

## ECONOMICS 182 FINAL EXAM

Spring 2005

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Instructions: You have three hours to do the exam, which is worth a total of 100 points. Please make your answers as concise and relevant as possible. No credit is allowed for providing true but irrelevant information or reasoning.

**Part 1. Definitions.** *Briefly* define all of the following terms or concepts. (24 points, 4 each)

1. Financial account credit.
2. Trilemma of monetary policy in the open economy.
3. Fisher effect.
4. Economic stability loss from joining a currency area.
5. "Institutions theory" of the world income distribution.
6. Purchasing power parity theory of exchange rate determination.

**Part 2. Short questions.** Answer all of the following. (28 points, 7 each)

1. A country permanently and unexpectedly devalues its currency. What is the short run effect in a (classical, i.e. pre-Keynesian) model in which all prices are completely flexible? What is the short run effect in the AA-DD model? What is the long-run effect in the AA-DD model?
2. The "automatic stabilizers" argument for a floating exchange rate assumes that a currency depreciation cushions output and employment from negative export-demand shocks by lowering the price of domestic output relative to foreign. In many countries a large fraction of domestic output consists of agricultural goods or resources with prices determined by stiff competition in world markets, not by domestic wages. For such goods--call them "bananas"--the domestic price,  $P_b$ , equals the world banana price times the domestic price of foreign currency,  $EP_b^*$ , and any rise in  $E$  (other things equal) causes an immediate and proportional jump in  $P_b$ . How does the ability of automatic exchange-rate changes to cushion total output depend on the fraction of output consisting of flexible-price goods like our "bananas"?
3. Explain why, under the Bretton Woods system, the United States had so much power over the world money supply.
4. In the AA-DD model, suppose there is a sudden and arbitrary shift in exchange rate expectations:  $E^e$  simply rises. Show the short-run effect on the economy under a floating exchange rate. Under a fixed exchange rate, this would be a speculative crisis and the domestic interest rate,  $R$ , would rise. How does  $R$  behave when the exchange rate floats, and why?

**Part 3. Short essays.** Try to be concise and organized, and try not to stray from the point. (24 points, 12 each)

1. Europe has had a single currency since 2000. Describe one problem for monetary policy in the Euro Zone, and one for fiscal policy.
2. Explain briefly how the international gold standard helped worsen the Great Depression of the 1930s.

**Part 4. Essay.** Read the accompanying article and answer the following questions. (The article is long; key paragraphs therefore have been numbered for easy reference.) (24 points, 3 each)

- a. Why might the IMF and World Bank see any connection between America's "fiscal irresponsibility" and its current-account deficit? (#1)
- b. Japan, if anything, is more "fiscally irresponsible" than the U.S. (It's government deficit, as a percent of GNP, is twice as big!) Yet Japan has a very big current account *surplus*. What must be true of Japanese *private saving* and *investment*?
- c. Paragraph #2 points out that more and more U.S. Treasury bonds are being bought by foreigners; see also the graph at the start of the article. Why do you think the graph shows such a big jump in foreign holdings of Treasury bonds around 1971-73?
- d. Why would the "natural adjustment mechanism for America's rapidly growing foreign liabilities" be a decline in the dollar? (#3).
- e. Why is it "expensive" for a central bank to sterilize increases in foreign exchange holdings when the interest rate on domestic debt is higher than that on foreign reserves and the exchange rate is fixed? (#4)
- f. Can you think of a way a central bank can continue to sterilize even after it has run out of domestic government debt to sell? (#5)
- f. Presumably, the currency of a central bank (such as China's) which is buying lots of dollars would *appreciate* if that central bank stopped intervening. In that case, if there is a chance the fixed exchange rate will be abandoned, what does interest parity tell us about the relative interest rates on domestic and foreign currency debt?
- g. Explain whether this prediction fits Japan (#6), where interest rates are zero and far below those in the U.S., or the cases mentioned in paragraph (#4) (and referred to in part *e* above). Why do you think there is a difference -- is this just a mental lapse on the writer's part or is there some difference between the economies being discussed? [Hint: China tries to prevent capital inflows with controls, and is managing interest rates so as to restrain domestic inflation.]

[UNFORTUNATELY I HAVE NOT BEEN ABLE TO LOCATE THE ORIGINAL ARTICLE

*ACCOMPANYING THIS QUESTION—MO]*