

AFRICAN ECONOMIC RESEARCH CONSORTIUM

JOINT FACILITY FOR ELECTIVES
JULY-OCTOBER, 1995

INTERNATIONAL ECONOMICS

Second Session: Final Examination

TIME ALLOWED: 3 Hours

October 2, 1995

INSTRUCTIONS: Answer only four (4) of the following six (6) questions.

Note: Use of graphs and mathematical representations (where applicable) is recommended. To achieve high marks the answers must be well structured, and not include irrelevant topics.

QUESTION 1. Domestic and Foreign Interest Rates.

The countries in the European Union have agreed (the Maastricht Treaty) to form a currency union with one single European currency, perhaps already during 1997. Two weeks ago Italian officials, and some economists, claimed that the Italian economy, despite their current problems, was on the right track. Italy would soon be in a position where they could give up the lira and adopt the single European currency. The German minister of finance responded, that he did not agree. According to his opinion, the Italian economy is in such a large imbalance that the Italians will not be able to join the European currency area in the near future. His speech had a direct effect on exchange and money markets. As a result the interest rates of several European countries went up in relation to the interest rates in Germany.

- a) Identify the possible factors that explain interest differentials between countries in general, and discuss which specific factor(s) that are/is the most likely to have caused the increase in the differential mentioned above. (10 marks)
- b) Identify positive and negative effects for the Italian economy if Italy is not allowed to join the European currency union. (5 marks)

QUESTION 2. Exchange Rate Adjustment.

- a) Explain how different adjustment speeds on financial and real markets might affect the adjustment of floating foreign exchange rates. (12 marks)
- b) Also, in a world where the rate of depreciation is determined by expectations, discuss possible consequences on domestic income following a sudden unexpected change in monetary policy. (3 marks)

QUESTION 3. Balance of Payments Adjustment.

- a) Explain the open-economy-multiplier, and derive the so-called Marshall-Lerner conditions? What do the multiplier and the Marshall-Lerner condition tell us? (7 marks)
- b) Discuss the limitations of the Marshall-Lerner conditions. Why are they not sufficient for a complete analysis, which factors are missing? Your answer should include a discussion about the absorption-approach. (8 marks)

QUESTION 4. Fundamentals and Excess Volatility on Exchange Markets.

During September, the U.S. dollar has fluctuated against the German mark and the Japanese yen, during some days the changes has been relatively large. Many view this as excess volatility on the foreign exchange markets.

- a) Show with a simple model how foreign exchange rates are(can be) related to economic fundamentals, like money stocks, income etc. (8 marks)
- b) Show how foreign exchange fluctuations are related to expectations. What are the conclusions from a rational expectations model? (7 marks)

QUESTION 5. International Capital Flows.

A large part of the turnover on foreign exchange markets are made up of international capital flows. What determine these flows, and are they signs of high international mobility?

- a) Discuss, (shortly), ways of estimating/measuring the degree of capital mobility. (3 marks)
- b) Discuss how to formulate a single equation for estimating capital flows, based on economic theory. (9 marks)
- c) Discuss the expected consequences on capital flows following a liberalization of the capital account. (3 marks)

QUESTION 6. Open Economy Macroeconomics

Suppose that there is a sudden unexpected increase in the net savings of the private sector in a small open economy, without exchange restrictions. What are the short-run consequences?

- a) Under fixed exchange rates? (4 marks)
- b) Under floating exchange rates? (4 marks)
- c) What are the most effective ways to dampen the effects on domestic income of the shock in case a and b? (4 marks)
- d) Discuss, the limitations of your analysis. (3 marks)