Assignment 2
Due on: Wednesday, September 30

Points: 30

Note: Your work must be typed and returned in hard-copy format during class on the due date. You should work on this assignment as a team and submit one completed assignment for the team. The grade on the assignment will apply to each member of the team. I expect each member of the team to contribute productively towards completion of the assignment and follow UGA’s academic honesty policy. Any complaints/reports/evidence about free-riding off others’ work or violation of the university’s academic honesty policy will be taken seriously and reported to the Terry MBA office.

Question 1

(a) During World War II, both Germany and England had plans for a paper weapon: they each printed each other’s currency, with the intention of dropping large quantities by airplane. Why might this have been an effective weapon?

(b) In the country of Wiknam, the velocity of money is constant. Real GDP grows by 5 percent per year, the money stock grows by 14 percent per year, and the nominal interest rate is 11 percent. What is the real interest rate? [6+4=10]

Question 2

Answer the following questions, using the demand-supply model of the money market.

(a) Explain the effects of an open market purchase of government bonds by the Federal Reserve on short-term and long-term nominal interest rates. Explain your answer graphically and supplement it with a short, but clear explanation.

(b) What consequences might the above policy have on output and spending?

(c) Explain the effects of an increase in the velocity of money on short term nominal interest rates. As in part (a), use both a graphical illustration and a short intuitive explanation. [3+2+5=10]

Question 3

Suppose that the Central Bank of Timbuktu has announced that it will maintain a fixed exchange rate with respect to the US dollar. Answer the following two questions, given the above information.

(a) How should the Central Bank react when (i) foreign investors in Timbuktu suddenly start selling assets denominated in the local (Timbuktu) currency, and (ii) an unexpected discovery of an oil field increases the demand for investment in Timbuktu?

(b) Suppose that Timbuktu is in a deep recession and it becomes imperative for the Central Bank to stimulate economic activity. Is it possible for the Central Bank of Timbuktu to lower the domestic nominal interest rate to stimulate economic growth? Why or why not? [6+4=10]