Part One

Instruction: Answer the following questions and depict appropriate diagrams as required.

1. (5 points) The US current account deficit has been rising and it is currently approximately 6 percent of GDP. However, the new Fed chairman, Ben Bernanke, suggests that the rise in current account deficits posts no concern, because it reflects foreigners’ willingness to lend funds to the US. Do you agree with him? Why?

2. (5 points) Suppose the Fed and the European Central Bank unexpectedly expand money supply at the same time in the same scale. However, the money supply expansion in the US is permanent, while that in the euro zone is temporary. Explain the effects of the policy changes on the dollar-euro exchange rate. Depict an appropriate diagram. Is there exchange rate overshooting?

3. (5 points) Based on the information in the last question, predict the long-run exchange rate using the monetary approach and the general approach. Do the two approaches give the same prediction?

4. (5 points) Suppose the Bush administration wishes to reduce the US current account deficits. Based on the AA-DD framework, what policy will you recommend the administration? Depict a AA-DD diagram to support your proposal.

Part Two

Instruction: In the answer sheet, mark the test form as ”01.” 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. (0.5 point each)
1. Based on the current account identity, the government in a closed economy such as North Korea has to balance its budget.

2. When current account of a country has a positive sign, that country is a lender.

3. When financial account of a country has a positive sign, that country is a lender.

4. Export growth can make a borrower become a lender.

5. The US cannot reduce its current account deficits without reducing its investment.

6. Interest parity predicts that a rise in European interest rate makes the euro appreciate, all else equal.

7. When there is a rumor in the foreign exchange market that the Mexican peso will depreciate, Mexico’s central bank cannot prevent the peso from depreciating.

8. An unexpected increase in the US capital gain tax makes the US dollar appreciate, all else equal.

9. Tax on interest rate earnings in the US make the US dollar appreciate, all else equal.

10. The Fed can control real money demand using an open-market operation.

11. The Fed can reduce money supply by selling domestic bonds to commercial banks in the US.

12. When the Fed sells domestic bonds to commercial banks in the US, the asset stock in its balance sheet also falls.

13. Exchange rate overshooting arises because of price flexibility.

14. The Fed can reduce volatility of exchange rate by signaling its policy changes in advance.

15. The Fed can reduce the degree of exchange rate overshooting by signaling its policy changes in advance.

16. Trade barriers create deviations from the law of one price.

17. The presence of nontradables such as haircut is a reason why the data do not support the absolute purchasing power parity.

18. The relative purchasing power parity predicts that the currency of high-inflation economy will appreciate in the long run.
19. The Balassa-Samuelson hypothesis suggests that economic growth reduces real exchange rate in the long run.

20. Both the absolute and the relative purchasing power parity predicts stable real exchange rate.

21. The Fisher effect predicts that banks in high-inflation economy offers high interest rate on deposit accounts.

22. According to the monetary approach, the permanent money expansion in the US and in Argentina makes the Argentine peso appreciate because the US economy is larger than the Argentine economy.

23. According to the monetary approach, output demand expansion in the US makes the dollar appreciate.


25. The general theory of long run exchange rate determination predicts that both real and nominal exchange rate fluctuates over time.

26. According to the general theory of long run exchange rate determination, productivity growth in the US make the dollar appreciate.

27. The aggregate demand theory predicts that a temporary money expansion has no effect on exchange rate, because that does not change expectation about future exchange rate.

28. The aggregate demand theory suggests that a temporary money reduction worsens current account.

29. A tax cut has no effects on output unless it is made permanent.

30. When the public expects a future temporary monetary expansion, the current output remains unchanged because the current interest rate is not affected.