Advanced International Economics

ECON 758

Professor Yamin Ahmad

Final Exam
Name________________________ **Id # ________________________**

Instructions: There are two parts to this midterm. Part A consists of multiple choice questions. Please mark the answers to the multiple choice questions on the scantron sheet provided as well as indicating your answer on the exam paper.

Part A has 30 questions and is worth 60%.

Part B is worth 40% and consists of short answer questions**.**

Please Note:
In taking this exam, it should be implicitly understood that you should not discuss ANY part of the exam (including your answers) with other people. Please refer any clarification questions to me. Your answers here should reflect your knowledge of the content covered in lectures.

Please mark the answers to the multiple choice questions on the scantron sheet provided in class as well as indicating your answer on the exam paper.

Part A: MULTIPLE CHOICE. Choose the one alternative that best completes the statement or answers the question.

1) The official settlements balance or balance of payments is the sum of 1) ________

A) The current account balance and the capital account balance
B) The current account balance and the non reserve portion of the financial account balance
C) The current account balance, the capital account balance, the non reserve portion of the financial account balance
D) The current account balance, the capital account balance, the non reserve portion of the financial account balance, the statistical discrepancy
E) None of the above.

2) An American buys a Japanese car, paying by writing a check on an account with a bank in New York. How would this be accounted for in the balance of payments? 2) ________

A) Current account, a Japanese good import
B) Current account, a U.S. good import
C) Financial account, a U.S. asset import
D) Financial account, a U.S. asset export
E) Only B and D.

3) The earnings of a Spanish factory with British owners are 3) ________

A) are part of Spain's GNP
B) are part of Britain's GNP
C) are counted in Britain's GDP
D) counted in Spain's GDP
E) Only A and B.

4) If the dollar interest rate is 10 percent and the euro interest rate is 6 percent, and the expected return on dollar depreciation against the euro is eight percent, then 4) ________

A) An investor should invest only in dollars.
B) An investor should be indifferent between dollars and euros.
C) An investor should invest only in euros.
D) It is impossible to tell given the information.
E) All of the above.

5) Suppose that the one-year forward price of euros in terms of dollars is equal to $1.113 per euro. Further, assume that the spot exchange rate is $1.05 per euro, and the interest rate on dollar deposits is 10 percent and on euro it is 4 percent. Under these assumptions, 5) ________

A) Covered interest parity does hold.
B) Covered interest parity does not hold.
C) It is hard to tell whether covered interest parity does or does not hold.
D) Not enough information is given to answer the question.
E) None of the above.

6) How many British pounds would it cost to buy a pair of American designer jeans costing $45 if the exchange rate is 1.50 dollars per British pound? 6) ________

A) 20 British pounds
B) 25 British pounds
C) 35 British pounds
D) 30 British pounds
E) 10 British pounds

7) Which one of the following statements is the most accurate? 7) ________

A) A depreciation of a country's currency makes its goods cheaper.
B) A depreciation of a country's currency makes its goods cheaper for foreigners.
C) A depreciation of a country's currency makes its goods more expensive for foreigners.
D) A depreciation of a country's currency makes its goods cheaper for its own residents.
E) None of the above.

8) Which of the following statements is the most accurate? 8) ________

A) For a given U.S. interest rate and a given expectation with regards to the future exchange rate, a rise in the interest rate paid by euro deposits causes the dollar to appreciate.
B) A rise in the interest rate paid by euro deposits causes the dollar to depreciate.
C) For a given U.S. interest rate and a given expectation with regards to the future exchange rate, a rise in the interest rate paid by euro deposits causes the dollar to depreciate.
D) A rise in the interest rate paid by euro deposits does not affect the value of the dollar.
E) None of the above.

9) In the beginning of 2006, you pay $100 for a share of stock that pays you a dividend of $1 at the beginning of 2007. If the stock price rises from $100 to $109 per share over the year: 9) ________

A) Then you have earned a rate of 5 percent over 2006
B) Then you have earned a rate of 10 percent over 2006
C) Then you have earned a rate of 9 percent over 2006
D) Then you have earned a rate of 4 percent over 2006
E) Then you have earned a rate of 1 percent over 2006

10) If the goods' money prices do not change, a depreciation of the dollar against the pound 10) ________

A) Makes British sweaters more expensive in terms of American jeans
B) Makes American jeans more expensive in terms of British sweaters
C) Doesn't change the relative price of sweaters and jeans
D) Makes British sweaters cheaper in terms of American jeans
E) None of the above.

11) An increase in 11) ________

A) real output decreases the interest rate while a fall in real output increases the interest rate, given the price level.
B) nominal output raises the interest rate while a fall in real output lowers the interest rate, given the price level and the money supply.
C) real output raises the interest rate while a fall in real output lowers the interest rate, given the money supply.
D) real output raises the interest rate while a fall in real output lowers the interest rate, given the price level and the money supply.
E) nominal output raises the interest rate while a fall in real output lowers the interest rate, given the price level.

12) In the model without PPP, after a permanent increase in the money supply, 12) ________

A) The exchange rate overshoots in the short run.
B) The exchange rate smoothly appreciates in the short run.
C) The exchange rate overshoots in the long run.
D) The exchange rate smoothly depreciates in the short run.
E) None of the above.

13) Money includes 13) ________

A) Currency
B) Bank deposits on which check may be written
C) Both A and B.
D) Travelers checks
E) A, B and D.

14) For a given level of 14) ________

A) real GNP, changes in interest rates cause a decrease of the L(R,Y) schedule.
B) real GNP, changes in interest rates cause an increase of the L(R,Y) schedule.
C) nominal GNP, changes in interest rates cause an increase in the L(R,Y) schedule.
D) real GNP, changes in interest rates cause movements along the L(R,Y) schedule.
E) nominal GNP, changes in interest rates cause movements along the L(R,Y) schedule.

15) An increase in a country's money supply 15) ________

A) causes a more than proportional increase in its price level.
B) leaves its price level constant in long-run equilibrium.
C) causes a less than proportional increase in its price level.
D) causes a proportional increase in its price level.
E) None of the above.

16) The expected real interest rate (r^e) in terms of the nominal interest rate (R) and the expected inflation rate (π^e) is given by 16) ________

A) $r^e = R^2 - \pi^e$
B) $r^e = 2\pi^e + R^2$
C) $r^e = R - \pi^e$
D) $r^e = \pi^e + R$
E) $r^e = \pi^e + R^2$

17) The monetary approach makes the general prediction that 17) ________

A) The exchange rate, which is the relative price of American and European money, is fully determined in the short- and long run by the relative supplies of those monies and the relative demands for them
B) The exchange rate, which is the relative price of American and European money, is fully determined in the long run by the relative supplies of those monies.
C) The exchange rate, which is the relative price of American and European money, is fully determined in the short run by the relative supplies of those monies and the relative demands for them
D) The exchange rate, which is the relative price of American and European money, is fully determined in the long run by the relative supplies of those monies and the relative demands for them
E) None of the above statement is true.

18) Which of the following statements is the most accurate? In general, under the monetary approach to the exchange rate, 18) ________

A) While the short–run interest rate does not depend on the absolute *level* of the money supply, continuing *growth* in the money supply eventually will affect the interest rate.
B) The long–run interest rate does not depend on the absolute *level* of the money supply, and thus continuing *growth* in the money supply will not affect the interest rate.
C) While the long–run interest rate does depend on the absolute *level* of the money supply, continuing *growth* in the money supply do not affect the interest rate.
D) While the long–run interest rate does not depend on the absolute *level* of the money supply, continuing *growth* in the money supply eventually will affect the interest rate.
E) None of the above statement is true.

19) Under a flexible–price monetary approach to the exchange rate, 19) ________

A) When the domestic money supply falls, the price level would eventually fall, keeping the interest rate constant
B) When the domestic money supply falls, the price level would fall right away, causing a reduction in the interest rate.
C) When the domestic money supply falls, the price level would fall right away, keeping the interest rate constant
D) When the domestic money supply falls, the price level would eventually fall, increasing the interest rate.
E) When the domestic money supply falls, the price level would fall right away, causing an increase in the interest rate.

20) Which of the following statements is the most accurate? 20) ________

A) The law of one price applies to individual commodities while PPP applies to both the general price level and to individual commodities.
B) The law of one price applies to individual commodities while PPP applies to the general price level.
C) The law of one price applies to the general price level while PPP applies to individual commodities.
D) The law of one price applies only to the general price level.
E) PPP applies only to individual commodities.

21) Under the monetary approach to the exchange rate, 21) ________

A) A rise in the money supply will cause currency depreciation.
B) A rise in the money supply will cause depreciation.
C) A rise in the money supply will cause immediate currency depreciation.
D) A reduction in the money supply will cause immediate currency depreciation.
E) A rise in the money supply will cause immediate currency appreciation.

22) Interest rate differences between countries depend on 22) ________

A) differences in expected inflation, but not on expected changes in the real exchange rate
B) differences in expected changes in the real exchange rate, but not on expected inflation
C) differences in expected inflation and nothing else
D) differences in expected inflation, and on expected changes in the real exchange rate
E) neither differences in expected inflation, nor on expected changes in the real exchange rate

23) How does a rise in real income affect aggregate demand? 23) ________

A) Y ↑→ Yd ↑→Im ↑→CA ↑→AD ↑, and Y ↑→ Yd ↑→ C ↑→ AD ↑
B) Y ↑→ Yd ↑→Im ↓→CA ↓→AD ↓, but Y ↑→ Yd ↑→ C ↑→ AD ↑ by less
C) Y ↑→ Yd ↑→Im ↓→CA ↓→AD ↓, but Y ↑→ Yd ↑→ C ↑→ AD ↑ by more
D) Y ↑→ Yd ↑→Im ↑→CA ↓→AD ↓, but Y ↑→ Yd ↑→ C ↑→ AD ↑ by less
E) Y ↑→ Yd ↑→Im ↑→CA ↓→AD ↓, but Y ↑→ Yd ↑→ C ↑→ AD ↑ by more

24) The Marshall–Lerner Condition states that 24) ________

A) Import dependency reinforces the effects of depreciation on the current account.
B) Depreciation always has a favorable effect on the current account
C) High elasticity of exports is sufficient for the favorable effects of depreciation on the current account to be observed.
D) Depreciation has a favorable effect on the current account only if the sum of export and import elasticities is greater than one.
E) The sum of import and export elasticities must be equal to one in order for depreciation to occur.

25) If the economy starts in long–run equilibrium, a permanent fiscal expansion will cause 25) ________

A) An appreciation of the exchange rate, E
B) A depreciation of the exchange rate, E
C) Shifting of the AA curve up and to the right
D) A decrease in output, Y
E) An increase in output, Y

26) In the long–run equilibrium, after a permanent money–supply increase there follows: 26) ________

A) A depreciation in the exchange rate, E
B) An increase in output, Y
C) An appreciation of the exchange rate, E
D) A decrease in output, Y
E) Both B and D.

27) In the short run, with prices fixed, how would an increase in government spending affect the DD–AA schedule? 27) ________

A) It will increase output and appreciate the currency.
B) It will decrease output and depreciate the currency.
C) It will increase output and depreciate the currency.
D) It will decrease output and appreciate the currency.
E) None of the above.

28) If the representative basket of European goods and services costs 40 euros, the representative U.S. basket costs $50, and the dollar/euro exchange rate is $0.90 per euro, then the price of the European basket in terms of U.S. basket is 28) ________

A) [(40 euro per a European basket)]/[(50 $/U.S. basket)x(0.9 $/euro)]
B) [(50 $/U.S. basket)]
C) [(50 $ U.S. basket)x(40 euro per a European basket)]/[(0.9 $/euro)]
D) [(0.9 $/euro)x(40 euro per a European basket)]/[(50 $/U.S. basket)]
E) [(0.9 $/euro)x(50 $/U.S. basket)]/[(40 euro per a European basket)]

29) The DD schedule shows all combinations of which 2 variables so that the output market is in equilibrium? 29) _______

A) Output and exports.
B) Imports and exports.
C) Foreign prices and the exchange rate.
D) Output and the exchange rate.
E) Exports and the exchange rate.

30) Imagine that the economy is at a point on the DD–AA schedule that is above both AA and DD, where both the output and asset markets are out of equilibrium. Which first action is true: 30) _______

A) The exchange rate will first drop to a point on the AA schedule.
B) The economy will stay at this level in the short run.
C) The exchange rate will first move to a point on the DD schedule.
D) The AA–DD equilibrium will shift to the position of the economy.
E) None of the above.

Part B: SHORT ANSWER QUESTIONS (40%)

Please answer the following short answer questions. **For essay type questions, please keep your answers for each question to a length of one page.** Points are awarded for the succinctness, consistency and clarity of your answer. **You will not get points for verbosity.** Feel free to use graphs (as they apply) to help elucidate your answer. Show any calculations as necessary in answering the questions.

31. (10%) Use the table below to answer the following question.

	CLOSE	CHANGE	3 months
i. British Pound (**in** U.S. Dollars)	2.02915	-0.00010	2.02147
ii. Japanese Yen (**per** U.S. Dollar)	110.965	+0.07	109.795
iii. Euro (**per** U.S. Dollar)	0.68425	+0.0002	0.68341

"CLOSE" is the spot rate that prevails after "CHANGE," which is the change on the previous day's close. "Three Months" is a 3-month forward rate. This method of reporting exchange rates frequently appears in some business publications. For each of the currencies above:

a. [3 pts] Indicate whether it appreciated or depreciated on the spot market that day.

b. [4 pts] Determine the change that day in the dollar value of 5 million units of local currency.

c. [3 pts] Indicate whether the currency is at a forward premium or forward discount.

32. (10 %)

a. [4 pts] Suppose that a bank in London is currently quoting 8.5% on 12-month Eurodollar deposits (dollar deposits held in non-US banks). The same bank is quoting $1.60 **per euro** and $1.645 **per euro** for the spot and 12-month forward rate respectively. If a customer asks the bank for a quote on euro deposits, what interest rate should the bank quote? [You should write your answer in percentage terms to 2 decimal point, e.g. 48.24%]

b. [4 pts] Assume that forward rate quoted above represents the exchange rate that market participants are expecting to occur 12 months now, i.e. it is the expected future exchange rate one year from now. Suppose that the interest rate on euro deposits changes to 6%. In the space below, draw a graph to show what happens to the spot dollar-euro exchange rate and to interest rates in the United States as a result of this change. [Note: I am interested in the movements here as opposed to the actual value that they end up at].

c. [2 pt] What are the implications for the money market in the United States? What happens to the quantity of real money balances as a result?

33. (10 %) Consider the table below which contains information on interest rates, inflation rates, along with a spot exchange rate for the US dollar and the British Pound Sterling.

US Interest Rate	UK Interest Rate	Current Spot $/£ Rate	US Inflation Rate	UK Inflation Rate
4.5%	5.75%	2.029	3.54%	2.1%

Sources: Board of Governors of the Federal Reserve System; Bank of England (12/5/07)

a. (3 pts) Using the information in the table above, determine the expected future dollar-sterling rate that would be predicted by Uncovered Interest Rate Parity (UIP). What do market participants expect to happen to the dollar over time, based on UIP?

b. (3 pts) Using the information in the table above, determine the expected future spot rate that would be predicted through Purchasing Power Parity. [Hint: think about which version of PPP might help you answer this question!] What would participants forming their expectations based on PPP expect to happen to the dollar over time?

c. (4 pts) Using one of the models of exchange rate determination that we have studied, reconcile these two views.

34. (10 %) Suppose that a country was in a recession and at the same time depended heavily on its exports sector (as was the case of Japan for most of the past 15 years). It is important to the government that GDP be raised without harming exports. You are hired as a policy consultant for this country. What combination of fiscal and/or monetary policy (you must discuss both) would you recommend to that government? Use the AA-DD model [or the IS-LM model if we manage to finish it in class] to justify your recommendations.