

YOU SHOULD HAVE 8 PAGES FOR THIS EXAM. EXAM WILL END AT 2:30. MAKE SURE YOUR NAME IS ON THE FIRST AND LAST PAGE OF THE EXAM.

I. Multiple Choice (30 points – 2 points each) For each of the following questions, place your answer in the appropriate space on the last page. Only answers placed in these blanks will be graded.

- 1) Under a managed float system, central banks can
 - a. allow international reserve changes.
 - b. let exchange rates adjust to market pressures.
 - c. experience reserve changes and exchange rate changes.
 - d. al of the above.

- 2) Suppose that the United Kingdom devalues the pound. If both exports and imports are written in terms of pounds, then the UK balance of trade
 - a. worsens.
 - b. improves.
 - c. is unaffected.
 - d. falls for a while before increasing.

- 3) It costs FF120 to have your car's oil changed in France. In Switzerland, it costs SF40 to have your car's oil changed. The exchange rate is FF3.5/SF11. This is an example of
 - a. purchasing power parity.
 - b. the law of one price.
 - c. an opportunity for arbitrage.
 - d. none of the above.

- 4) Exchange rates are the same in different markets at the same time because
 - a. all foreign exchange markets are linked to a central market administrator.
 - b. each currency is traded in just one market.
 - c. arbitrage will instantly eliminate market violations.
 - d. of the existence of the forward market.

- 5) If the exchange rate for the Australian dollar is US\$0.7833/A\$ and the exchange rate for the Hong Kong dollar is US\$0.1280/HK\$, then the Hong-Kong Australian dollar exchange rate (HK\$/A\$) is
 - a. 1.2767.
 - b. 7.8133.
 - c. 6.1195
 - d. 9.9738.

- 6) Purchasing power parity (PPP) implies
- exchange rates are the same in different foreign exchange markets at any given time.
 - interest rates will be the same across countries at any given time.
 - exchange rates will adjust to offset differing inflation rates between countries.
 - the law of one price will never hold.
- 7) If today's spot rate on the British pound is \$2 and the one-month forward rate on the pound is \$2.10 (ignoring any interest earnings or costs),
- a speculator who had purchased 100 British pounds forward today will make a profit of \$10 one month from now.
 - a speculator who had purchased 100 British pounds spot today will make a profit of \$10 one month from now.
 - a speculator who had sold 100 British pounds forward today will make a profit of 1 pounds one month from now.
 - a speculator who had sold 100 British pounds spot today will make a profit of 10 pounds one month from now.
 - none of the above.
- 8) Which of the following is recorded as a debit item in the U.S. balance of payments accounts?
- An Italian firm pays \$5 million in dividends to the holders of its stock in the United States.
 - The French Club Med hires four American scuba diving instructors for its new resort on the Italian island of Sardinia.
 - Toyota builds a factory in the United States to manufacture the Toyota Camry.
 - Remittances from Cambodian immigrants in the United States flow to their relatives in Thailand's refugee centers.
- 9) All other things being equal, which of the following would ***not*** cause the price of a foreign currency to fall?
- A rise in the home country's expected inflation rate.
 - A rise in the foreign country's expected inflation rate.
 - A drop in the foreign country's real income.
 - A rise in the foreign country's money supply.
- 10) If a country's nominal interest rate increases by the same percentage that the inflation rate has increased
- international investors will withdraw their funds from the country.
 - international investors will pour more funds into the country.
 - international investors will demand an increase in the real interest rate they are paid.
 - none of the above.

- 11) A government might want to devalue its currency if
- exporters have a strong lobbying arm.
 - import buyers have a strong lobbying arm.
 - policymakers worry about high domestic inflation rates.
 - foreign governments tell it not to.
- 12) One advantage of a fixed exchange rate system is that
- the economy is likely to be more stable.
 - the value of the foreign reserves of the country will not change much since the exchange rate is fixed.
 - destabilizing speculation is unlikely if officials are committed to keeping exchange rates fixed.
 - prices are kept fixed under a fixed exchange rate.
- 13) When Argentina pegged its peso to the U.S. dollar
- it reduced people's expectations of further inflation in the country.
 - it lost independent control over its money supply.
 - it reduced inflation from an annual rate of 3000% in 1989 to 4% (the same rate as in the United States) in 1994.
 - all of the above.
- 14) The dominant international borrower in the past decade has been
- the developing countries.
 - the European Community.
 - the former Soviet Union.
 - the United States.
- 15) A five percent ownership participation by General Motors in an Irish software developer is considered
- direct foreign investment.
 - portfolio investment.
 - official aid.
 - short-term lending.

Short Answer (40 points – 10 points each) Answer each of the following short answer questions in the space provided. Be concise, but do not simply use bullet-points to answer the questions. You may use the backside of these pages if you need more room.

1) Describe the international monetary system known as the Bretton Woods system, or the gold exchange standard that existed from the mid 1940s to the early 1970s. How did the system work? Why did it eventually break down?

2) Why do you suppose that small countries choose to peg their exchange rates, whereas the largest countries float their currencies?

3) To aid in its efforts to get reelected, the current government of a country decides to increase the growth rate of the domestic money supply by two percentage points. The increased growth rate becomes “permanent” because once started it is difficult to reverse. What do you think will happen to the exchange rate value of this currency in the long run? Why? What does this say about purchasing power parity (PPP)?

4) Will the law of one price (PPP) apply better to gold or Big Macs? Why?

Problems (30 points) For each of the following questions, circling the final answer to each part. Partial credit will be given, so show your work.

Problem #1. (14 points) In 1975, the price level for the United States was 100, the price level for Ireland was 100, and in the foreign exchange market one Irish pound (IR£) was equal to \$1. In 1995, the US price level had risen to 260, and the Irish level had risen to 390.

- a. (5 points) According to PPP, what should the IR£-US\$ exchange rate be in 1995?
- b. (5 points) If the actual dollar-pound exchange rate is \$1/IR£ in 1995, is the pound overvalued or undervalued relative to PPP?

Here is further information on the US and Irish economies:

	1975			1995		
	<u>M^s</u>	<u>Y</u>	<u>P</u>	<u>M^s</u>	<u>Y</u>	<u>P</u>
US	20,000	800	100	65,000	1,000	260
Ireland	10,000	200	100	58,500	300	390

- c. (2 points) What is the value for v for the US in 1975? For Ireland?
- d. (2 points) Using the v found in (c) for each country, does this same v hold for 1995?

Problem #2 (16 points – 2 points apiece)

The spot exchange rate between the dollar and the British pound is floating or flexible exchange rate. What are the effects of each of the following on this exchange rate?

- a. There is a large increase in British demand for US exports as US culture becomes more popular in Britain.
- b. There is a large increase in British demand for investments in US\$-denominated financial assets because of a British belief that the US political situation has improved since the Nov. 7 election.
- c. Political uncertainties in Europe have lead US investors to shift their financial investments out of Britain and back into the US.
- d. US demand for products imported from Britain falls significantly as bad press reports lead Americans to questions the quality of British products.

Assume now that the dollar-pound exchange rate is fixed (or pegged) within a narrow band around a central rate. For each (a)-(d) above, what intervention is necessary by the US Federal Reserve to defend the fixed rate if the changes shift the equilibrium exchange rate to outside the exchange rate band. Label your answers (e), (f), (g), and (h), where (e) corresponds to the action the Fed would take in (a), (f) would be the action the Fed would take in (b), (g) with (c), and (h) with (d).

Multiple Choice

Name(ID)

1. _____

2. _____

Multiple choice = _____ X 2= _____

3. _____

Short Answer #1 _____

Short Answer #2 _____

4. _____

Short Answer #3 _____

Short Answer #4 _____

5. _____

Problem #1 _____

6. _____

Problem #2 _____

7. _____

Total Points _____

8. _____

9. _____

10. _____

11. _____

12. _____

13. _____

14. _____

15. _____