

NAME:

STUDENT ID:

Economics 103 — Spring 2003
International Monetary Relations
First Midterm Exam
April 29, 2003

Time: 80 minutes
Total score: 80 points

1 Current account: 10 minutes

Consider the GNP equation $Y = C + I + CA$ with the common definitions of macroeconomic variables. Show that the current account must satisfy $CA = S - I$.

Suppose a country suffers a temporary negative income shock. How do you expect the current account to respond right after the shock? You may consider investment as fixed, given some world-market interest rate. 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?

2 Current account imbalances: 10 minutes

Policy makers are concerned with current account imbalances. What are reasons to avoid excessive current account deficits *and* surpluses? Discuss both extremes briefly.

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3 Covered and Uncovered Interest Parity: 10 minutes

State the Uncovered Interest Parity condition and the Covered Interest Parity condition. Which variables differ between the two? Why is one condition called covered and the other uncovered? Which condition is more likely to fail and why? Answer briefly.

4 Uncovered Interest Parity: 10 minutes

Consider the three NAFTA countries Canada, Mexico and the USA. Interest rates in Canada and the USA are the same but the interest rate in Mexico is much higher. Use the Uncovered Interest Parity condition and show that the Mexican peso must *depreciate* against the US dollar and the Canadian dollar *at the same rate*.

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5 Changes in Expectations and the Exchange Rate: 10 minutes

Investors suddenly learn that the Federal Reserve Board intends to increase money supply by a fixed amount 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 euro interest rate are unaltered.

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6 Permanent Reduction in Money Demand: 10 minutes

Suppose there is a *permanent* increase in aggregate *demand* for money. Use a diagram showing the exchange rate, the expected currency returns and money holdings to analyze the *short-term* effect on the USD interest rate and the nominal exchange rate if prices are sticky. What is the effect under flexible prices?

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7 Overshooting: 10 minutes

Can there be exchange rate overshooting if prices are fully flexible? Discuss briefly, considering nominal money supply and real money demand shocks.

[*Hints:* You may find it useful to state the condition for money market equilibrium. You may but need not illustrate your argument with a suitable diagram.]

8 Real Exchange Rate: 10 minutes

State the Law of One Price and Purchasing Power Parity (PPP). You may state PPP either in its absolute or its relative form. Explain why the Law of One Price implies that the PPP condition you stated must hold.