Prof. Dr. Karl-Heinz Paqué **Summer Term 2011**

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, three or four 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 expands in Home. How does this affect the equilibrium combination of rates of return and the exchange rate, and why?

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

Question 2:

"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?

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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? Explain your result economically.

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 an expansionary fiscal policy 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 fixed exchange rates. How do the results change? Answer this question using algebra, graphics and economic reasoning.