Multiple Choice: (2 points each, 30 point total) Choose the best answer. Write answer on scantron.

MC#1) All of the following contributed to the Asian financial crisis of 1997 except:
   a) Lack of bank regulation.
   b) Contagion across countries.
   c) Excessive capital controls
   d) IMF aid packages with conditions

MC#2) If the U.K. has lower money growth and lower output growth than the euro area, then the monetary approach to exchange rates says the value of the British pound should
   a) appreciate
   b) depreciate
   c) not change
   d) not enough information

MC#3) What does the LRBC (long-run budget constraint) require for the U.S.?
   a) National expenditure must equal national income each period.
   b) A trade deficit one year must be balanced by a trade surplus in some future year.
   c) Saving equals investment each period.
   d) None of the above.

MC#4) A currency board
   a) is responsible for maintaining a fixed exchange rate.
   b) has no monetary policy independence.
   c) cannot run out of reserves in a speculative attack/currency crisis.
   d) all of the above.
   e) both a and b but not c

MC#5) Economists estimated the Japanese earthquake in 2011 cost Japan $300 billion. Which of the following is true according to consumption smoothing under the long run budget constraint?
   a) Japan’s consumption should remain unchanged and borrow $300 b. from abroad.
   b) Japan’s consumption should decrease by $300 b. for the year and keep CA unchanged.
   c) Japan’s consumption should decrease by less than $300 b. and CA should fall.
   d) Japan’s consumption should decrease by less than $300 b. and CA should remain unchanged.
   e) None of the above is true.

MC#6) Which one of the following is an impossible combination according to the Trilemma tradeoff?
   a) Fixed exchange rate, no capital controls, monetary policy autonomy.
   b) Floating exchange rate, some capital controls, monetary autonomy.
   c) Fixed exchange rate, capital controls, no monetary autonomy.
   d) Floating exchange rate, no capital controls, monetary autonomy.
   e) All of the above are possible.
MC#7) Relative purchasing power parity requires:
   a) Real Exchange Rate = 1.
   b) The price of a Big Mac is the same in New York as in Moscow.
   c) A country with a higher inflation rate should have a currency depreciating in value.
   d) The nominal interest rates are the same in the U.S. and E.U.

MC#8) Which of the following statements is false about the IMF (International Monetary Fund)?
   a) IMF lends currencies to a country with a temporary current account deficit.
   b) IMF was created with the goal of promoting development of poor countries.
   c) The IMF can impose conditions if a country borrows more than its quota.
   d) During 1997 Asian financial crisis, countries like Korea and Thailand received IMF loans.

MC#9) Which of the following would make it difficult for Greece to function well as part of the monetary union in Europe?
   a) low labor mobility.
   b) shocks that are symmetric.
   c) fiscal federalism has increased with recent bailouts.
   d) extensive trade integration with the rest of Europe.
   e) all of the above.

MC#10) Which of the following is not true about the “twin deficit” hypothesis?
   a) The current account falls with a rise in government spending.
   b) U.S. government budget deficit and current account deficit did move in sync in 1980s, but not in recent years.
   c) The financial account in the balance of payments rises when government saving rises (all else constant).
   d) A government can finance its budget deficit by borrowing abroad.

MC#11) According to the “Asset Approach” to exchange rates, which of the following could cause a fall in the $/euro exchange rate?
   a) a rise in U.S. interest rate
   b) a fall in European interest rate
   c) a fall in the expected future exchange rate
   d) all of the above

MC#12) When a British businessman buys a California wine company from a Californian, using a bank account in the U.K., how will this be recorded in the U.S. balance of payment accounts?
   a) Credit entry in the financial account and a debit entry in the financial account
   b) Credit entry in the current account and a debit entry in the financial account
   c) Two credit entries in the financial account
   d) Credit entry in the current account and a credit entry in the financial account
   e) Debit entry in the current account and a debit entry in the financial account

MC#13) The LM curve implies that when real income Y increases, which of the following statements about the real money market is true?
   a) Nominal money supply must increase
   b) Real money demand must increase
   c) If real money supply does not change, then the nominal interest rate must increase to clear the money market
   d) If real money supply does not change, then the nominal interest rate must decrease to clear the money market.
MC#14) The overshooting theory is useful for explaining:
   a) High exchange rate volatility after the collapse of the Bretton Woods system
   b) The worsening of the Great Depression under the Gold Standard
   c) Excessive accumulation of reserves by some countries afraid of currency crises
   d) Speculative attacks in the foreign exchange market
   e) Recessions after currency crises.

MC#15) The Gold Standard:
   a) Is followed by the U.S. today.
   b) Makes it difficult to maintain internal balance.
   c) Helps maintain external balance by allowing the nominal exchange rate to adjust.
   d) All of the above.

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**Question 1: Parity Conditions** (10 points total, 2 points each item)

Suppose that the following conditions all hold: uncovered interest rate parity (UIP), covered interest rate parity (CIP), real interest rate parity (RIP), absolute purchasing power parity (PPP) and relative purchasing power parity (relative PPP). And suppose you have the following information:
- The forward exchange rate between the British pound and the euro is 1.01 (pound per euro)
- The nominal interest rate on 1-year British pound deposits is 4% (0.04).
- The expected inflation rate for the coming year in Europe is 1% (0.01).
- The nominal interest rate on 1-year European euro deposits is 3% (0.03).

For each of the following, compute a value using the information above. Write on scantron.

The current spot exchange rate (pound per euro)
MC#16) a) 1.01 b) .98 c) .99 d) 1 e) none of the above

The expected future exchange rate for one year from now (pound per euro).
MC#17) a) 1.01 b) .98 c) .99 d) 1 e) none of the above

The expected inflation rate in Britain for the coming year.
MC#18) a) -0.02 b) 0.02 c) 0 d) 0.01 e) none of the above

The real interest rate in Europe.
MC#19) a) 0.04 b) -0.04 c) -0.02 d) 0.02 e) none of the above

The real interest rate in Britain.
MC#20) a) -0.01 b) -0.02 c) 0.02 d) 0.01 e) none of the above
**Question 2: IS-LM model in Open Economy:** (14 points total, 1 point each item)

Use the IS-LM model to study the short-run if the U.S. House of Representatives passes a tax cut. Make the usual assumptions of the ISLM model: Consumption is just a function of disposable income; investment is just a function of the interest rate; assume that the trade balance is a function both of the real exchange rate and income levels. Assume also that the U.S. has flexible exchange rates.

You may draw a graph to help yourself, but it is not required and will not be graded.

What will the effect be on the following: (Mark on your scantron)

<table>
<thead>
<tr>
<th>MC#21) IS curve shifts:</th>
<th>a) no shift</th>
<th>b) left</th>
<th>c) right</th>
<th>d) ambiguous</th>
</tr>
</thead>
<tbody>
<tr>
<td>MC#22) LM curve shifts:</td>
<td>a) no shift</td>
<td>b) left</td>
<td>c) right</td>
<td>d) ambiguous</td>
</tr>
<tr>
<td>MC#23) Output:</td>
<td>a) no change</td>
<td>b) fall</td>
<td>c) rise</td>
<td>d) ambiguous</td>
</tr>
<tr>
<td>MC#24) Interest rate:</td>
<td>a) no change</td>
<td>b) fall</td>
<td>c) rise</td>
<td>d) ambiguous</td>
</tr>
<tr>
<td>MC#25) Consumption:</td>
<td>a) no change</td>
<td>b) fall</td>
<td>c) rise</td>
<td>d) ambiguous</td>
</tr>
<tr>
<td>MC#26) Investment:</td>
<td>a) no change</td>
<td>b) fall</td>
<td>c) rise</td>
<td>d) ambiguous</td>
</tr>
<tr>
<td>MC#27) Trade balance:</td>
<td>a) no change</td>
<td>b) fall</td>
<td>c) rise</td>
<td>d) ambiguous</td>
</tr>
<tr>
<td>MC#28) Exch. rate ($/euro):</td>
<td>a) no change</td>
<td>b) fall</td>
<td>c) rise</td>
<td>d) ambiguous</td>
</tr>
<tr>
<td>MC#29) Real money demand:</td>
<td>a) no change</td>
<td>b) fall</td>
<td>c) rise</td>
<td>d) ambiguous</td>
</tr>
</tbody>
</table>

Now instead suppose the U.S. had a fixed exchange rate. Then what would the tax cut have done to the following variables:

| MC#30) Output:         | a) no change| b) fall| c) rise  | d) ambiguous |
| MC#31) Investment:     | a) no change| b) fall| c) rise  | d) ambiguous |
| MC#32) Trade Balance:  | a) no change| b) fall| c) rise  | d) ambiguous |
| MC#33) Real money demand: | a) no change| b) fall| c) rise  | d) ambiguous |
| MC#34) U.S. Foreign exch. reserves: | a) no change| b) fall| c) rise  | d) ambiguous |

**Question 3: More IS-LM:** (10 points total, 1 point each item)

Use the IS-LM model to study the short-run effect of a cut in money supply. Make the usual assumptions of the ISLM model: Consumption is just a function of disposable income; investment is just a function of the interest rate; assume that the trade balance is a function both of the real exchange rate and income levels. Assume also that the U.S. has flexible exchange rates.

You may draw a graph to help you answer the question, but it is not required (and will not be graded).
What will the effect be on the following: (Mark on your scantron)

MC#35) IS curve shifts:  
a) no shift  
b) left  
c) right  
d) ambiguous

MC#36) LM curve shifts:  
a) no shift  
b) left  
c) right  
d) ambiguous

MC#37) Output:  
a) no change  
b) fall  
c) rise  
d) ambiguous

MC#38) Interest rate:  
a) no change  
b) fall  
c) rise  
d) ambiguous

MC#39) Investment:  
a) no change  
b) fall  
c) rise  
d) ambiguous

MC#40) Exch. rate ($/euro):  
a) no change  
b) fall  
c) rise  
d) ambiguous

MC#41) Trade balance:  
a) no change  
b) fall  
c) rise  
d) ambiguous

Now instead suppose the U.S. fixed its exchange rate. In this case, if the U.S. undertakes an open market operation aimed at cutting the money supply, what effect would this policy have on the following variables in the short run equilibrium:

MC#42) Output:  
a) no change  
b) fall  
c) rise  
d) ambiguous

MC#43) Interest rate:  
a) no change  
b) fall  
c) rise  
d) ambiguous

MC#44) U.S. Foreign exch. reserves:  
a) no change  
b) fall  
c) rise  
d) ambiguous

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**Question 4: Currency Crises** (14 points)

In 1992 France was hit by a speculative attack, in which there was a sudden fall in the expected future value of the French franc (rise in expected future franc/mark ratio), despite the fact that France was and remained committed to a fixed exchange rate pegged to the German mark.

Draw IS-LM and Foreign Exchange market graphs for France to illustrate the short turn macroeconomic effects of this shock. Be sure to label all axes and curves, indicate curve shifts with an arrow, and make the initial equilibrium as point 1 and the short run equilibrium as point 2. Explain each curve shift briefly. (8 points)
What will the effect be on the following variables: (Mark on your scantron) (1 points each)
MC#45) Output: a) no change b) fall c) rise d) ambiguous
MC#46) Interest rate: a) no change b) fall c) rise d) ambiguous
MC#47) Foreign exchange reserves a) no change b) fall c) rise d) ambiguous
MC#48) Money supply: a) no change b) fall c) rise d) ambiguous

Discuss in a couple of sentences how such a speculative attack can be self-fulfilling. (2 points)

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**Question 5: Overshooting** (12 points)

Suppose there is a permanent rise in the U.S. money demand. Discuss how this can give rise to overshooting in the exchange rate between the dollar and the Japanese yen ($/yen), as requested below. (Make the usual assumptions: prices are sticky in the short run and flexible in the long run, and that uncovered interest rate parity holds. Assume for simplicity, unless told otherwise, the usual case in this model, where money demand is a function of the interest rate alone and not affected by income.)

a) (8 points) Using four time series diagrams, illustrate how the exchange rate ($/yen), U.S. interest rate, U.S. price level, and real exchange rate ($/yen \times \frac{P_{\text{Japan}}}{P_{\text{US}}}$) change over time. (You may draw money market and foreign exchange graphs to help, but they will not be graded.)
b) (4 points) Explain in a few sentences how your diagrams above illustrate the fact that the uncovered interest rate parity condition holds. (Note that the U.S. interest rate will equal the interest rate differential, since we assume the Japanese interest rate is constant.)

Question 6: Short Answer (10 points)

The following two claims were made in an actual argument at a recent meeting of G20 government officials. Do you agree with both of them, or only one of them, or none? Explain your answers in a paragraph or two, along with equations where appropriate. (Assume a long-run perspective to address this issue.)

*Chinese Premier:* the U.S. policy of extraordinarily high money supply growth in recent years is exporting inflation to China and many other countries, and is partly to blame for a rising problem of inflation in the developing world.

*U.S. Finance Secretary:* the real cause 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.