

Assignment 4

Part A: Record the best answer for questions 1-10 on the response sheet.

1. The *volume effect* is:
 - A. The effect of a change in real exchange rate on imports and exports.
 - B. The effect of a change in tariffs on the volume of foreign trade.
 - C. The effect of a change in disposable income on imports and exports.
 - D. The effect of a change in nominal exchange rate on imports and exports.
 - E. None of the above.

2. A real depreciation of the domestic currency will result in:
 - A. An increase in exports
 - B. A decline in exports
 - C. An increase in imports
 - D. A decline in imports
 - E. None of the above.

3. An increase in disposable income worsens current account because:
 - A. It raises consumption which reduces exports, because now there are fewer goods that can be exported, and more are consumed domestically.
 - B. Consumers demand more of all goods including imported goods while exports are not affected.
 - C. It raises the real exchange rate and therefore worsens the current account.
 - D. It lowers the real exchange rate and therefore worsens the current account.
 - E. None of the above.

4. Which of the following changes does NOT shift the DD schedule in the short run?
 - A. An increase in the domestic price level
 - B. An increase in government purchases
 - C. An increase in the foreign price level
 - D. An increase in the exchange rate
 - E. An increase in investment

5. If the economy's output is initially above full employment, which of the following policy combination could restore full employment and keep the exchange rate at the same level?
 - A. Contractionary monetary and fiscal policy
 - B. Contractionary fiscal policy and expansionary monetary policy
 - C. Contractionary monetary policy and expansionary fiscal policy
 - D. Expansionary monetary and fiscal policy
 - E. None of the above.

6. A *J-curve* describes:
- The desired level of the current account.
 - The exchange rate overshooting effect.
 - The gradual effect of real depreciation on the current account.
 - Inflation bias.
 - None of the above.
7. If the central bank purchases assets, it will result in:
- A decline in the money supply.
 - An increase in the money supply.
 - An increase in the central bank's net worth.
 - A decline in the central bank's net worth.
 - None of the above.
8. What is the interest parity condition under a fixed exchange rate regime?
- $R = R^* + E^e/E$
 - $R = R^* + (E^e - E)/E^e$
 - $R = R^*$
 - $R^* = R + (E^e - E)/E^e$
 - $R^* = R + E/E^e$
9. If there is a decline in output, to keep the exchange rate fixed, the central bank has to:
- Purchase foreign assets.
 - Purchase domestic assets.
 - Sell domestic assets.
 - Sell foreign assets.
 - None of the above
10. What is the effect of an increase in the money supply under fixed exchange rates and perfect asset substitutability in the short run?
- A decline in output and interest rates.
 - An increase in output and interest rates.
 - An increase in output and no change in interest rates.
 - A decline in output and no change interest rates.
 - None of the above.

Assignment 4 Response Sheets

Turn in pages 3 & 4 *only*.

Part A

1	A	B	C	D	E
2	A	B	C	D	E
3	A	B	C	D	E
4	A	B	C	D	E
5	A	B	C	D	E
6	A	B	C	D	E
7	A	B	C	D	E
8	A	B	C	D	E
9	A	B	C	D	E
10	A	B	C	D	E

Part B

1.

Central Bank Balance Sheet 12/31/2009		
	Assets	Liabilities
Domestic	H\$ 100 m.	H\$ 120 m.
Foreign	H\$ 20 m.	

Given above is the balance sheet of the central bank of Humidor at the end of 2009. In 2009, Humidor's CA = 0. Due to exogenous shifts in preferences, in 2010, Humidor exported H\$ 10 million worth of cigars and imported H\$ 9 million worth of air-conditioners, where H\$ is the Humidorian currency.

Assume throughout that there are no capital account transactions and respond to the following:

a. Fill in the following Balance of Payments equation if exchange rates are flexible.

BOP H\$ _____ = CA Balance H\$ _____ + Non-official FA Balance H\$ _____

- b. Complete Humidor's central bank's balance sheet for 2010 assuming *flexible* exchange rates. Explain what happens to Humidor's money supply in 2010.

Central Bank Balance Sheet 12/31/2010		
	Assets	Liabilities
Domestic	H\$ 100 m.	H\$ ____ m.
Foreign	H\$ ____ m.	

- c. Now fill in the following balance of payments equation if Humidor has a *fixed* exchange rate and there are no private capital flows.

$$\text{BOP H\$ } \underline{\hspace{2cm}} = \text{CA Balance H\$ } \underline{\hspace{2cm}} + \text{Non-official FA Balance H\$ } \underline{\hspace{2cm}}$$

- d. Under the assumptions that Humidor has a fixed exchange rate and there are no private capital flows, demonstrate how the balance sheet of the central bank changes.

Balance Sheet of the Central Bank 12/31/2010		
	Assets	Liabilities
Domestic	H\$ ____ m.	H\$ ____ m.
Foreign	H\$ ____ m.	

- e. Using the DD-AA framework, explain what must happen to Humidor's money supply in 2010 to prevent the exchange rate from changing.