

Midterm 2

The total time for the exam is 60 minutes, although you are given 70 minutes to complete it. Points are allocated proportionally to the time allocations.

Part I: Multiple Choice (35 minutes, 3.5 min. each)

1. A central bank wishes to sterilize a reserve outflow. Which of the following achieve this goal?
 - a. Expand net domestic assets at the same rate as the reserve outflow is contracting the money supply.
 - b. Reduce net domestic assets at the same rate as the reserve outflow is expanding the money supply.
 - c. Use open market operations to sell treasury securities on the private market.
 - d. Use open market operations to reduce domestic money supply
 - e. Enlist the help of the fiscal branch to create expenditure switching activities.

2. The US CPI is growing at 4 percent per year and the Euro area CPI is growing at 6 percent per year. If relative PPP holds, then one would expect the dollar to be
 - a. depreciating at 2 percent per year.
 - b. constant.
 - c. depreciating at 10 percent per year.
 - d. appreciating at 2 percent per year.
 - e. appreciating at 4 percent per year.

3. In the IS-LM-BP=0 model, under fixed exchange rates, in the short-term, a fiscal contraction will lead to
 - a. decreased income, lower interest rates and a balance of payments deficit.
 - b. decreased income, lower interest rates and a balance of payments surplus.
 - c. decreased income, lower interest rates and an ambiguous effect on the balance of payments.
 - d. decreased income, higher interest rates and an ambiguous effect on the balance of payments.
 - e. increased income, lower interest rates and an ambiguous effect on the balance of payments.

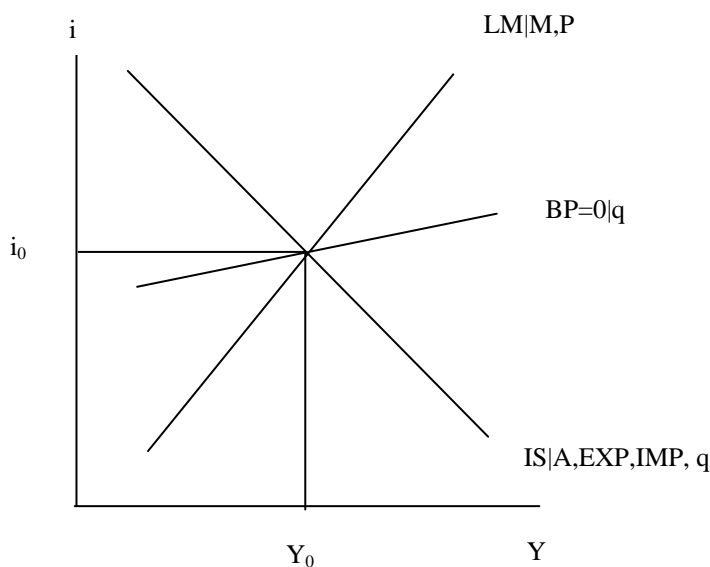
4. Under fixed exchange rates, an increase in the sensitivity of capital flows to interest rate differentials is likely to result in
 - a. a larger balance of payments deficit following a fiscal expansion.
 - b. small losses in reserves following a monetary expansion.
 - c. a more substantial capital outflow following a monetary expansion.
 - d. a higher long-run increase in income following a fiscal expansion.
 - e. none of the above.

5. How does increasing the mobility of capital change the effectiveness of fiscal policy under fixed and floating exchange rate regimes?
 - a. Under fixed exchange rates, more capital mobility leads to more effective fiscal policy. Under floating exchange rates, more capital mobility leads to less effective fiscal policy.
 - b. It increases the effectiveness of fiscal policy under both exchange rate regimes.
 - c. It decreases the effectiveness of fiscal policy under both exchange rate regimes.
 - d. Under fixed exchange rates, more capital mobility leads to less effective fiscal policy. Under floating exchange rates, more capital mobility leads to more effective fiscal policy.
 - e. The effect is ambiguous.

6. The one year interest rate in the US is 6 percent and the interest rate in the Euro area is 2 percent. If the covered interest parity condition holds, then it *must* be true that:
- the one year forward rate is 4 percent higher than the current spot rate (both exchange rates expressed in \$/€).
 - the forward discount is 4 percent.
 - the one year forward rate is 4 percent lower than the current spot rate (both exchange rates expressed in \$/€).
 - the market expectation of the spot rate one year hence is 4 percent higher than the current spot rate.
 - (a) and (b) above.
7. Under the monetarist (or flexible price monetary model) of the exchange rate, an increase in the foreign interest rate will
- lead to depreciation of the domestic currency.
 - increase the demand for real balances.
 - lead to an appreciation of the home currency.
 - lead to an increase in income.
 - none of the above.
8. Assume that in the long run, the exchange rate is determined by money stocks, incomes and interest rates. Then
- an increase in the domestic money supply necessarily weakens the currency.
 - an increase in the money supply always causes a proportional increase in the exchange rate immediately.
 - a decrease in the domestic money supply causes a large initial appreciation of the dollar, with depreciation over time if there is some price stickiness.
 - an immediate jump of the nominal exchange rate to its long run value.
 - (a) and (c) above.
9. Suppose stock prices depend upon dividends and the expected stock price in the future, as in the present value model. Which of the following will induce a downward move in the stock price today?
- A downward revision of expectations about future stock prices.
 - A downward revision in expectations of future interest rates.
 - An upward revision in expectations of future interest rates.
 - A decrease in the expected price of the stock in the future.
 - all of the above except (b).
10. Uncovered interest rate parity
- implies that interest rates are equalized.
 - requires that the expected rate of return expressed in dollars of saving in dollar and foreign currency denominated assets must be equal
 - requires that returns denominated in bundles of consumption goods be equalized.
 - requires that the forward rate and the expected spot rate be equal.
 - both (b) and (d).

Part II: Short Answer (25 minutes)

Suppose you are given a standard IS-LM-BP model under floating exchange rates:



1. (4 minutes) Suppose the Home government decreases lump sum taxes. Show what happens both immediately and over time. Clearly label new equilibrium values of output and interest rates, and indicate curve shifts with arrows.

2. (6 minutes) Discuss what happens economically, in the context of the graph. Discuss also what happens to the level and composition of output. What happens to the trade balance?

3. (5 minutes) Suppose in Question 1, the economy were under *fixed* exchange rates, and the government does not sterilize capital flows. Show what happens then using a graph. Explain the result using words and/or equations.

4. (6 minutes) Show what happens if instead of a decrease in lump sum taxes in Question 1 (under floating exchange rates), the foreign interest rate falls (you may assume that the foreign interest rate is exogenous). Explain what happens to income, the interest rate, the exchange rate, net exports, and the money supply. Be sure to use a graph to explain your answer.

5. (4 minutes) Suppose again the foreign interest rate falls, and the Home central bank decides that it wants to maintain the current exchange rate. What must it do? Explain using a graph.