Sample In-Class Final Examination

Closed Book, One page of notes allowed. Time Limit: 110 minutes

Section I. Define the following terms and indicate their significance in international economics. (15 points)

1. Covered interest arbitrage
2. Real effective exchange rate
3. Optimum currency area

Section II. Indicate whether each of the following statements is TRUE or FALSE and explain your reasoning (10 points each). If a statement is partly true and partly false, please explain both parts. Points are awarded on the quality of your answer.

1. If the nominal British sterling exchange rate depreciates from $1.80/£ to $1.50/£, it is possible that the real British pound sterling exchange rate has appreciated.

2. When the statistical discrepancy is small, it implies that no large transactions have been left out of the balance of payments.

3. In order for a country to be in balance of payments equilibrium, the current account should be zero, on a yearly basis, year after year.

4. In order to maintain a pegged exchange rate, a country’s central bank must be prepared to buy up its home currency when it is undervalued, and sell its home currency when it is overvalued.

5. According to the monetary approach to the exchange rate, a rise in domestic income will lead to a depreciation of domestic currency as people use the extra income to buy foreign goods.
Section III. Short Calculations (10 points each)

1. Given the following data:

$/NZ$ spot exchange rate: $0.50
3-month Euro-$ interest rate: 6.00% per annum
3-month Euro-NZ$ interest rate: 12.00% per annum

a. What value of the 3-month forward rate ($/NZ$) establishes covered interest rate parity?

b. What range of values of the 3-month forward rate ($/NZ$) would lead to covered arbitrage outflows from US$ to NZ$?

2. Given the following data:

$$
\begin{array}{ccc}
\text{time} = t & \text{time} = t+5 \text{ years} \\
$/DM$ exchange rate & $0.50/DM & $0.40/DM \\
\text{German price level} & 50 & 90 \\
\text{U.S. price level} & 100 & 120 \\
\end{array}
$$

is it correct to say that the DM depreciated in nominal terms and in real terms over the five-year period? Explain your reasoning.

Section IV. Short Essay (25 points)

1. Currently the nation of Argentina uses a “Currency Board” system for their exchange rate. But there is active discussion among top-level Argentine policymakers to abandon this system and adopt a system of “Dollarization” in its place.

a. Briefly define what is meant by a “Currency Board” system.

b. Discuss the major advantages and disadvantages of a currency board system for a country like Argentina.

c. Discuss the reasons that Argentina might want to abandon the currency board and move toward “Dollarization.”