

**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. In each question, a maximum of 30 points can be reached. The total number of points is 120.
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Question 1:

“Some people argue that exchange rates ensure purchasing power parity (PPP) of currencies between all countries with free convertibility of their currencies. This is wrong. And it is wrong not only in the short run, but even in the long run.”

- (a) Discuss this statement with respect to the so-called overshooting of exchange rates in the short run. Consider the example of a monetary expansion affecting the parity, which then adjusts over time.
- (b) Discuss the statement with respect to the existence of non-traded goods in the long run. Consider different scenarios of productivity growth in the economy with traded and non-traded goods.
- (c) Given the undeniable deficiency of the PPP-assumption even in the long run: Why do we make it at all? What sense does it make? What does it help us? Shouldn't we drop it altogether?

Question 2:

In the short run, the market for foreign exchange can be described by the asset market approach, in the long run by the monetary approach.

- (a) Explain the main distinguishing assumptions of both approaches and compare them. Focus on the role of the interest rate and the price level.
- (b) Assume a setting with two countries (Home and Foreign). Explain economically how an exogenous **decline** of the
 - [1] money supply in Home,
 - [2] output in Foreign
 - [3] liquidity preference in Foreign
 - [4] interest rate in Foreignaffects - **in Home** - the interest rate, the price level and the exchange rate in the short run and in the long run.

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Question 3:

“China has a huge current account surplus. To get rid of it, China should lower tariffs or other trade barriers to let more foreign goods into the country.”

Discuss this statement in a standard long run open economy model with full employment. In particular:

- (a) Show algebraically and graphically how the recommended policy affects the real exchange rate (ϵ), net foreign investment (NFI) and net exports (NX), the interest rate (r), investment (I) and the price level (p). Explain your results economically.
- (b) Show algebraically and graphically what happens when China not only lowers trade barriers, but also taxes – thus raising the government deficit, but also the disposable income of people. Explain your results economically.
- (c) How do your results in (a) and (b) change when international capital mobility is perfect? Use algebra, graphics and economic reasoning.

Question 4:

In the course of the global financial crisis, Estonia experienced a massive capital flight, but continued to peg its currency to the Euro. It did so because the political aim remained the introduction of the Euro (“joining Euroland”) in the medium run.

(a) Show algebraically and graphically how the “capital flight” affected

- 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 rise of a risk parameter (σ) as the relevant exogenous shock.

- (b) Explain your results from part (a) economically.
- (c) Evaluate the effects of the exchange rate peg against the background of free floating. Use economic reasoning. Do so with respect to
 - short-run output and employment effects,
 - the long-run confidence in the economy’s stability.

Assume you were in charge for Estonian policy making at the onset of the crisis: what would you have done?