

International Economics: A Policy Approach
EC 340 Spring 2005
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PRACTICE FINAL EXAM - SOLUTIONS

Question 1: Beginning from a point of equilibrium, suppose residents of country A decide to hold a smaller quantity of real money balances at each level of income and interest rate. (Money demand in our domestic economy falls.) Illustrate and explain the effect in the foreign exchange market.

Solution:

A falling money demand in our domestic economy will reduce the interest rates on domestic assets. Lower interest rates on domestic assets will increase the demand for foreign assets, i.e. shifting the demand curve for foreign assets to the right.

Under flexible rates this leads to an increase in the exchange rate, i.e. a depreciation of the domestic currency and an appreciation of the foreign currency.

Under fixed exchange rates this adjustment cannot take place. The central bank has to intervene by increasing the supply of foreign assets to hold the exchange rate at the constant level.

Question 2: In class we discussed the advantages and disadvantages a country faces when fixing its exchange rate. Please list and explain three arguments in favor and three arguments against fixed exchange rates. To what extent can fixed exchange rates present a risk for financial crises? Give an example from class.

Solution:

Arguments in favor of fixed rates:

Low inflation
Increased trade and financial flows
Import of credibility and stability

Arguments against fixed rates:

Loss of domestically oriented monetary policy
Exchange rate cannot function as an automatic shock absorber
Costly to maintain

Example: Fixed rates promote the inflow of foreign capital flow, which puts the country at a risk of sudden withdrawals if international confidence falls. (Argentina, Asia, Russia...)

Question 3: Assume you are a U.S. importer buying goods from Britain. You need to deliver a payment of £20,000 a year from now and you are wondering how many dollars you will need to make the payment and whether to keep the payment in \$ until the payment date comes or to convert them to British pounds immediately.

You are given the following information:

U.S. interest rate 1.08%

U.K. interest rate 3.81%

Spot exchange rate 1.772\$/£

Expected exchange rate in one year 1.681\$/£

What would you do? Please show all your work.

Solution:

Invest in US and exchange at expected rate:

$$\text{\$ } X * 1.0108 * (1/ 1.681 \text{ \$/£}) = \text{£}20,000$$

solve for X:

$$X = \text{\$ } 33260.78$$

Exchange at spot rate and invest in Britain:

$$\text{\$ } X * (1/1.772 \text{ \$/£}) * 1.0381 = \text{£}20,000$$

solve for X:

$$X = \text{\$ } 34139.29$$

Choosing the first method one has to invest less \$ to obtain the £20,000 in one year, therefore you would invest the money in the US and then exchange at the expected rate.

Question 4: Imagine you have \$ 10,000 that you want to invest for one year and you are given the following information:

$$R_{\$} = 1.75$$

$$R_{\text{£}} = 3.34$$

$$E_{\text{\$/£}} = 1.7902$$

$$E^e_{\text{\$/£}} = 1.7539$$

Would you prefer to invest your money in the US or to transfer to British pounds and exchange back a year from now?

Solution:

Invest in US:

$$\text{\$ } 10,000 * 1.0175 = \text{\$ } 10175$$

Transfer to Pounds, invest in UK and transfer back:

$$\text{\$ } 10,000 * (1/1.7902 \text{ \$/£}) * 1.0334 * 1.7539 \text{ \$/£} = \text{\$ } 10124.46$$

It is therefore better to invest the money in the US.

(You can also use the interest parity condition to solve this problem)

Question 5: Economists have various theories on what can explain exchange rates and exchange rate movements. From the readings, discuss two different theories that can explain the determination of exchange rates.

Solution:

Compare text by Hopper: What determines the exchange rate, market factors or market sentiment? (International Economics and International Economic Policy).