Part One

Instruction: In the answer sheet, mark the test number 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. Suppose the dollar short-term interest rate is 1% and the euro short-term interest rate is 2%. The uncovered interest parity implies that the dollar is expected to appreciate against the euro.

2. Suppose the dollar short-term interest rate is 1% and the euro short-term interest rate is 2%. The covered interest parity implies forward discount on the dollar.

3. A permanent sale of government bond by the Fed causes the dollar interest rate to rise in the short run.

4. A permanent sale of government bond by the Fed causes the dollar interest rate to rise in the long run.

5. Nontraded goods and services cause deviations from the absolute purchasing power parity.

6. Nontraded goods and services cause deviations from the relative purchasing power parity.

7. The absolute purchasing parity implies that the long-run real exchange rate is one.

8. The relative purchasing parity implies that the long-run real exchange rate is one.

9. Inflation in the U.S. causes the U.S. real exchange rate rate to appreciate, all else equal.

10. Inflation in the U.S. causes the purchasing power of the dollar to fall at home but to rise abroad, all else equal.

11. With free capital mobility, currencies of high-inflation countries pay higher nominal interest rate than currencies of low-inflation countries.

12. With free capital mobility, currencies of high-inflation countries pay higher real interest rate than currencies of low-inflation countries.
13. Based on the Fisher effect, a rise in inflation reduces the real cost of borrowing.

14. According to the monetary approach to exchange rate, permanent productivity growth in the euro area depreciates the dollar in the short run, all else equal.

15. According to the monetary approach to exchange rate, permanent productivity growth in the euro area depreciates the dollar in the long run, all else equal.

16. According to the monetary approach to exchange rate, temporary productivity growth in the euro area depreciates the dollar in the short run, all else equal.

17. According to the monetary approach to exchange rate, temporary productivity growth in the euro area depreciates the dollar in the long run, all else equal.

18. According to the asset market approach to exchange rate, the dollar appreciates in the short run when the Fed raises the interest rate, all else equal.

19. According to the asset market approach to exchange rate, the dollar appreciates in the short run when the Fed is expected to raise the interest rate, all else equal.

20. A permanent money reduction by the Fed creates exchange rate overshooting when goods prices are sticky, all else equal.

21. A temporary money reduction by the Fed creates exchange rate overshooting when goods prices are sticky, all else equal.

22. There is no exchange rate overshooting when goods prices are flexible.

23. There is no exchange rate overshooting when asset prices are flexible.

24. The U.S. is a debtor because the U.S. has current account deficit.

25. The U.S. is a borrower because the U.S. has current account deficit.

26. When capital account is balanced, financial account deficit implies current account surplus.

27. Mexico is a net exporter of labor services. Therefore, Mexico has net factor income account surplus.

28. Net factor income account of a debtor country is always negative, since its external assets are smaller than its external liabilities.

29. Appreciation of the yuan-dollar exchange rate increases the dollar value of China’s external wealth.

30. Appreciation of the yuan-dollar exchange rate increases the yuan value of China’s external wealth.
Part Two

Instruction: Answer the following questions below each question. Depict appropriate diagrams as required. (30 points)

1. (10 points) Use the monetary approach to exchange rate in the long run to answer the following questions.

   (a) (5 points) Bank of Japan has continued to increase money supply in the past 10 years. Over the same period, output in Japan barely grew and the price level in Japan has fallen. The Japanese yen has appreciated against the U.S. dollar. Is the behavior of the yen-dollar exchange rate consistent with the monetary approach? Explain your reasoning.

   (b) (5 points) The Fed has continued to increase money supply in the past 3 years. Over the same period, output in the U.S. fell and the price level in the U.S. has increased slightly. The dollar has depreciated against some major currencies such as the Swiss franc. Is the behavior of the franc-dollar exchange rate consistent with the monetary approach? Explain your reasoning.
2. (10 points) Assume that the money demand function in the U.S. and the euro area are identical, and the elasticity of money demand with respect to income is one.

(a) (5 points) Suppose the Fed increased money supply permanently. Explain the effects of this policy on the dollar-euro exchange rate. Is there exchange rate overshooting? Display the time paths of the dollar-euro exchange rate, the U.S. price level and the dollar interest rate.

(b) (5 points) Suppose that when the Fed increased money supply permanently, the U.S. national income increased permanently in the same scale too. Use the FX diagram to explain the effects of these changes on the dollar-euro exchange rate. Is there exchange rate overshooting?
3. (10 points) In the 1980s, many countries in Latin America suffered with high inflation after years of large-scale capital inflows. As a result of high inflation, currencies of these countries depreciated sharply. In response to that, some Latin American central banks decided to fix its exchange rate against the U.S. dollar to stabilize value of its currency.

(a) (5 points) Based on the Trilemma in international finance, how would you characterize the policy adopted by these central banks?

(b) (5 points) Based on the Trilemma in international finance, was there an alternative policy that could stabilize value of currencies in Latin America?