Multiple choice: Choose the best answer. (3 points each, 24 points total)

Please record your multiple choice answers here:

1____ 2____ 3____ 4____ 5____ 6____ 7____ 8____

1) If a U.S. car manufacturer purchases steering wheels from a Mexican company, using a bank account in Mexico, this will enter the U.S. balance of payments accounts as a ____ in the current account and a ____ in the financial account.
   a) credit, credit  
   b) credit, debit  
   c) debit, credit  
   d) debit, debit

2) The covered interest rate parity condition (CIP) differs from the uncovered form (UIP) in that
   a) it involves the forward exchange rate
   b) it is subject to exchange rate risk
   c) it holds less well in actual data
   d) all of the above

3) For an open economy, it must be that
   a) national saving equals investment
   b) the financial account equals saving
   c) current account equals saving minus investment
   d) current account equals financial account minus capital account

4) All of the following contribute to failures in the law of one price and purchasing power parity except:
   a) transportation costs
   b) arbitrage
   c) sticky prices
   d) trade barriers

5) According to the monetary approach to exchange rates, if there is a permanent rise in money supply in the U.S., then the U.S. price level should ____ and the $/euro exchange rate should ____ in the long run.
   a) fall, fall.
   b) fall, rise
   c) rise, fall
   d) rise, rise
   e) not change, not change

6) According to the asset approach to exchange rates, a temporary fall in the domestic interest rate should lead to a ____ in the current spot exchange rate (home currency per foreign).
   a) rise
   b) fall
   c) not change
   d) impossible to tell

7) According to the trilema, if Peru has no capital controls, then it can have
   a) monetary policy autonomy
   b) a fixed exchange rate
   c) none of the above
   d) both a and b
   e) either a or b, but not both

8) According to the long-run budget constraint of the U.S., a U.S. current account deficit this year implies (assuming no valuation effects at work):
   a) a rise in national external wealth.
   b) the need for trade surpluses in the future.
   c) a financial account deficit.
   d) all of the above.
**Problem 1: Interest Rate and Purchasing Power Parities** (15 points total, 5 points each)

Suppose that the following conditions all hold: uncovered, covered and real interest rate parities, relative and absolute purchasing power parity. And suppose you have the following information:
- Inflation is expected to be 3 percentage points higher in Mexico than the U.S. during the next year.
- The nominal interest rate on 1-year U.S. dollar deposits is 2%.
- The U.S government has promised to keep the U.S. real interest rate at a level of 1%.

For each of the following, compute a value using the information above, or state if there is not enough information to compute an answer. Show your work in each case and name which parity conditions you are using.

a) The percentage expected change in the spot exchange rate ($/peso) over the next year. Is the peso expected to rise in value or fall?

b) The Mexican nominal interest rate

c) The Mexican real interest rate

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**Problem 2: The Asset Approach and Exchange Rate Overshooting** (28 points)

This question considers the relationship between the British pound (£) and the U.S. dollar ($). Let the exchange rate be defined as U.S. dollars per pound $E_{£/£}$. Suppose that with financial innovation in the U.S., real money demand in the U.S. increases permanently, but U.S. nominal money supply remains unchanged. (Make the usual assumptions: prices are sticky in the short run and flexible in the long run, and that uncovered and covered interest rate parity hold.)
a) (16 points) Illustrate in graphs of the U.S. money market and the foreign exchange market how this change affects the money and foreign exchange markets. Label your initial equilibrium point A, label the short-run equilibrium point B, and your long-run equilibrium point C. (You can put short run and long run on the same graphs.) Label all axes, and indicate curve shifts with arrows. Explain the reason for each curve shift briefly.

b) (8 points) Using a time series diagram, illustrate how the exchange rate (E$/£), interest rate, and - REAL U.S. money supply change over time. Explain briefly what particular feature of the foreign exchange market this theory is useful for explaining.
c) (4 points) Now draw a time series diagram illustrating how the forward exchange rate changes over time. Discuss in a sentence or two the logic of how you figured this out.

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**Question 3: National income accounting and Balance of Payments** (15 points total, 3 points each part)

During the financial crisis and recession of 2008 the U.S. current account deficit was reduced somewhat (moved closer to current account balance). There were several other things going on during this time which are listed below. Using the national income and balance of payments accounting identity equations, state for each item below if it is a candidate explanation for why the current account deficit was reduced (moved closer to balance) or not, and explain your reasoning in a sentence or two:

a) fall in investment expenditure due to the recession

b) fall in taxes due to the stimulus package (assume no change in consumption)

c) rise in government spending due to the stimulus package

d) rise in saving due to low consumer confidence

e) Is it possible that the trade balance could worsen during the time that the current account was improving? Explain what might be going on.
**Question 4: Monetary approach to exchange rates** (16 points)

Use the monetary approach to exchange rates to explain and critique in a couple paragraphs the following two claims in an argument at a recent meeting of G20 government officials (explain the economic logic behind each position, using equations where appropriate, and conclude by discussion which position you agree with more):

*Chinese Premier: the U.S. policy of high money supply growth is exporting inflation to China and other countries, and is partly to blame for inflation in many other countries.*

*U.S. Finance Secretary: the real problem is that China and other countries fix their exchange rates to the dollar; if they let their currency float then U.S. inflation need not be a problem for other countries.*