NAME: ___________________________________

Student ID No.: ____________________________

Economics 340
International Economics
Prof. Alan Deardorff
Second Midterm Exam

Form (KEY) 0

November 19, 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 <u>EIGHT</u> DIGIT NUMBER FROM YOUR M-CARD) ON THE EXAM <u>AND</u> 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 15 pages of the exam, including this cover sheet.

5. **Part 1** consists of 25 multiple choice questions worth 2 points each. Answers to these 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. 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. Note that you must fill in circles on the scantron for the computer to read your name, ID, and form number, as well as your answers.

8. 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. What is the connection, if any, between comparative advantage (CA) and foreign direct investment (FDI)?

   a. Nothing. CA has nothing to do with FDI.
   b. When a country's firms invest abroad, this helps to create CA in the same industry at home.
   c. When a country's firms invest abroad, this helps to create CA in the same industry in the country where they undertake the investment.
   d. Countries engage in FDI in industries where the country they invest in has a comparative disadvantage.
   e. Countries engage in FDI in industries where the country they invest in has a comparative advantage.

2. During the 1950s, foreign direct investment

   a. Was greater, in proportion to GDP, than it is today because of the need to rebuild after World War II.
   b. Was greater, in proportion to GDP, than it is today because of the opportunity to apply new technologies that had been invented during the 1940s.
   c. Took place at about the same rate, in proportion to GDP, as it does today.
   d. Was smaller, in proportion to GDP, than it is today because governments placed controls on capital flows and exchange of currencies.
   e. Was smaller, in proportion to GDP, than it is today because only the less developed countries wanted it, and they were too poor to afford it.

3. Which of the following is an example of foreign direct investment from the United States to Mexico?

    a. Sale of a U.S. Treasury Bill to a corporation in Mexico.
    b. Acquisition of a convenience store in Mexico City by a lawyer in Chicago on behalf of an American client.
    c. Deposit by an American professor of US dollars into a bank in Mexico.
    d. Sale of land in Mexico by an American to a Mexican.
    e. Sale of land in the U.S. by an American to a Mexican.

4. Which of the following would appear as a (positive) credit in the Financial Account of the U.S. balance of payments?

    a. Deposit in a Chicago bank of $15,000 by a resident of South Africa.
    b. Purchase by a Florida corporation of an orange-squeezing machine from Germany.
    c. Purchase by an American student of a villa in the south of France.
    d. Sale of a Boeing 757 airplane by the U.S.-based Boeing Corporation to Singapore Airlines.
    e. Sale by a Korean executive to an American executive of shares of stock in the Ford Motor Company.

5. Which of the following, in recent years, has been the largest entry in the U.S. balance of payments?

    a. U.S. exports of goods and services.
    b. U.S. imports of goods and services.
    c. Net unilateral transfers.
    d. Gross domestic product.
    e. Statistical discrepancy.

6. A surplus in the balance of trade or in the balance on current account (assume they're the same for this question) implies that

    a. The country's volume of employment is expanding.
    b. The country is spending on goods and services more than it is earning from producing them.
    c. The country is lending to foreigners more than foreigners are lending to it.
    d. The country is accumulating reserves of foreign currency.
    e. All of the above.

7. The table below shows a portion of the exchange rate report from the Wall Street Journal.

	U.S. $ EQUIVALENT		CURRENCY PER U.S. $	
Country	**Fri**	**Thu**	**Fri**	**Thu**
Argentina (Peso)	.3490	.3487	2.8653	2.8678
Australia (Dollar)	.7078	.7042	1.4128	1.4201

Based on these data, which of the following statements is correct?

a. The Argentine peso is worth about one half of a U.S. dollar.
b. On Friday, the spot rate for Australia was .7078 Australian dollars per U.S. dollar.
c. From Thursday to Friday, the Australian dollar depreciated relative to the U.S. dollar.
d. From Thursday to Friday, the Argentine peso appreciated relative to the U.S. dollar.
e. The real exchange rate between Argentina and the U.S. on Thursday was 2.8678 pesos per U.S. dollar.

8. Suppose that the spot rate for the British pound is $1.50 and the 1-month forward rate is $1.53. That means that if you buy one thousand pounds, £1000, today on the 1-month forward market, you will

a. Pay $1500 today and receive £1000 one month from now.
b. Pay $1500 one month from now and receive £980 today.
c. Pay $1530 today and receive £1000 one month from now.
d. Pay $1530 one month from now and receive £1000 one month from now.
e. Pay $1530 one month from now and receive £980 today.

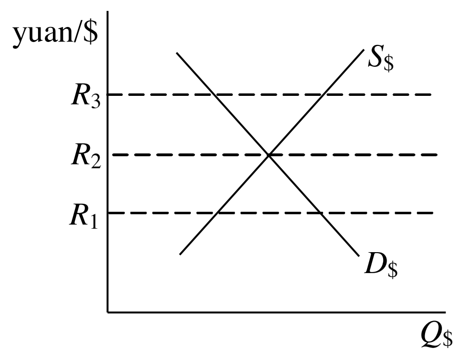
9. According to the asset theory of the exchange rate,

a. The exchange rate cannot be in equilibrium at a rate different from what people in the market expect.
b. The value of a currency reflects the value of assets dominated in that currency.
c. If people in the market expect a currency to depreciate, they buy more of it because of its expected low price.
d. The exchange rate must be whatever people think that it recently has been.
e. The exchange rate adjusts to make the prices of comparable assets in different countries equal.

10. According to the supply and demand approach to explaining a floating exchange rate, which of the following, if it was not caused by a change in the exchange rate, would cause the currency of Canada to appreciate?

    a. A rise in interest rates in the U.S.
    b. A rise in Canadian imports.
    c. A large payment of dividends by the U.S.-based Microsoft Corporation to stockholders in Canada.
    d. An increase in Canadian aid to Bangladesh.
    e. The expectation that the Canadian dollar is about to fall in value.

11. The graph at the right shows the exchange market for U.S. dollars with respect to the Chinese yuan, with three different exchange rates noted. Suppose that you know that the Chinese money supply is growing due to China's failure to sterilize. Which of the following could describe the situation in China's exchange market?



    a. The exchange rate is R_1 and the Chinese are adding to their international reserves
    b. The exchange rate is R_1 and the Chinese are losing international reserves.
    c. The exchange rate is R_2 and the Chinese are neither gaining nor losing international reserves.
    d. The exchange rate is R_3 and the Chinese are adding to their international reserves
    e. The exchange rate is R_3 and the Chinese are losing international reserves.

12. When a country with a pegged exchange rate has an over-valued currency,

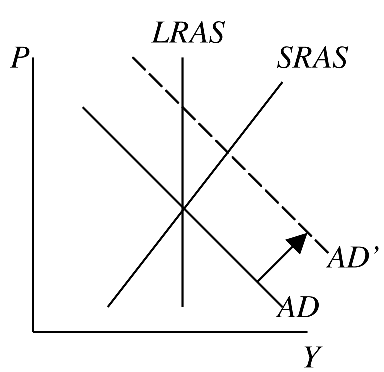
    a. There is a black market in which the currency trades for less than the official rate.
    b. If the central bank is sterilizing the effects of its intervention, then the country's money supply is contracting.
    c. If the central bank is not sterilizing the effects of its intervention, then the country's money supply is expanding.
    d. The country is adding to its reserves of foreign currency.
    e. If the central bank is sterilizing the effects of its intervention, then it is buying bonds.

13. News recently reported that workers have been laid off by the olive industry in Spain. Why?

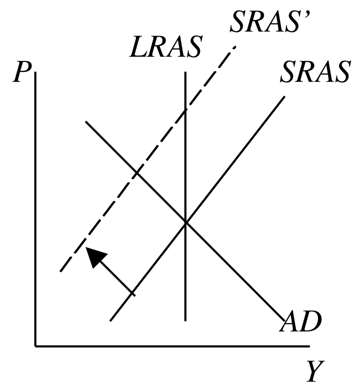
    a. Spain uses the euro, whose appreciation made Spanish olives too expensive to export.
    b. Spain dropped out of the eurozone, blocking exports of Spanish olives to other European countries.
    c. The crisis in Greece made Greek olives cheaper than Spanish olives.
    d. The US imposed tariffs on Spanish olives in response to Spanish subsidies and dumping.
    e. US customs officers mis-translated the Spanish word for olive and thought that they were subject to the US 25% tariff on steel.

14. Suppose that a country's currency appreciates as a result of a change from abroad in the demand for its currency (not, therefore, due to a change in policy or behavior at home). Which of the following aggregate supply and demand graphs shows the effect that such an appreciation will have on the economy?

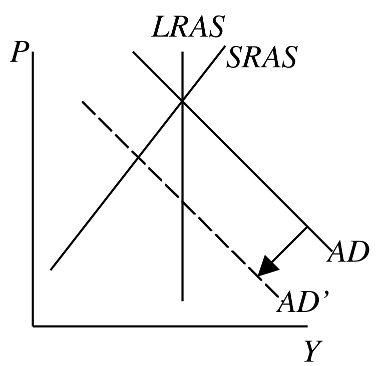
a.



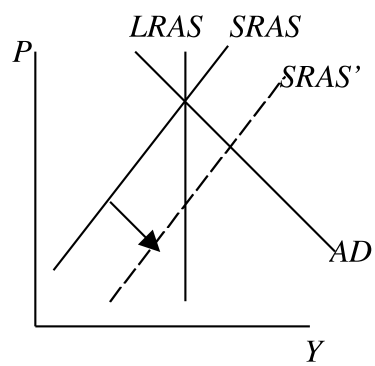
b.



c.



d.



e. None of the above. An appreciation does not cause the aggregate supply or demand curves to shift.

15. Which of the following changes would cause the home country's currency to depreciate?

   a. A rise in the foreign interest rate.
   b. A domestic monetary contraction.
   c. An increase in foreign demand for the home country's exports.
   d. An increase in domestic investment.
   e. A fall in the amount that domestic residents choose to save out of any given income.

16. In the assigned reading by Levy, he argues that pressuring China to appreciate the yuan will do no good, since even if China appreciates, the US trade deficit will remain unchanged because

   a. The dollar is a reserve currency.
   b. The US will continue to import just as much, but from other countries.
   c. The Fed will respond by appreciating the dollar.
   d. The Fed will use sterilization operations to prevent the trade balance from changing.
   e. The US has tariffs on Chinese goods.

17. Suppose that a country has a mixture of individuals and companies that are in the following situations:
   I. These have borrowed in domestic currency to finance assets whose values are also in domestic currency.
   II. These have borrowed in foreign currency to finance assets valued in domestic currency.
   III. These have borrowed in domestic currency to finance assets valued in foreign currency.
   IV. These have borrowed in foreign currency to finance assets valued in (the same) foreign currency.

   Which of these groups sees the domestic-currency value of its wealth <u>fall</u> when the country devalues? (Assume in each case that the initial value of the assets is at least as great as what was borrowed.)

   a. I only.
   b. II only.
   c. III only.
   d. IV only.
   e. None.

18. Which of the following countries was <u>not</u> among the 12 that initially adopted the euro?

   a. United Kingdom
   b. Germany
   c. Portugal
   d. Finland
   e. Italy

19. The “floating snake” referred to

    a. Italy’s managed floating exchange rate during the interwar period.
    b. The damage done by hyperinflation that was experienced by Argentina after its exchange-rate crisis.
    c. The system in which European currencies were pegged to each other but floated relative to the US dollar.
    d. A floating exchange rate’s propensity to undermine a country’s competitiveness when it appreciates.
    e. The wide-band exchange rate system adopted by European Central Bank.

20. The assigned article by Kulish, “No Fireworks for Euro as It Reaches the 10-Year Mark,” is critical of the euro on the grounds that

    a. Although it claims to be a new currency, its value has been pegged to the US dollar, making it no more than a proxy for the dollar.
    b. The European Central Bank has been irresponsible, expanding the currency unduly and leading to the current crisis in the Eurozone.
    c. The introduction of the euro was deflationary, as most prices had to be reduced in order to satisfy regulations.
    d. The paper currency lacked personality, as it depicted no actual people or places, so as to treat all the member countries equally.
    e. The US dollar value of the euro has declined steadily ever since its introduction.

21. The assigned article by Smaghi, “The perverse loop that is the euro's key weakness,” says that the EU should make which of the following changes to make countries less likely to stop using the euro?

    a. The European Commission should take over the government of any country threatening to leave the eurozone.
    b. Require that a country leaving the euro also leave the EU.
    c. Countries should stop denominating their government debt in euros, and denominate it instead in US dollars.
    d. Countries should stop denominating their government debt in euros, and denominate it instead in their national currency.
    e. The euro should be made to pay a positive rate of interest.

22. Which of the following, according to the assigned material from Zupnick, was one of the two main reasons for an increase in foreign direct investment into the United States in the late 1980s?

    a. The change in the political party holding the US presidency in 1986.
    b. The start of the Uruguay Round of trade negotiations.
    c. An increase in US tariffs and non-tariff barriers, causing "tariff-jumping" FDI.
    d. The fall in wages of unskilled labor in the United States.
    e. The decline in the exchange-market value of the US dollar.

23. When a country devalues its currency, we expect that

    a. Income will rise because the devaluation stimulates aggregate demand.
    b. Income will rise because the devaluation stimulates aggregate supply.
    c. Income will fall because the devaluation reduces aggregate demand.
    d. Income will fall because the devaluation reduces aggregate supply.
    e. There will be no change in income because income is earned from production, not from trade.

24. Why did the United States announce it would withdraw from the 144-year old treaty administered by the Universal Postal Union?

    a. The treaty itself was a bad deal, negotiated by Democrats.
    b. The treaty sets the price of shipping from China to the US lower than shipping within the US.
    c. Postage has ceased to be relevant to the world economy due to the growing importance of e-commerce.
    d. A recent change in control of the Postal Union deprived the US of a veto over its rates.
    e. The Postal Union prevented the US from choosing whom to honor with pictures on its stamps.

25. In what way has the number seven recently become significant in the market for exchange of US dollars and Chinese yuan?

    a. The Chinese currency is depreciating and may soon reach 7.00 yuan per dollar.
    b. The Chinese currency is appreciating and may soon reach 7.00 yuan per dollar.
    c. The Chinese currency is depreciating and may soon reach 7.00 dollars per yuan.
    d. The Chinese currency is appreciating and may soon reach 7.00 dollars per yuan.
    e. The Chinese government has announced that it will peg the exchange rate at the "lucky number" seven.

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 should appear there positively (contributing to a surplus in that account) or negatively. Just put a plus or a minus sign in the appropriate column.

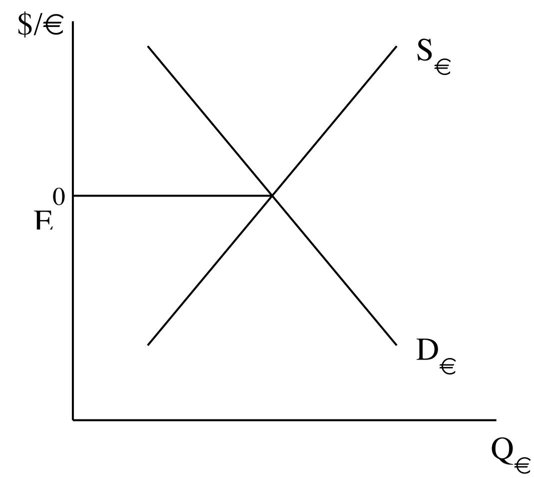
		Current Account	Financial Account
a.	Alan Deardorff sells some Iowa farmland to a French corporation.		
b.	Qianru Zheng (your GSI) gives half her paycheck to a relief agency in Somalia.		
c.	University of Michigan Library buys an encyclopedia from England at half its list price.		
d.	The owners of Pizza House (in Ann Arbor) put their profits in a bank account in Switzerland.		
e.	A politician in Australia prepares for retirement by depositing into a bank account in New York.		
f.	A Canadian, living in Windsor, Ontario, is paid her wage as a waitress in Detroit.		
g.	The OECD in Paris pays your professor to write a paper for a conference there.		
h.	The Australian politician (see above) earns interest on her bank account in New York.		
i.	Microsoft Corporation (a US company) buys a small software company in Estonia.		
j.	A Texas rancher withdraws 50,000 euros from a London bank to buy a prize steer from Oklahoma.		
k.	A church group in Indiana buys Mexican paper currency to take with them on a tour there next year.		
l.	Steven King, an American author, earns royalties on sales of his books in South Africa.		

2. (11 points) In each part below, a change is described that will alter the supply or demand in a particular exchange market whose supply and demand curves are shown at the right. For each of these changes,
    i) represent the change by an appropriate shift of the supply and/or demand curves for currency shown at the right. (Pay close attention to the labeling of the axes to know which currency is which.)
    ii) Then record whether the indicated currency appreciates or depreciates as a result of the change, by circling the appropriate word.

a. The U.S. increases its interest rates, attracting a capital inflow from Europe.

The U.S. $ appreciates

depreciates



b. Japan reduces its tariff on imported rice,
causing a large increase in Japanese imports from California.

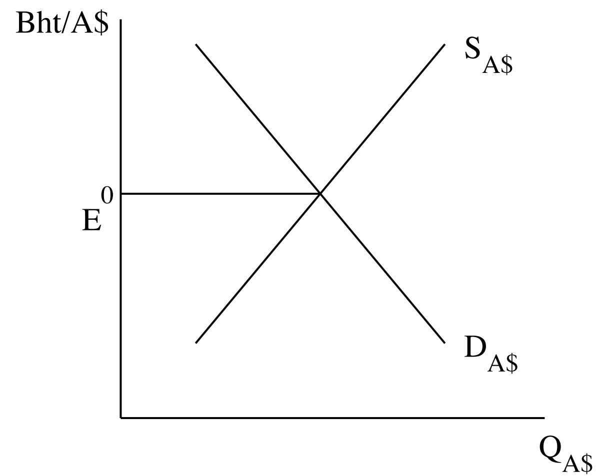
The Japanese yen appreciates

depreciates

c. Fear of a currency crisis in Thailand causes Thais to withdraw funds from Thai banks and then deposit them in Australia.

The Thai baht appreciates

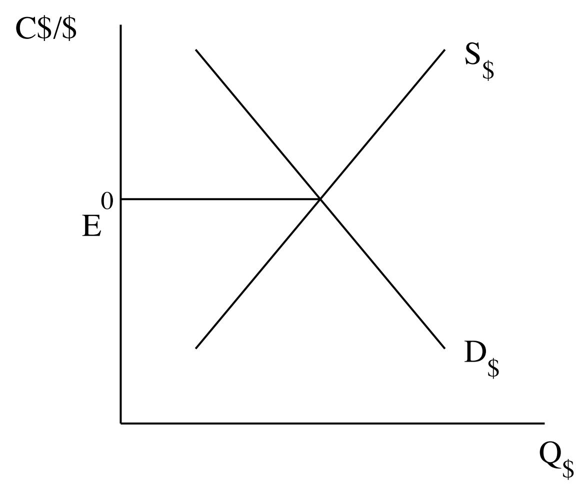
depreciates



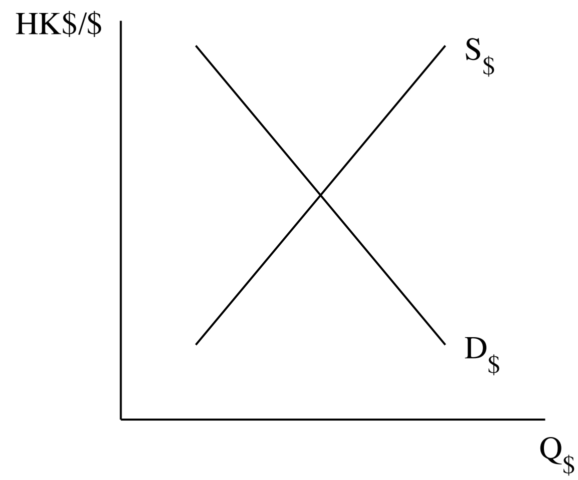
d. The U.S. expands its money supply to stimulate its economy.

The Canadian $ (denoted C$) appreciates

depreciates



e. Hong Kong, which has been pegging its currency, the Hong Kong Dollar ("HK$"), to the U.S. dollar, finds that its reserves are increasing over time. No need to draw shifts of supply or demand curves in this case. Instead, show in the figure what the pegged exchange rate might have been, drawing a horizontal line at that level and labeling it E_1.

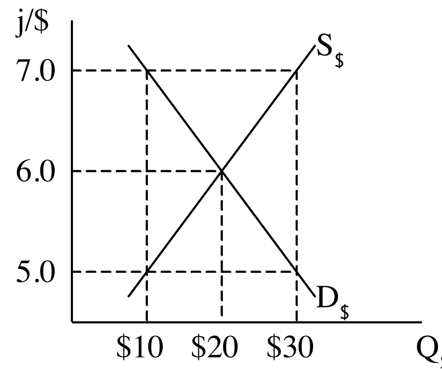


Now suppose that Hong Kong becomes reluctant to hold so many dollars and changes its peg so as to reduce the inflow of reserves. Show a new exchange rate that will accomplish this, and label it E_2.

Is this an appreciation or a depreciation of the Hong Kong dollar? (circle one)

appreciation depreciation

3. (10 points) The country of Ipana has a currency called the jelo (pronounced "yellow," denoted j), which it pegs to the U.S. dollar. Initially, its market for foreign exchange has the supply and demand curves shown at the right, and it is pegging at the rate of 5.0 j/$ (that is, five jelo per dollar). Answer the questions below in the blanks provided.



a. How much is a jelo worth in dollars? ______________

b. At the initial pegged exchange rate of 5.0 j/$, how many dollars are being added to (+) or removed from (–) Ipana's international reserves each time period? (Show sign, + or –, and size.) ______________

c. If Ipana sterilizes the effects of this intervention, by how much does its money supply (monetary base, actually) change each period, + or –, in jelos? ______________

d. If Ipana does *not* sterilize, by how much does its money supply change each period, + or –, in jelos? ______________

e. Suppose Ipana starts with international reserves of $80, and suppose that the supply and demand curves shown above do not change over time. After how many periods will Ipana run out of reserves? ______________

4. (5 points) True-False

a.	Denmark and the U.K. chose to "opt out" of the adoption of the euro, even though they ratified the Maastricht Treaty.	True	False
b.	Japan is a major "host" of FDI.	True	False
c.	The US has a deficit in its balance of trade but a surplus in its current account.	True	False
d.	If a country's currency depreciates, that is expected to increase its exports.	True	False
e.	An optimal currency area is the region within a country where the currency issued by local government primarily circulates.	True	False

5. (4 points) What do the following acronyms, each from the past or present of the euro, stand for and/or mean?

   a. ECU

   b. EMU

   c. ERM

   d. EMS

6. (6 points) Define:

a. Foreign direct investment

b. Crawling peg

c. Doom loop

d. Forward exchange rate

e. Current account

f. Stability and Growth Pact