

1. (20%) Consider an open market economy with floating exchange rates:
 - a) Suppose a financial crisis leads banks to reduce their willingness to lend, at the same time household cut back on their consumption. Use the ISLM-FX model and the AD-AS model to show the combined effects of these two shocks on Y , i , E , and P .
 - b) Suppose that the central bank intervenes by buying domestic assets to increase bank reserves. How would this affect Y , I , E , and the current account balance?
 - c) Suppose instead that the government tried to stabilize the economy with fiscal policy. What would it do, and how would this affect Y , i , E , and the current account balance?
 - d) Suppose that (b) and (c) are used together to offset the effects of (a). Once the economy returns to full employment, the government then temporarily cuts taxes. How would this then affect Y , i , E , the current account balance, and P ?
 - e) Suppose investors are considering the long-run prospects for this economy, and suddenly decide that the government budget and trade deficits make the current exchange rate unsustainable in the long run. Use the ISLM-FX model to show how this change in expectations for E should affect the economy.

2. (10%) Consider a two-economy model with floating exchange rates, in which two large countries are experiencing a recession. The Home country chooses to stimulate their economy with fiscal policy, while the foreign country chooses to use monetary policy instead. How will this affect E – the price of Foreign’s currency for Home – and the success of each country’s efforts to stimulate their economy? Use appropriate graphs to explain.

3. (10%) Consider a small economy that has unilaterally pegged its currency against that of a large trading partner, and its currency is currently considered undervalued (i.e., it has pegged E above the market-clearing rate).
 - a) What are the advantages and disadvantages of having E pegged too high?
 - b) Why might the effects of having an undervalued currency depend on whether the economy is below full employment or not?

4. (20%) Consider a small economy that has unilaterally pegged its currency against that of a large trading partner, and it unexpectedly decides to devalue its currency.
 - a) Using the ISLM-FX model, explain how this unexpected devaluation will affect the current account, the balance of payments, and the money supply. What are the effects on Y , i , and E ?
 - b) Suppose instead that speculators in the forex market predicted a devaluation that was not intended. How might they see this as a one-sided bet, and what might they do? Using the ISLM-FX model, explain how the mere expectation of a devaluation might affect the balance of payments and the money supply. What are the effects on Y , i , and E ?
 - c) Consider how the central bank might respond to speculative expectations of a devaluation. Using an appropriate graph, show how (i) a proactive defense of the currency, (ii) a passive defense of the currency, and (iii) sterilization of any forex intervention, would each affect a country’s probability of “falling off the cliff”. Does it matter if the country has borrowed from abroad in its own currency, or in a foreign currency? What role might the IMF play in preventing the country from falling off the cliff, and what would it expect in return?

5. (10%) Consider a two-economy model with fixed exchange rates, in which two large countries are experiencing a recession. Would the Home country prefer to act alone, or in coordination with the Foreign country, if it chose to use fiscal policy? What would it prefer if it chose to use monetary policy? Would it matter whether the fixed exchange rate regime was symmetric (e.g., the gold standard or the EMS) or asymmetric (e.g., the Bretton Woods system, with Home as the Reserve Currency country).

6. (15%) How do fixed exchange rate regimes compare to floating rate regimes in:

- the effects on the Home economy of an increase in the foreign price level?
- the effects on the Home economy of an increase in foreign income?
- the effects on the Home economy of an increase in foreign interest rates?
- the effects of a tariff by the Home country on foreign imports?
- the volume of global capital flows for purposes of diversification, assuming monetary shocks are more common than fiscal shocks.

7. (15%) Short answers:

- What is the J-curve? Is it more likely to apply in the short run or the long run? Is it more likely when trade is balanced, in surplus, or in deficit?
- What is the Trilemma? Why are all three points of the trilemma individually desirable?
- What are the conditions for an optimal currency area?

Bonus: Was there any important question you felt prepared to answer, but which was not asked? Write the question, and then answer it. Your grade depends on my subjective judgment of the merits of the question and the accuracy of your answer.