UNIVERSITY OF JOHANNESBURG

SCHOOL OF ECONOMICS AND ECONOMETRICS

KINGSWAY CAMPUS
Monetary Theory A
Supplementary Assessment
July, 2019

Time: 180 minutes

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Question 1 is COMPULSARY.

Question 1 ***[30]***
Make use of the information in Attachment A and answer the following questions:

i) ***According to Dornbusch the over-reaction after a monetary shock in the international monetary and financial markets will have real economic impacts on the domestic economy in the short run***[1]:

- **Name and discuss** the possible reason for such an over-reaction of nominal exchange rates after a shock? **(6)**
- **How** can one **detect** such an **over-reaction of nominal exchange rates** and explain the **reason** for such an **over-reaction** in the foreign exchange market **in the short run**? **(6)**
- Is there **any indication** of such over-reaction in the **ZAR/$ exchange market** in the **graph (Attachment A)**. **(2)**
- **Explain the reason** for your answer above. **(4)**

ii) **Name and discuss,** in accordance with the **Post-Keynesian theory,** the **impact** of a **domestic nominal shock** on **nominal and real exchange rates**? **(6)**

[1] Copeland, L. (2005): Exchange Rates and International Finance. 4th Edition. Essex: Pearson Education

iii) What would be according to **Davidson and Harvey reasons** for such impacts? **Explain** your answer. **(6)**

Do any *one (1)* of the following questions

Question 2

[30]

2.1 According to Copeland, a foreign exchange market can be considered as an efficient market only under certain conditions. Name and explain those conditions. ***(10)***

2.2 According to Davidson and Rogers:

i. **What is needed in an economy** to hedge true uncertainty? **Explain**. **(5)**

ii. **Explain why** investors may still decide to invest in a country like Greece. **(5)**

2.3 According to Davidson:

i. **Explain the reason** why one will **not be able to assign** a probability ratio to future outcomes and their consequences. **(5)**

ii. **Explain how and why** a probability ratio **can be assigned** to outcomes and their consequences. **(5)**

OR

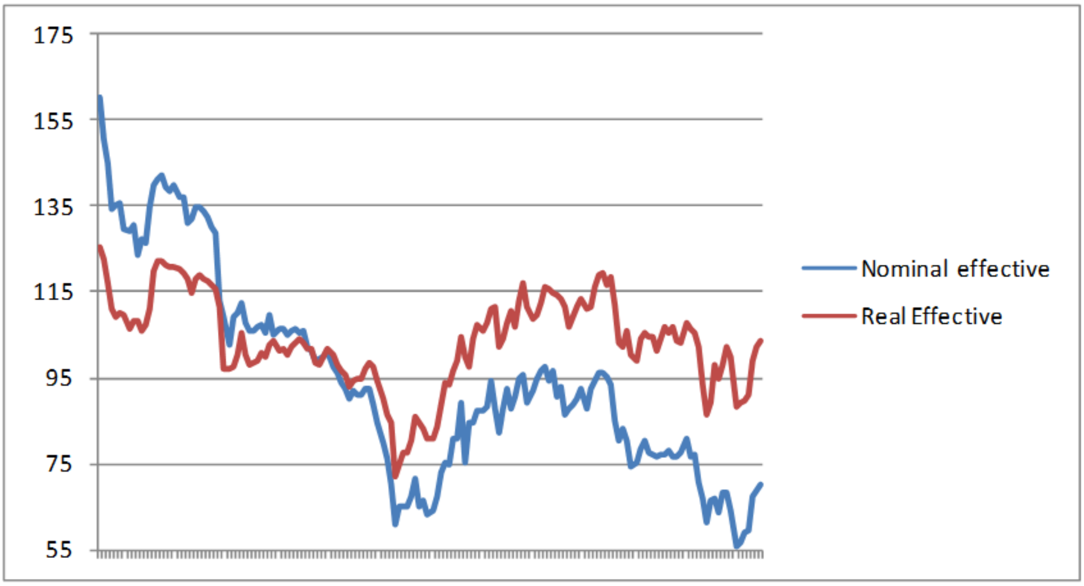
Question 2 *[30]*

On May, 8th a general election takes place. A lot of political uncertainty exists in the run-up to the election. When will such a non-economic or nominal variable like politics will have permanent and long run real impacts on the economy of South Africa? Discuss and explain under the following headings:

(i) The **conditions needed** for such a shock to have a permanent impact. **(10)**

(ii) **Why such a non-economic shock is transmitted** into real changes in the R/$ exchange rate and in the profitability on real investment. **(20)**

Attachment A



Nominal vs. Real ZAR/$ exchange rate: Monthly January 2013 - March 2014

Section B

Question 1 **[15]**

(i) Describe the three motives behind the demand for money by Keynesian theory. (6)

(ii) Recent empirical evidence (post-1973) supports instability in the money demand function. Discuss the major reason attributed to this phenomenon. (4)

(iii) From the equation of exchange, show that:

$\pi = \%\Delta M - \%\Delta Y$:

Where π is rate of inflation; M is the money supply and Y is aggregate output. (5)

Question 2 **[15]**

(i) An economy is facing a recessionary gap. Use the expectations-augmented Phillips curve model to analyse the short run and long run self-correcting mechanism as suggested by the model. (Hint: Recessionary gap, actual unemployment is above natural rate). (10)

(ii) The post-1970s empirical evidence generally suggests that the original Phillips Curve trade off no longer exists. What are some of the main reasons attributed to this observation? (5)

Question 3 **[15]**

(i) Discuss the three theories of the term structure of interest rates. Include in your discussion the differences in the theories, and the advantages/disadvantages of each. (12)

(ii) Explain the difference between the term structure of interest between the USA and SA? A devolved and a developing country? (3)

Question 4 **[15]**

(i) Discuss the advantages and disadvantages for money rules and discretionary policy. [6]

(ii) Given the different results in using discretionary and rules policy which option will fit best a country that aims for long run growth? Also explain how they can achieve this. (3)

(iii) Explain the possible time inconsistency with relation to an announced restrictive monetary policy in a country with high levels of unemployment. (6)

<u>END</u>