Economics 103 — Spring 2003

International Monetary Relations

Mini-Mock Midterm Exam

April 24, 2003

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

1 Current Account Imbalance under the Gold Standard: 10 minutes

Suppose an international gold standard is in place and a country faces a temporary current account deficit. If the country has no outstanding debt or credit with the rest of the world, is it becoming a net borrower or a net lender in the short term? Explain how the Price-Specie-Flow mechanism will ultimately restore a balanced current account.

2 Changes in Expectations and the Spot Exchange Rate: 10 minutes

Investors suddenly learn that the European Central Bank intends to lower the interest rate on euro deposits in the near future but not immediately. Use a suitable diagram to determine the effect on the *current* USD/EUR exchange rate. You may assume that present interest rates on dollar and euro deposits do not change and that expectations of the dollar interest rate are unaltered.

3 Permanent Drop in National Income: 10 minutes

Suppose there is a *permanent* drop in domestic GNP. Use a diagram (or diagrams) showing the exchange rate, the expected currency returns and money holdings to analyze the *long-term* effect on the USD interest rate and the nominal exchange rate.

4 Law of One Price: 10 minutes

The Law of One Price fails empirically. Briefly discuss three reasons that can explain why.