

Name: _____

ID#: _____

Instruction: Write your name and student ID number on both this exam and your scantron. Be sure to answer all multiple choice question on your scantron, answers to multiple choice questions written on this test will not be counted. Answer all short answer questions in the place provided. Be sure to turn in both this exam as well as your scantron. Good luck!

Multiple Choice (total 40 points, 2.5 points each)

1. The equation $E_{\$/\pounds} = 2$ means that:
 - A) 1 dollar buys 2 pounds.
 - B) 1 dollar buys $\frac{1}{2}$ of a pound.
 - C) 2 pounds buy 1 dollar.
 - D) 1 dollar buys 1 pound.

2. A sudden and pronounced loss of value of one nation's currency against others is known as:
 - A) a currency crisis.
 - B) a forced devaluation.
 - C) a thinning of value.
 - D) a default.

3. From uncovered interest parity, we know that when the domestic currency is expected to depreciate, the domestic interest rate should be:
 - A) greater than the foreign interest rate.
 - B) greater than the foreign exchange rate.
 - C) less than the foreign interest rate.
 - D) less than the foreign exchange rate.

4. Using Norway's oil industry as an example, it is possible to finance large and profitable investment without:
 - A) risk to investors.
 - B) government interference.
 - C) large initial consumption sacrifices.
 - D) service payments on debt or repayment of principal.

5. When PPP does not hold in the short run, economists have developed an alternative short run explanatory theory based on the idea that:
 - A) currency values are different from other prices, since currencies are not considered assets.
 - B) currency values are influenced in the short run by the fact they serve as short-term assets.
 - C) currency values will eventually result in PPP over time, so no short-run theory is needed.
 - D) currency values are set by government entities and the IMF so that the value often does not result in PPP.

6. What is the Big Mac index?
- A) It is a price index for the top 20 stocks traded internationally.
 - B) It reflects inflation trends through trade in laptop computers and international price competition.
 - C) It is an index of the price of McDonald's hamburgers quoted in one currency designed to measure whether absolute PPP holds for Big Macs.
 - D) It is a measure of unemployment in the service industries of poor nations where Western retailers such as McDonalds have infiltrated.
7. The Fisher effect creates a link between _____ and _____.
- A) expected profits; unemployment rates
 - B) exchange rates; expected profits
 - C) inflation rates; unemployment rates
 - D) inflation rates; interest rates
8. A nation's use of international capital markets enables it to do all of the following *except*:
- A) provide for a higher level of national defense
 - B) smooth consumption over time
 - C) build a productive national capital stock
 - D) reduce risk through diversification
9. The effect on a country's consumption as a result of a permanent shock is:
- A) that consumption smoothing is not possible.
 - B) a temporary change in consumption.
 - C) a permanent change in consumption.
 - D) that consumption smoothing is not possible and there is a permanent change in consumption.
10. If the United States is currently a net international debtor, then:
- A) it has negative net international wealth.
 - B) it has positive net international wealth.
 - C) it must run trade deficits to eliminate its net international debt.
 - D) it must borrow internationally to eliminate its net international debt.
11. Overshooting occurs because:
- A) expectations adjust slower than prices.
 - B) expectations adjust at the same rate as prices.
 - C) expectations adjust faster than prices.
 - D) expectations do not adjust.
12. The present discounted value of an infinite stream of payments of \$5 per year when the interest rate is 20% is:
- A) 1
 - B) 5
 - C) 25
 - D) 100

13. An open economy has:
- A) greater ability to smooth its consumption due to the absence of domestic shocks.
 - B) greater ability to smooth its consumption due to the ability to borrow internationally.
 - C) less ability to smooth its consumption due to the lower marginal product of capital.
 - D) less ability to smooth its consumption to weak links present in the financial system.
14. As long as at least some output shocks are asymmetric, it is possible to:
- A) avoid all risk.
 - B) lower the volatility of income by international diversification of capital assets.
 - C) lower the risk of default.
 - D) avoid any consumption declines as a result of the shocks.
15. Investment spending will occur as long as the marginal product of capital:
- A) is rising.
 - B) is falling.
 - C) is greater than the real rate of interest.
 - D) is greater than the increase in consumer spending.

Use the following to answer question 16:

Table: Currency Values II: How Much 1 U.S. Dollar Will Buy of Other Currencies in 2007 and 2008

Currency	2007	2008
\$1	1.5 euros	1 euro
\$1	2 Brazilian reais	1.5 Brazilian reais
\$1	2 British pounds	3 British pounds
\$1	45 Indian rupees	50 Indian rupees

16. (Table: Currency Values II) The dollar depreciated against which currencies?
- A) the euro
 - B) the real
 - C) the pound
 - D) the euro and the real

(You can put short run 4 and long run on the same graphs.) Label all axes, and indicate curve shifts with arrows. Explain the reason for each curve shift briefly.

- b. (12 points)** Using a set of four time series diagrams, illustrate how the nominal exchange rate ($E\$/Y$), U.S. nominal interest rate, the U.S. price level, and U.S. real exchange rate ($E\$/Y * P_{Japan}/ P_{US}$) change over time. Be careful about how the long run value relates to the initial value.
- c. (5 points)** Is there an arbitrage opportunity here to make a profit in the financial market? If so, explain the sequence of deposits, loans, and currency exchanges (and their timing) that you could use to make a profit off of this set of events.