

---

**Question 1: Economics****(40 points)**

Country A is a large economy that is facing stagnating economic activities and continuing falls in general prices (deflation). Its central bank has responded to the situation by reducing the official interest rates to close to zero and pumping even larger amounts of funds into the inter-bank market. It is expected that this policy will bring interest rates on the inter-bank market down to nearly zero, and that reserves held with the central bank will substantially increase and there will be excess reserve deposits. This kind of policy is referred to as "Quantitative Monetary Easing." At the same time, Country A's government will be working closely with the central bank to step up intervention in the foreign exchange markets so as to avoid any excessive appreciation of its currency and stave off any detrimental impact on the domestic economy due to a stronger home currency.

- a) Describe briefly the common instruments of monetary policy. (8 points)
- b) Answer the following questions about the effects of Quantitative Monetary Easing.
- b1) What would be the effect of Quantitative Monetary Easing (including intervention on the foreign exchange markets) on interest rates and exchange rates, vis-a-vis the situation where no Quantitative Monetary Easing was introduced? (6 points)
- b2) If Quantitative Monetary Easing has the effects intended by policy-makers, discuss the course by which these effects will materialize. Assume a closed economy which only consists of government companies, private-sector companies, and households. Several distinguishing features of country A's financial markets are as follows: the government has raised enormous funds in excess of GDP through short-term and long-term government securities; private-sector companies raise most of their funds from banks at floating interest rates; and households have net financial assets worth double the GDP, but half of them are in the form of bank deposits while stock holdings are low. (10 points)
- b3) State two unintended negative side-effects on the long-term economic activity from Quantitative Monetary Easing. Explain the course leading to these side effects (knowing that spending does not react strongly to the decline in income from household financial assets). Assume a closed economy which only consists of government, private-sector companies, and households. (8 points)
- c) Discuss the effects of Country A's monetary policy described above in this question in relation to foreign economies when domestic interest rates are already low. Assume that the Marshall-Lerner Condition holds true and recall that the economy is in a deflationary phase. (8 points)