

- 1. (10%)** Using a supply and demand diagram for the Forex market, show how an increase in import tariffs would affect the direct foreign exchange rate (E), and explain how this would in turn affect exports and the trade balance (NX). Then using the AA-DD diagram, show and explain why a permanent tariff increase has different effects under fixed and floating rate systems. Why might this help explain the expansion of global trade?
- 2. (20%)** Consider a country (like the U.S. in 1929) with gold-based fixed exchange rates, with a central bank holding three assets – gold, foreign exchange reserves, and domestic bonds – to back up its monetary base. (a) Suppose a financial crisis reduces the deposit expansion multiplier. Prior to any central bank intervention in the forex market, use the E-R-M diagram and the AA-DD diagram to predict what would happen to E, NX, national income (Y), and the interest rate (R). What happens to the balance of payments? (b) What should central bank intervention do to the monetary base, and how would this affect the economy? (c) Suppose the central bank sterilizes its international gold flows by offsets in its holdings of domestic bonds. What would be the effect of this? (d) Using the AD-SRAS diagram, show the effects of all this on the price level (P) and real output (Q) in the home country. (e) Using the HH-FF diagram, show the effects of all this on foreign trade partners through both the trade sector and the balance of payments.
- 3. (10%)** Consider a country (like the U.S. in the 1960s) with fixed exchange rates, in which foreign central banks take primary responsibility for intervention in forex markets. Suppose the economy is at full employment, and government purchases (G) suddenly rise dramatically due to the costs of fighting a war. How would this affect Y, P, Q, and R? How would this affect the economies of major foreign trade partners? Use the same diagrams as above.
- 4. (10%)** What is the J-Curve, and why might it occur? Is it more likely in the short-run or the medium-run? Is it more likely if a country is running a trade surplus, or if it is running a trade deficit?
- 5. (10%)** Suppose that foreign investors start to believe that the risk of holding dollar assets has increased significantly but temporarily. What would you predict would happen to E, Y, and NX, assuming we are currently in a recession and our trade balance is in deficit? Use the AA-DD diagram to show and explain. Would there be any overshooting?
- 6. (10%)** Assume that next year the economy has recovered to full employment, and due to concerns about inflation the Fed begins to engage in open market operations to temporarily reduce the monetary base. At the same time, new financial reforms reduce the perceived risk of our financial markets. Use the E-R-M and AA-DD diagrams to show and explain how these two events should affect R, E, Y, and NX. Use the AD-SRAS diagram to predict the effects on P and Q in the medium-run and the long-run.
- 7. (10%)** Suppose that during his first term, President Obama refuses to reauthorize most of President Bush's tax cuts, effectively increasing T to balance the federal budget. If Forex traders realize that this is permanent, what would you predict would happen to E, Y, and NX? Use the AA-DD diagram to show and explain.

8. (20%) Shorter Essay Questions. Answer four of the following five questions (5% each). For bonus points, you may answer the fifth one too.

- A. An unexpected devaluation for a country with unilateral fixed exchange rates can have positive economic effects, but the expectation of a devaluation can have severe consequences, even if the country has adequate foreign exchange rate reserves. Why?
- B. How did the Bretton Woods system differ from the gold standard? Why did it collapse?
- C. What is the Trilemma? Explain.
- D. What is a Currency Board, and why is it often recommended for small countries?
- E. What are the conditions for an Optimal Currency Area? Does Europe meet these conditions? Why must monetary policy for the Euro area be conducted by a single European Central Bank, rather than allowing the individual central banks in each member country the right to issue Euros in place of their own currency?