Part One

Answer whether the following statements are true or false.

**Chapter 12**

1. According to the current account identity, government budget is always balanced in a closed economy.

2. When balance of payments of a country has a negative sign, that country is borrowing from the rest of the world.

3. Industrialized countries are all creditor countries.

4. In order to correct the U.S. fiscal deficits, American firms have to export more to the rest of the world.

**Chapter 13**

5. The uncovered interest parity implies that Mexican peso deposit is as safe as U.S. dollar deposit.

6. Announcements of policy changes made by the Federal reserve are more important than the actual policy changes in determining exchange rate.

7. Forward exchange rate is a good indicator of future spot exchange rate.

8. When U.S. interest rate exceeds European interest rate, there is positive forward premium on euro against dollar.
Chapter 14

9. Credit cards make transactions convenient and therefore people do not need to hold a large amount of cash. Therefore credit cards reduce money demand.

10. One of the reasons that exchange rate exhibits high volatility is that good prices are sticky.

11. If prices are all flexible, there will not be exchange rate overshooting.

12. Exchange rate overshooting will not occur if output also responds to monetary policy changes.

Chapter 15

13. The relative purchasing power parity assumes that real exchange rate is constant.

14. According to the monetary approach, a permanent rise in nominal interest rate causes exchange rate to appreciate.

15. According to the general theory of long run exchange rate determination, nominal exchange rate depends on output demand and supply.

16. According to the general theory of long run exchange rate determination, a permanent rise in nominal interest rate causes exchange rate to appreciate.

Chapter 16

17. That Americans spent less on traveling to foreign countries in the past 12 months is consistent with the aggregate demand theory, given the decline of U.S. dollar.

18. The goal of monetary and fiscal policy in the short run is to increase output.

19. An expansionary monetary policy and an expansionary fiscal policy both causes exchange rate to appreciate.

20. We observe exchange rate depreciation in response to a contractionary fiscal policy.
Part Two

Answer the following questions. Depict appropriate diagrams as required. (In the midterm, you will see only one question.)

1. What does a positive or negative sign of current account balance mean? What is its implication on the direction of capital flows? Use the current account identity to explain how a nation will reduce its current account deficits.

2. What is Fischer effect? Explain the current upward trend in U.S. nominal interest rate in the context of Fischer effect? Explain how the upward trend in U.S. nominal interest rate will affect dollar-euro exchange rate? Will your answer change if the European Central Bank begins raising its interest rate too?

3. What is the Balassa-Samuelson effect? What is its implication on exchange rate of fast growing country such as China? If we are to apply the Balassa-Samuelson effect to the U.S. case, when will be the appropriate period in the history? (Hint: contrary to the popular belief, the U.S. was actually a developing country. When was it?)

4. Suppose the economy is at the full employment level today. Suppose the Federal reserve announces that it will increase money supply temporarily one month from now. Explain the effects of such an announcement on today exchange rate using the AA-DD framework. Explain also the effects of money supply expansion on exchange rate one month later. Write down the time path of money supply and exchange rate.