NAME: ________________________________

Student ID No.: ___________________________

Economics 340
International Economics
Prof. Alan Deardorff
Second Midterm Exam

Form (KEY) 0

March 26, 2018

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. Find the **FORM NUMBER** above and enter it where it asks for "KEY" on the scantron sheet. Be sure to fill in the bubbles.

4. This exam has 100 points and you have approximately 80 minutes to complete the test. Check that you have all 14 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. Part 2 has 48 points total.

7. That leaves 2 points unaccounted for. You will get these if (and only if) you put your name and ID number on both this exam booklet and the scantron sheet, **and** if you enter the form number (see above) on the scantron.

8. Good luck!

FORM (KEY) 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. 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.

2. 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.

3. 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.

4. 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.

5. If our Financial Account is in surplus and we are not selling property to foreigners, it must be true that

   a. Our trade balance is positive.
   b. We are lending more than we are borrowing.
   c. The US is adding to its holdings of assets abroad.
   d. The rest of the world is giving us money.
   e. Our net debt to the world is rising.

6. Letting C=consumption, S=saving, I=investment, X=exports, M=imports, and assuming that G=government purchases=0, then

   a. X–M = I–S
   b. X+M = I+S
   c. M–X = I–S
   d. M+X = C–I–S
   e. X–M = C+I–2S

7. The Wall Street Journal used to report the 30-day forward exchange rate for the British pound. This rate represents

   a. The best guess of the Journal's reporters about what the spot rate for the pound will be 30 days from now.
   b. The amount of U.S. dollars one would need to hand over today in order to get pounds 30 days from now.
   c. The amount of U.S. dollars one would need to pay thirty days from now for pounds that they receive today.
   d. The exchange rate that one will get today if they are one of the first 30 people in line at the foreign exchange market.
   e. The exchange rate one will both pay and receive 30 days from now if they enter into a contract today.

8. Underlying the Asset Theory of the exchange rate is the idea that

   a. Asset holders will try to purchase massive amounts of a currency whose value they expect to rise.
   b. Physical assets in different countries are the most important determinants of exchange rates because they represent the countries' productivity.
   c. Physical assets in different countries are the most important determinants of exchange rates because they cannot easily be moved.
   d. Financial assets, especially bonds, are the primary tool of monetary policy used by central banks to influence exchange rates.
   e. The volume of foreign direct investment is greater than the volume of trade.

9. 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,

   a. The $/€ exchange rate rises.
   b. The ¥/€ exchange rate rises.
   c. The ¥/$ exchange rate rises.
   d. The £/$ exchange rate rises.
   e. The €/¥ exchange rate rises.

10. 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

    a. Its exports will expand as foreign markets recognize the high value.
    b. It will run out of international reserves.
    c. People will engage in smuggling to avoid the official exchange rate.
    d. Prices in the country will rise.
    e. It will be asked to give up its membership in the International Monetary Fund.

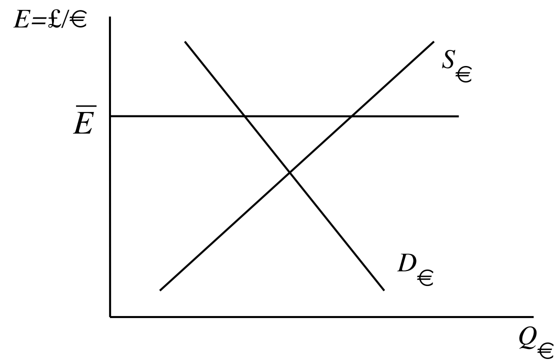
11. Under a crawling peg

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

12. With a freely floating exchange rate determined by supply and demand for foreign exchange, which of the following would cause a country's currency to appreciate?

    a. An increase in demand for its exports.
    b. A rise in its interest rate.
    c. An increase in remittances from its citizens working abroad to their families at home
    d. All of the above
    e. None of the above

13. The diagram at the right 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 $\overline{E}$. Which of the following **must** be true?



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

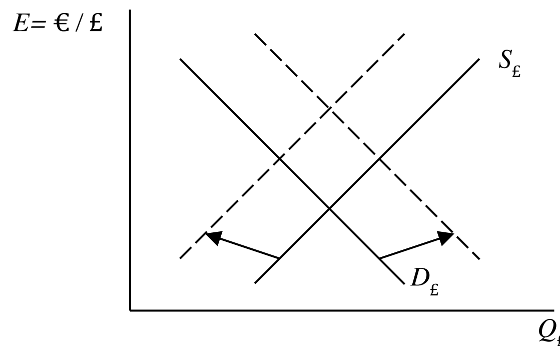
14. A macroeconomic tax increase in a country with a floating exchange rate causes its currency to

a. Appreciate, because of a capital inflow.
b. Depreciate, because it stimulates imports
c. Appreciate, because it stimulates exports
d. Depreciate, because it lowers the domestic interest rate.
e. 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?

a. Japanese income rises
b. Japanese price level rises
c. Japanese interest rate falls
d. Japanese unemployment falls
e. 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. A monetary contraction in the euro area.
   b. A decline in the desire to engage in domestic investment in the U.K.
   c. A rise in the interest rate in the U.K.
   d. An increase in consumer confidence in the euro area.
   e. A fiscal expansion in Germany and France.

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

   a. Fixed exchange rates, because price changes are harmful.
   b. Flexible exchange rates, because markets do a better job than government at setting prices.
   c. Fixed exchange rates, because government should stand behind the value of the money it has created.
   d. Flexible exchange rates, because price volatility is an indication of economic strength.
   e. 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

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

    a. U.S. industrial competitiveness is declining
    b. Other countries are dumping in the U.S.
    c. Foreign countries are restricting imports from the U.S.
    d. U.S. GDP is rising
    e. 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., free capital mobility), then it must give up

    a. Deficit spending
    b. Free trade
    c. Protection
    d. Monetary independence
    e. Chocolate

21. The "snake in the tunnel" is

    a. The use of tariffs to attract foreign direct investment.
    b. What central bankers call exchange-rate speculators.
    c. A narrow peg among several currencies that collectively float within a wide band.
    d. The response of GDP to an increase in aggregate spending, first rising and then falling back to its initial level.
    e. One of the strategies used by people smugglers.

22. The Maastricht Treaty called for convergence of all of the following **except**

    a. Real wages
    b. Inflation rates
    c. Interest rates
    d. Budget deficits
    e. Government debts

23. When it came into existence on Jan 1, 1999, the euro was worth $1.18 because

   a. Europeans sought purchasing power parity with the U.S. dollar.
   b. This happened to be the value of the Deutsche Mark at the time.
   c. This made the after-tax value of one euro equal to one dollar.
   d. This was the market value of the basket of currencies in one ECU.
   e. The number was chosen to commemorate the year of the end of World War I.

24. What is a "reciprocal tax"?

   a. A tariff designed to defend national security against efforts by foreign countries to eliminate or otherwise undermine a domestic industry.
   b. A countervailing duty.
   c. An anti-dumping duty.
   d. A portion of the revised US tax code signed by President Trump.
   e. A US tax on imports of a good from another country set equal to the tariff that country levies on US exports of the same good.

25. Under what U.S. law did President Trump recently sign an order to levy tariffs on imports of steel and aluminum?

   a. Section 201 on safeguards
   b. Section 232 on national security
   c. The anti-dumping law
   d. The countervailing duty law.
   e. No law. He just used his presidential authority.

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

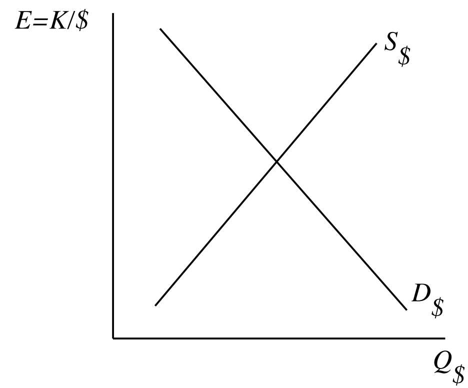
1. (12 points) Identify each of the following transactions by whether it belongs in the current account or in the financial account of the United States, and also by whether it will appear there positively (contributing to a surplus in that account) or negatively. Just put a plus or a minus sign in the appropriate column. Note that you are only recording the single transaction stated, and not any other change that might have accompanied it.

		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 (former President of U of M) collects interest on a saving account in a Swiss bank.		
d.	Theresa May (Prime Minister of the U.K.) pays tuition for her son attending U of M.		
e.	A French farmer on vacation in Florida buys admission to Disneyworld.		
f.	A Canadian, living in Windsor, Canada, 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 in the second half of the 1980s, the dollar [rose / remained about constant / fell].

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 quantity of Banalbia's imports changed?

____ Risen ____ Fallen ____ No change ____ Can't tell

f. How has the quantity of Banalbia's exports changed?

____ Risen ____ Fallen ____ No change ____ Can't tell

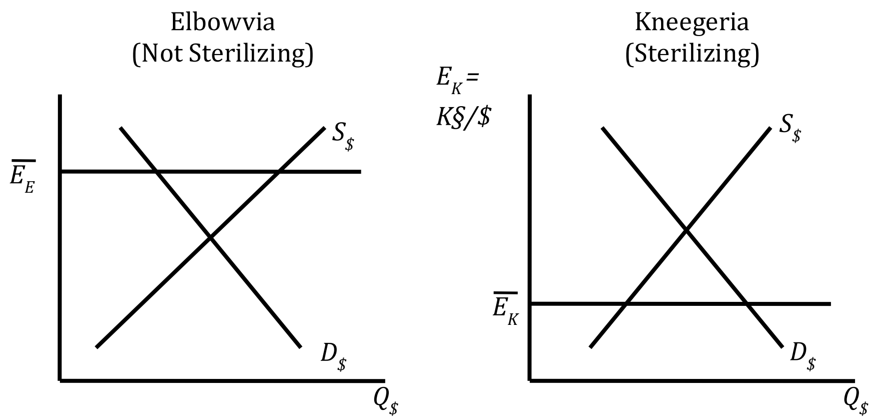
g. Suppose that Banalbia has previously been suffering from a recession. From the standpoint of dealing with this recession, would the country have been better off or worse off if it had been pegging its exchange rate at E_1 when world demand for voquila increased?

____ Better off ____ Worse off ____ No difference ____ Can't tell

h. If Banalbia were not in recession, and if it was pegging its exchange rate at E_1 when world demand for voquila increased, what would this increase do to the country's GDP?

____ Increase ____ Decrease ____ No change ____ Can't tell

4. (9 points) The figures below show the foreign exchange markets for two countries, Elbowvia whose currency is the éclat, 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 $\overline{E}_E$ and $\overline{E}_K$. 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 at the rates shown, 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 now 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 \$1.8 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/\$ In bhat	Before E_1 = 20 bhat/\$ In \$	After E_2 = 40 bhat/\$ 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 / a depreciation]** of its own currency can make it **[rich / better off / worse off / bankrupt]**.

6. (6 points) Define:

a. Financial account surplus

b. Tax inversion

c. Hedging (as relevant to the foreign exchange market)

d. Plaza Accord

e. Stability and Growth Pact

f. Currency board