

# **UNIVERSITY COLLEGE LONDON**

## **EXAMINATION FOR INTERNAL STUDENTS**

**MODULE CODE : ECON2004**

**ASSESSMENT : ECON2004A**  
**PATTERN**

**MODULE NAME : Macroeconomic Theory and Policy**

**DATE : 16 May 2016**

**TIME : 10:00 am**

**TIME ALLOWED : 3 hours**

This paper is suitable for candidates who attended classes for this module in the following academic year(s):

**2014/15 and 2015/16**

**SUMMER TERM 2016**

**ECON2004: Macroeconomic Theory and Policy**

**TIME ALLOWANCE: 3 HOURS**

*Answer 4 questions from Part A and 2 from Part B*

*Questions in Part A carry 12.5 per cent of the total mark each and questions in Part B carry 25 per cent of the total mark each.*

*In cases where a student answers more questions than requested by the examination rubric, the policy of the Economics Department is that the student's first set of answers up to the required number will be the ones that count (not the best answers). All remaining answers will be ignored.*

**PART A**

Answer **all** questions from this section.

**A1.** Use the wage-setting (WS)/ price-setting (PS) model to explain what determines the level of inflation at a particular level of output. Your answer should include a careful description of the foundations of the WS and PS curves.

**A2.** Why is there a zero lower bound (ZLB) on nominal interest rates? Explain under what circumstances the ZLB can constrain monetary policy.

Note: It is not necessary to draw a diagram to score full points.

**A3.** In a small open economy with perfect capital mobility, how can the central bank use monetary policy to stabilize business cycle fluctuations?

a) Take the example of a temporary negative demand shock to illustrate your answer.

b) Comment briefly on why the central bank may choose to stabilize fluctuations.

c) What is the role of perfect capital mobility in your analysis?

Note: It is not necessary to draw a diagram to score full points.

**TURN OVER**

**A4.**

a) Explain in words why there can be multiple unemployment equilibria with constant inflation in an open economy. What are you assuming about wage setting behaviour?

A small open economy of the type in part (a) is initially at equilibrium with constant inflation and a trade surplus. The government implements a fiscal expansion.

b) What would happen to the trade balance and why?

c) Draw a diagram using output and the real exchange rate on the axes to illustrate the situation of this economy before and after the fiscal expansion.

Note: Do not discuss the dynamic adjustment of the economy.

**TURN OVER**

## PART B

Answer 2 questions from this section.

- B1.** Use the three-equation model combined with the government debt model to explain the macroeconomic causes and consequences of a government debt crisis **in a closed economy**. Your answer should include

- a) An explanation of how a government debt crisis can arise.
- b) Use of the three-equation model to show the effects of a crisis on the macroeconomy.
- c) A description of policies that can be used to mitigate the effects of the crisis.
- d) Examples drawn from events since 2007.

- B2.** “One of the major questions in applied economics would seem to be the issue as to whether government policies can have a stabilizing role in [an]... economy” (Andrea Boltho)

Explain the theoretical mechanisms by which demand-side policies can stabilise output and the empirical evidence as to the effectiveness of such policies.

Your answer should discuss both fiscal and monetary policy, explaining how they affect output and what determines the size of the effects.

- B3.** Consider the following statements about global imbalances:

S1. Global current account imbalances reflect differences in natural resource endowments and investment opportunities across countries.

S2. Global current account imbalances reflect differences in growth strategies across countries.

- a) Explain what is meant by each statement, making reference to models you have studied and country examples.
- b) Assess the claim that global current account imbalances threaten the stability of the world economy.

**TURN OVER**

- B4.** 'For a country to thrive in a common currency area, it either needs to be very similar to the other members or to have institutions that enable wages and prices to respond rapidly to country-specific shocks.'

Use economic models to explain the logic of this claim and to critically evaluate its value as a guide to the decision of a country to join. In the course of your answer, you should explain

- a) what a common currency area is and how responsibility for different macroeconomic policies is assigned
- b) how membership affects the response of a country to a shock
- c) the relevance of wage and price adjustment to the benefits of membership
- d) important omissions in the statement that affect a country's ability to thrive in a common currency area
- e) how examples from the Eurozone shed light on the statement.

**END OF PAPER**