NAME: STUDENT ID:

Economics 103 — Spring 2005

International Monetary Relations

Second Midterm Exam

May 17, 2005

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

1 Open Economy Trilemma: 10 minutes

The Open-Economy Trilemma relates three macroeconomic objectives to each other. State the thee objectives. For each of the three policy objectives, give a period in history where this objective was sacrificed.

2 Macroeconomic Diagnosis: 10 minutes

Suppose a country's economic analysts observe a sudden drop in international demand for domestic exports. The country's monetary authorities are legally obliged to maintain a fixed exchange rate. What is the effect on the home economy? Use an AA-DD diagram to illustrate the effect. What can policymakers do to restore equilibrium?

3 Effectiveness of Economic Policies: 10 minutes

Discuss briefly the effectiveness or ineffectiveness of *temporary* monetary expansions and *temporary* fiscal expansions for output changes under a floating exchange rate. Use diagrams to support your discussion.

4 Revaluation: 10 minutes

China is under international pressure to revalue its fixed currency to an appreciated new peg. Use an AA-DD-XX diagram to show the short-run effect of a *permanent* currency revaluation on output and the current account when prices are sticky.

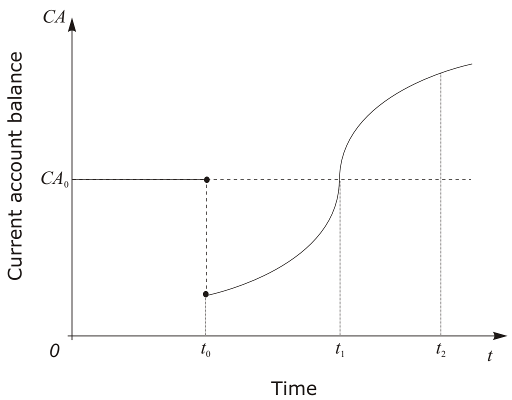
5 Sterilized Intervention: 10 minutes

Foreign bonds and domestic bonds are imperfect substitutes. Write down the Adjusted Uncovered Interest Parity condition. What does the risk premium ρ depend upon and with what sign?

Suppose the home central bank conducts a *temporary* sterilized purchase of foreign assets. Use an AA-DD-XX diagram to show how the nominal exchange rate, output, and the current account react under imperfect asset substitutability.

6 The J-Curve and the DD Schedule: 10 minutes

Consider a current account response over time as depicted.



- Does the volume effect or value effect dominate at t_0? What is the relationship between the real exchange rate and output at this point in time? Is the slope of the DD schedule positive or negative?

- Does the volume effect or value effect dominate at t_2? What is the relationship between the real exchange rate and output at this point in time? Is the slope of the DD schedule positive or negative?

7 Oil Price Shock: 10 minutes

The world economy suffers a *permanent* oil price shock, a permanent increase in the relative price of crude oil relative to all other goods and services.

- To start, suppose the resulting price inflation from the oil price shock is the same throughout the world and keep domestic and foreign monetary policies unchanged. How does the real exchange rate adjust? How does the nominal exchange rate adjust initially?
- State the domestic money market equilibrium condition. How is the domestic nominal interest rate affected? How is the differential between home and foreign nominal interest rates affected? How does domestic output respond if interest rates have no autonomous effect on output? Use an AA-DD-XX diagram to substantiate your answer.
- Now suppose that domestic output increases in response to lower nominal interest rates and falls in response to higher interest rates. How are domestic output and the domestic current account affected by the oil price shock? Use the same AA-DD-XX diagram to depict your answer. Does the response resemble more the recent current account and exchange rate experience of China or that of the U.S.?

8 Facts and Fallacies: 10 minutes

State whether the following statements are true or false. Provide a brief explanation.

- A permanent nominal monetary expansion can only lead to an output response if the exchange rate overshoots simultaneously.
- If assets are perfect substitutes, it is irrelevant whether central banks intervene in the open market with domestic or foreign assets.