

NAME: _____

Student ID No.: _____

**Economics 340
International Economics
Prof. Alan Deardorff
Second Midterm Exam**

Form 0

November 20, 2006

INSTRUCTIONS: READ CAREFULLY!!!

1. Please do not open the exam until you are told to do so.
2. **PLACE YOUR NAME AND STUDENT ID NO. (THE EIGHT DIGIT NUMBER FROM YOUR M-CARD) ON THE EXAM AND ON THE SCANTRON SHEET.**
3. **After** you are told to open the exam, find the **FORM NUMBER** at the top of page 2 and copy it to the scantron sheet.
4. This exam has 100 points and you have approximately 80 minutes to complete the test. Check that you have all 13 pages of the exam, including this cover sheet.
5. **Part 1** consists of 25 multiple choice questions worth 2 points each. Answers to the multiple-choice questions in Part 1 should be marked on the scantron sheet using a #2 pencil. There are no penalties for guessing.
6. **Part 2** consists of short-answer questions for which you must provide written answers on these sheets. Point values for questions in Part 2 are indicated in parentheses.
7. Good luck!

FORM 0

Economics 340 Second Midterm Exam

Part 1: Multiple Choice (2 points each)

Select the **best** answer of those given. Answers to this part should be marked on the scantron sheet using a #2 pencil. There is only one correct answer per question, and there is no penalty for guessing.

1. Suppose that labor migrates from Bulgaria to the UK. According to our analysis of the effects of migration based on supply and demand for labor, which of the following is made worse off by this movement?
 - a. Workers who remain in Bulgaria
 - b. Owners of factors other than labor in the UK
 - c. The workers who migrate
 - d. All of the above
 - e. None of the above

2. Operation Gatekeeper is one of the policies used by the United States to prevent illegal immigration across the US-Mexican border. According to Skerry and Rockwell, whose article you read on this subject, these policies have
 - a. Increased the number of legal immigrants.
 - b. Increased the number of illegal immigrants.
 - c. Reduced the cost of illegal immigration.
 - d. Forced some migrants into indentured servitude.
 - e. Increased congestion at the border.

3. Which of the following countries and groups of countries is **not** a significant host of foreign direct investment?
 - a. United States
 - b. Japan
 - c. Europe
 - d. Asia other than Japan
 - e. None of the above; that is, all of the above **are** major host of FDI.

4. When a company engages in “tariff-jumping” FDI, its purpose is to
 - a. Enter a foreign market before other firms from its home country can get there.
 - b. Invest in lobbying of foreign governments to persuade them to raise tariffs.
 - c. Sell to the local market in the foreign country from behind the protection provided by its tariff.
 - d. Take advantage of foreign low-cost inputs in order to produce for export.
 - e. Take advantage of a low rate of effective protection.

5. Which of the following would be an example of foreign direct investment from the United States to Taiwan?
 - a. A U.S. bank buys bonds issued by a Taiwan computer manufacturer.
 - b. A U.S. car manufacturer enters into a contract with a Taiwan firm for the latter to make spark plugs and sell them to it.
 - c. Microsoft hires a Taiwanese computer programmer to debug some software for it.
 - d. A California toy manufacturer buys a building in Taipei, Taiwan, to use as a warehouse for storage of toys made in China before shipping them to the U.S.
 - e. Warren Buffet (a U.S. citizen) buys a single share in a Taiwanese electronics firm in order to become eligible to vote as a shareholder.

6. I travel to Mexico, give a lecture, and am paid a fee of 10,000 pesos in cash. Under which of the following circumstances will the United States current account **not** be affected?
 - a. I keep the pesos, because the currency is pretty.
 - b. I deposit the pesos in a Mexican bank that I find on the Internet.
 - c. I sell the pesos in the foreign exchange market to an American student who keeps them in his wallet for later use.
 - d. I sell the pesos to a Mexican immigrant, working in Ann Arbor, who sends them to his family in Mexico City
 - e. I use the pesos to buy 100% ownership of a Mexican Internet company that is being sold cheap.

7. The United States in 2002 (the year for which international transactions were reported in your textbook) had a surplus in its
 - a. Balance on merchandise trade.
 - b. Balance on goods and services.
 - c. Balance on current account.
 - d. Balance on financial account.
 - e. None of the above.

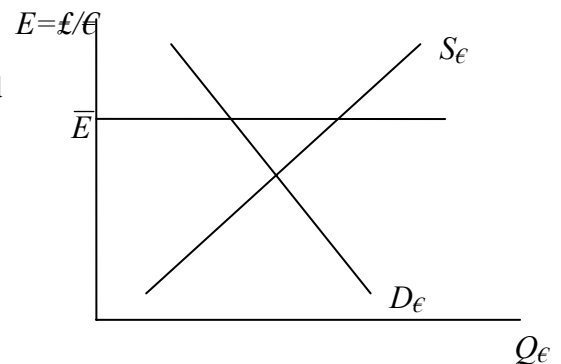
8. The Wall Street Journal reports the 30-day forward exchange rate for the British pound. This rate represents
- The best guess of the Journal's reporters about what the spot rate for the pound will be 30 days from now.
 - The amount of U.S. dollars you would need to hand over today in order to get pounds 30 days from now.
 - The amount of U.S. dollars you would need to pay thirty days from now for pounds that you receive today.
 - The exchange rate that you will get today if you are one of the first 30 people in line at the foreign exchange market.
 - The exchange rate you will both pay and receive 30 days from now if you enter into a contract today.
9. Underlying the Asset Theory of the exchange rate is the idea that
- Asset holders will try to purchase massive amounts of a currency whose value they expect to rise.
 - Physical assets in different countries are the most important determinants of exchange rates because they represent the countries' productivity.
 - Physical assets in different countries are the most important determinants of exchange rates because they cannot easily be moved.
 - Financial assets, especially bonds, are the primary tool of monetary policy used by central banks to influence exchange rates.
 - The volume of foreign direct investment is greater than the volume of trade.
10. Suppose that the dollar appreciates relative to the euro, and at the same time the dollar depreciates relative to the yen. You can be sure that, also at the same time,
- The $\$/\text{€}$ exchange rate rises.
 - The $\text{¥}/\text{€}$ exchange rate rises.
 - The $\text{¥}/\text{\$}$ exchange rate rises.
 - The $\text{£}/\text{\$}$ exchange rate rises.
 - The $\text{€}/\text{¥}$ exchange rate rises.
11. If a country pegs its exchange rate at a level that is, and continues to be, overvalued, then it will eventually be the case that
- Its exports will expand as foreign markets recognize the high value.
 - It will run out of international reserves.
 - People will engage in smuggling to avoid the official exchange rate.
 - Prices in the country will rise.
 - It will be asked to give up its membership in the International Monetary Fund.

12. Under a crawling peg

- The exchange rate moves, but by amounts too little to notice.
- The exchange rate is permitted to change only slowly within the band.
- The par value of the currency is kept secret and changed slowly over time.
- The central bank intervenes to slow down exchange rate movements during a day.
- The official value of a pegged exchange rate is changed frequently, by small amounts, and with advance notice.

13. The diagram below shows the foreign exchange market from the point of view of the British, whose domestic currency is the pound (£) with foreign currency the euro (€). Suppose that the British central bank (The Bank of England) pegs the pound to the euro at the rate shown as \bar{E} . Which of the following **must** be true?

- The pound is overvalued relative to the euro.
- The British are running a trade surplus (goods and services).
- The British are spending more than their income.
- The Bank of England is acquiring international reserves.
- The money supply in the United Kingdom is expanding over time.



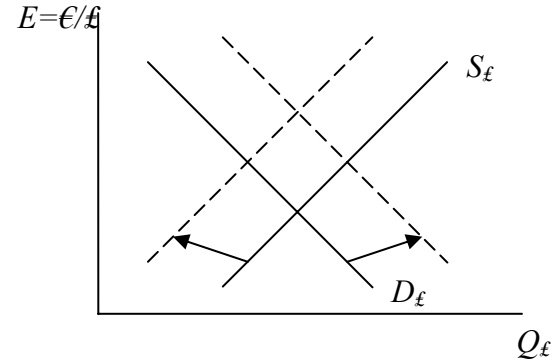
14. A macroeconomic tax increase in a country with a floating exchange rate causes its currency to

- Appreciate, because of a capital inflow.
- Depreciate, because it stimulates imports
- Appreciate, because it stimulates exports
- Depreciate, because it lowers the domestic interest rate.
- Not change, because fiscal policy requires a balanced budget.

15. Suppose that a fiscal expansion causes income, the price level, and the interest rate all to rise in the United States, while unemployment falls and the U.S. government budget moves into deficit. Which of the following would you **not** expect to happen in Japan as a result?

- Japanese income rises
- Japanese price level rises
- Japanese interest rate falls
- Japanese unemployment falls
- Japanese yen depreciates

16. The figure at the right shows an exchange market between the euro (€) and the British pound (£). Which of the following macroeconomic events might shift the supply and/or demand curves as shown?



- A monetary contraction in the euro area.
- A decline in the desire to engage in domestic investment in the U.K.
- A rise in the interest rate in the U.K.
- An increase in consumer confidence in the euro area.
- A fiscal expansion in Germany and France.

17. Milton Friedman views the exchange rate as a “price.” As a result, he favors

- Fixed exchange rates, because price changes are harmful.
- Flexible exchange rates, because markets do a better job than government at setting prices.
- Fixed exchange rates, because government should stand behind the value of the money it has created.
- Flexible exchange rates, because price volatility is an indication of economic strength.
- Neither fixed nor flexible exchange rates, because money is too important to be subject to market forces.

18. An advantage of a floating exchange rate is that

- It causes wages in different regions of a country to be equal.
- It raises the value of the currency to a higher level than could be achieved with a pegged rate.
- It permits the country to conduct an independent monetary policy.
- It constrains the government from issuing excessive debt.
- It prevents inflation.

19. According to the assigned article by Griswold, “Are Trade Deficits Good for the U.S. Economy?,” a rising U.S. trade deficit usually means that

- U.S. industrial competitiveness is declining
- Other countries are dumping in the U.S.
- Foreign countries are restricting imports from the U.S.
- U.S. GDP is rising
- U.S. companies are “exporting jobs”

20. A lesson of the “impossible trinity” is that, if a country wants to have both exchange-rate stability and financial market integration (i.e., capital mobility), then it must give up
- Deficit spending
 - Free trade
 - Protection
 - Monetary independence
 - Chocolate
21. The “snake in the tunnel” is
- The use of tariffs to attract foreign direct investment.
 - What central bankers call exchange-rate speculators.
 - A narrow peg among several currencies that collectively float within a wide band.
 - The response of GDP to an increase in aggregate spending, first rising and then falling back to its initial level.
 - One of the strategies used by people smugglers.
22. The Maasricht Treaty called for convergence of all of the following **except**
- Real wages
 - Inflation rates
 - Interest rates
 - Budget deficits
 - Government debts
23. When it came into existence on Jan 1, 1999, the euro was worth \$1.18 because
- Europeans sought purchasing power parity with the U.S. dollar.
 - This happened to be the value of the Deutsche Mark at the time.
 - This made the after-tax value of one euro equal to one dollar.
 - This was the market value of the basket of currencies in one ECU.
 - The number was chosen to commemorate the year of the end of World War I.

24. Pascal Lamy, writing in an Op Ed piece in the Wall Street Journal, is hoping that
- a. The US Congress will extend the president's trade negotiating authority.
 - b. Immigrant workers will send money to their families at home.
 - c. The ECB will maintain "strong vigilance" over inflation.
 - d. China will appreciate its currency.
 - e. The US Treasury will stand behind the value of US currency, even bills that are old or tattered.
25. During the last couple of years, the United Kingdom has been getting much more immigration than it expected from
- a. Bulgaria
 - b. Ireland
 - c. Italy
 - d. Poland
 - e. Romania

Part II: Short Answer. Answer on these sheets in the spaces provided.

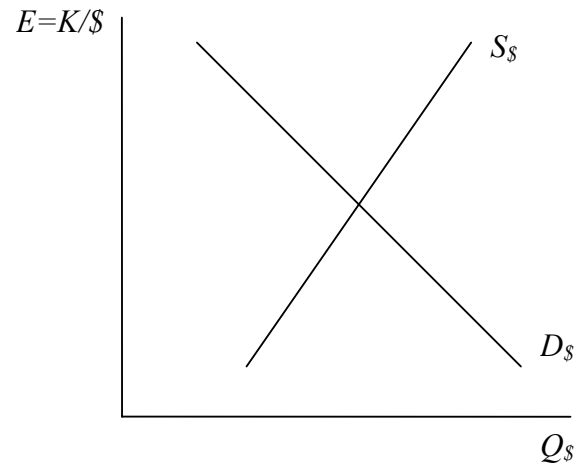
1. (12 points) Identify each of the following transactions by whether it belongs in the current account or in the financial account of the United States, and also by whether it will appear there positively (contributing to a surplus in that account) or negatively. Just put a plus or a minus sign in the appropriate column.

	Current Account	Financial Account
a. Bill Gates (an American) buys an Ethiopian software company.		
b. The mayor of Ann Arbor buys an Italian suit.		
c. Mary Sue Coleman (President of U of M) collects interest on a saving account in a Swiss bank.		
d. Tony Blair (Prime Minister of the U.K.) pays tuition for his son attending U of M.		
e. A French farmer on vacation in Florida buys admission to Disneyworld.		
f. A Canadian, living in Windsor, is paid her wage as a waitress in Detroit.		
g. Your professor wins the Michigan Lottery and uses his winnings to buy stock in a Mexican cement company.		
h. Donald Trump (an American) buys a New York office building from Nelson Mandela (a South African).		
i. Richard Gere (an American) gives \$10,000 to the Dalai Lama (in India).		
j. Mary Sue Coleman (see above) withdraws \$50,000 from her account in a Swiss bank.		
k. My grandson (an American) acquires a one euro note for his collection of foreign money.		
l. The (American) author of your textbook earns royalties on sales in Finland.		

2. (3 points) Circle the correct alternative in each case:

In the first half of the 1980s, the value of the U.S. dollar [rose / fell] by around 50%, causing sales of U.S. auto companies to [increase / decrease]. After this, the dollar [continued to rise / remained about constant / fell to about where it had started].

3. (9 points) The figure at the right shows initial supply and demand in the foreign exchange market from the perspective of Banalbia, a country whose currency is the kronut, K . From Banalbia's perspective, the foreign currency is the dollar, $\$$.



- a. Indicate in the figure the initial equilibrium exchange rate and label it E_1 .
- b. At the initial equilibrium exchange rate, the country's current account balance is

Positive Negative Zero Can't tell
- c. Suppose now that there is a large increase in world demand for the major Banalbian export, voquila. Show in the figure how this will alter supply and/or demand. Identify the new equilibrium exchange rate and label it E_2 .
- d. How has the value of the currency, the kronut, changed?

Appreciate Depreciate No change Can't tell
- e. How has the value of Banalbia's imports changed?

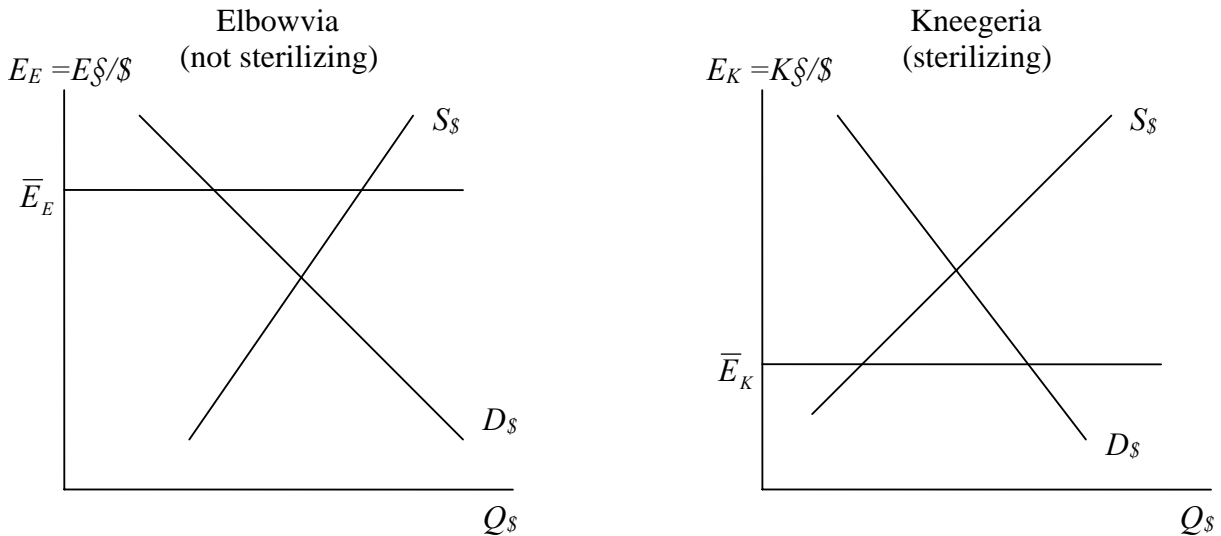
Risen Fallen No change Can't tell
- f. Suppose that Banalbia has previously been suffering from a recession. Does this change in world demand for voquila help (that is, does it reduce its unemployment), does it hurt, or what?

Help Hurt No change Can't tell
- g. From the standpoint of dealing with this recession, would the country have been better off or worse off if it had been pegging its exchange rate at E_1 when world demand for voquila increased?

Better off Worse off No difference Can't tell
- h. If instead Banalbia had previously been suffering inflation instead of recession would this change in world demand for voquila have helped (that is, reduce its inflation), hurt, or what?

Help Hurt No change Can't tell

4. (9 points) The figures below show the foreign exchange markets for two countries, Elbowvia whose currency is the élat, E\$, and Kneegeria whose currency is the krispin, K\$. Both of these currencies are pegged by their central banks to the dollar, at the rates shown as \bar{E}_E and \bar{E}_K . Kneegeria is sterilizing; Elbowvia is not.



- a. Indicate in each of the figures the amount of exchange market intervention by the country's central bank, in dollars, that is needed to maintain the pegged exchange rate, and label it either "buy \$" or "sell \$".
- b. In the situation shown and described, state which country or countries are doing the following by writing one of the following into each blank below: "Elbowvia," "Kneegeria," "both," "neither," or "can't tell."

- | | |
|---|-------|
| Has an undervalued currency | _____ |
| Buying their own currency | _____ |
| Losing international reserves | _____ |
| Allowing their money supply to expand | _____ |
| Allowing their money supply to contract | _____ |

- c. Suppose that the supplies and demands shown in the figures will continue over time and do not include exchange-market speculation. Which country would you expect to become subject to speculation that may force it to give up pegging its currency at the rate shown? (Answer in the blank, as in part (b).)

- d. Ignoring now your answer to part (c), suppose that speculators come to believe that Elbowvia will soon devalue its currency, whether or not that is a reasonable expectation. Show in the figure for Elbowvia how the supply and/or demand curves of Elbowvia's foreign exchange market will shift as a result of this speculative behavior.

5. (9 points) Suppose that people in Thailand initially hold assets, denominated in their own currency, the bhat, worth 40 million bhat, and that they have liabilities to foreigners, denominated in US dollars, worth \$1.5 million. The exchange rate is initially $E_1 = 20$ bhat/\$.

- a. Calculate the values of assets and liabilities in the other currency and enter them into the blanks in the “Before” column in the table below. Then calculate the net worth of the people of Thailand, both in bhat and in dollars, and enter these in the row for “Net Worth”.

	Before $E_1 = 20$ bhat/\$		After $E_2 = 40$ bhat/\$
	In bhat	In \$	In \$
Assets	40 m. bhat	_____	_____
Liabilities	_____	\$1.8 m.	_____
Net worth	_____	_____	_____

- b. Now suppose that the exchange rate changes to $E_2 = 40$ bhat/\$. Calculate the dollar values of assets, liabilities, and net worth, and enter these in the “After” column of the table.
- c. What has happened in this example? Circle the choices from those in brackets below to provide the most accurate explanation:

If a country has borrowed in foreign currency to finance assets in its own currency, then an [**appreciation / depreciation**] of its own currency can make it [**rich / better off / worse off / bankrupt**].

6. (3 points) Fill in the blanks below with the names of countries mentioned in recent news:
- a. Trade negotiators at the WTO approved admission of _____ as its 150th member.
- b. European Union issued a report that was critical of _____, indicating that it may suspend negotiations for the country to enter the EU.
- c. One of the countries that joined the EU in 2004, _____, said it would hold a referendum on adopting the euro.

