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Final Examination Spring 2007
International Economics: Finance Page Count = 13

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 each):

ALL STUDENTS MUST ANSWER THE FIRST QUESTION AND ONE MORE FOR A TOTAL OF TWO (2) OF THE FOLLOWING QUESTIONS:
Time allotted: 30 minutes per question.
(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, and a detailed graphical analysis, carefully providing full "intuition" for the model.) How supportive has empirical work been of the basic overshooting model? (Refer *in detail* to specific studies.)

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.)

LA3. Use the method of undetermined coefficients to solve the monetary approach model under rational expectations when fundamentals follow the AR(2) process:

$$\tilde{m}_t = \mu_0 + \mu_1 \tilde{m}_{t-1} + \mu_2 \tilde{m}_{t-2} + u_t$$

where u_t is white noise.

LA4. What "puzzles" were found in the forward exchange rate data by Fama? (Give a full derivation, integrating discussion of the empirical results.) Is there a necessary conflict between rational expectations and the empirical results? (Explain why Fama thought so, and offer a model based response.)

LA5. Use dynamic programming to solve the consumption problem of an infinitely-lived forward-looking consumer, derive the implications for current account behavior, and discuss how these implications differ from those of traditional models.

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. The total income of the private sector is

(a) GDP
(b) GNP
(c) GNP plus unilateral transfers received from abroad
(d) GNP plus M2
(e) GNP less taxes

MC3. In our Classical model of a small open economy with perfect capital mobility and flexible exchange rates, an increase in government expenditure

(a) increases income.
(b) decreases income.
(c) improves the current account ($\Delta CA > 0$)
(d) deteriorates the current account ($\Delta CA < 0$)
(e) none of the above

MC4. Imported TV sets are entered in the balance of payments as a

(a) credit to merchandise trade in current account.
(b) debit to merchandise trade in current account.
(c) debit to merchandise trade in private capital account.
(d) credit to direct investment in private capital account.
(e) all of the above

MC5. If a U.S. citizen rents a car in Paris, the rental should generate a

(a) credit for merchandise trade in current account.
(b) debit for merchandise trade in private capital account.
(c) credit for direct investment in private capital account.
(d) debit for transportation services in current account.
(e) not enough information to tell.

MC6. 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