Name: Student ID:

Economics 103 — Spring 2003

International Monetary Relations

Second Midterm Exam

May 20, 2003

Time: **80 minutes**
Total score: **80 points**

1 Open-economy Trilemma: 10 minutes

The open-economy trilemma states that a country can only achieve two out of the following three objectives simultaneously: International capital mobility, monetary autonomy, and stable exchange rates. Give an example of how one objective has to be sacrificed in exchange for two other objectives. Explain briefly how, in your example, the sacrificed objective would conflict with the other two objectives.

2 Fiscal Expansion under a Floating Exchange Rate Regime: 10 minutes

Show the effect of a *temporary* tax cut on the current account and output under a floating exchange rate. Use a diagram that depicts the nominal exchange rate, output and some current account target. Suppose prices are sticky initially.

3 Monetary Shocks under a Fixed Exchange Rate Regime: 10 minutes

Show the effect of a *temporary* negative monetary shock on the current account and output under a fixed exchange rate. Use a diagram that depicts the fixed nominal exchange rate, output and some current account target, and suppose the central bank did not anticipate the shock but can respond immediately.

4 Monetary Policy and Imperfect Asset Substitutability: 10 minutes

Assume domestic and foreign assets are *imperfect* substitutes. So, the *relative risk premium* on domestic asset holdings is not zero. Write down the Adjusted Uncovered Interest Parity condition under this assumption.

The central bank wants to pursue a sterilized monetary expansion to reduce the interest rate, while keeping the exchange rate at a given level. Is such a policy feasible? You may answer briefly and need not use a diagram.

5 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 *permanent* monetary policy and show, in the diagram, how it could achieve the current account target in the *short run*.

Would a *permanent* fiscal policy be effective? You may answer briefly in words, without using the diagram.

6 Reserve Effect of a Devaluation: 10 minutes

Central banks under fixed exchange rate regimes typically gain reserves in the course of a one-time devaluation. Use a diagram showing the exchange rate, expected currency returns and real money holdings and verify, in the diagram, how this effect comes about. [*Hint:* You may suppose that prices are flexible and that the central bank's monetary intervention mainly involves foreign asset transactions.]

Would the central bank also experience a reserve gain if investors expected a further devaluation very soon? You may answer briefly in words, without using the diagram.

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

Consider a country on the Gold Standard. The country experiences a negative 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*.

8 Mirage of Fixed Exchange Rates: 10 minutes

"Fixed exchange rates are infeasible to sustain because hardly any central bank has the currency reserves to counter the volume of capital in private hands that may move against its currency." This is a misperception and you are asked to show why.

Suppose a central bank has no foreign currency reserves at all to intervene in the foreign exchange market. However, it holds domestic assets, which can be used for domestic money market interventions. Apply a diagram showing the nominal exchange rate, expected currency returns and real money holdings to analyze a defense strategy for the central bank. Suppose the trigger of the attack is a monetary shock to the exchange rate, comparable to an increase in the foreign interest rate.

Why do you think central banks are reluctant to pursue strong defense strategies like this in practice? Explain briefly in words.