Part One

Answer whether the following statements are true or false. In the Final, you will see 40 true/false questions with 0.5 point each. In short, Part One will be worth 20 points. 20 percent comes from Chapters 12-16 and 80 percent from Chapters 17-18 and 20-22.

Chapters 12-16

1. According to current account identity, countries that face government budget deficit also have current account deficit.

2. Exchange rate overshooting arises because the foreign exchange market participants overreact to news.

3. China currently fixes its exchange rate with U.S. dollar. The purchasing power parity then implies that Chinese inflation rate is the same as that in the U.S.

4. According to the aggregate demand theory, increase in investment demand makes exchange rate appreciate.

Chapters 17-18 and 20-22

5. Fiscal policy is more effective with fixed exchange rate regime than with flexible exchange rate regime.

6. Under fixed exchange rate regime, appreciation pressure on exchange rate will result in capital inflows.
7. Sterilized intervention does not alter exchange rate because it does not change money supply and interest rate.

8. When a central bank purchase domestic bonds, the risk premium on the domestic bond rises.

9. Recently the U.S. budget deficit has expanded and been financed by new issues of treasury bills. The theory predicts that the risk premium on treasury bills will rise.

10. The money supply at the time of balance-of-payments crisis rises sharply because of the expansion of domestic credit.

11. The impossible trinity suggests that a central bank can prevent a balance-of-payments crisis by limiting the cross-border flows of capital.

12. According to the price-specie-flow mechanism, gold outflows will cause the price to fall.

13. The price-specie-flow mechanism is the unique mechanism of the gold standard and does not exist under the silver standard.

14. Returning to the gold standard after the World War I resulted in world wide deflation because the gold price in terms of U.S. dollar fell.

15. The optimal level of the current account cannot be achieved in the short run without an adjustment in exchange rate.

16. The European Union suffers with the N-1 Problem because Germany is the reserve currency country.

17. Before the emergence of the euro, the European Union fixed their exchange rate with German currency, the Mark. In that period, Germany did not suffer economic stability loss as much as other member countries.

18. Based on the theory of optimum currency area, Italy benefits from joining the euro zone more than Germany because it has higher inflation.

19. The euro zone should encourage free labor mobility to increase the gain from forming a currency union.

20. Adding new member countries to the euro zone will increase the gain from forming a currency union.
Part Two

Answer the following questions. Depict appropriate diagrams as required. In the Final, Part Two will be worth 20 points. You will see 4 essay questions with 5 points each.

1. Assume a fixed exchange rate policy, using the AA-DD model to explain the effects of import tariffs on output. How will your answer change if exchange rate is flexible? Show also the central bank’s balance sheet in each case.

2. Recently 10 eastern European countries joined the European Union. Explain how these new countries will affect the optimality of the currency area using the GG-LL framework. What are the conditions for these countries to increase the benefits from joining the currency union?

3. Suppose an investment project costs 50 million dollars. In the next period, with 1/4 of probability, it will pay 0 million dollars. With 3/4 of probability 60 million dollars. Supposed that this project will be funded by international bank loans. Calculate the expected profits, with and without government guarantee. Explain how the government guarantee creates a ”moral hazard” problem.

4. Before the Asian financial crises, the crises countries maintained a de facto fixed exchange rate with the U.S. dollar. Many economists blamed the exchange rate policy as the cause of excessive borrowing from abroad before the financial crises. What is the rationale behind this claim? Explain using the uncovered interest parity.