Exam SØK 2009 fall 2016
Correcting guidlines
jr, 15/12/2016

Question 1

The introduction of the Euro was motivated partly by the need to control inflation.

a) Explain the incentive to surprise inflation and high equilibrium inflation.
b) Show how equilibrium inflation varies between countries because of differences in preferences and labor market structure.
c) Discuss how membership of the Euro can help solve the inflation problem of a country.

Question 2

Exchange rates vary over the business cycle. Analyze how a negative shift in the income level will influence the exchange rate.

Guidelines

The core answer to question 1 is covered by De Grauwe, Economics of Monetary Union, 11th ed, chapter 2.3, in particular figures 2.12 (question 1a), 2.13 (question 1b), and 2.14 (question 1c).

Question 2 requires the understanding of the simultaneous equilibrium of the money market and the foreign exchange market shown in figure 15.6 in Krugman, Ostfeld and Melitz, International Economics, 10th edition. The elements of this model must be explained – the foreign exchange market (figure 14.4) and the money market (figure 15.3). The effect of a positive shift of the income level in the money market is shown in figure 15.5, and for the simultaneous equilibrium in figure 17.6.

An extension of the analysis of question 2 could cover the separation of temporary and permanent shift and possible long term effects and/ or the use of the AA-DD model of figure 17.8. It should be noticed that you cannot study the negative income shock as an exogenous shift in the income level in figure 17.8 since the income level is an endogenous variable – in the AA-DD model you will need to assume some background shift in the demand curve such as in figure 17.12. Policy responses can be discussed in the AA-DD model.