Econ 429 University of Illinois
Spring 2003/04 Gerald Willmann

Midterm Exam

This is a 90 min exam. There are three equally weighted questions. Please read them carefully and answer each of them. If you have problems understanding a question please ask. *Good luck, viel Glück, bonne chance, y mucha suerte !!!*

Question 1: Parities.

a) Suppose you are offered a job in Geneva with a salary of 130,000 Swiss Francs. Your other offer is from Toronto paying 120,000 Canadian Dollars. Describe how you would go about comparing these two offers. By the way, the spot exchange rate as of last night is 1 CAD = .967 CHF.

b) You are given the following (additional) market data: the one-year interest rate in Canada is $2\frac{7}{32}\%$, in Switzerland it is $\frac{13}{32}\%$, and the one-year forward exchange rate is 0.949. Check whether covered interest parity holds.

c) Suppose interest payments are taxed whereas capital gains are not. How does this affect your investment decision? Explain.

Question 2: The Keynes–Mundell–Fleming Model.

a) For each of the three curves of the KMF-model (i.e. LM, IS, and FF) write down the defining equation and explain the slope of the curve. Explicitly discuss how the slope of the FF curve depends on the degree of capital mobility.

b) Graphically analyze the effects of a monetary expansion for a large country under flexible exchange rates and perfect capital mobility.

c) Why would your result from b) differ under a fixed exchange rate regime. Is there any possibility of having both, a fixed exchange rate and an effective monetary policy. Explain.

Question 3: The Monetary Model.

a) Depict uncovered interest parity and money market equilibrium in a diagram with returns on the horizontal axis, the exchange rate to the North, and real money to the South. Define and explain all curves (and lines) in your diagram.

b) Assuming sticky prices and using the diagram from a), explain in detail how an increase in the nominal supply of money leads to a change in the exchange rate. Why does the exchange rate overshoot? Depict the time paths of nominal money supply, the price level, the exchange rate, and the domestic interest rate.

c) Consider a country with a fixed exchange rate and chronic budget deficits. Describe mathematically or graphically when this country will be attacked and forced to abandon its peg.