Econ 371: Final Exam - Form A

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Part One

Mark your test form as "A." 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. (40 questions with 0.5 point each)

1. Assuming that private savings and investment are constant, the U.S. government must cut its spending or increase tax to reduce the current account deficits.

2. Foreign exchange market participants have been expecting the Federal Reserve to raise its interest rate in recent month, so the U.S. dollar must have depreciated.

3. With short-run price stickiness, a permanent reduction in money supply causes exchange rate to undershoot.

4. According to the Fischer effect, a rise in inflation reduces the real return on assets because nominal interest rates are fixed in the short run.

5. According to the monetary theory of exchange rate determination, an increase in the U.S. output relative to the euro zone causes the U.S. dollar to appreciate.

6. According to the general theory of exchange rate determination, an increase in the U.S. output relative to the euro zone causes the U.S. dollar to appreciate.

7. In the AA-DD framework, import tariffs will shift the AA curve to the right because it reduces import demand and improves the current account.

8. In the AA-DD framework, a permanent tax cut causes exchange rate appreciation.


10. Under fixed exchange rate regime, a fiscal expansion will lead to a reduction in foreign exchange reserves.

11. Under fixed exchange rate regime, a monetary expansion will lead to a reduction in foreign exchange reserves.

12. Under fixed exchange rate regime, investment boom will lead to a reduction in foreign exchange reserves.

13. Under fixed exchange rate regime, depreciation pressure on exchange rate results in capital flight.

14. With the same inflationary policy, a country that starts out with a large stock of foreign exchange reserves will face speculative attacks on its currency later than those with low reserves.
15. The money supply at the time of balance-of-payments crisis rises sharply because of the expansion of domestic credit.

16. The impossible trinity suggests that country with fixed exchange rate that adopts inflationary policy cannot avoid balance-of-payments crises.

17. Balance-of-payments crises result from irrational behaviors of speculators in foreign exchange markets.

18. Central banks use sterilized interventions to isolate money supply from foreign exchange market interventions.

19. Sterilized interventions keep money supply and exchange rate constant.

20. When sterilized interventions involve a reduction in foreign assets, the risk premium on the domestic bonds rises.

21. The U.S. government has issued a large sum of treasury bills to finance its deficits. However, this does not affect the risk premium on the treasury bills because the U.S. dollar is the international currency.

22. The silver and the gold standard intrinsically operate with the same price-specie-flow mechanism.

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

24. The deflation during the Great Depression can be explained by outflows of gold.

25. A new discovery of gold supply usually makes gold price drop and creates deflation.

26. The gold exchange standard suffers with the N-1 problem unlike the gold standard.

27. Under the Bretton Woods System, countries can easily reach their internal balance by using fiscal policy.

28. Countries can still reach their external balance in the long run even without exchange rate adjustment.

29. The choice between fixing or floating a national currency is entirely monetary and has nothing to do with goods trade.

30. When a central bank chooses to fix exchange rate, it loses control over its interest rate unless it imposes cross-border capital control.

31. The theory of optimum currency area states that countries with similar incomes benefit from forming a currency union.
32. Based on the theory of optimum currency area, the euro zone is an optimum currency area like the U.S.

33. The new members of the euro zone such as Czech Republic increases the efficiency gain of the euro zone if they trade more with other member countries than with the rest of the world.

34. Low labor mobility reduces the economic stability loss from joining a fixed exchange rate area.

35. Similar economic structure reduces the economic stability loss from joining a fixed exchange rate area.

36. Risk-averse agents base their investment decision on the expected return.

37. Assets classified as debt instruments such as bonds are not risky because their returns are fixed.

38. The growth of Eurodollar markets from the 1960s had nothing to do with the Federal Reserve policy because Eurocurrency trading takes place offshore.

39. Government guarantees on international loans increase economic efficiency because it increases investment in developing countries.

40. Balance-of-payments crises can create financial crises because devaluations increase the foreign debt burden.
Part Two

Write your test form as "A" at the cover page of your bluebook. Answer the following questions. Depict appropriate diagrams as required. (4 questions with 5 points each)

1. Assume a fixed exchange rate regime. Suppose the central bank of a small country faces a rise in the world interest rate $R^*$. Explain the effects on the foreign exchange reserves and money supply, using a diagram describing foreign exchange market and money market. Can the central bank offset any of these effects through domestic open-market operations? (Hint: An open-market operation means the central bank’s sales or purchases of the domestic bonds.)

2. Bank of Mexico currently adopts a managed floating exchange rate regime. Explain how Bank of Mexico manages its exchange rate without changing money supply by exploiting the imperfect substitutability between the Mexican government bonds and the U.S. treasury bills. Illustrate the mechanism with a diagram describing foreign exchange market and money market.

3. Suppose the Californian citizens decide to form an independent nation separated from the U.S. Then the Golden State will emerge as the world’s 6th largest economy and establish its central bank called Bank of California. Suppose that Bank of California issues its currency and fixes it with the U.S. dollar. Use the GG-LL framework to analyze the impacts of this event on the optimality of the U.S. as a currency area.

4. Suppose an investment project costs 50 million dollars. In the next period, with the probability $\lambda$, it will pay 0 million dollars. With the probability $1 - \lambda$, it will pay 60 million dollars. Suppose that this project needs to be funded by international bank loans. How do you define the "moral hazard" problem in this case? Calculate the values of $\lambda$ that can create moral hazard.