The 556 midterm exam will consist of two questions. The first question will be chosen from among the three listed below; the second question will not be available in advance. The midterm exam will be offered on Wednesday, February 24th, during our regularly scheduled class. Please come to the exam with only a pen or pencil. Students are not permitted to consult notes, books or any other materials during the exam.

You are welcome to work with other members of the class on pre-exam preparation. Effective answers will be concise, well-organized and focused.

1. Use the model of the (long-run) small open economy (summarized by the graph with net exports on the horizontal axis and the real exchange rate on the vertical axis) to predict what would happen to the trade balance, the real exchange rate, and the nominal exchange rate in response to each of the following events:

   (a) A fall in consumer confidence about the future induces consumers to spend less and save more.

   (b) The introduction of an environment-friendly line of imported cars makes some consumers prefer foreign cars over domestic cars.


   (a) What defines a “recession”? Why is it not possible to date recessions (or expansions) in real time?

   (b) Describe two macroeconomic policy options available to countries experiencing an economic downturn that might help them avoid a recession. Explain how these policies might provide the country with a soft landing (slower growth but no recession) and sketch out graphically (using the IS-LM model) the likely effects of these policies on interest rates and output. How would your choice between the two policy options be influenced by the initial state of the economy?

   (c) What are the potential problems that may arise when governments attempt to use macroeconomic policies to stabilize the economy in the short run?

3. Explain why each of the following statements is true. And, discuss the impact of monetary and fiscal policy in each of these special cases:

   (a) If investment does not depend on the interest rate, the IS curve is vertical.

   (b) If money demand does not depend on the interest rate, the LM curve is vertical.

   (c) If money demand does not depend on income, the LM curve is horizontal.

   (d) If money demand is extremely sensitive to the interest rate, the LM curve is horizontal.