

**UNIVERSITY OF SWAZILAND
FACULTY OF SOCIAL SCIENCE
DEPARTMENT OF ECONOMICS
MAIN EXAMINATION
MAY 2012**

TITLE OF PAPER: INTERMEDIATE MACROECONOMIC THEORY

COURSE CODE: ECON 304

TIME ALLOWED: THREE (3) HOURS

- INSTRUCTIONS:**
- 1. ANSWER THREE (3) QUESTIONS:
QUESTION ONE(1) IS COMPULSORY AND
YOU CAN THEN CHOOSE ANY TWO (2)
QUESTIONS FROM THE REMAINING
FOUR (4) QUESTIONS PROVIDED.**

 - 2. QUESTION 1 CARRIES 50 MARKS AND
THE CHOSEN TWO QUESTIONS CARRY 25
MARKS EACH**

**THIS PAPER IS NOT SUPPOSED TO BE OPENED UNTIL PERMISSION
HAS BEEN GRANTED BY THE INVIGILATOR**

Question 1 (Compulsory)

- a) Provide answers to the following multiple choice questions: **(two marks each)**
- 1) In the Keynesian model, actual expenditures equals:
 - A) GDP
 - B) Money supply
 - C) The supply of real balances
 - D) Unplanned inventory investment

 - 2) An explanation for the slope of the IS curve is that as the interest rate increases, the quantity of investment _____, and this shifts the investment function _____, thereby decreasing income.
 - A) Increases; downward
 - B) Increases; upward
 - C) Decreases; upward
 - D) Decreases; downward

 - 3) An IS curve shows combinations of :
 - A) Taxes and government spending.
 - B) Nominal money balances and price levels.
 - C) Interest rates and income that bring equilibrium in the market for real balances.
 - D) Interest rates and income that bring equilibrium in the market for goods and services.

 - 4) If the interest rate is above the equilibrium value, then:
 - A) Demand for real balances exceeds the supply.
 - B) Supply for real balances exceeds the demand.
 - C) Market for real balances clears.
 - D) Demand for real balances increases.

 - 5) An increase in income raises money _____ and _____ the equilibrium interest rate.
 - A) Demand; raises
 - B) Demand; lowers
 - C) Supply; raises
 - D) Supply; lowers

- 6) Using the Keynesian analysis, assume that the consumption function is given by $C = 100 + 0.6(Y - T)$. If investment is 100 and T is 100, then the level of G needed to make equilibrium Y equal 1000 is:
 - A) 200
 - B) 240
 - C) 250
 - D) 260

- 7) In the IS-LM model when taxes increase, interest rates _____ and output/income _____.
 - A) Rises; falls
 - B) Rises; rises
 - C) Falls; rises
 - D) Falls; falls

- 8) If money supply increases, then in the IS-LM analysis the _____ curve shifts to the _____.
 - A) LM; left
 - B) LM; right
 - C) IS; left
 - D) IS; right

- 9) In the IS-LM model when the central bank decreases money supply, people _____ bonds and the interest rate _____, leading to a(n) _____ in investment and income.
 - A) Buy; rises; increases
 - B) Sell; falls; decreases
 - C) Sell; rises; decrease
 - D) Buy; rises; decrease

- 10) Aggregate supply is the relationship between the quantity of goods and services supplied and the _____.
 - A) Money supply
 - B) Unemployment rate
 - C) Interest rate
 - D) Price level

- b) Consider a closed economy where consumption is given by the equation $C = 700 + \frac{1}{2}(Y - T)$. Planned investment is $I = 500 - 50i$; $G = 500$ and $T = 400$.
- i) Find the equilibrium level of Y when $i = 6$. (6)
 - ii) Does $S = I$? verify (4)
- c) Assume that i is fixed at $i = 6$ as in b) and G increases by 100,
- i) What is the new equilibrium value of Y ? (4)
 - ii) In an IS-LM setting where i is not fixed, would the increase in G increase or decrease i ? (6)
 - iii) What effect would the change in i have on investment? (2)
 - iv) What is the name of the phenomenon you described in iii). (2)
- d) Outline the main instruments or tools of monetary policy that the central bank uses to control money supply in the economy? (6)

Question 2

- a) Differentiate between the balance of payments and the balance of trade. (5)
- b) Compare and contrast the macroeconomic views suggested by the monetarist school of thought to that of the rational school. (20)

Question 3

- a) The government of Swaziland is currently experiencing a crisis in its fiscal policy. It has been reported on newspapers that expenditure far exceeds the revenue available. The minister of finance has hinted that his government would borrow domestically (from the private sector and draw down reserves from the central bank) in order to finance this huge deficit. As an economist advise the minister on the likely problems the economy would face if he only relies on this particular type of deficit financing. (6)
- b) Due to the current financial crises affecting Swaziland, the members of parliament have voted for a fiscal stimulus to overcome the crises. Explain using the IS-LM model how the desired objective will be achieved. (6)
- c) Distinguish between a liquidity trap and the crowding out of investment. (7)
- d) Differentiate between Irvin Fisher's equation and the equation of exchange. (6)

Question 4

- a) Consider a small open economy operating under a fixed exchange rate regime. Assume that in this economy capital is perfectly mobile. Describe how the internal and external equilibria of the economy will be determined if the economy undertakes an expansionary monetary policy. Illustrate your answer with the aid of a diagram. (12)
- b) Derive the balance of payments curve graphically. What influences its slope? What factors can cause it to move upwards or downwards (shift)? (13)

Question 5

a) Write short explanatory notes on the following concepts:

- i) Efficiency wage models (3)
- ii) Inflationary gap (3)
- iii) Natural rate of unemployment (3)

b) The Swaziland Federation of Trade Union (SFTU) and Swaziland Federation of labors (SFL) in their wage negotiations with their employers managed to attain a bargained real wage represented by the following function: $W/P_e = m_0 + m_1 Y$. Let us assume that these unions were basing their wage negotiations on adaptive expectations so that they expect the price level to be constant over time i.e. $P_e = P_{-1}$. Given that the price that firms set after taking into account the bargained real wage is represented by

$P = (1-b)W$, where b is the mark-up:

- i) Derive the aggregate supply equation for the Swazi economy using the information provided above and also graph the aggregate supply curve. (10)
- ii) What are the properties of the aggregate supply curve you derived in (i) (6)