Econ 434 Fall 2005

Final Exam

Instructions

Read the entire exam over carefully before beginning. The value of each question is given. Allocate your time efficiently given the price schedule that is imposed. Graphs and diagrams can be very helpful, use whenever possible and label clearly. There are no trick questions.

1. *(25%)* Consider a small open economy with a fixed exchange rate and open capital markets (high degree of capital mobility). The economy is in both internal and external balance. Draw a diagram showing the initial situation (in $i - e$ space). Provide a brief explanation of the slopes of the two curves.
   (a) Now suppose that, all of a sudden, foreign investors become scared about this country. The economy is no longer in external balance. If the economy does not suffer from currency mismatch show that exchange rate and interest rate policies can be used (in some combination) to restore external balance and maintain internal balance.
   (b) Suppose that the country suffers from currency mismatch. Why might the normal (conventional) assignment of policies to deal with the loss of external balance be problematic? Explain. Why does this differ from what happens in part (a)? Explain.
   (c) Why do countries suffer from currency mismatch? Why is this an important feature of third generation financial crises? Explain.

2. *(10%)* "The advantage of a fixed exchange rate is that it allows monetary policy to be independent." Do you agree or disagree? Explain.

3. *(10%)* What is Gibson's paradox? Why is it a puzzle?

4. *(30%)* Under the classical gold standard capital mobility was very high. What were the critical features of the gold standard that made this possible?
   (a) If countries played by the rules of classical gold standard what would we expect to observe with regard to the interest differential across these countries? Explain.
   (b) After WW1 attempts to put the gold standard back in place failed. What changed to make it so difficult? Why was it so much harder to play by the "rules of the game" after WW1?
   (c) It is sometimes argued that the problem was "too low a price of gold" after WW1. Why would this have been a problem? Explain.
   (d) How did the Bretton Woods system attempt to cope with the problems of the interwar system?
   (e) Why did the Bretton Woods system eventually collapse? Are there any fundamental lessons to be learned from this?

5. *(25%)* The US current account deficit is more than 5.7% of GDP. Why might this be expected to cause the dollar to depreciate?

   (a) Will dollar depreciation *necessarily* improve the position of the US current account? Explain.

   (b) If dollar depreciation does not cause the current account deficit to shrink what will likely happen to US interest rates? Explain. What effect will this have on the current account deficit?

   (c) Why does the behavior of central banks in China and the rest of Asia matter for the value of the dollar? Explain. Why might they wish to prevent the dollar from depreciating? Explain.

   (d) Why might central banks in China and the rest of Asia be likely to change their behavior in the near future? Explain.

   (e) If the current account is to improve why must the dollar depreciate? Explain. Why is this question different from that of part (a)? Explain.