Part One

Answer whether the following statements are true or false. If you answer true, mark "A" in the answer sheet. Mark "B" otherwise. Note that you must use pencil no. 2 to answer questions in Part One. (1 point each)

1. According to the current account identity, government budget deficit is always identical to private savings net of investment.

2. When current account of a country has a positive sign, that country is accumulating foreign assets.

3. That the U.S. is a debtor country implies that Americans do not hold foreign assets.

4. Reducing the federal budget deficit will result in a reduction of the U.S. current account deficit.

5. Hong Kong has been maintaining fixed exchange rate policy at 7.8 Hong Kong dollar per 1 U.S. dollar. The uncovered interest parity then implies that Hong Kong interest rate must be equal to U.S. interest rate.

6. Based on the uncovered interest rate parity condition, output expansion has no effects on exchange rate because output has nothing to do with foreign exchange market.

7. Any announcement made by the Federal Reserve regarding future monetary policy is reflected in today exchange rate.

8. When U.S. interest rate exceeds European interest rate, there is positive forward discount on euro against dollar.
9. Country with high population growth experience exchange rate depreciation more than country with low population growth.

10. An announcement about future money expansion reduces the degree of exchange rate overshooting.

11. Exchange rate overshooting will occur even if money expansion is temporary as long as price is sticky.

12. A permanent money expansion creates exchange rate overshooting, while a permanent money contraction creates undershooting.

13. According to the monetary approach, a permanent rise in inflation causes exchange rate to depreciate.

14. According to the monetary approach, output demand expansion results in exchange rate appreciation.

15. The general theory of long run exchange rate determination assumes that real exchange rate fluctuates around unity.

16. According to the general theory of long run exchange rate determination, output demand expansion causes exchange rate to appreciate.

17. According to the aggregate demand theory, a fall of U.S. dollar causes the U.S. real exchange rate to appreciate. Therefore it will reduce the U.S. current account deficits.

18. According to the aggregate demand theory, money expansion increases output because it reduces interest rate and causes investment to expand.

19. According to the aggregate demand theory, an expansionary monetary policy and an expansionary fiscal policy both cause exchange rate to appreciate in the short run.

20. According to the aggregate demand theory, an expansionary monetary policy and an expansionary fiscal policy both cause output to expand in the short run. Therefore countries can use either policy to stimulate their economy without potential side effects.
Part Two

Answer the following questions and depict appropriate diagrams as required. (10 points)

Suppose the economy is at the full employment level today. Suppose the Bush administration announces that it will cut income tax next year and the tax cut will last for 5 years. Let us assume for now that government spending and money supply stay constant all the time.

- Explain the effects of such an announcement on today exchange rate using the AA-DD framework. Explain also the effects of the tax cut on exchange rate one year later. Depict the AA-DD diagram. (4 points)

- Suppose the Federal reserve reduces money supply 1 year before the removal of the tax cut, without any pre-announcement and the policy change is temporary. Explain the effects of this policy on output and exchange rate. Depict the money-market-and-foreign-exchange-market diagram. Also, depict the AA-DD diagram. Show the time path of exchange rate and interest rate. (6 points)