AMERICAN UNIVERSITY
Department of Economics

Midterm Examination | Spring 2005
International Economics: Finance | Page Count = 2

MIDTERM EXAMINATION IN INTERNATIONAL FINANCE

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 ANSWER (30 points)

ALL STUDENTS MUST ANSWER ONE (1) OF THE FOLLOWING QUESTIONS. (Ph.D. students should answer the first question.)

LA1. Consider the monetary approach to flexible exchange rates under rational expectations. Using recursive substitution, derive the algebraic relationship between the spot rate and expected future fundamentals. Be sure to accompany your algebraic derivation with detailed commentary and justifications. Be sure to discuss the problem of speculative bubbles. Suppose the exchange rate "fundamentals" follow a random walk: derive the effect on the spot rate of a period t innovation to the fundamentals, illustrate this effect graphically, and provide an intutive discussion.

LA2. Present and discuss the crude monetary approach to flexible exchange rates. What are its predictions? (Derive them algebraically.) How has it performed empirically? (Along with other studies, be sure to discuss *in detail* the Frenkel (1976) application of this model to the German hyperinflation.)

2. MULTIPLE CHOICE (1 point each)

ANSWER ALL OF THESE. (Pick the one 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. What are the units of the real exchange rate?

(a) dollars per pound
(b) USD/GBP
(c) domestic currency units per foreign currency unit
(d) *domestic commodity baskets per foreign commodity basket
(e) none of the above

MC3. Which of the following describe the pre-float expectations about floating exchange rates held by many economists?

(a) Nominal exchange rates would be about as stable as policy “fundamentals”.
(b) Real exchange rates would be very stable in the long run.
(c) Large trade imbalances would be rare.
(d) Instruments for hedging foreign exchange risk would become widely available.
(e) *all of the above.

MC4. Which of the following predictions by economists about flexible exchange rates were realized?

(a) Floating exchange rates would be as stable as the exchange rate fundamentals.
(b) Large trade imbalances would be rare.
(c) *Instruments for hedging foreign exchange risk would become available.
(d) a. and b.
(e) all of the above

MC5. A forward exchange rate is

(a) the actual spot rate at a predetermined future date.
(b) the exchange rate which speculators expect to prevail at a future date.
(c) *the rate at which one contracts today for foreign exchange in the future.
(d) b and c
(e) all of the above

MC6. If the dollar is expected to lose value against the German mark

(a) A German investor will subtract the expected rate of dollar depreciation from the dollar interest rate when computing the rate of return on US assets.
(b) A U.S. investor will add the expected rate of mark appreciation to the mark interest rate when computing the rate of return on German assets.
(c) A U.S. investor and a German investor may reach entirely different assessments about the expected returns of U.S. and German assets, even if the have a common expectations about exchange rate changes.
(d) *a. and b.
(e) All of the above

MC7. 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