Multiple Choice: Choose the best answer. (2 points each, 16 points total)

Please record your multiple choice answers here:

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

1) A U.S. current account deficit implies which of the following (assuming a zero capital account balance)
   a) financial account deficit
   b) falling external wealth of the U.S.
   c) saving equals investment
   d) all of the above

2) If you sell some corporate stocks to a German person, and you then use the proceeds to buy a Mercedes car, this will be recorded in the U.S. balance of payments as:
   a) a FA debit and a CA debit
   b) a FA debit and a CA credit
   c) a FA credit and a CA debit
   d) a FA credit and a CA credit

3) The “trilemma” states that if China wants a fixed exchange rate and an independent monetary policy, then it cannot have:
   a) international reserves
   b) free capital mobility
   c) unilateral transfers
   d) exchange rate stability

4) If Poland fixes its exchange rate to the euro, then if the European Central bank lowers the euro interest rate, what will happen to the holdings of euro reserves at the central bank of Poland? (assume capital mobility)
   a) rise
   b) fall
   c) no change
   d) not enough information

5) In the scenario of the preceding question, what will happen to the supply of money in circulation in Poland?
   a) rise
   b) fall
   c) not change
   d) not enough information

6) When did the U.S. peg its currency to gold?
   a) The Bretton Woods System of the mid 20th Century
   b) The Gold Standard of the late 19th Century
   c) Both of the above
   d) The U.S. never pegged its currency to gold.

7) A good thing about the Gold Standard System is
   a) It helps prevent recessions.
   b) It helps prevent unsustainable current account imbalances.
   c) It gives governments control over their money supplies.
   d) All of the above.

8) According to the Twin Deficits Hypothesis, which of the following could worsen the U.S. current account deficit?
   a) rise in private saving
   b) fall in investment.
   c) rise in taxes
   d) fall in government saving
**Question 1** (16 points)

The U.S. has been using an expansionary monetary policy for the last several years. Use the IS-LM model to study the effects of this policy (Make the usual IS-LM assumptions: consumption is a function of disposable income, investment is a function of the interest rate, and assume for simplicity that the trade balance is a function just of the real exchange rate (not incomes). The U.S. has a flexible exchange rate regime.)

a) (10 points) Draw the ISLM and foreign exchange market graphs to show the short-run effects of a rise in money supply. Label the starting equilibrium point A, and the short run equilibrium point B, label curves and axes.

State the direction of movement of the following variables (rise, fall, no change, not enough info):
output ____________, interest rate ____________, investment ____________, exchange rate (domestic currency per foreign) ____________, trade balance ____________.

b) (6 points) Explain briefly the economic reason why the ISLM theory thinks investment is a function of the interest rate.

In the recent experience of the U.S., investment does not seem to have changed in response to the monetary policy. Suppose we change our ISLM theory to assume that investment is a constant, not responding to anything. How would it affect the shape of the IS curve and the change in equilibrium output you found in part (a) above?
Question 2: (22 points)

Both the U.S. and Spain are considering using a tax increase to deal with large government budget deficits. But they are nervous that this could create a new recession. One big difference between the two countries is that while the U.S. has a flexible exchange rate, Spain is part of a fixed exchange rate regime. (Make the usual IS-LM assumptions: consumption is a function of disposable income, investment is a function of the interest rate, and assume for simplicity that the trade balance is a function just of the real exchange rate (not incomes)).

a) (9 points) Draw the ISLM and foreign exchange market graphs to show the short-run effects of a rise in taxes under a flexible exchange rate regime. Label the starting equilibrium point A, and the sort run equilibrium point B, label curves and axes.

State the direction of movement of the following variables (rise, fall, no change, not enough info): output _______, consumption _______, investment _______, trade balance ________.
b) (9 pts) Now suppose the country has a fixed exchange rate regime. Use the ISLM and foreign exchange market graphs to show how the tax rise would have affected the economy. Label the starting equilibrium point A, and the short run equilibrium point B, and label curves and axes.

State the direction of movement of the following variables (rise, fall, no change, not enough info):
output ____________, investment ____________, trade balance ____________,
central bank foreign reserves ________.

c) (4 points) Explain briefly which exchange rate regime makes it harder to balance the government budget in the current situation, given that people don’t like recessions, and why this is so.