Final Exam
International Economics 446/546

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Answer 7 of the following 9 questions. Please answer each question True, False, or neither and explain the reasons for your answers. **Use graphs and/or equations in your explanations whenever possible.** Required graphs and equations are listed in brackets. Be sure to label all graphs and to define any economic terms in the statements. Assume that exchange rates are flexible unless the question explicitly states otherwise. Credit for each question depends entirely on your explanations.

1. Assume the US begins with current account balance. A strong fall in expected future income would create a US current account deficit. [Use q graph with relative supplies and demands and AA-DD-XX curves with initial current account balance for short run extended model]

2. If the US puts a tariff on Chinese goods, the US current account deficit will be reduced. [AA-DD-XX curves for simple model with permanent shock beginning with a zero current account deficit and q graph.]

3. Greece is reducing government spending in an effort to end its recession and reduce its current account deficit [AA-DD-XX curves for short run for a fixed exchange rate economy with the economy initially in a recession with current account deficit]

4. With flexible exchange rates monetary expansion at home increases output in both the home and foreign countries in the short run. In the long run, domestic and foreign prices both rise and both outputs return to their initial levels. [ simple model: AA-DD-XX curves for domestic country with both short run and long run; equations for foreign country]

5. Assume that a country has been running a current account deficit. A sudden stop in capital flows under a fixed exchange rate requires an end to the current account deficit and creates a recession. [AA-DD-XX curves for extended model with initial current account deficit. Write the equation for interest rate parity including a risk premium]

6. A country can permanently increase its current account with a currency devaluation (AA-DD-XX in simple model with fixed exchange rates short run and long run).

7. Under fixed exchange rates, a permanent increase in government spending, without tax financing, creates a current account surplus, a fall in foreign exchange reserves, and sets the country on the path to a generation one exchange rate crisis. [AA-DD-XX curves in simple model. Begin at full employment with current account balance. Let government spending increase. Then let price adjust to get to the long-run. Be sure to work with fixed exchange rates. Define generation one exchange rate crisis]

8. A currency crisis is more likely in a recession because agents believe that the government would abandon the fixed exchange rate and use expansionary
monetary policy to end the recession. [AA-DD-XX curves in fixed exchange rate extended model]

9. US monetary policy to increase the US interest rate will create recession and a current account deficit in an emerging market country whose exchange rate is pegged to the dollar. [AA-DD-XX curves for emerging market country under fixed exchange rates – extended model]