ECONOMICS 3B

FINAL ASSESSMENT
ATTENDANCE FORM

Surname and initials	

Student number	
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.**

3. Check that your paper has **15 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:

____.

COLLEGE	College of Business & Economics
SCHOOL	Economics
CAMPUS	APK; SWC
MODULE NAME	Economics 3B
MODULE CODE	ECO3B/EKN3B
SEMESTER	Second
ASSESSMENT OPPORTUNITY	Final assessment
MONTH & YEAR	November 2019

ASSESSMENT DATE	November 2019	**SESSION**	1
ASSESSOR(S)	Ms K Mmelesi and Mr F Kirsten		
INTERNAL EXTERNAL MODERATOR(S)	Prof B Simo Kengne Mr M Sekome		
DURATION	3 HOURS	**TOTAL MARKS**	100

INFORMATION/INSTRUCTIONS

This is a fill-in paper.
The paper has 15 numbered pages.
There are three questions with sub-sections.
A noiseless calculator is allowed.

SURNAME	
INITIALS	
STUDENT NUMBER	
CELL NUMBER	

	Marks	Total
A		15
B1		20
B2		15
B3		10
B4		20
B5		20

GRAND TOTAL /100

Section A – Multiple Choice

[15]

<u>Complete Section A on the answer sheet on the assessment paper.</u>

1. Which of the following is not proposed as an explanation for the term structure of interest rates?

A. The expectations theory.

B. The liquidity preference theory.

C. The safety of principal theory.

D. Modern portfolio theory.

2. The expectations theory of the term structure of interest rates states that;

A. forward rates are determined by investors' expectations of future interest rates.

B. forward rates exceed the expected future interest rates.

C. yields on long- and short-maturity bonds are determined by the supply and demand for the securities.

D. All of these are correct.

3. The expectations theory of the term structure of interest rates states that;

A. forward rates are determined by investors' expectations of future interest rates.

B. forward rates exceed the expected future interest rates.

C. yields on long- and short-maturity bonds are determined by the supply and demand for the securities.

D. None of these is correct.

4. When economic agents make decisions based on nominal values alone, ignoring real values, what is it called?

A. Money illusion

B. Seignorage

C. Arbitrage

D. Inflation

5. What will happen if the nominal rate of interest in a country rises substantially above the natural rate of interest?

A. Unemployment will fall

B. Current account will experience an unsustainable surplus

C. Economic growth will fall in the short run

D. Inflation will rise

6. If the rand is currently R10/$ and according to purchasing power parity it should be R12/$, how would one describe the state of the rand?

A. Indirectly quoted

B. Fixed

C. Overvalued

D. Undervalued

7. If you compare the current inflation rate in South Africa and the current inflation rate in the USA, what should have happened to the R/$ exchange rate according to the theory of PPP?

A. The rand should depreciate against the US dollar
B. The rand should appreciate against the US dollar
C. The SARB will be forced to devalue the Rand
D. The SARB will be forced to revalue the Rand

8. What effect will a sudden and unexpected depreciation of a country's currency have on its major macroeconomic indicators?

A. The inflation rate will start to fall
B. The volume of exports will eventually fall
C. The unemployment rate will decrease
D. Imports will become more expensive

9. What will the impact in the domestic money market be if the SARB buys foreign currency on the foreign exchange market?

A. A decrease in reserve currencies held by banks.
B. An increase in rand supply through printing of physical notes and coins.
C. An increase in ZAR supply through a reduction in foreign reserves.
D. The buying and selling of ZAR by the SARB in exchange for foreign buying bonds.

10. An increase in the buying of bonds denominated in US dollar will result in:

A. Capital inflows to the RSA.
B. An appreciation in the ZAR/US dollar exchange rate.
C. A depreciation in the ZAR/US dollar exchange rate.
D. i and ii.

11. If there is an increase in the demand for ZAR, what will happen to the expected return on foreign bonds according to the AA/DD model?

A. The expected foreign return on bonds will increase.
B. The expected prices on foreign bonds will increase and return will as result decrease.
C. The ZAR will appreciate in and the expected return on foreign bonds will increase.
D. Will have no impact on the expected return on foreign bonds.

12. A country with high unemployment and uncertainty like in South Africa will prefer a(n):

A. The SARB to increase the repo rate.
B. Depreciation in the ZAR/dollar exchange rate.
C. Decrease in expected the return on ZAR denominated bonds.
D. Overvalued ZAR.

13. A government in a country with a large degree of certainty in the long-run:

A. Will use permanent expansionary fiscal policy to counter cyclical unemployment.
B. Will use temporary fiscal policy to counter cyclical unemployment.
C. Will use temporary monetary policy to counter cyclical unemployment.
D. Will use socio-economic policy to counter employment.

14. If the current short term interest rate is higher than the current 2-year bond rate under uncertainty, the income risk averting agent expects the future short run interest rate in the expectations theory to:

A. Increase to compensate for risk
B. Decrease to compensate for risk
C. To be high enough to also compensate her risk before investing in the short run
D. None of the above

15. Inflation in a commodity system is uncommon in the long run because:

A. Of the unique nature of gold.
B. It is much easier to be affected by monetary policy.
C. Commodity production costs reflect the real value of the commodity.
D. Its face value can differ from its intrinsic value in the long run

Section A - Answer Sheet

(Remember to write your student number on the bottom of this sheet as well)

***Indicate the correct answer by a cross* which fills the full space of the block.**

Question/Alternative	i	ii	iii	iv
1				
2				
3				
4				
5				
6				
7				
8				
9				
10				
11				
12				
13				
14				
15				

Question B1
[maximum 20]

You are working on the financial market as an Economist. The current spot rate of asset B1 is higher than the current long-run spot price (mature in 2 years) of asset B2. In terms of the term structure of interest rate what will be the following?

What will be the expectation on the future short run spot rate under the expectation theory if no risk exists in the bond market?
Explain:

(4)

Assume Uncertainty, what will be the expectation on the future short run spot price under the market segmentation theory?
Explain:

(4)

The expectation on the price of B1 under the preferred habitat theory

Explain:

(4)

What is the difference between the two types of risk aversive investors?
Name and explain:

(4)

Why do most Investors Prefer Short-Term Bonds?

Name and explain:

(4)

Question *B2* **[maximum 15]**

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

1. **Risk averse investor**	*Explanation*

(3)

2. Simple rule	*Explanation*

(3)

3. Relative Purchasing Power Parity	*Explanation*

(3)

4. Arbitration	*Explanation*

(3)

5. XX schedule	*Explanation*

Question ***B3*** **[10]**

3.1 During the financial crisis the Federal Reserve Bank cut US interest rate too close to zero, yet the impact on economic stimulation was minimal. Explain using a graph why this happened and explain how the USA government used Quantitative easing to get the country out of the crisis **(6)**

3.2 Use the completed graph above and answer the following questions:

➢ *Assume the central bank is selling bonds in the financial market:*

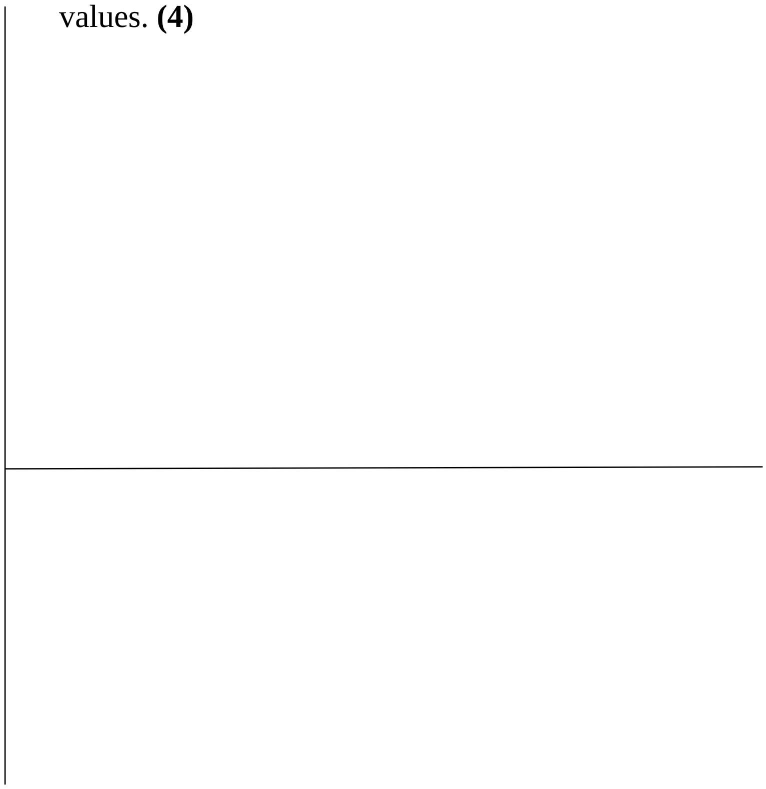
What will the impact be on the level of the bond price and on the level of the interest rate? Explain. **(2)**

Impact	***Explanation***
- **Bond price** - **Interest rate**	

3.3 Use the fisher equation to explain what will happen to nominal and real interest rates if economic growth rate increases by 0.5% in a demand driven economy **(2)**

Question *B4* **[20]**

4.1 Complete the diagram below ***to demonstrate*** equilibrium in the foreign exchange market. Assume an equilibrium exchange rate of ZAR 14.72 = 1 US$ and an expected return on ZAR deposits of 10%. Label all axes and curves and fill in the equilibrium values. **(4)**



i) Given a decrease in ZAR money supply, ***demonstrate on the graph*** the impact of this action on the foreign exchange market. **(4)**

ii) By making use of the graph in i) discuss the relationship between expansionary monetary policy and the value of South Africa's currency in the foreign exchange rate market. Refer in your answer to the reason for the exchange rate to overshoot in the short run. **(4)**

4.2 South Africa's headline consumer inflation rose to 4.3 percent year on year in August after ticking up modestly by 0.3 percent month on month from 4 percent in July as food prices persist. (Source: IOL) Recent food prices increases are expected to rise and thus the inflation expectations are also on a rise.

(i) How will the event described above affect the following variables?

long run nominal exchange rate **(2)**

South African overdraft rate **(2)**

(ii) Explain 2 immediate problems with the purchasing power parity theory of exchange rate which relates to the law of one price **(4)**

Question *B5* **[20]**

5.1 Draw an AA-DD-XX diagram below and label all axes and curves which should show equilibrium in the foreign exchange market. Assume an expected long run exchange rate equilibrium of R14 = 1 euro. **(6)**

<u>AA-DD-XX diagram</u>

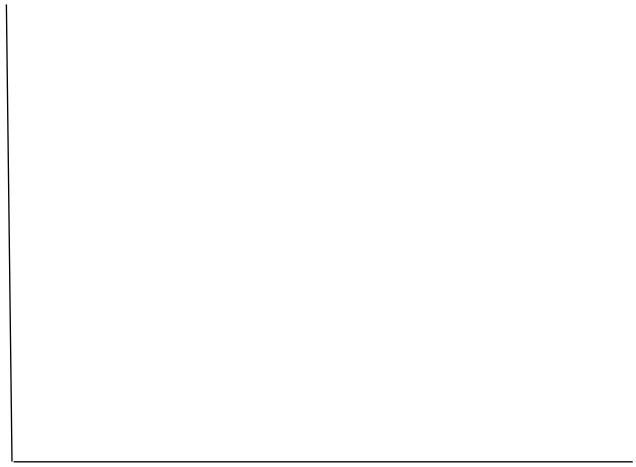
5.2 By making use of the diagram in 5.1 explain the short run impact of:

An increase in the buying of bonds by the SARB on the (i) long run exchange rate and (ii) unemployment **(4)**
The impact and the reason for such an impact:

An ongoing increase in political and social unrest on the (i) expected long run exchange rate and (ii) production **(4)**
The impact and the reason for such an impact:

5.3 Discuss the two factors affecting the position of the DD schedule. **(2)**

5.4 Given the following two situations (i) Nominal exchange rate remains constant (ii) South Africa output remains constant. Explain what happens to the DD curve given the situations in (i) and (ii) and show the impact on the graph. **(4)**



GOOD LUCK!!!!!!