

Midterm Exam
Economics 461. International Macroeconomics
Prof. Byron Gangnes
October 8, 2009

- Write all answers in blue books. Make sure your name is on each blue book.
- Carefully read the instructions for each section.
- The weight of each answer in your grade is proportional to the time indicated.
- Times for the various sections sum to 60 minutes. You may have until 2:45 to finish the exam.

Section I (25 minutes)

Evaluate **five** of the following six statements. Indicate whether the statement is true or false and briefly explain why.

1. A natural disaster is likely to reduce a country's current account balance by changing savings and investment rates.
2. If U.S. dollar deposits pay a 10% nominal interest rate, British pound deposits pay a 5% interest rate, and you expect the exchange rate to change from 1.5 \$/£ to 1.65 \$/£ during the coming year, then you will prefer to invest in dollar deposits. (Show your work.)
3. Exchange rates *overshoot* because investors are forward-looking.
4. The DD curve slopes up because value effects are bigger than volume effects.
5. Arbitrage should keep the cost of living in Hawaii similar to that on the mainland.
6. If sustained, the recent large increase in US Federal government spending should lead to a long-run real appreciation of the dollar.

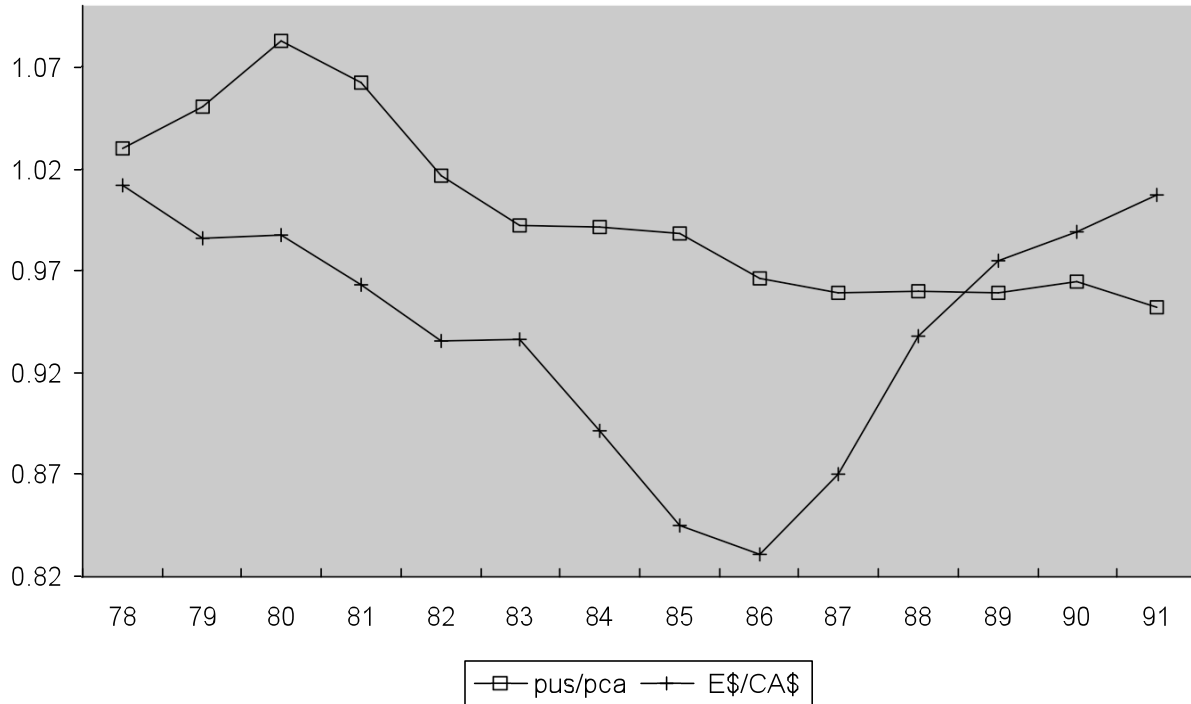
Section II (20 minutes)

In essay 2, you wrote about prospects for the dollar in coming months. This question asks you to analyze two new developments over the past week. Use foreign exchange market/money market model diagrams and complete verbal explanations to answer each of the following questions:

1. How would you expect the dollar's value to be affected by news that foreign central banks have begun to raise interest rates?
2. How would you expect the dollar's value to be affected by news that US job losses in September were larger than expected?
3. What could the Fed do if it wanted to halt the dollar's decline? Show and explain. Do you think they will want to do this now?

Section III (15 minutes)

The following graph shows the movement during the 1980s in the U.S. dollar/Canadian dollar exchange rate and the US/Canada relative price level:



1. Why did some economists claim that the dollar was overvalued relative to the Canadian dollar in 1986?
2. What happened to the US/Canada real exchange rate between 1978 and 1986? Could this change be explained by high government deficit spending in the U.S.? Are there other possible explanations?