billion
- Statutory reserve ratio 10%
- Excess reserve ratio 2%
- Price Level 10%

(03 Marks)

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