Student ID _____ Name _____ Section(TA) _____

Economics 160B, Spring 2011

You will have 120 minutes to complete this exam. It is divided into 150 points. This exam has 8 pages.
Test Form A: Please indicate on your scantron your test form version.

Multiple Choice: (2 points each, 44 point total) Choose the best answer. Write answer on scantron.

MC#1) According to asset approach to exchange rate determination, a temporary decrease in money supply will ___ the interest rate, and ___ the value of the home currency.
a. increase, depreciate
b. increase, appreciate
c. decrease, depreciate
d. decrease, appreciate

MC#2) Which one of the following can cause a rightward shift of the IS curve?
a) Increasing tax.
b) Fall in the interest rate.
c) Fall in output.
d) Increase in government expenditure.
e) None of the above.

MC#3) "Crowding out" is used to refer to:
a) The worsening of trade balance due to expansionary fiscal policy.
b) The ineffectiveness of fiscal policy under fixed exchange rate.
c) The increase in output when investment increases in Keynesian Cross.
d) The impact on total output when private saving decrease.
e) The loss of monetary autonomy when a country commits to fixed exchange rate.

MC#4) Which one of the following statement is WRONG about portfolio diversification?
a) Both income and consumption can be smoothed if there is no restriction on asset trading.
b) Diversifying the portfolio can effectively increase world income.
c) It does not help pooling the risk if the negative shock is global.
d) Portfolio diversification is a way to pool risk.
e) In practice, investors put most of their wealth in home country assets.

MC#5) What does the LRBC (long-run budget constraint) require for the U.S.?
a) Its trade balance is zero in each period.
b) Its current account is zero in each period.
c) Loans borrowed from the rest of the world must be paid off eventually.
d) The present value of national expenditure over time equals the present value of national income over time.
e) All of the above.

MC#6) Some economists estimated the devastating earthquake in March cost Japan $309 billion. Which one of the following is true according to consumption smoothing?
a) Japan's consumption should remain unchanged and borrow $309 b. from abroad.
b) Japan's consumption should decrease by $309 b. for the year and keep CA unchanged.
c) Japan's consumption should decrease by less than $309 b. and CA should remain unchanged.
d) Japan's consumption should decrease by less than $309 b. and current account should fall.
e) None of the above is true.

MC#7) When a country increases its money supply while committing itself to fixed exchange rate, which one of the following will increase in the short run?

(i) Interest Rate (ii) Exchange Rate(home/foreign) (iii) Output (iv) Government Expenditure

a) (ii) and (iii)
b) (i) and (iv)
c) (ii), (iii), and (iv)
d) Only (iv)
e) None of the above increases.

MC#8) Which one of the following is an impossible combination according to the Trilemma tradeoff?

a) Fixed exchange rate, no capital control, monetary policy autonomy.
b) Floating exchange rate, some capital control, monetary autonomy.
c) Pegged exchange rate, capital control, no monetary autonomy.
d) Floating exchange rate, no capital control, monetary autonomy.
e) All of the above are possible.

MC#9) Relative purchasing power party requires:

a) Real Exchange Rate = 1.
b) The price of a Big Mac is the same in New York as in Moscow.
c) Countries with a fixed exchange rate must have the same inflation rate
d) The nominal interest rates are the same in the U.S. and E.U.
e) None of the above is true.

MC#10) When interest rate increases, which one of the following is likely to happen in the Keynesian Cross (goods market)?

a) Consumption decreases.
b) Investment decreases.
c) Output decreases.
d) all of the above are true.
e) Just (b) and (c) are true.

MC#11) Which of the following statements is false about the IMF (International Monetary Fund)?

a. IMF lends currencies to a country with a temporary current account deficit.
b. IMF was established after WWI as an international institution to support the Gold Standard.
c. The IMF can impose conditions if a country borrows more than its quota.
d. During 1997 Asian financial crisis, countries like Korean and Thailand received IMF loans.

MC#12) A currency board___.

a. is responsible for maintaining a fixed exchange rate.
b. should use expansionary monetary policy in a recession.
c. buys domestic government bonds to increase money supply.
d. is required to hold sufficient reserves to back 100% of money base in the economy.
e. a and d.

MC#13) Which of the following is not true about the "twin deficit" hypothesis?

a. The current account falls with a rise in government spending.
b. U.S. government budget deficit and current account deficit did move in sync in 1980s, but not in recent years.
c. The financial account in the balance of payments rises when government saving rises (all else constant).
d. A government can finance its budget deficit by borrowing abroad.

MC#14) Which of the following may reduce the U.S. current account deficit?

a. President Obama's fiscal stimulus package
b. Subsidizing high-tech industries to promote more investment in high technology
c. Rise in oil prices
d. Dollar depreciation
e. All of the above

MC#15) When a British businessman buys a beach house in California using a bank account in the U.K., how will this be recorded in the U.S. balance of payment accounts?

a. Credit entry in the financial account and a debit entry in the financial account
b. Credit entry in the current account and a debit entry in the financial account
c. Two credit entries in the financial account
d. Credit entry in the current account and a credit entry in the financial account
e. Debit entry in the current account and a debit entry in the financial account

MC#16) The LM curve implies that when real income Y increases, which of the following statements about the real money market is true?

a. Nominal money supply must increase
b. Real money demand must increase
c. If real money supply does not change, then the nominal interest rate must increase to clear the money market
d. If real money supply does not change, then the nominal interest rate must decrease to clear the money market.

MC#17) The overshooting theory is useful for explaining:

a. High exchange rate volatility after the collapse of the Bretton Woods system
b. The worsening of the Great Depression under the Gold Standard
c. Excessive accumulation of reserves by some countries afraid of currency crises
d. Speculative attacks in the foreign exchange market
e. Recessions after currency crises.

MC#18) All of the following contributed to the Asian financial crisis of 1997 except:

a) Poor bank regulation.
b) Contagion across countries.
c) Excessive capital controls
d) IMF aid packages with conditions

MC#19) According to the monetary approach to exchange rates, if Nicaragua has higher inflation than Guatemala, then the relative value of the Nicaraguan currency should:

a) appreciate
b) depreciate
c) not change
d) not enough information

MC#20) If the U.K. has lower money growth and lower output growth than the euro area, then the monetary approach to exchange rates says the value of the British pound should

a) appreciate
b) depreciate
c) not change
d) not enough information

MC#21) Which of the following can cause a currency crisis:
a) a shift in investor expectations
b) external imbalance
c) contagion
d) all of the above

MC#22) Which of the following is <u>not</u> a benefit of financial globalization?
a) Current account balance
b) Efficient investment
c) Consumption smoothing
d) Risk sharing

<u>Question 1:</u> Parity Conditions (12 points total, 2 points each item)

Suppose that the following conditions all hold: uncovered interest rate parity (UIP), covered interest rate parity (CIP), real interest rate parity (RIP), absolute purchasing power parity (PPP) and relative purchasing power parity (relative PPP). 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 3% (0.03).
- The forward exchange rate is 0.99 pound per euro.
- The expected inflation rate for the coming year in Europe is 1% (0.01)

For each of the following, compute a value using the information above.

The current spot exchange rate (pound per euro)
MC#23) a) -1 b) 0.01 c) 0.02 d) 1 e) none of the above

The expected future exchange rate for one year from now (pound per euro).
MC#24) a) .98 b) .99 c) 1 d) 1.01 e) none of the above

The expected inflation rate in Britain for the coming year.
MC#25) a) -0.02 b) 0 c) .01 d) .02 e) none of the above

The real interest rate in Europe.
MC#26) a) -0.02 b) 0 c) .01 d) .02 e) none of the above

The real interest rate in Britain.
MC#27) a) -0.02 b) 0 c) .01 d) .02 e) none of the above

The real exchange rate (UK / EU).
MC#28) a) .98 b) .99 c) 1 d) 1.01 e) none of the above

Question 2: IS-LM model in Open Economy: (26 points, 2 pts each item)

Use the IS-LM model to study the short-run implications of raising taxes to reduce the government budget deficit. Make the usual assumptions of the ISLM model: Consumption is just a function of disposable income with MPC<1; investment is just a function of the interest rate; for simplicity assume that the trade balance is only a function of the real exchange rate and not of income levels. Assume also that the U.S. has flexible exchange rates.

You may draw a graph to help you answer the question, but it is not required (and will not be graded).

What will the effect be on the following variables: (Mark on your scantron)

MC#29) Consumption:	a) rise	b) fall	c) no change	d) ambiguous
MC#30) Investment:	a) rise	b) fall	c) no change	d) ambiguous
MC#31) Trade balance:	a) rise	b) fall	c) no change	d) ambiguous
MC#32) Output:	a) rise	b) fall	c) no change	d) ambiguous
MC#33) Interest rate:	a) rise	b) fall	c) no change	d) ambiguous
MC#34) Exch. rate ($/euro):	a) rise	b) fall	c) no change	d) ambiguous
MC#35) Real money demand:	a) rise	b) fall	c) no change	d) ambiguous
MC#36) Private saving:	a) rise	b) fall	c) no change	d) ambiguous

Now instead suppose the U.S. had a fixed exchange rate, as under the Bretton Woods system. Then what would the tax increase have done to the following variables:

MC#37) Output:	a) rise	b) fall	c) no change	d) ambiguous
MC#38) Investment:	a) rise	b) fall	c) no change	d) ambiguous
MC#39) Trade Balance:	a) rise	b) fall	c) no change	d) ambiguous
MC#40) Real money demand:	a) rise	b) fall	c) no change	d) ambiguous
MC#41) U.S. Foreign exch. reserves:	a) rise	b) fall	c) no change	d) ambiguous

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Question 3: Currency Crises (20 points)

In 1992 France was hit by a speculative attack, in which there was a sudden fall in the expected future value of the French franc (rise in expected future franc/mark ratio), despite the fact that France was and remained committed to a fixed exchange rate pegged to the German mark. Draw IS-LM and Foreign Exchange market graphs to illustrate the short turn macroeconomic effects of this shock. Be sure to label all axes and curves, indicate curve shifts with an arrow, and make the initial equilibrium as point 1 and the short run equilibrium as point 2. Explain each curve shift briefly. (9 points)

What will the effect be on the following variables: (Mark on your scantron) (2 points each)

MC#42) Output:	a) rise	b) fall	c) no change	d) ambiguous
MC#43) Interest rate:	a) rise	b) fall	c) no change	d) ambiguous
MC#44) Foreign exchange reserves	a) rise	b) fall	c) no change	d) ambiguous
MC#45) Money supply:	a) rise	b) fall	c) no change	d) ambiguous

Discuss in a couple of sentences how such a speculative attack can be self-fulfilling. (3 points)

Question 4: Overshooting (24 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) (14 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) (6 points) Using two time series diagrams, illustrate how the exchange rate ($E_{\$/yen}$) and U.S. interest rate change over time.

c) (4 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 in the short run, 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 5: Essay: Optimal Currency Area Theory and the "California peso" (24 points)

California is suffering a recession worse than most of the rest of the country, and it also has a particularly large government debt. Some commentators have jokingly suggested that California would be better off if it withdrew for the U.S. dollar currency union and had its own currency, a California peso. In a paragraph describe how California might benefit from having its own currency, in terms of the recession and the government debt. In a second paragraph, describe features of the U.S. economy that allow it to respond to asymmetric shocks despite having a common currency.