ECONOMICS 3B

SUPPLEMENTARY ASSESSMENT
ATTENDANCE FORM

Surname and initials	

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Venue	

REQUEST: READ THE FOLLOWING GENERAL INSTRUCTIONS AND ADHERE TO EACH ONE OF THEM:

1. **Do not remove the staple.**

2. **Tear off (remove) only the top page (this page), complete requests 1-5, sign and hand in.**

3. Check that your paper has ***17*** **numbered pages**.

4. Write your student number **direct after each page number at the left bottom of each page**.

5. WRITE DOWN YOUR SURNAME AND INITIALS. **THIS IS ESSENTIAL** FOR THE SORTING OF PAPERS AND THE CAPTURING OF MARKS.

Sign in full below to confirm your adherence to these 5 requests:

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ECONOMICS 3B

Supplementary Assessment

SCHOOL OF ECONOMICS AND ECONOMETRICS

Date	January, 2019
Marks	120
Time	3 hours
Examiners:	Kesaobaka Mmelesi and Christie Schoeman
Internal moderator:	Prof Beatrice Simo-Kengne
External examiner and moderator:	Prof Anmar Pretorius

Surname																				

Initials			

Student number									

	Marks	Total
A		15
B1		20
B2		10
B3		20

B4		30
B5		25

Percentage	/120

Section A – Multiple Choice [15]

Answer the multiple choice questions on the answer sheet. Mark the correct option clearly with a **full cross in the relevant bloc**k.

1. What is the relationship between changes in the relative money supply of a country, ***ceteris paribus***, and the nominal exchanges rate of that country?

   A) No relation between the relative money supply of a country, ***ceteris paribus***, and the nominal exchanges rate of that country.
   B) Is perfectly correlating.
   C) Reflective of relative prices of currencies.
   D) None of the above

2. The income risk aversive agent will:
   A) Invest in a long run bond if such the bond rate is undervalued.
   B) Stay liquid.
   C) Invest at the current long run rate in a bond if the price of a bond is hugely undervalued.
   D) Prefer to buy short run assets.

3. Savers in an environment of risk care about :
   A) The return on an asset.
   B) The given risk an asset brings to their portfolio.
   C) The liquidity an asset brings to the portfolio.
   D) B and C.

4. In an environment of uncertainty a decrease in interest rate leads to:
   A) An immediate decrease in the price level.
   B) A change in planned investment.
   C) A change in expectation about the future.
   D) B and C.

5. In an environment of uncertainty a further decrease in an already low level of the interest rate leads to:
   A) An immediate decrease in the general price level.
   B) An increase in the supply of bonds.
   C) A decrease in the demand of money deposits.
   D) B and C.

6. In an environment of uncertainty a decrease in an already high level of the interest rate leads to:
   A) An immediate increase in the price level.
   B) An increase in the supply of bonds.
   C) A decrease in the demand for money deposits.
   D) B and C.

7. Investors in an environment of uncertainty care about :
   A) The expected rate of profit to be earned on an asset.
   B) The given risk an asset brings to their portfolio.
   C) The liquid nature of the asset in the portfolio.
   D) A and C.

8. The suppliers of bonds in an environment of uncertainty care about :
   A) The expected rate of profit to be earned on an asset.

B) The expected price at which a bond can be bought.
C) The liquid nature of the asset in the portfolio.
D) A and C.

9. Which of the following statements is the MOST accurate? The law of one price states

A) in competitive markets free of transportation costs, a general accepted international currency and no official barriers to trade, identical goods sold in different countries must sell for the same price when their prices are expressed in terms of the same currency.
B) in competitive markets free of transportation costs and official barriers to trade, identical goods sold in the same country must sell for the same price when their prices are expressed in terms of the same currency.
C) in competitive markets free of transportation costs and official barriers to trade, identical goods sold in different countries must sell for the same price.
D) identical goods sold in different countries must sell for the same price when their prices are expressed in terms of the same currency.

10. Equation of the Purchasing Power Parity is:
A) E$/E = PUS/PE.
B) E$/E = PE/PES.
C) E$/E = PUS + PE.
D) E$/E = PUS - PE.

11. Which of the following statements is the MOST accurate?
A) Absolute PPP does not imply relative PPP.
B) Relative PPP implies absolute PPP.
C) There is no causality relation between the two.
D) Absolute PPP implies relative PPP.

12. Which of the following statements is the MOST accurate? In general
A) the monetary approach to the exchange rate is a long run theory.
B) the monetary approach to the exchange rate is a short run theory.
C) the monetary approach to the exchange rate is both a short and long run theory.
D) the monetary approach to the exchange rate neither long run nor short run theory.

13. The monetary approach makes the general prediction that
A) the exchange rate, which is the relative price of American and European money, is fully determined in the long run by the relative supplies of those monies.
B) the exchange rate, which is the relative price of American and European money, is fully determined in the short run by the relative supplies of those monies and the relative demands for them.
C) the exchange rate, which is the relative price of American and European money, is fully determined in the short run and long run by the relative supplies of those monies and the relative demands for them.
D) the exchange rate, which is the relative price of American and European money, is fully determined in the long run by the relative supplies of those monies and the relative demands for them.

14. In long run equilibrium (in the AA/DD model):
A) The external value of a currency of a country reflects the true value of the real economy
B) Arbitrage between money assets and real assets in the economy takes place
C) Interest Parity and Purchasing Power Parity exist at the same time
D) A and C

15. The current account balance is:

A) the supply of a country's exports less the country's own demand for imports.
B) the demand for a country's exports plus the country's own demand for imports.
C) the country's own demand for imports less the demand for a country's exports.
D) the demand for a country's exports less the country's own demand for imports.

Section A / Afdeling A - Answer Sheet

Question / *Vraag*	A	B	C	D
1				
2				
3				
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15				

Section B

Question *B1* **[max 20]**

You are working in the financial market as an economist. The current spot price of asset I1 (2018) is higher than the current long run spot price of asset I2 (2018) which matures in 2 years' time from today. In terms of the term structure of interest rate what will:

Your expectation be of the future interest rate when it is assumed that all investors are risk neutral given the current structure.
Name and explain:

(6)

Your expectation be on the future interest rate when it is assumed that all investors are capital risk aversive given the current structure.
Name and explain:

(6)

Your expectation be on the future bond prices when it is assumed that all investors are income risk aversive given the current structure.

Name and explain:

(6)

Your expectation be on the price of I1 (2019) under the preferred habitat theory.
Name and explain:

(4)

Question *B2* **[10]**

Explain *<u>in short</u>*, the *meaning of the* following concepts:

Liquidity trap.	*Explanation*

(2)

Time to maturity.	*Explanation*

(2)

Exogenously determined money demand.	*Explanation*

(2)

Certainty.	*Explanation*

(2)

Foreign exchange market.	*Explanation*

(2)

Question *B3* **[20]**

The SARB are buying Euros in the financial market under conditions of already very low interest rates and increasing uncertainty. Name and explain the impact this will have on:

Savings in the RSA economy	Impact:
Explanation:	

(4)

On employment in the RSA economy.	Impact:
Explanation:	

(4)

On the demand for bonds in the RSA bond market.	Impact:
Explanation:	

(4)

On the demand for ZAR.	Impact:
Explanation:	

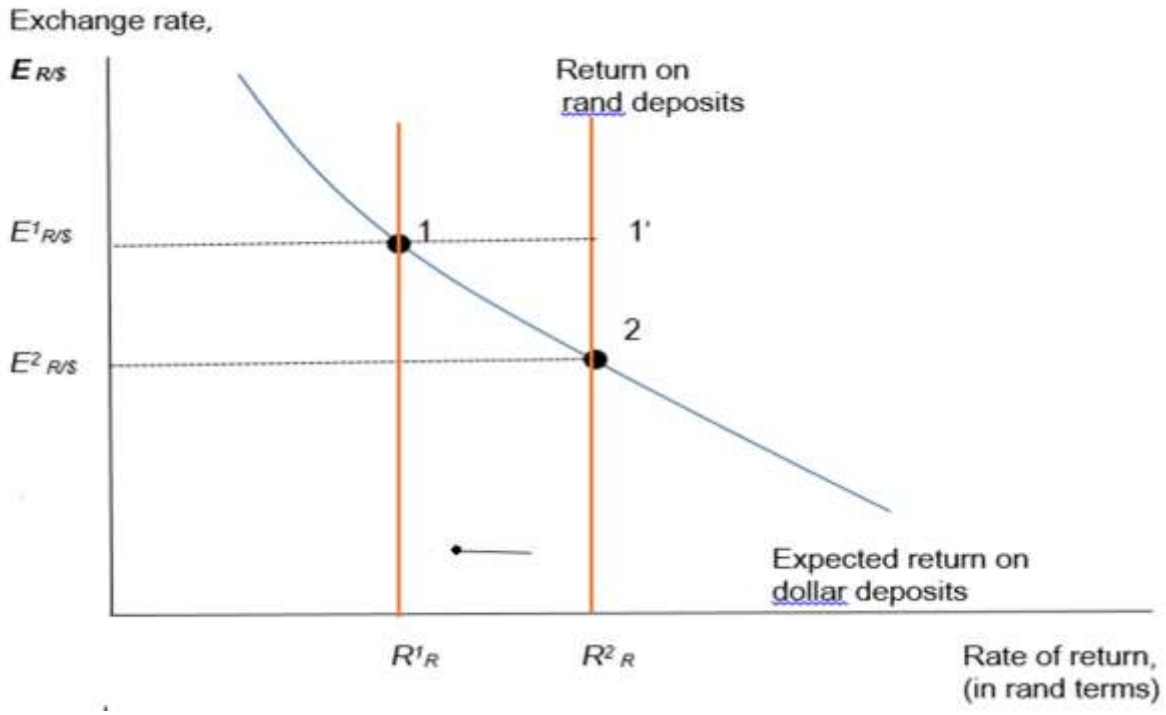
(4)

On production in the RSA economy	Impact:
Explanation:	

(4)

Question *B4* **[maximum 30]**

The graph below shows equilibrium in the foreign exchange market in South Africa if interest rate parity and purchasing parity holds. Assume a long run equilibrium exchange rate of R14 =1 US$, a current spot of R12=1 US$ and return on ZAR deposits of 10%.



Make use of the diagram to identify and explain the impact of the following on the ZAR/1 US$ spot exchange rate:

A decrease (shift) in the demand for money deposits in South Africa.
The impact and the reason for such an impact:

(5)

When the SARB exchange US dollar for ZAR.
The impact and the reason for such an impact:

(5)

An increase (shift) in the interest rate on money deposits in the USA.
The impact and the reason for such an impact:

(5)

A depreciation in the expected long run equilibrium exchange rate.

The impact and the reason for such an impact:

(5)

An decrease (shift) in the demand for money deposits in the USA.
The impact and the reason for such an impact:

(5)

An increase in the buying back of bonds by the Federal Reserve.

The impact and the reason for such an impact:

(5)

Question *B5* **[25]**

With the aid of an AA-DD model, show the effect of permanent *expansionary* monetary policy. Label all axes on your diagram and provide a full explanation of all shifts in the curves in (i) and (ii) below. Assume the economy starts **at full-employment output.** **[10]**

(i) Explanation of the initial (temporary) effect **(7.5)**

(ii) Explanation of the permanent effect: **(7.5)**

THE END

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