Mini-Mock Final Exam

June 12, 2003

Time: **40 minutes (if this were a midterm)**
Total score: **40 points (if this were a midterm)**

1 Price-Specie-Flow Mechanism and the 'Rules of the Game' Revisited: 10 minutes

Consider a country on the Gold Standard. The country experiences a positive demand shock for its export goods. Will this shock result in an incipient current account surplus or deficit? [*Hint:* Consider only the current account by itself. Do not consider short-term equilibrium yet.] If the country's central bank plays by the rules of the game, what monetary policy does it have to pursue?

Suppose prices are *flexible*. Does real money supply change?

Use a diagram that shows the nominal exchange rate, output and the current account target to analyze the output and current account response in the *long term*.

2 Optimum Currency Areas: 10 minutes

A country has N regions and neither labor nor capital move between them. Suppose prices and wages are unrealistically sticky so that nominal price and wage levels can prevail for decades. Exchange rates are flexible, however, when introduced. Considering gains and losses from a currency union, how many currencies should the country have: 1, N, or some intermediate number?

3 Self-fulfilling Currency Attack: 10 minutes

Consider the following attack game (with foreign and domestic asset holdings such that $W^{\mathrm{CB}} < B^{\mathrm{CB}}$). There is a number J of investors who all own one unit of currency. In the case of a defense, the central bank incurs losses of R per attacking investor to whom it has to sell $(1/\bar{E}$ units of) foreign reserves.

<div align="center">Central Bank</div>

Investor i	*Defend* ($\Delta E = 0$)		*Devalue* ($\Delta E > 0$)	
Attack	$-c$		$\Delta E - c$	
		$-R \cdot (I+1)$		$\Delta E(W^{\mathrm{CB}} - B^{\mathrm{CB}})$
Hold	0		$-\Delta E$	
		0		$\Delta E(W^{\mathrm{CB}} - B^{\mathrm{CB}})$

Investor i and the central bank anticipate that I other investors will attempt to attack.

Show that a successful attack is an equilibrium for every investor i if there is a large number I of other attacking investors. Also show that a no-attack-no-devaluation equilibrium exists.

Why is $\Delta E > 0$ in a self-fulfilling crisis but not in a fundamentals-driven crisis?

4 Monetary Shocks and Exchange Rate Regime: 10 minutes

Suppose an economy with a large and unstable government sector has a sound monetary system. The economy suffers frequent fiscal but hardly any monetary shocks. The country wants to choose an exchange rate regime that stabilizes output and employment. What exchange rate regime would you recommend and why? You may make your case without a graph.