Wilfrid W. Csaplar Jr., Ph.D. Economics 488 (365) Exam #2 2003/04/01

Write your name on the cover of the test booklet and nowhere else. Enclose this sheet with the booklet. Failure to follow these directions will cost you 1 point. The test has 100 points and is scheduled to take 50 minutes. Therefore, expect to spend 1 minute for every 2 points. For example, a 16-point question should take 8 minutes. I will give a few extra minutes, but probably no later than about 5 or 10 minutes after the hour.

1) (14 points) Do EITHER part A OR part B.
A) What are currency swaps and exchange futures? When would you use currency swaps? Why would you use them then?
B) Draw the diagram for covered interest arbitrage with i - i* versus the forward premium. Label the area of capital outflow. How can you tell that it is capital outflow? Why is there a band around the covered interest arbitrage line?

2) (24 points) Do EITHER part A OR part B.
A) Why does $F = f(\overset{-}{i}, \overset{+}{i^*}, \overset{+}{EA}, \overset{-}{RP}, \overset{-}{Y}, \overset{-}{P}, \overset{+}{W})$? State what F is. Explain why FIVE of the terms have their signs.
B) Show the time paths that result from a one-time increase in the money supply that leaves the money supply at the new higher level. Show the paths for TWO of the following interest rates, the price level, and the exchange rate, Explain each of the variables takes that path.

3) (30 points broken down as described below) Do EITHER parts A1 - A4 OR parts B1 - B2.
A) Use the graph on the back to answer ALL sections of part A. The green crosses are the demand for the good, the yellow squares are the supply of the good with one exchange rate and the red triangles are the supply of the good with the other exchange rate. The other currency is the Nigerian Naira (x).
A1) (6 points) Is this diagram showing the Nigerian demand for US exports or US demand for imports from Nigeria? How can you tell?
A2) (6 points) **Given your answer in part A**, can you find two points on the supply of US$, the demand for US$, demand for x, or supply for x? How can you tell?
A3) (6 points) If one demand line corresponds to US$0.01/x and the other demand line corresponds to US$0.005/x, which line corresponds to which exchange rate? How can you tell?
A4) (12 points) Derive two points on either the supply or the demand for x. Show all work and briefly explain what you did.
B) Do both sections B1 and B2.
B1) (16 points) Draw the J-curve and use the Marshal-Lerner condition to explain why it takes that shape.
B2) (16 points) Draw the supply and demand for Sri Lankan Rupees (Rs.) that has an unstable equilibrium. Explain why it is unstable.

4) (32 points) Illustrate EITHER the event in part A OR the event in part B on BOTH the IS/LM/BP diagram and the 45° diagram, a.k.a. Keynesian cross diagram. Use the same event in both diagrams and explain the movements of the curves. Make sure the economy goes back to equilibrium. You can draw the BP curve either flatter or steeper than the LM curve. Assume

there is a fixed exchange rate.
A) The government increases the money supply.
B) The marginal propensity to consume increases.