NAME: ______________________________

Student ID No.: ________________________

Economics 340
International Economics
Prof. Alan Deardorff
Second Midterm Exam

Form (KEY) 0

Answers

November 18, 2019

INSTRUCTIONS: READ CAREFULLY!!!

1. Please do not open the exam until you are told to do so.

2. **ENTER 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 it. Check that you have all ?? 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. Part 2 has 48 points total.

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

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. In the data on foreign direct investment, Japan is

   a. Both a large source country and a large host country.
   b. A large source country but not a large host country.
   c. A large host country but not a large source country.
   d. Not significant as either source or host.
   e. Not distinguished from other countries in Asia, so it is impossible to say what role it plays.

   Ans: b

2. Comparing multinational corporations (MNCs) to local firms in the same industry,

   a. MNCs pay lower wages than local firms.
   b. MNCs require workers to work longer hours, and in harsher conditions, than local firms.
   c. MNCs make more extensive use of machinery than do local firms.
   d. The products of MNCs are less likely to be protected by import tariffs.
   e. MNCs do not buy raw materials from the local economy.

   Ans: c

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

   a. Countries often engage in FDI in industries where the country they invest in has a CA.
   b. If a country attracts large amounts of FDI in order to sell to its home market, that indicates it has a CA as an FDI host.
   c. When a country's firms invest abroad, this helps to create CA in the same industry at home.
   d. Firms that engage in FDI do so because they have a CA relative to other firms.
   e. Nothing. CA has nothing to do with FDI.

   Ans: *a*

4. Suppose that a country has the following data on international transactions in a given year:

Exports of goods and services	1000
Imports of goods and services	800
Net change in assets owned abroad	500
Net change in foreign-owned assets at home	400
Unilateral transfers received	0
Unilateral transfers paid	200
Investment income paid to foreigners	300
Investment income received from foreigners	400

   Then its balance on current account for that year is

   a. +200
   b. +100
   c. 0
   d. –100
   e. –200

   Ans: *b*

5. The trade deficit of the United States has been very large in recent years. How has this been possible?

   a. It's not. The data are wrong.
   b. While the value of imports has been large, the quantity has been small, so that the quantities of US exports and imports have been equal.
   c. Other countries have been willing to give us the money, as unilateral transfers, to pay for our excess imports.
   d. The US invested so much abroad during earlier decades that the income from these investments is now enough to pay for our excess imports.
   e. The US has borrowed increasing amounts from foreigners, especially foreign central banks.

   Ans: *e*

6. What policy does Warren Buffett suggest in order to eliminate the U.S. trade deficit?

   a. Stop trading with China.
   b. Devalue the dollar.
   c. Issue Import Certificates to exporters, to be used by importers.
   d. Require that countries wishing to export to the U.S. use Special Drawing Rights.
   e. Make outsourcing of jobs illegal.

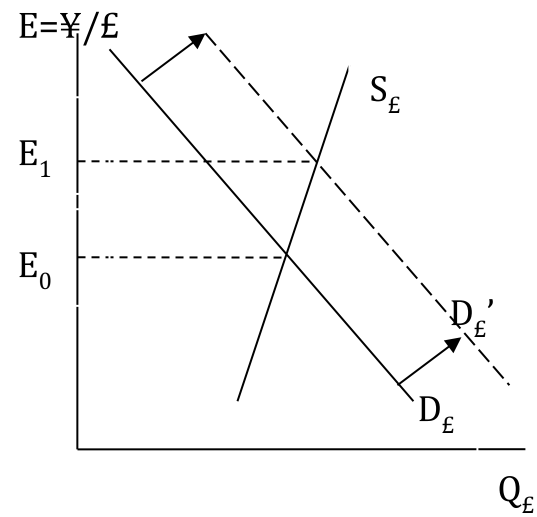
   Ans: *c*

7. In the years 2011 and 2014 (for which we saw US balance of payments data from two editions of the Gerber textbook), the United States 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.

   Ans: *d*

8. The figure shows the market for the British pound, £, as the foreign currency for Japan, whose own currency is the yen, ¥. Which of the following changes would cause the demand for pounds to shift to the right, as shown?



a. An increased British demand for Japanese cars.
b. The sale of a Japanese company to a British investor.
c. British aid to Japan after a Japanese earthquake.
d. A fall in the interest rate on bonds in Japan.
e. A new suspicion on the part of Japanese investors that the pound is about to depreciate.

Ans: *d*

9. The table below shows hypothetical values for the nominal euro/dollar exchange rate in 2019 and as well as price indices for the US, P^u, and the eurozone, P^e. Five different values for each of these are also listed for the year 2020, labeled (a)-(e). In which one of these has purchasing power parity been maintained from 2019 to 2020?

	2019	2020: (a)	(b)	(c)	(d)	(e)
E	0.80 €/$	0.88 €/$	0.72 €/$	0.88 €/$	0.80 €/$	0.72 €/$
P^u	120	132	144	120	132	120
P^e	150	150	150	165	162	120

Ans: *c*

10. Forward exchange rates are useful for those who wish to

a. Protect themselves from the risk that the exchange rate will change before a transaction is completed.
b. Gamble that a currency will rise in value.
c. Gamble that a currency will fall in value.
d. Exchange currencies at a point in time in the future.
e. All of the above.

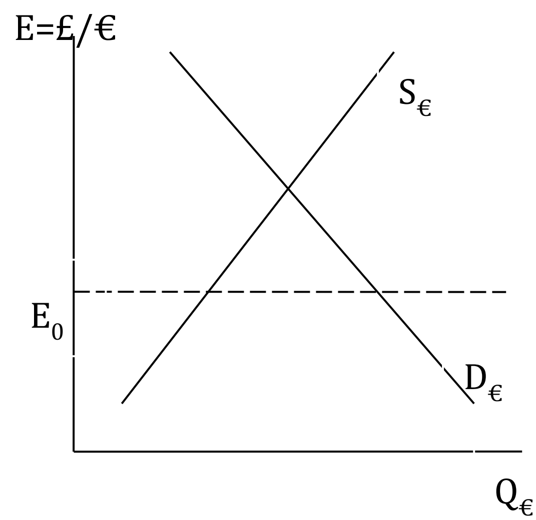
Ans: *e*

11. According to the Asset Theory of the exchange rate, the price of foreign currency will be

    a. Whatever will equate the values of assets at home and abroad.
    b. What people in the market expect the exchange rate to be in the very near future.
    c. The difference between the domestic and foreign interest rates.
    d. Whatever will equate the buying power of domestic and foreign currencies.
    e. Equal to the relative price of domestic and foreign bonds of comparable maturity and risk.

    Ans: *b*

12. Suppose that the Bank of England (BoE) were pegging the British currency, the pound, £, to the euro, €, at the exchange rate E_0 shown in the figure. Suppose also that the BoE is engaged in sterilization. Which of the following would then be true?



    a. The pound is undervalued
    b. The BoE is adding to its international reserves.
    c. The British money supply is increasing.
    d. The BoE is buying British bonds.
    e. All of the above.

    Ans: *d*

13. An "exchange rate band" is

    a. The group of foreign currencies that a currency such as the Chinese yuan may be pegged to.
    b. The range of exchange-rate values above and below par value that a pegged exchange rate is allowed to move within.
    c. The gap between the foreign and domestic price levels within which an exchange rate must stay in order to maintain purchasing power parity.
    d. The path followed by an exchange rate as it adjusts to a change in expectations.
    e. Winner in 2019 of the Eurovision Music Contest.

    Ans: *b*

14. The term “leaning against the wind” refers to

    a. Use of a monetary contraction to fight inflation.
    b. Safeguards policy to limit a sudden surge of imports.
    c. A sale of foreign currency on the forward market in anticipation that the foreign currency will fall in value over time.
    d. A purchase of foreign currency on the forward market in anticipation that the foreign currency will fall in value over time.
    e. Use of a managed floating exchange rate in order to reduce fluctuations in the rate.

    Ans: *e*

15. If a country’s currency appreciates, and if the wealth effect of that appreciation is zero, then the trade effect of the appreciation will lead to the following macroeconomic changes (according to the standard Aggregate Supply and Demand Model of GDP and the price level):

    a. The price level rises temporarily and GDP rises permanently.
    b. GDP rises temporarily and the price level rises permanently.
    c. The price level falls temporarily and GDP falls permanently.
    d. GDP falls temporarily and the price level falls permanently.
    e. The price level rises permanently and GDP falls temporarily.

    Ans: *d*

16. Assume (as we did in class) that changes in capital flows have a larger effect than changes in trade on supply and demand for foreign exchange. Suppose that Denmark is pegging its currency to the euro and that its international reserves of euros are declining over time. What macroeconomic policies in Denmark would slow or reverse this decline in reserves?

    a. A monetary contraction and a fiscal expansion.
    b. A monetary contraction and a fiscal contraction.
    c. A monetary expansion and a fiscal contraction.
    d. A monetary expansion and a fiscal expansion.
    e. None of the above.

    Ans: *a*

17. If you know that your country's currency, the drachma, was about to depreciate by 25%, in which of the following cases would that hurt you most (or help you least)?

    a. Your assets and debts are both in drachmas.
    b. Your assets are in drachmas and your debts are in dollars.
    c. Your assets are in dollars and your debts are in drachmas.
    d. Your assets and debts are both in dollars.
    e. It doesn't matter. Your wealth declines by 25% in all cases.

    Ans: *b*

18. The assigned article from the *Economist* titled "More Spend, Less Thrift" was critical of which country for running budget surpluses that reduce aggregate demand in Europe?

    a. Italy
    b. France
    c. Greece
    d. Germany
    e. Poland

    Ans: *d*

19. Which of the following is **not** required for a country to be named a currency manipulator by the US Treasury Department?

    a. It conducts substantial trade with the US
    b. It has a bilateral trade surplus with the US
    c. It repeatedly purchases foreign exchange
    d. It has a current account surplus
    e. It holds large amounts of US dollar assets

    Ans: *e*

20. During the years 2000-2019 (the period for which we showed the graphs of the China's exchange rate and reserves), in which period was it true that both
    i) China's currency was depreciating over time, and
    ii) China's international reserves were rising?

    a. 2000-2005
    b. 2005-2008
    c. 2008-2014
    d. 2014-2019
    e. Never

Ans: *e*

21. According to the assigned article from the *Economist*, "China and currency manipulation," which country engaged in the most currency manipulation?

    a. Switzerland
    b. China
    c. Germany
    d. South Korea
    e. United States

    Ans: *a*

22. What did the leader of the European Central Bank say that, according to the assigned reading by Smialek and Ewing, caused President Trump to accuse "Europe of bolstering its economy at America's expense"?

    a. That "additional stimulus will be required"
    b. That "Germany and the Netherlands should increase spending on infrastructure"
    c. That "the US dollar is no longer to be trusted as a store of value"
    d. That "the euro is overvalued"
    e. That "the euro is undervalued"

    Ans: *a*

23. Which country and its currency was reported in recent news to have fallen to its lowest level in ten years and was said to be "more global trade sensitive than almost anyone else"?

    a. Brazil's real.
    b. China's renminbi
    c. India's rupee
    d. Mexico's peso
    e. Sweden's krona

    Ans: *e*

24. The United Kingdom was scheduled to leave the European Union on October 31. What did UK Prime Minister Boris Johnson do?

    a. He successfully reached a deal with the EU for how to conduct Brexit.
    b. He had the UK House of Commons meet on a Saturday.
    c. He sent a letter to the EU requesting an extension of the deadline.
    d. He sent a letter to the EU saying that an extension would be damaging.
    e. He did all of the above.

    Ans: *e*

25. In the news it was reported that a WTO panel ruled in favor of the United States in a trade dispute naming another country as providing $7 billion in annual subsidies to its companies, saying that these subsidies violate WTO rules. Which country was that?

    a. Chile
    b. China
    c. India
    d. Thailand
    e. Turkey

    Ans: *c*

Part II: Short Answer

Answer on these sheets in the space provided.

1. (7 points) What do the following acronyms stand for in international economics, and/or what do they mean? (You need only answer either what they stand for or what they mean, but if you give both and get either correct, you'll get full credit.)

a. DFI *Ans: Direct Foreign Investment; Building or buying real assets, such as factories and equipment, in another country*

b. APEC *Ans: Asia Pacific Economic Cooperation; a large group of countries in the Asian and Pacific region that meets regularly to discuss issues of international economics. It got into the news when its planned meeting in Santiago, Chile, was cancelled due to disruption there, stopping China and the US from using the event as a venue for signing a trade deal.*

c. PPP *Ans: Purchasing Power Parity; the theory that exchange rates in the long run reflect the relative buying power of the currencies.*

d. TNC *Ans: Transnational corporation; Same as Multinational Corporation, but usually used with a negative connotation.*

e. LRAS *Long Run Aggregate Supply: The vertical curve in the AD/AS framework showing the only level of GDP that is consistent with non-accelerating inflation, and thus the level to which the economy will converge over time.*

f. IMF *International Monetary Fund: the international organization that was created after World War II to oversee a system of pegged exchange rates, but that now primarily provides financial assistance to countries in financial crisis.*

g. RCEP *Regional Comprehensive Economic Partnership: The large free trade agreement that was to include 16 countries of Asia, centered on China. The agreement has almost finished, but India has dropped out.*

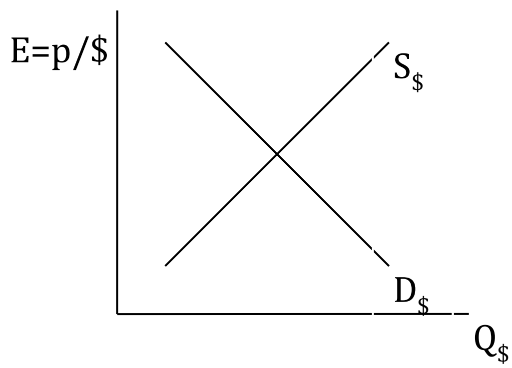
2. (14 points) Identify the following transactions by whether they belong in the U.S. current account or financial account, and also whether they enter positively (contributing to a surplus in that account) or negatively. Put a plus or a minus sign in the appropriate column.

	Current Account	Financial Account
a. An American student buys an airline ticket on the German airline, Lufthansa.	–	
b. A Chicago politician deposits $20,000 in a savings account in a Brazilian bank.		–
c. A Boston church borrows $15,000 from a French church.		+
d. A publisher in Singapore pays royalties to a University of Michigan professor.	+	
e. A commercial bank in China collects interest payments on US government securities that it had previously bought.	–	
f. The American company Boeing sells an airplane to a Japanese airline	+	
g. Your American professor buy 100 shares of stock in the Swedish retailer IKEA.		–

3. (14 points) In each part below, the figure shows supply and demand curves in the foreign exchange market from the perspective of an indicated country. In some cases, a particular exchange rate, $\bar{E}$, is also shown, indicating that the country is pegging its exchange rate at that level. If an $\bar{E}$ is not shown, then the country has a floating exchange rate. In each case, a change is described in words, and you should begin by drawing into the figure the shift that this will cause in the supply or demand curves (one such shift is enough). Then answer the questions that follow by circling the correct choice among those offered in brackets ([ ]).

a. Mexico, whose own currency is the peso (p) and whose foreign currency is the dollar, faces an increase of tariffs on its exports to the United States.

Ans: The supply curve for $ shifts to the left, causing the p/$ exchange rate to move up in the diagram.

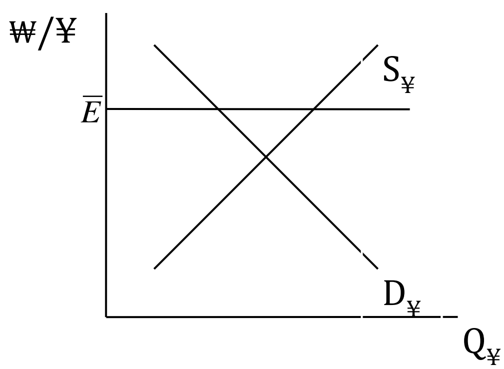


As a result, the Mexican peso [appreciates / depreciates / remains unchanged],

which causes Mexican imports from the U.S. to [increase / decrease / not change]. *Ans: dep; dec*

b. S. Korea, whose own currency is the won (₩) and whose foreign currency is the yen (¥), raises its interest rate.

Ans: This makes Korean bonds more attractive causing a capital inflow to Korea, shifting the supply curve for ¥ to the right (and/or shifting the demand curve to the left).

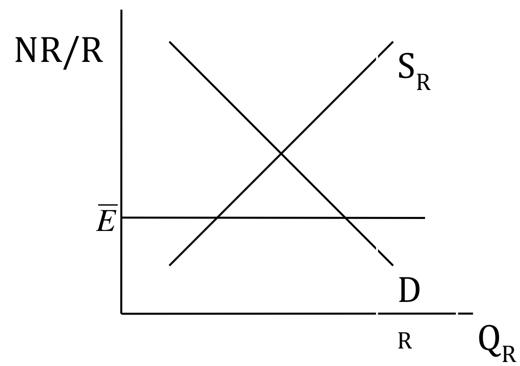


As a result, the Korean central bank must [increase / decrease / not change]

the quantity of yen that it is [buying / selling] in the exchange market.

Ans: inc; buy

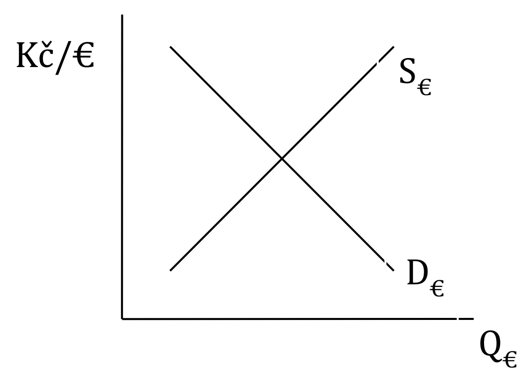
c. Nepal, whose own currency is the Nepalese rupee (NR) and whose foreign currency is the Indian rupee (R), experiences a decline in charitable contributions from India's wealthy, whose wealth has fallen.



Ans: As the givers or receivers exchange fewer R for NR, this decreases the supply of R. So the supply curve shifts to the left.

As a result, the Nepalese central bank must [increase / decrease] the amount of Indian rupees that it is [buying / selling] in the foreign exchange market. If it does not sterilize the effects of this intervention on its money supply, then Nepal's money supply will [grow / shrink] [more / less] rapidly than before. *Ans: inc;sell;shrink;more*

d. The Czech Republic, whose own currency is the koruna (Kč), whose foreign currency is the euro (€), and which is running a trade deficit, begins to intervene in the exchange market in order to stimulate its exports to the EU.



Ans: To stimulate exports it needs to make them, and thus its currency, cheaper. It sells its own currency, buying euros, shifting demand for euros right. Or you might show a peg by drawing a horizontal line below the intersection.

As a result, the Czech koruna [appreciates / depreciates], eventually causing the Czech balance of trade to become [more / less] negative.

Ans: dep;less

4. (3 points) Suppose that a company in Argentina initially owns a factory worth 180 million pesos, that it has borrowed 55 million US dollars to finance its construction, and that these are its only assets and liabilities.

   a. If the exchange rate is initially 3 pesos per dollar, what is the initial value of the company, in pesos?

      +15 million pesos (= 180 – 3×55)

      What is its value in dollars?

      +5 million dollars (= 180/3 –55)

   b. If the peso now depreciates to 4 pesos per dollar, what does the value of the company become, in pesos?

      –40 million pesos (= 180 – 4×55)

      And in dollars?

      –10 million dollars (= 180/4 –55)

   c. Did the company gain or lose from this depreciation?

      It lost.

5. (5 points) Answer the following by circling the correct choice from among those offered in brackets ([ ]).:

    a. If a country pays less investment income to foreigners than it receives from foreigners, and if net unilateral transfers to foreigners are zero, then its current-account deficit will be [larger / smaller] than its trade deficit. *Ans: smaller*

    b. If a country's price level rises by a smaller percentage than that of another country, and if the nominal exchange rate between their currencies is unchanged, then the real exchange rate of the first country by definition [appreciates / depreciates]. *Ans: depreciates*

    c. The "J-curve" describes the phenomenon that, when a country's currency depreciates, its balance of trade first [deteriorates / improves], and then later [deteriorates or deteriorates further / improves or improves further]. *Ans: deteriorates; improves [Not in lecture, but from textbook Ch. 11]*

    d. In the 1930s, many countries devalued their currencies by [adopting / leaving] the Gold Standard. *Ans: leaving*

7. (5 points) Define the following terms as they are used in international economics:

a. Export platform — *Ans: A host country for FDI whose purpose is to export to another country*

b. Current account — *Ans: The portion of the balance of international transactions that includes trade, income on investments (and wages), and unilateral transfers.*

c. Real exchange rate — *Ans: The nominal exchange rate between two currencies after adjustment for inflation in both countries;* $R=Ep^e/p^u$ *for* $E=\$/€$.

d. Depreciation — *Ans: A fall in the value of a currency. (Not a fall in the exchange rate; that would be ambiguous unless you've explicitly defined the exchange rate as the price of domestic currency.)*

e. Currency envy — *Ans: Concern with the absolute value of one's own currency, compared to the absolute value of another.*