NOVA SCHOOL OF LAW

Academic year 2021-2022

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Exam of Macroeconomics

27th June 2022

Duration 2:15

I (30%)

Please comment on the **veracity of the following statements:**

a) Expenditure decisions are not affected by interest rates.

False. Expenditure decisions, notably desired investment, are affected by interest rates. Higher interest rates make it more costly to obtain credit and increase the opportunity cost of investing, thus decreasing the amount of investment firms want to implement.

b) Investments fully based on imported machinery do not contribute to the GDP.

True. If investment corresponds entirely to the import of foreign products it does not contribute to GDP because higher I is cancelled by higher M (with a minus sign), or more intuitively, because there is no value added created in the country. In the long term, productive investment will increase the capital stock and thus overall GDP.

c) The absence of capital flows implies that exports must be equal to imports.

True. The balance of payments corresponds to the sum of capital flows and net exports (exports-imports). If CF=0, then NX must be zero and consequently X=M.

d) Banks are important to facilitate transactions but do not contribute to economic growth.

False. Banks contribute to economic growth because they perform an intermediation service, putting in contact savers and investors. This makes it

possible for the economy to invest, accumulate capital and grow. New technological approaches are slowly altering this paradigm.

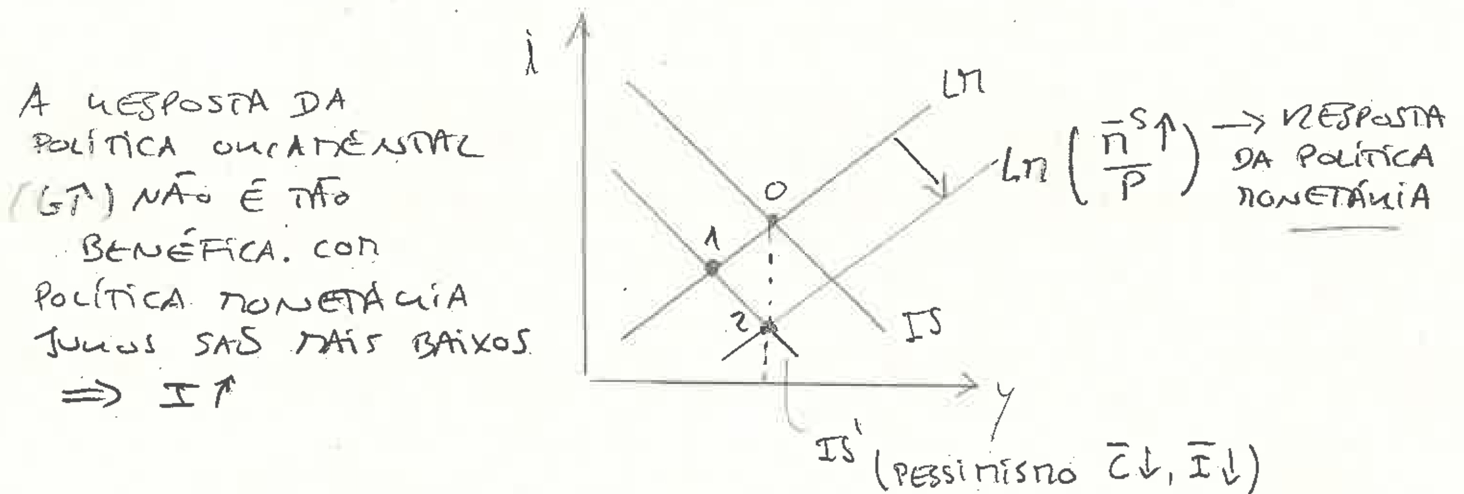
e) Prices tend to increase when observed output is above its potential level.

True. If output is above potential (positive output gap), this means that resources in the economy are used above normal capacity, triggering and increase in their prices due to their excess demand. Higher prices in inputs will translate in higher final prices.

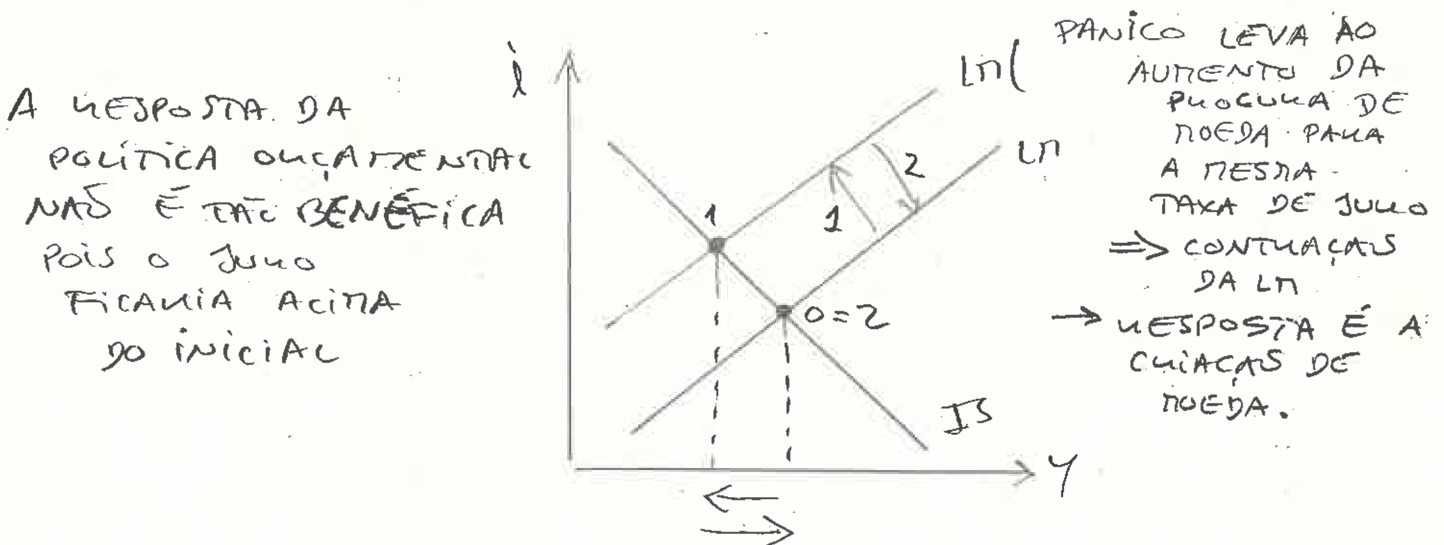
II (30%)

Consider the following shocks, discuss their **impact on the IS/LM model** and choose the **best policy** to put the economy back on the initial level of output (do not consider the possibility of using a policy-mix).

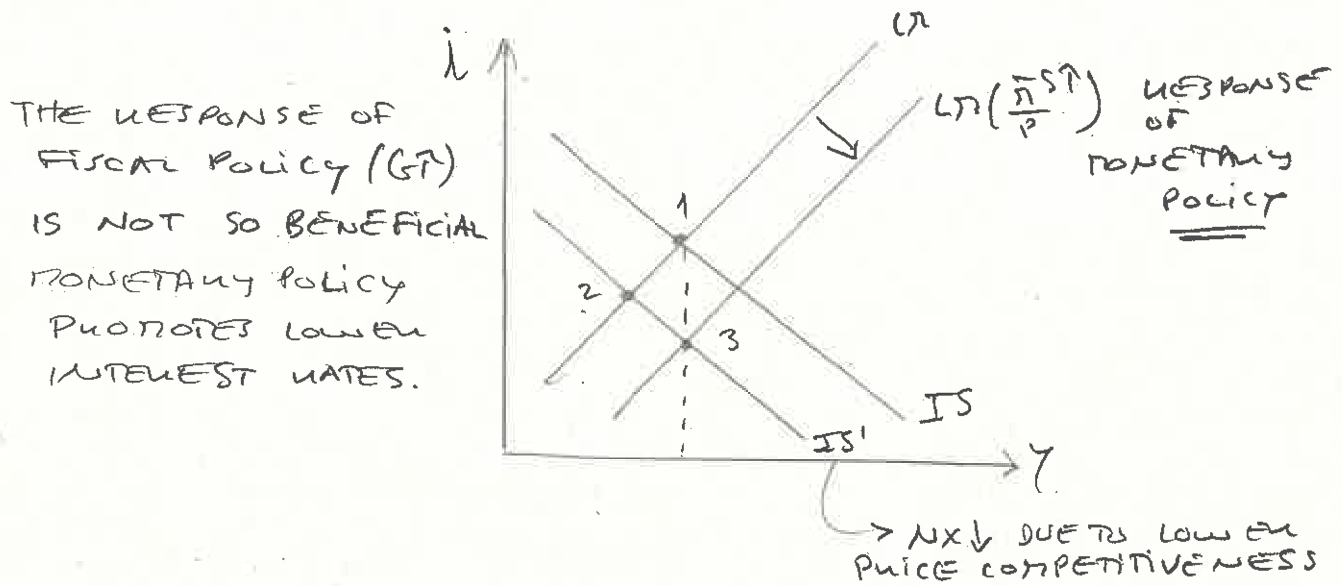
a) Increase in pessimism due to the invasion of Ukraine by Russia.



b) Panic in financial markets leading to massive sell out of bonds by individuals.



c) Decrease in net exports due to competitiveness losses.

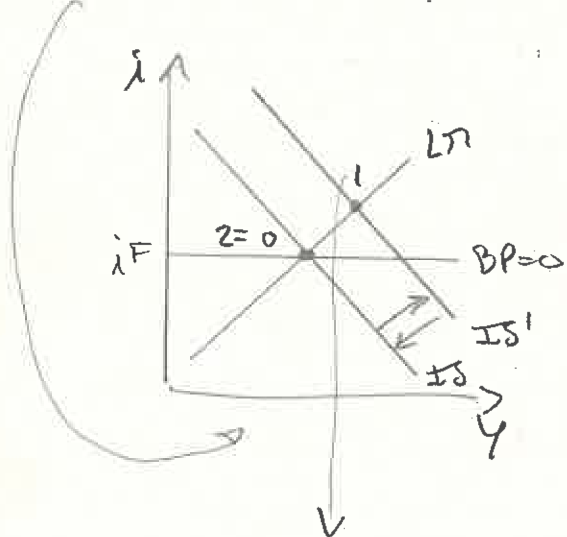


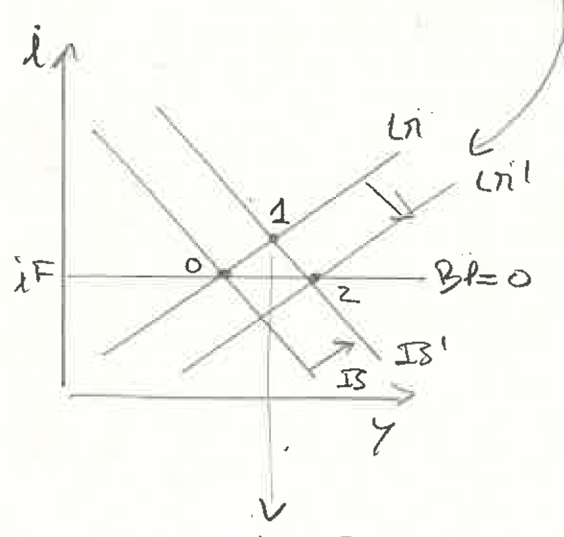
III (40%)

In an open economy setting, macro policies have far-reaching impacts. Please answer the following questions and justify.

a) Is fiscal policy powerful to affect output in the Mundell-Fleming model?

YES IN FIXED EXCHANGE RATE REGIME.
NO " FLEXIBLE " " " .





$i > i^F \Rightarrow$ CAPITAL INFLOW

EXCESS DEMAND DOMESTIC CURRENCY $\Rightarrow e\downarrow, R\downarrow \Rightarrow X\downarrow M\uparrow$

$R = \frac{eP^F}{P}$

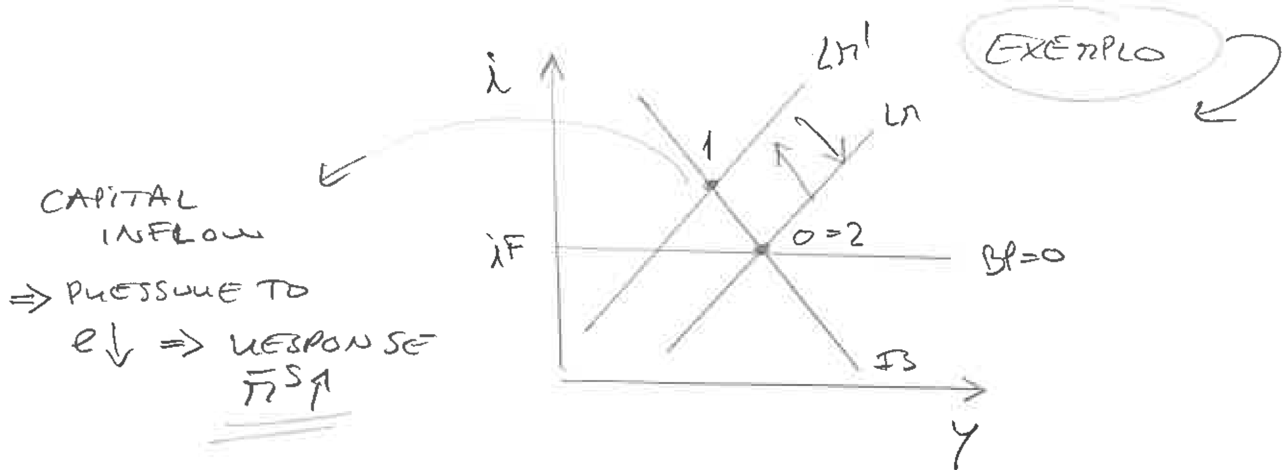
$i > i^F \Rightarrow$ CAPITAL INFLOW

EXCESS DEMAND DOMESTIC CURRENCY $\Rightarrow$ Response BY CENTRAL BANK TO AVOID $e\downarrow$

$\Rightarrow \bar{M}^S\uparrow$

b) Is monetary policy still available for countries that join a monetary union?

NO, COUNTRIES IN A MONETARY UNION WORK IN A FIXED EXCHANGE RATE REGIME ⇒ MONETARY POLICY IS INACTIVE.



c) Do speculative attacks exist on a flexible exchange rate regime?

No. If the central bank does not commit to intervene in the exchange rate markets to maintain the value of the currency, there is no risk of speculators drying out the reserves of foreign currency in the central banks and thus forcing the switch to flexible exchange rates, making a profit out of it

d) Could a contractionary monetary policy in the US help the euro area economy?