Instructions:

This exam is being taken on the honor system! By taking it, you are committing to not cheating in any way.

Answer all questions. You have 80 minutes in total; watch your time carefully. Potential grades are proportional to time allocated. No supplementary materials are allowed (except dictionaries for non-native English speakers). Grades are proportional to suggested time allocated.

Please label your exam in the following way: on the front cover of your exam legibly print your first and last name clearly, as well as your student number; also record the number (but not your name!) in at least one other place inside your exam.

Brevity and clarity will be rewarded. Give examples where appropriate. Make your assumptions and diagrams clear and explicit. Bullet-point-form is acceptable.

If you do not understand what any instruction entails, PLEASE ASK!

Finally: 1) Enjoy, and 2) do well.

Part 1: Multiple Choice (8 minutes): Circle the correct answer

1  The idea that a country’s trade balance may first deteriorate after a currency devaluation and only later improve is known as the
   A. relative price effect.
   B. elasticity effect.
   C. pass through affect.
   D. J-Curve.

   Answer: D

2  Uncovered interest rate parity may not hold exactly due to
   A. a risk premium.
   B. a hedge adjustment.
   C. the inflation effect.
   D. an adjustment for nominal rather than real interest rates.

   Answer: A

3  Suppose the measure of real GDP in a given year is $8 billion. If we know that consumption spending was $5.5 billion, government spending was $1.5 billion, exports were $1 billion and imports were $1.2 billion, what was the value of investment spending in this year?
   A. –$0.2 billion
   B. $0.8 billion
   C. $1.2 billion
   D. $2.4 billion

   Answer: C
4 Suppose MPC = 0.6, MPS = 0.3 and MPIM = 0.1. A $1 billion increase in autonomous expenditure would lead to a $ ________ billion increase in equilibrium real income.

A. 10
B. 3.33
C. 2.5
D. 1

Answer: C

5 The quantity of real money balances supplied is determined by

A. the nominal interest rate.
B. the demand for real money balances.
C. real aggregate expenditures.
D. the nation’s Central Bank.

Answer: D

6 The size of trade flows relative to capital flows for a typical OECD country is

A. considerably larger.
B. roughly equal due to trade balances effects.
C. exactly equal due to double entry accounting.
D. quite minuscule.

Answer: D

7 A nation is running a current account deficit if

A. imports are less than exports and real income is less than absorption.
B. imports are less than exports and absorption is less than real income.
C. exports are less than imports and real income is less than absorption.
D. exports are less than imports and absorption is less than real income.

Answer: C

8 The spot yen / dollar exchange rate is currently in the

A. 100’s
B. 130’s
C. 150’s
D. 180’s

Answer: B

Part 2: Quick Answers (16 minutes)

1 Who is the president of the European Central Bank? _______________________

Answer: Wim Duisenberg

2 Name two small open floating countries in the German/European “sphere”:
   a) ____________________
   b) ____________________
Answers include: Sweden, UK, and Switzerland

3 Name two small fixed countries in the American “sphere”:
   a) ____________________
   b) ____________________

   Answers include: Hong Kong, China, Argentina (pre ‘01), and Mexico (pre ‘94)

4 The annual US current account is approximately _________________
   Answer: about $350 billion in deficit.

5 The “Marshall-Lerner” condition implies _________________
   _________________
   _________________
   _________________.

   Answer: It’s the assumption that the prices elasticities of import demand sum to a number of at least one. It implies that a real depreciation leads the current account to move into surplus.

6 “Covered Interest Parity” works well in the sense that _________________
   because _________________
   _________________
   _________________.

   Answer: CIP works well in the sense that deviations from it (the “covered differential”) are within a few basis points of zero (i.e., a few hundredths of one percentage point), because deviations from CIP constitute a riskless arbitrage opportunity.

7 Name two ways to hedge foreign exchange risk:
   1) _________________________________________________________________
   2) _________________________________________________________________

   Answer: Forward markets; future markets; options; and swaps.

8 Why does “political risk” exist? ____________________________________
   _________________________________________________________________
   _________________________________________________________________.

   Answer: While foreign exchange risk exists because there are different currencies, political risk exists because there are different countries that pose the threat of capital controls, expropriation, default and so forth.

Part 3: True, False or Uncertain? Justification determines grade. Provide your answer in the space provided (i.e., no more than one half of one sheet of paper) (56 minutes => 14 minutes each).

1 “Argentina’s current account is moving rapidly into surplus. Any reasonable person (i.e., no economist) can see that it’s going to pull them out of their recession soon.”

   U/F: The first part of the sentence is true (though it’s still in deficit currently); it would be foolish to dispute it. The question is: why?
   The topic is “exogeneity” (as promised). And don’t forget, we haven’t spent time on Argentina.
Ask yourself: “Why is the Argentine current account growing into surplus? Part of it is low investment and high savings, both a result of the poor state of the economy. It is reasonable to state that the causes of the Argentine soon-to-appear current account surplus are slow growth, tight fiscal policy (and high savings), and low investment (in turn caused by e.g., financial collapse and other such things associated with the current crisis). Since the collapse of the 1:1 peso:dollar link the real exchange rate has also depreciated, providing a further boost to net exports. Until something fundamental (“exogenous”) happens to change the growth prospects, the current account deficit can be expected to shrink and eventually turn into a surplus. Succinctly, the Argentine current account surplus is an endogenous reaction (as are all current accounts), and cannot be treated as an exogenous phenomenon.

2  “The dollar is grossly over-valued and therefore bound to depreciate.”

T/U: First, ensure that you’re referring to the American dollar (there are many others). On PPP grounds, the dollar does appear to be over-valued compared to a PPP norm (especially compared to e.g., Australia, Canada and the EMU). But PPP works only over longish period of time; the tendencies are weak in the short-term. (Hence the last statement is too strong at the very least.) Still, the US is running a large current account deficit, which also leads one to believe that the dollar will probably depreciate, and US fiscal policy is turning looser, which leads in the same direction. So it’s probably reasonable to believe this; still, predicting exchange rate changes over short periods of time is dangerous (recall the extreme volatility of floating exchange rates).

3  “The German recession is making Carlsberg (a Danish brewing company) nervous but Danish bar-owners happy.”

T: Denmark is a small open economy fixed to the euro (and previously the deutschemark). The German slowdown means that Danish exports (of e.g., Danish beer) are likely to fall (Y* falls from the point of view of Carlsberg); so the first part of the sentence is true. But the German slowdown makes it more likely that the ECB will lower Euro interest rates (since they fear a downturn in German economic activity). This will tend to lower interest rates for all the small open economies in the European periphery, including Denmark. As the exogenously given (to Denmark) euro interest rate falls, capital will tend to flow into Denmark, its reserves and monetary base will expand, leading to a right shift in the Danish LM curve and an expansion in Danish income. This is likely to make Danish pub-owners happy.

4  “When domestic and foreign bonds are perfect substitutes, a central bank should be indifferent about using domestic and foreign assets to implement monetary policy in a fixed exchange rate regime.”

F: Problem Set 5, Q#2  A central bank that is maintaining a fixed exchange rate will require an adequate buffer stock of foreign assets on hand during periods of persistent balance of payments deficits. If a central bank depletes its stock of foreign reserves, it is no longer able to keep its exchange rate from depreciating in response to pressures arising from the BoP deficit. If the central bank loses its ability to control the amount of reserves because the private demand for them exceeds its supply, it can no longer control the exchange rate. Thus, a central bank maintaining a fixed exchange rate is not completely indifferent about using domestic or foreign assets to implement monetary policy.