Original

Prof. Dr. Karl-Heinz Paqué **Winter Term 2008/9**

Examination for the lecture "International Finance and Open Economy Macroeconomics"

Preliminary Remarks:

- ***Time:*** *2 hours.*
- ***Aids:*** *no aids are allowed, except a bilingual dictionary.*
- ***Language:*** *English. Answers in German are possible for students who are registered in German-speaking programmes of the University.*
- ***Structure:*** *4 questions (1,2,3,4). Each question is to be answered using standard tools of economic reasoning. Each question is weighted equally and consists of two or three parts. In each question, a maximum of 30 points can be reached. The total number of points is 120.*

Question 1:

"Overshooting" is a well-defined phenomenon in the theory of exchange rate determination.

(a) Give a graphical illustration of overshooting for the case of an expansionary monetary policy in a setting with two countries (Dollarland and Euroland).
(b) Explain the economics of overshooting as an equilibrium phenomenon.
(c) Define the real exchange rate. Explain how it develops in the course of overshooting.

Question 2:

There are two major types of theories to analyze the market for foreign exchange: the "asset market approach" and the "monetary approach".

(a) Explain the main distinguishing assumptions and characteristics of the two approaches. In doing so, choose an appropriate two-country setting (Dollarland and Euroland).
(b) Explain economically within the appropriate approach how
    - a rise of the Dollar money supply,
    - a rise of output in Euroland
    - a rise of liquidity preference in Dollarland

    affects the interest rates, the exchange rate and the price levels
    - in the short run,
    - in the long run.

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Question 3:

In an open economy with full employment, the government pursues a supply side policy that is successful in raising the level of output (Y).

(a) Show algebraically and graphically how this policy affects
- the interest rate (r) and investment (I),
- the real exchange rate (ε), net foreign investment (NFI) and net exports (NX),
- the price level (p).

Use a standard long run open economy model. Assume that Y changes exogenously.

(b) Explain your results from part (a) economically. Explain also why the effect of the rise of Y on the nominal exchange rate is ambiguous whereas the effect on the real exchange rate (calculated in part (a)) is unambiguous.

(c) How do your results change when international capital mobility is perfect? Use algebra and graphics. Explain your result economically.

Question 4:

Think of a developing country in a state of underemployment. Assume that, due to a successful macroeconomic stabilization with a pegged exchange rate, the government of this country has been able to massively improve its rating as a debtor. As a consequence, the country is now experiencing a "capital glut", i. e. a massive inflow of capital.

(a) Show algebraically and graphically how the "capital glut" affects
- the interest rate (r),
- investment (I) and output (Y)
- the money supply (M).

Use a standard short run open economy model with fixed exchange rates. Use a decline of an exogenous risk parameter (σ) as the relevant exogenous shock.

(b) Explain your results from part (a) economically.

(c) Evaluate the effects of the capital glut from the perspective of a government that puts high priority on long-term macroeconomic stability. Are there macroeconomic risks involved in the "capital glut"? If so, what would you recommend to mitigate these risks? Explain your answer.