Some Past Final Exam Questions

Note that because topics have varied over the years some questions may be less applicable in the current semester. You have to figure that out for yourself. There is no free lunch.

1. It is convenient to distinguish between first-generation and second-generation currency crises. What is the basic difference between these two types of currency crises?
   (a) How do these two approaches treat the timing of currency crises?
   (b) How do these two approaches differ with respect to the role of investors (speculators)? How do they differ with regard to the role of the government?
   (c) Why are the currency crises of the 1990's more like the second generation than the first?
   (d) If a crisis was anticipated, what signals would we observe in financial markets? Is the absence of such signals more consistent with the first or second-generation models?

2. An "expert" on TV argues that the announcement of a fixed exchange rate between the dollar and the yen would eliminate forever any uncertainty about the dollar-yen exchange rate.
   (a) Do you agree with this expert? Explain.
   (b) A second "expert" joins the discussion and proposes that adopting the gold standard would eliminate all exchange rate uncertainty. How do you assess this proposition?
   (c) A third "expert" dismisses the gold standard but claims that a currency board is the way to go. Discuss.
   (d) It is your turn to reveal the most effective, albeit radical, means of reducing, if not eliminating, all exchange rate uncertainty. What is this policy?

3. How can a financial institution be illiquid but not insolvent? Explain.
   (a) What is the connection between illiquidity and the short-term nature of liabilities?
   (b) What is the connection between illiquidity crises and the coordination problems of lenders? Explain.
   (c) Why does the presence of a large investor have the potential to eliminate an illiquidity crisis? Explain.
   (d) Why might the presence of the IMF squeeze out any role for the large investor?

4. Consider a small open economy with a flexible exchange rate and perfect capital markets. The economy is at full employment and external equilibrium.

   (a) Now suppose that all of a sudden foreign investors become scared about this country. Capital inflows now require a higher interest rate than in the rest of the world, and this premium increases with the size of the inflow. Use an IS-LM diagram to show what happens to income, the exchange rate, and domestic interest rates in this economy.
   (b) Given that the economy was initially at full employment, suppose that the monetary authorities seek to offset the effect on income in part (a). What can they do? Explain.
   (c) Suppose instead that this economy had a fixed exchange rate prior to the loss of confidence. What would be the impact of the sudden change in capital flows? Explain.

5. Use the two-country model of interest-rate determination with savings and investment to analyze the Asian Financial Crisis. Treat Asia as one country, and the rest of the world as the other. Suppose that initially at world interest rates Asia has a current account deficit financed by capital inflows from the rest of the world. Draw the savings-investment diagram and the equilibrium world interest rate for both countries.

   (a) Suppose that all of a sudden the rest of the world no longer is willing to lend to Asia. What happens to the interest rate in Asia?
   (b) In fact, after the crisis started Asia still had to service its debts. What must happen to domestic interest rates in Asia for this to be possible? Explain.
   (c) What are the likely consequences for the domestic economy of the sudden change in the current account balance that is associated with the currency crisis? Explain

6. Consider a small open economy under fixed exchange rates and imperfect capital mobility. Suppose that foreign income (Y^*) increases. Trace the effects on the domestic economy. Suppose that the monetary authorities engage in sterilized intervention to offset the effects of the rise in Y^*.

   (a) Carefully explain how the process of sterilization works.
   (b) Explain how country size, the degree of capital mobility, and financial development effect the ability of a central bank to engage in sterilized intervention.
   (c) Suppose that the economy had a flexible exchange rate. What would be the effect of the rise in Y^*? Explain.

7. Some observers argue that the Asian financial crisis arose due to premature financial liberalization. Present the basis of this argument.

   (a) What features of the crisis point to premature financial liberalization as the culprit?
   (b) Explain the role of moral hazard in this explanation.
   (c) How do financial crises become currency crises?

8. *(30%)* Given the costs that must be borne by countries afflicted with currency crises it is surprising that they fixed their exchange rates to begin with. Why do (some) countries choose to fix their exchange rates?

   (a) What advantages did these countries obtain from operating a fixed exchange rate regime? Be specific.

   (b) Consider a typical country where fundamentals are leading to a crisis. If this country had a flexible exchange rate regime what would happen?

   (c) Some argue that a fixed exchange rate regime provides more discipline. Given your answer in part (b) how do you assess this argument? Explain.

9. "The essence of currency crises is the conflict between domestic and external objectives. The crisis manifests when the government must choose between these objectives." Discuss.

   (a) What is the nature of this conflict?

   (b) Why are governments typically forced to choose between the two? Provide an example.

   (c) Does this depend on the type of currency crisis that occurs? Explain.

10. Suppose that the monetary authorities announce, to everyone's surprise, that they have reduced the level of the money stock. Explain what will happen to the exchange rate immediately, and how it will adjust to the new full equilibrium. Why will the impact effect and the full effect differ? Would your answer be different if the policy were expected? Explain.

11. Many observers argue that a currency board is the best protection against a currency crisis. What is the reasoning behind such a view? Explain. How can a currency board protect an economy against the types of pressures that countries in Asia have suffered? Given that countries that experience such crises had fixed exchange rates what possible benefits can a currency board provide? Why don't all countries adopt currency boards? Explain.