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Final Examination
International Economics: Finance

Spring 2005
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DIRECTIONS: If a question has multiple parts, indicate exactly where you answer each part. This exam has two (2) sections; be sure to follow the directions for each section.

1. LONG ANSWERS (30 points):

ALL STUDENTS MUST ANSWER ONE (1) OF THE FOLLOWING QUESTIONS:

Time allotted: 30 minutes.

(Ph.D. students must include detailed supportive algebra.)

- LA1. What is exchange rate “overshooting” and why is it important? Under what conditions does overshooting occur? (Give a detailed algebraic exposition, including the rational expectations dynamics if you are a Ph.D. student, and a detailed graphical analysis, carefully providing full “intuition” for the model.) How supportive has empirical work been of the basic overshooting model? (Refer to specific studies *as well as* your own homework explorations.)
- LA2. Set up the mean-variance optimization problem discussed in class and solve for the optimum portfolio of domestic and foreign bonds. Make sure you explain the role of first-order *and* second-order conditions for optimization in this problem. Supplement your algebra with detailed verbal explanations of the framework and a thorough verbal interpretation of your algebraic results. (For example, be sure to *prove* that the optimum portfolio can be expressed as the sum of two components, and to provide a detailed interpretation of each component.)

2. MULTIPLE CHOICE (1 point each):

ANSWER ALL OF THESE. Choose the best answer.

- MC1. Why did Milton Friedman (and others) expect speculation to be stabilizing under floating exchange rates?
- (a) Speculation was poorly understood in the 1950s.
 - (b) Monetarists have an inordinate faith in the stability of competitive markets.
 - (c) Successful speculation increases the demand for foreign exchange when demand is low and increases the supply of foreign exchange when supply is low.
 - (d) They carefully modeled the contribution of rational “noise traders”.
 - (e) All of the above.
- MC2. Suppose exchange rate “fundamentals” are constant except for the domestic money supply, which follows a random walk. According to the monetary approach under rational expectations, a 1% increase in the domestic money supply will cause
- (a) a 1% increase in price level
 - (b) a 1% increase in exchange rate
 - (c) no change in real money balances.
 - (d) no change in expected inflation.
 - (e) *All of the above

- MC3. According to the real interest differential model of floating exchange rates, which of the following statements are true?
- (a) In the short run, a country can raise interest rates by means of contractionary monetary policy, in which case its assets will attract foreign investors and appreciate the exchange rate.
 - (b) In the long run, a country can raise interest rates by means of contractionary monetary policy, in which case its assets will attract foreign investors and appreciate the exchange rate.
 - (c) In the long run, a country can raise interest rates by means of expansionary monetary policy, which will cause inflation and tend to depreciate the exchange rate.
 - (d) a. and b.
 - (e) a. and c.
- MC4. If we modify the simple monetary approach to flexible exchange rates by replacing the purchasing power parity assumption with endogenously determined terms of trade, a fiscal expansion in the resulting Classical model has the following effects.
- (a) the nominal exchange rate appreciates
 - (b) the real exchange rate appreciates
 - (c) the price level rises
 - (d) a. and b.
 - (e) all of the above.
- MC5. If we modify the simple monetary approach to flexible exchange rates by replacing the purchasing power parity assumption with endogenously determined terms of trade, a monetary expansion in the resulting Classical model has the following effects.
- (a) the nominal exchange rate depreciates
 - (b) the real exchange rate depreciates
 - (c) the price level rises
 - (d) a. and b.
 - (e) *a. and c.
- MC6. Which of the following make it *less* likely that a devaluation will improve our net earnings of foreign exchange?
- (a) low import elasticities
 - (b) high import elasticities
 - (c) high export elasticities
 - (d) satisfaction of the Marshall-Lerner condition
 - (e) none of the above
- MC7. By the end of 2004, the US current account was
- (a) in deficit by about USD 165B per month.
 - (b) in deficit by about USD 165B per quarter.
 - (c) in deficit by about USD 165B per year.
 - (d) in surplus by about USD 165B per quarter.
 - (e) in surplus by about USD 165B per year.