UNIVERSITY OF COLOMBO, SRI LANKA
FACULTY OF ARTS

SECOND YEAR EXAMINATION IN ARTS (ECONOMICS) – 2018

ECN 2115 MACROECONOMICS

Time Allowed: Two (02) Hours

Answer 03 questions, including question (1).
Whenever necessary use rough sketches of graphs to illustrate your answers.
Calculators can be used.
Marks: 50 for question (1) and, 25 for each of the other questions.

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(1) Answer any 5 of the following questions:

i. "J.M. Keynes witnessed and experienced Great Depression in the 1930s". Do you think what he witnessed and experienced was important for his publication in 1936? Explain briefly.

ii. "The expenditure multiplier of an open economy model is smaller than that of a closed economy model". Explain whether this is true or false by *deriving* the two multipliers.

iii. "A decline in the marginal tax rate will make the IS line steeper". Explain whether this is true or false, by *deriving* the IS equation of a closed economy.

iv. "An inelastic LM line will make fiscal expansion less effective on output". Do you agree? Explain why.

v. Explain the link between the money market and the bond market, by taking any of the relevant monetary policy measure as adopted by the Central Bank.

vi. "As investors in the Greek bond market lost confidence in Greek bonds, the interest rates in Greece began to rise sharply above the European average interest rate". Explain why.

vii. "An increase in money supply leads to a balance of payments deficit regardless of the degree of capital mobility". Explain whether this is true or false.

viii. "In the recent past, the Federal Reserve Bank increased the interest rates in the US. At the same time, Sri Lanka's rupee-dollar exchange rate depreciated." Can there be a connection between the two incidences? Explain why or why not.

(10 arks for each)

(2) Following information represent a closed economy with government:

Private consumption	$C = 25 + 0.8Yd$
Private investment	$I = 200 - 2000r$
Government expenditure	$G = 75$
Tax	$T = 0.15Y$

While Y, Yd, and r are total income, disposable income, and interest rate respectively, all values are in LKR millions.

Answer the following questions.

(i) Find the equilibrium level of national income, assuming that the interest rate remains at 5 percent.
(ii) What is the level of budget surplus or deficit at equilibrium income?
(iii) What are the values of the government expenditure multiplier and of the tax multiplier? What does the difference between the two multipliers mean?
(iv) If interest rate is increased to 7 percent, how does it affect the equilibrium income?
(v) How does the increase in interest rate as above affect the government budget?

(5 Marks for each)

(3) Assume a closed economy with government which suffers from the lack of business confidence. As a result, private investment does not rise, nor does it respond to the changes in interest rate. The government keeps spending to compensate for lack of private spending. Answer the following questions:

i. Show the initial equilibrium of this economy. What is the economic impact of the increase in government expenditure?

(10 marks)

ii. After a change in government business confidence was restored, private investment begins to rise and becomes highly sensitive to changes in interest rate. Analyze the economic impact of this change. If this change is accompanied by a monetary expansion, then how does your answer change?

(15 marks)

(4) Assume an open economy with no capital mobility, faced with a balance of payments deficit. The government finds it difficult to implement expansionary macroeconomic policies as they would aggravate the balance of payments deficit. Answer the following questions:

i. Show the balance of payments deficit of the above economy within an IS-LM-BOP framework. Explain why expansionary policies lead to a worsened BOP deficit, using fiscal and monetary policy measures.

(10 marks)

ii. An economic advisor to the government recommended for liberalizing the capital account before adopting expansionary macroeconomic policies so that there might be a different policy outcome. Evaluate the validity of this policy recommendation.

(15 marks)

(5) An economy with perfect capital mobility, reported a balance of payments surplus due to sudden increase in tourist arrivals and the resulting expansion in its tourism industry. The Central Bank decided to purchase foreign exchange in the market in order to avoid exchange rate appreciation. Answer the following questions:

i. Explain the above incidence and its economic implications using IS-LM-BOP framework.

(10 marks)

ii. What are the economic implications of the policy decision of the Central Bank? If the Central Bank did not intervene in purchasing foreign exchange, what would have been the result?

(15 marks)

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