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Prof. Dr. Karl-Heinz Paqué **Summer Term 2009**

Examination
for the lecture
"International Finance and Open Economy Macroeconomics"
(20046)

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:

"There is a close link between foreign exchange markets and national money markets".

(a) Show this link graphically. Explain it economically for a model setting with two countries (Home and Foreign).

(b) Assume that the money supply contracts in Home. How does this affect the equilibrium combination of rates of return and the exchange rate, and why?

(c) Assume that output expands in Foreign. How does this affect the equilibrium combination of rates of return and the exchange rate, and why?

Question 2:

Not all goods in an economy are traded internationally. Those that are not we call "non-traded goods" (to be distinguished from "traded goods").

(a) Assume perfect intersectoral mobility of labour between the production of traded goods and non-traded goods. Explain economically how the presence of non-traded goods affects price inflation over time

[1] if productivity growth is faster in the traded goods sector than in the non-traded goods sector of the economy,

[2] if, at equal sectoral productivity growth, the labour intensity in the production of non-tradable goods is much higher than in the production of tradable goods.

(b) Assume that one of the two if-conditions in (a) holds persistently over long periods of time. What would you then expect for international comparisons of per-capita income or output levels? What does this imply for Purchasing Power Parity (PPP) in the long run? Explain your answers.

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Question 3:

Assume an open economy in the long run under the standard assumptions as specified in the lecture.

(a) Derive algebraically and show graphically the effects of a decline of government expenditure on the interest rate, the real exchange rate as well as domestic investment and net foreign investment.

(b) Explain economically how and why the results in (a) come about.

(c) Assume now fixed nominal exchange rates. How do the results change? Answer this question using algebra, graphics and economic reasoning.

Question 4:

Assume an open economy in the short run under the standard assumptions as specified in the lecture.

(a) Derive algebraically and show graphically the effects of a rise of the money supply on the interest rate and output as well as the real exchange rate, domestic investment and net exports.

(b) Explain economically how and why the results in (a) come about.

(c) Assume now perfect international capital mobility. How do the results change? Answer this question using algebra, graphics and economic reasoning.