

Final Exam
Economics 160B, Spring 2007

You will have 120 minutes to complete this exam. It is divided into 125 points. This exam has 5 pages.

Multiple Choice: (3 points each, 30 point total) Choose the best answer. Write answer on scantron.

- 1) The “twin deficits” hypothesis says that:
 - a) national saving must equal investment.
 - b) the financial account rises when saving rises.
 - c) the current account falls with a rise in government spending.
 - d) both a and c
 - 2) When the U.S. government pays a \$100 return on U.S. Treasury bills held by a Japanese citizen, it enters U.S. balance of payments accounts as:
 - a) \$100 debit in the current account.
 - b) \$100 credit in the current account.
 - c) \$100 debit in the financial account.
 - d) \$100 credit in the financial account.
 - 3) According to the “Monetary Approach” to exchange rates, which of the following could explain the appreciation of the euro relative to the dollar in recent years:
 - a) fall in European money demand
 - b) rise in U.S. income
 - c) rise in U.S. money supply
 - d) rise in U.S. money demand
 - 4) Under a fixed exchange rate regime, open market operations to raise the money supply will lead to _____ in the interest rate and _____ in the holdings of foreign reserves at the central bank.
 - a) a fall, a fall
 - b) no change, no change
 - c) a fall, no change
 - d) no change, a fall
 - 5) Suppose an open economy is experiencing a recession. If the value of the currency is high while the trade balance is low, which of the following shocks could explain that recession in the ISLM model?
 - a) rise in taxes
 - b) rise in money demand
 - c) fall in foreign demand for home goods
 - d) all of the above
 - 6) Under the Bretton Woods system of fixed exchange rates:
 - a) all countries pegged their currencies directly to gold.
 - b) The IMF made loans to promote growth in developing countries.
 - c) it was easy to maintain external balance.
 - d) the dollar was the main reserve currency.
 - 7) If a country lowers its trade balance \$100 this year to smooth consumption over a temporary shock to output, what must it do to the trade balance in all future years to satisfy the intertemporal budget constraint?
 - a) raise the trade balance \$100.
 - b) raise the trade balance more than \$100.
 - c) raise the trade balance less than \$100.
 - d) lower the trade balance \$100.
 - 8) What do the currency crises in Argentina in 2001-2 and Asia in 1997 have in common?
 - a) Severe recessions resulted
 - b) Banking systems were disrupted
 - c) IMF intervention
 - d) All of the above
 - 9) All of the following help explain why PPP does not hold well in the short run, except:
 - a) risk premium
 - b) sticky prices
 - c) nontraded goods
 - d) tariffs
 - 10) Which of the following would suggest that the United Kingdom (UK) would benefit on net by joining the European Monetary Union?
 - a) The UK trades more with the U.S. than Europe.
 - b) The UK economy tends to have recessions at the same time as France and Germany.
 - c) People in the UK tend not to move far away from their home towns
 - d) Most UK tax revenue is spent in the UK
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Question 1: Parity Conditions (20 points total, 5 points each part)

Suppose that the following conditions all hold: uncovered, covered and real interest rate parities, relative and absolute purchasing power parities. And suppose you have the following information:

- The nominal interest rate on 1-year British pound deposits is 2% (0.02).
- The nominal interest rate on 1-year European euro deposits is 12% (0.12).
- The forward exchange rate is 0.9 pound per euro.
- The expected inflation rate for the coming year in Europe is 10% (0.10)

For each of the following, compute a value using the information above. Show your work in each case and name which parity condition you are using.

- a) The current spot exchange rate (pound / euro)

- b) The expected future exchange rate for one year from now (pound / euro). Is the pound expected to appreciate or depreciate over the coming year?

- c) The expected inflation rate in Britain for the coming year.

- d) The real interest rate in Britain.

Question 2: IS-LM Model (30 points)

This question asks you to use the ISLM model to explain why a fixed exchange rate regime like the Gold Standard made the Great Depression worse for the United Kingdom in the 1930s than it would have been if the country had had a flexible exchange rate regime. Assume that the shock that caused the Great Depression was a temporary fall in investment demand.

- a) First, illustrate the effects of the fall in investment demand in a flexible exchange rate regime using IS-LM and the foreign exchange market graphs for the United Kingdom. Label axes and curves, and show curve shifts with arrows. Label the initial equilibrium point A, and the short-run equilibrium point B. Explain the reason for each curve shift briefly. (8 pts)

Record on your scantron what will happen to the following variables: (2 points each)

- MC#11:** output: a) fall b) rise c) no change d) ambiguous
MC#12: interest rate: a) fall b) rise c) no change d) ambiguous
MC#13: exchange rate (pound/\$): a) fall b) rise c) no change d) ambiguous
MC#14: trade balance: a) fall b) rise c) no change d) ambiguous

- b) Next, draw the IS-LM and foreign exchange graphs to illustrate the effects of this shock for the U.K. if it has a fixed exchange rate, as it did under the Gold Standard. Again Label axes and curves, and show curve shifts with arrows. Label the initial equilibrium point A, and the short-run equilibrium point C. Compare in a sentence or two how the effect on output compares to what you found in part a above. (6 points)

Record on your scantron what will happen to the following variables: (2 points each)

- MC#15:** interest rate: a) fall b) rise c) no change d) ambiguous
MC#16: trade balance: a) fall b) rise c) no change d) ambiguous

- c) Discuss in a couple sentences how this experience might have influence the United Kingdom's decisions during the EMS crisis of 1992. (4 points)

Question 3: Overshooting (25 points)

Suppose there is a permanent rise in the U.S. money supply. Discuss how this can give rise to overshooting in the exchange rate between the dollar and the Japanese yen (\$/yen), as requested below. (Make the usual assumptions: prices are sticky in the short run and flexible in the long run, and that uncovered interest rate parity holds. Assume for simplicity, unless told otherwise, the usual case in this model, where money demand is a function of the interest rate alone and not affected by income.)

a) (15 points) Illustrate in graphs of the U.S. money market and the foreign exchange market how this policy change affects the money and foreign exchange markets. Label your initial equilibrium point A, labor the short-run equilibrium point B, and your long-run equilibrium point C. (You can put short run and long run on the same graphs.) Label all axes, and indicate curve shifts with arrows. Explain the reason for each curve shift briefly.

b) (5 points) Using two time series diagrams, illustrate how the exchange rate ($E_{\$/yen}$) and U.S. interest rate change over time.

c) (5 points) Given our study of the macroeconomy using the ISLM model, we know that a rise in money supply can raise the level of output in an economy, and money demand can be affected by income. Discuss how this rise in output would affect the degree of exchange rate

overshooting you found above and why? Discuss what things would change in your diagram in part (a) above. (This question is a bit tricky.)

Question 4: Essay: Financial Globalization v. Capital Controls (20 points)

In a short essay of 2-3 paragraphs, compare the costs and benefits of financial market openness, where people are allowed to trade financial assets of various types and in various currencies with the rest of the world. First, explain the potential benefits from financial globalization. Next, explain why some countries forego these benefits and instead retain capital controls. Discuss the problems that financial openness created for Asian countries experiencing currency crisis in 1997. You can write on the bottom of this page, and on the back of the page if needed.