Economics 103 — Spring 2003

International Monetary Relations

Mini-Mock Midterm Exam

May 20, 2003

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

1 Export Demand Shock under a Floating Exchange Rate: 10 minutes

An economy with a floating exchange rate suffers a negative demand shock for its export goods. What effect does this have on the current account and aggregate demand in *short-term* equilibrium? Use a diagram that shows the nominal exchange rate, output and some current account target. [*Hint:* The exchange rate response in short-term *equilibrium* may cause a current account balance that is different from the initial current account response.]

Use the diagram to analyze how a *temporary* monetary intervention can restore the output level. Does the policy have to be contractionary or expansionary? Does the current account attain its target level? Answer briefly.

2 Monetary Shock under a Floating Exchange Rate Regime: 10 minutes

Show the effect of a negative monetary shock on the current account, interest rates and output under a floating exchange rate. Use a diagram that shows the nominal exchange rate and output. Distinguish between the *short-term* and the *long-term* equilibrium. Does it matter whether the negative monetary shock is *temporary* or permanent? Answer briefly.

3 Balanced-budget Rules and Stabilization Policy under Floating Exchange Rates: 10 minutes

Suppose the government of a country under a floating exchange rate regime wants to pursue a *temporary* fiscal expansion. However, the government's budget has to be balanced. So, both spending and taxes need to increase so that $\Delta G = \Delta T$. How large is the net effect on the economy? [*Hint:* The net effect is positive.]

Use a diagram that shows the nominal exchange rate, output and some current account target. What is the effect of this policy on the exchange rate, output and the current account? Would a *permanent* expansion be effective? Answer briefly.

4 Current Account Targeting: 10 minutes

Suppose a country under a floating exchange rate regime needs to raise its current account balance to meet foreign lenders' concerns. Use a diagram that shows the nominal exchange rate, output and the current account target to analyze how the change in the target level alters the country's perspective on the current equilibrium.

Propose a *temporary* fiscal policy and show how it could achieve the current account target in the short run. Would a *permanent* fiscal policy be effective?