Part One

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. (1 point each)

1. When a country runs current account surplus, it runs fiscal surplus too.

2. A creditor country always receive positive net investment income flows.

3. The uncovered interest rate parity predicts that the dollar depreciates when the Fed is expected to reduce interest rate.

4. A temporary monetary reduction does not create exchange rate overshooting.

5. A permanent monetary reduction does not create exchange rate overshooting.

6. A pre-announced permanent monetary reduction does not create exchange rate overshooting.

7. According to the monetary approach of long-run exchange rate determination, permanent money expansion appreciates the U.S. dollar.

8. According to the monetary approach of long-run exchange rate determination, productivity growth appreciates the U.S. dollar.

9. Uncovered interest rate parity implies that the domestic interest rate is equal to the foreign interest rate under the fixed exchange rate regime.

10. Assume that the external debt is in home currency, and the external asset is in foreign currency. When the external asset position is positive, home currency depreciation reduces the external asset position.

11. Assume that the external debts and assets are in foreign currency. When the external asset position is positive, home currency depreciation reduces the external asset position.

12. Given financial globalization and initially balanced current account, in the absence of investment a temporary improvement in productivity leads to capital outflows.
13. Given financial globalization and initially balanced current account, in the absence of investment a permanent improvement in productivity leads to capital outflows.

14. Given financial globalization and initially balanced current account, in the presence of investment a temporary improvement in productivity leads to an increase in consumption.

15. When exchange rate is flexible, a temporary and unanticipated money expansion reduces current account balance in the short run.

16. When exchange rate is fixed, a temporary and unanticipated money expansion reduces current account balance in the short run.

17. A temporary and unanticipated tax cut stimulates the aggregate demand and expands output in the short run regardless of exchange rate regime.

18. When exchange rate is fixed, a temporary and unanticipated tax cut decreases foreign exchange reserves.

19. When exchange rate is fixed, a temporary and unanticipated foreign tax cut decreases foreign exchange reserves.

20. When exchange rate is flexible, a temporary and unanticipated foreign tax cut improves the trade balance.

21. When exchange rate is flexible, an increase in the expected depreciation improves the trade balance.

22. Under the gold standard, a temporary and unanticipated tax cut triggers gold outflows.

23. Inflationary spending policy in the U.S. was a primary reason for the end of the Bretton Woods system.

24. The impossible trilemma suggests that foreign exchange controls can prevent a currency crisis.

25. The U.S. was the center country under the Bretton Woods system, therefore the U.S. was not subject to the impossible trilemma.

26. Currency crises depend on both economic fundamentals and market expectations.

27. Currency crises are different from banking crises and thus are not influenced by banking crises.
28. Central banks can implement sterilized intervention indefinitely if they impose foreign exchange controls.

29. Asymmetry of shocks can mitigate the stability loss from adopting a fixed exchange rate policy.

30. Capital mobility within a currency union is critical for reaping the benefits from the currency union.
Part Two

Instruction: Answer the following questions and depict appropriate diagrams as required. (60 points)

1. (10 points) Explain the effect of unanticipated and temporary fiscal expansion on output, interest rate, investment, money supply and exchange rate, under both flexible and fixed exchange rate regimes. Explain using IS-LM-FX model and depict appropriate diagrams. Which exchange rate regime has a stronger impact on output in the short run? Why?
2. (10 points) What is "sterilized intervention"? Explain the concept using the central bank’s balance sheet. When the foreign central bank cuts its interest rate, how would the domestic central bank respond using a sterilized intervention? In this case, what are its impacts on foreign exchange reserves and domestic bond holdings on the central bank balance sheet?
3. (10 points) What causes currency crises in the 1st generation model of currency crises? Is the model consistent with the impossible trilemma in international finance? Why?
4. (10 points) Assume all dollar units are real dollars in billions. In Year 0, Argentina finds $100 of domestic investment projects with a MPK of 10%. Argentina funds the investment in Year 0 by borrowing $100 from the rest of the world at the world real interest rate 5%. There is no further investment or borrowing after Year 0. Assume that Argentina initial wealth prior to Year 0 is zero. Assume also that G=0 always, and I=0 except in Year 0. Assume no unilateral transfers or labor income flows. The investment projects pay off in Year 1 and thereafter. The interest rate payments also take place in Year 1 and thereafter. Assume also that the domestic production without investment is $200 in all years. Calculate Argentina’s consumption, output, investment, trade balance, current account and external wealth in Year 0 and thereafter.
5. (10 points) What is the "valuation effect" of exchange rates on the external wealth? Explain and give a numerical example.
6. (10 points) Suppose California becomes an independent nation and has its own central bank called Bank of California. Bank of California issues its own currency called Cal Dollar. Discuss the impact of emergence of Cal Dollar on the optimality of the U.S. as an optimum currency area.