

University of Ruhuna

Master of Arts in Economics - Academic Year 2019/2020

1st Semester End Examination – September 2020

MAE 5101 - Macroeconomic Theory



This paper contains two parts.

Answer **four (04)** Questions selecting **two (02)** questions from sub section A and B.

Use of calculators are allowed.

Time: 03 Hours

SUB SECTION - A

- 1) Suppose that the following equations explain the value for selected macroeconomic variables in a hypothetical open economy. Answer the questions using appropriate data and information.

Private Consumption Expenditure	C	= 100 + 0.80(Y _d)
Taxes of the Government	T _n	= 50
Government Expenditure	G	= 100
Investment Expenditure (Private)	I	= 140 - 12i
Net Export	X _n	= 10 - 0.2Y
Demand for Money	L	= 0.20Y - 5i
Money Supply	M	= 100

- i. Calculate the IS and LM equations for the Economy

(04 marks)

- ii. Calculate the macro-equilibrium level of income

(04 marks)

- iii. Suppose that the given information above were collected from the Sri Lankan economy. Discuss with calculating the short-term impact of following fiscal policy statement on the level of national income and the private consumption assuming other things remaining constant.

"The Government of Sri Lanka quickly responded to the COVID -19 health crisis by establishing a cash transfer response, providing over 5.5 million monthly payments of LKR 5,000 to households. Payments were made in both April and May of 2020. The total cost is around LKR 55 billion".

(07 marks)

2). The Extracts given below explains the direction of monetary policies implemented by the Central Bank of Sri Lanka during the first half of 2020., Using graphical illustration of the ISLM framework, discuss the short-term impact and necessary adjustments to achieve the expected economic development targets of each of the policies.

- i. The Monetary Board of the Central Bank of Sri Lanka, at its meeting held on 29 January 2020, decided to reduce the Standing Lending Facility Rate (SLFR) of the Central Bank by 50 basis points from 10% in January to 7.50 per cent in July. The Board arrived at this decision following a careful analysis of current and expected developments in the domestic economy and the financial market as well as the global economy.

(Source: TRADINGECONOMICS.COM, CBSL)

(08 marks)

- ii. "Rs. 40,000 Million Treasury Bills were issued by the Central Bank of Sri Lanka as an agent to the government through an Auction held on 26 August 2020"
^Press Release, 26 August, 2020, CBSL)

(07 marks)

3). Write analytical notes on two (02) out of followings.

- i. The Classical Theory of Employment and Income Determination
- ii. The Crowding Out Effect of an increase the Government Expenditure
- iii. The Mundell-Fleming Model
- iv. The Keynesian Theory of Business Cycle

(8 marks for each, total 15 marks)

SUB SECTION - B

04. I. Discuss the three motives of Keynesian liquidity preference theory (03 marks)
- II. What are the various approaches to the definition of money? Explain the main differences between the conventional and Chicago approaches to the definition of money. (03 marks)
- III. The table below illustrates the data relevant for the money supply of a hypothetical economy. (All figures are in million rupees)

Items	Value (End 2019)
Currency Outstanding	1550
Currency held by the public	1200
Commercial Banks' Deposits with the Central Bank	750
Government Agencies' Deposits with the Central Bank	50
Demand Deposits held by the Public with Commercial Bank	1000
Broad Money Supply, M2	7450
Consolidated Broad Money Supply, M2b	9250

- a. Calculate reserve money, Currency with the Commercial Bank and time and Saving Deposits held by the public with Commercial Bank. (02 marks)
- b. Estimate Narrow Money Supply (M_1) for 2019. (01 mark)
- c. Using the above data, determine the M_{2b} Money multiplier for 2019 (01 mark)
- d. Estimate the value of the adjusted foreign currency deposits and identify what additional data is required to estimate M_4 for an economy like Sri Lanka. (02 marks)

- IV. Describe what is meant by monetary policy. (03 marks)

05. I. Explain how you derive the Phillips curve by using the aggregate demand and aggregate supply model. (03 marks)
- II. a). Describe briefly the factors that cause the breakdown of the short - run Phillips curve in the 1970s and early 1980s. (03 marks)
- b). How would a decrease in energy prices affect the Phillips curve? (02 marks)

III. Assume the “Newland” economy has a natural rate of unemployment of 8%. Its current rate of unemployment and the inflation rate are 6% and 7% respectively. Present the current state of the Newland economy in using a correctly labelled graph of the Phillips curve using the information given about unemployment and inflation.

(02 marks)

IV. “According to Friedman, **the long run Phillips curve is vertical at the natural rate of unemployment**. So, there is no long run trade-off between inflation and unemployment”. Elaborate your opinion on above statement using the theory of adaptive expectations.

(05 marks)

06. I. What factors contribute most to demand – pull inflation of an economy?

(03 marks)

II. Define the term “**price deflation**” and evaluate the consequences of price deflation in an economy.

(03 marks)

III. Describe the following concepts with adequate information and using graphs.

- a. The Keynesian theory of interest and money market equilibrium.
- b. The Liquidity trap
- c. The Stagflation

(09 marks)

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