Fiscal & Financial System in Japan A / International Finance

Fall 2013

Final Exam

13:35 - 14:45 Dec 20, 2013

- This is a closed book exam.
- You can use a simple calculator.
- You can withdraw anytime during the exam provided that you are sure you finished the exam. No class after exam.
- For model answers, visit my website.
- *Except for* the multiple-choice question #4, assume that the net factor income from abroad and the net unilateral transfers are small relative to trade balance and can be neglected, that is, $TB = CA$.
- When you use graphs in your explanations, be sure to include words as well.

Multiple-Choice Questions(5 points for each question)

1. With domestic and foreign prices constant, when a country's currency depreciates,

   (a) foreigners find that its exports are more expensive, and domestic residents find that imports from abroad are more expensive.

   (b) foreigners find that its exports are more expensive, and domestic residents find that imports from abroad are cheaper.

   (c) foreigners find that its exports are cheaper; however, domestic residents are not affected.

   (d) foreigners are not affected, but domestic residents find that imports from abroad are more expensive.

   (e) None of the above.

2. Which of the following statements is the most accurate?

   (a) For a fixed interest rate, a rise in the expected future exchange rate causes a rise in the current exchange rate.

   (b) For a fixed interest rate, a rise in the expected future exchange rate causes a fall in the current exchange rate.

   (c) For a fixed interest rate, a rise in the expected future exchange rate does not cause a change in the current exchange rate.

3. Suppose that a country's central bank increases the money supply, and at the same time, it also affects people's expectations about the future exchange rate and causes a *rise* in E_1^e (a decrease in expected future value of that currency). Assuming that income and prices are fixed, which of the following statements is the most accurate?

   (a) The currency depreciates more when peopole change their expectations than when people do not.

   (b) The currency depreciates less when peopole change their expectations than when people do not.

   (c) The currency depreciates by the same amount, whether people change their expectations or not.

4. Which one of the following statements is *not* correct?

   (a) A country with a current account deficit is increasing net foreign debt.

   (b) In theory, whenever a country runs a current account deficit, another country runs a current account surplus.

   (c) A country with a current account surplus always earns more than it spends.

   (d) A country with a current account surplus always exports more goods and services than it imports from abroad.

5. Which one of the following statements is the most accurate?

   (a) A rise in domestic income decreases aggregate demand for home output because of the increased demand for import.

   (b) A rise in domestic income keeps aggregate demand for home output at the same level.

   (c) A rise in domestic income raises aggregate demand for home output.

   (d) It is difficult to tell whether a rise in domestic income affects positively or negatively aggregate demand for home output.

6. An increase in expected future exchange rate (a decrease in expected future value of the currency) causes

   (a) an upward shift in the AA schedule, an increase in output, and currency appreciation.

   (b) an upward shift in the AA schedule, an increase in output, and currency depreciation.

   (c) a downward shift in the AA schedule, an increase in output, and currency appreciation.

   (d) a downward shift in the AA schedule, an increase in output, and currency depreciation.

7. Using the DD-AA framework, which one of the following statements is the most accurate?

   (a) Only monetary policy can bring the economy to full employment.
   (b) Only fiscal policy can bring the economy to full employment.
   (c) Only both monetary and fiscal policies can bring the economy to full employment.
   (d) Neither policy is capable of bringing the economy to full employment.
   (e) Monetary policy by itself or fiscal policy by itself can bring the economy to full employment.

8. Suppose that a counry's GDP has increased and its currency has appreciated. Using the DD-AA framework, which is the most unlikely cause behind?

   (a) The government has increased its purchases.
   (b) The country's central bank has increased the supply of money.
   (c) Foreign country's GDP has increased.
   (d) The foreign price level has risen.

Arithmetic/Essay Questions

1. Suppose you are wondering whether to deposit 100,000 yens in a commercial bank with an anual interest rate of 0.02 for three years, or to buy a 100,000 yens of bond with a yearly coupon payment of 1,000 yens, a face falue of 102,000 yens, and a maturity of 3 years. Which do you decide is a better investment opportunity? Explain how you reach the conclusion. (**10 points**)
   (Be careful you are not required to calculate the interest rate of this bond.)

2. Explain, with the help of diagrams and relevant discussions, how current account deficits can make a country better off in the face of a *temporary* fall in its output. (**10 points**)

3. Assume that the output, FX, and money markets are in equilibrium in Japan. Now suppose that the dollar interest rate has increased.

   (a) Explain how the yen interest rate and the yen/dollar exchange rate will be affected *in the short run*. Describe how the market reaches a new equilibrium. (**10 points**)
   (b) Using the DD-AA framework, demonstrate the *medium-term* effect on the level of Japan's output and the yen/dollar exchange rate. Be sure to draw the DD-AA diagram. (**10 points**)
   (c) Compare the short-term and the medium-term changes in the exchange rate and show which is greater. Explain how you reach the conclusion. (**10 points**)
   (d) Will Japan's current account worsen or improve as a result of an increase in the dollar interest rate? Explain how you reach the conclusion. (**10 points**)
   (hint:Write down the GDP identities ($Y = C + I + G + CA$) for the initial equilibrium and for the new equilibrium, and examine the two identities closely.)