International Financial Markets (2777)

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Fall term 2007/2008

Final Exam
January 28th, 2008

Surname ____________________

First Name ____________________

Matrik. Number ____________________

Please turn in this set of problems!
Perform the graphical analysis always in this problem set!

This document consists of 7 pages and 3 problems!

Time: 60 minutes
Maximum number of points: 60
You are allowed to use a ruler and a dictionary.
You have to work on all problems!

Please always label carefully

- the axes,
- the curves, and
- the shifts carefully

in all figures.

Problem 1: Mundell Fleming Model (25 points)

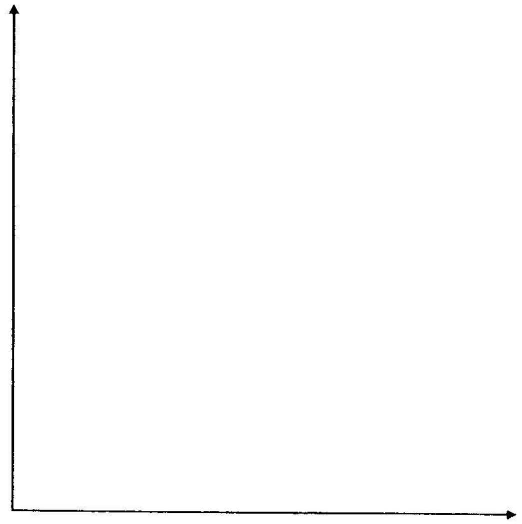
The most famous German product of the yellow press, namely the Bild Zeitung, reported in August 1993 on the problems in the European Exchange Rate system. The French central bank tried to defend its currency against a speculative attack to avoid a devaluation of the French franc. At some point in time the French central bank run out of reserves...

Analyze from the perspective of the French economy how an increase of the foreign interest rate (the German interest rate) influences the French economy. You can assume a fixed exchange rate system as well as complete capital mobility. Always argue from the perspective of the French economy!

a) In a first step, analyze this shock in the graph below. Assume also that the French central bank runs out of reserves, after the previously existing reserves were completely used up to defend the fixed exchange rate system. Hence, the French central bank does not have enough reserves to reach a new equilibrium! **(13 points)**

b) Please name three different policy tools the French institutions (central bank or government) can use to reach a new equilibrium. Briefly discuss how the new equilibrium would have been reached within the graph. **(9 points)**

c) The Bild Zeitung came up with a very interesting policy recommendation. In the article it is said that *"central banks never can go bankrupt [...] they always can print fresh money."* What would happen if the French central bank indeed followed the recommendation of the Bild Zeitung and performed a quasi expansionary monetary policy? Give a brief explanation how this would translate in the graph. **(3 points)**



Problem 2: Calvo/Mendoza Model **(10 points)**

Please circle the right answers:

What are the underlying assumptions of the Calvo/Mendoza model?

- The volatilities of the various assets are the same. **(true or wrong)**
- The correlation between the various assets is zero. **(true or wrong)**
- The expected return of the asset is the same for all assets. **(true or wrong)**

What kind of model implications can be derived?

- In the basic scenario (without any new country specific information) an investor can increase his return by investing in all J different investment opportunities. **(true or wrong)**
- In the basic scenario (without any new country specific information) an investor should invest a proportion 1/J of his wealth in each asset available. **(true or wrong)**

Please fill in the gaps:

After a profit warning an investor should decrease his investment in the country which is subject to the profit warning.

- This decrease should be the larger, the .... the number of different investment alternatives.
- This decrease should be the larger, the .... the risk aversion of the investor.
- This decrease should be the larger, the .... the volatility of the asset.

Problem 3: IS-LM model (25 points)

Please explain within the enriched IS-LM framework (Blanchard chapter 22) why the **built in stabilization mechanism** of an economy may fail.