

AFRICAN ECONOMIC RESEARCH CONSORTIUM
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MONETARY THEORY AND PRACTICE II TEST 2

Guide to Answers

Q1. (a) Internal Balance

This is equilibrium in the product and money markets such that there is

- (i) Full employment
- (ii) Price stability

External Balance

This refers to a situation of equilibrium in the foreign sector, i.e. the balance of payments is in equilibrium:

$$B = X - IM + F = 0$$

(b) Derive the slopes of the 2 curves as done in class.

But one can justify the slopes heuristically: all points above the EB curve imply a higher R and, hence, a surplus (given increased competitiveness). And all points to the right of the IB imply inflation as they imply inflow of resources in the face of full employment.

c) First point out that there are automatic adjustment mechanisms working through income, price, wealth and banking liquidity effects that work to restore balance in the BOP. They need reinforcement. So, adjustment policy is needed.

Second, note that at D, there is external balance with unemployment. Third, the policy to be chosen is expansionary FISCAL POLICY.

Reasons

1. To reinforce the automatic mechanism so as to get rid of unemployment.
2. To fulfill both Tinbergen's Rule and Mundell's Policy Assignment Principle.

Q2. (a) The gist of the question is that the BOP is a monetary phenomenon. Hence,

$$M^D = M^S \Rightarrow \text{BOP Surplus}$$

$$M^D = M^S \Rightarrow \text{BOP Balance}$$

$$M^D = M^S \Rightarrow \text{BOP Deficit}$$

- Derive the model - refer to class notes.
- the MABP is applicable to any country but with severe limitations
- (b) MABP takes into account ONLY the monetary sector.
- Elasticities Approach (EA) takes into account only the real sector (in fact, only relative prices of exports and imports).
- If Marshall-Lerner condition does not obtain, the EA is rendered useless.
- Both attempt to explain BOP determination but with flaws.

Q3. Question testing the material in the handout given in class.

- Explain the adaptive expectation (AE) model.
- Explain the rational expectations (RE) model.
- Point out the assumption underlying each model.
- Point out the main shortcomings of the two models; i.e. a critique of the models.
- Present a reasoned choice of the model applicable to your country.

Note: In the entire discussion, reference must be made to inflation.

Q4. (a) Define “stylized facts”;

- Regularities observed in the history of economic growth.
- List the “facts” as presented in class or in Branson (1989).
- Discuss whether or not they are borne out by the Solow -Swan growth model:
 - Yes, except the labour growth rate.

- Can be resolved if one takes into account "efficient labour" (E) which grows at n plus a positive number, say λ .
 - Illustration expected, e.g. that for E, all the "facts" are borne out.
- (b) The testing is on the understanding of a monetary growth model. That is, if money is introduced in a Solow-Swan neoclassical type of model, what will happen to steady state magnitudes (y^* and k^*)?
- Discuss a simple model, e.g. where there is exogenous money supply.

Example:

$$y = -m(g-q) + (n/\lambda)k^*$$

where g = growth rate of money supply and q = inflation etc.

- neutrality $\Rightarrow g = q$
nonneutrality $\Rightarrow g \neq q$
- This result appears to agree with the static conclusions of Friedman (1968) as regards the role of money in an economy.
Explain this a little more.

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