

Final Exam "International Monetary Economics II"

July 30, 2018

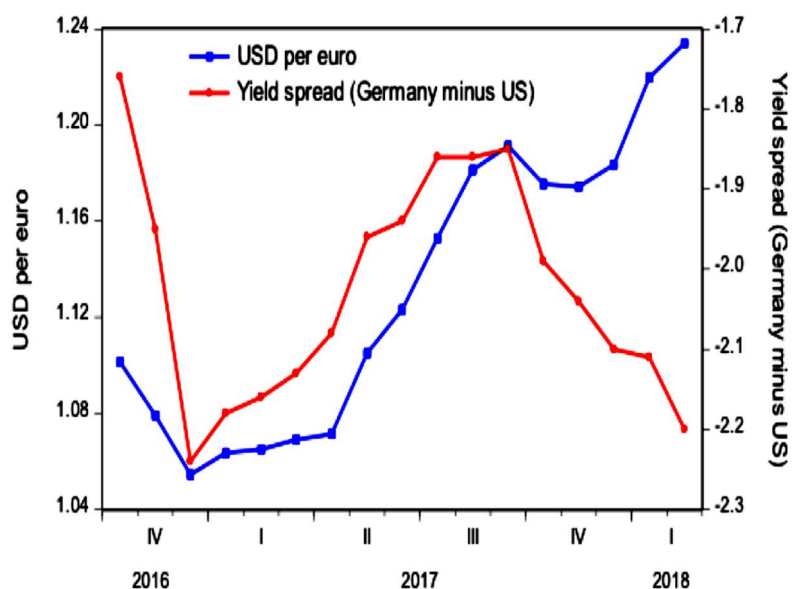
Question 1 (35%)

- The U.S. government has recently cut the corporate income tax. What consequences are to be expected for the U.S. current account according to the intertemporal theory?
- Price and wage levels differ widely internationally. What is larger, price differentials or wage differentials? Explain why.
- According to the Krugman/Flood/Garbers first-generation model, a currency crisis occurs at a point in time when the central bank still has ample foreign exchange reserves. Explain why.

Question 2 (25%)

The recent depreciation of the US dollar against the euro is widely regarded as puzzling. The adjacent graph plots the EUR-USD exchange rate against the 10-year EUR-USD yield spread for 2016-2018.

- What association between the two variables would you expect to see on theoretical grounds? Explain.
- What, then, is "puzzling" about the picture you see?
- What could potentially resolve the puzzle?



Question 3 (40%)

Consider the following model of a small open economy along the lines of Carlin and Soskice (and in their notation):

- $y_{t+1} = A - ar_t + bq_t$
- $L = \frac{1}{2} [y_t^2 + \beta(\pi_t - \pi^T)^2]$
- $\pi_t = \pi_{t-1} + \alpha y_t$

The foreign real interest rate is r^* and the inflation target is initially set equal to foreign inflation $\pi^T = \pi^*$.

- Give an economic interpretation of equations (1)-(3). What do parameters b and β express?
- Derive the monetary policy rule followed by the central bank. Starting from a long-term equilibrium, the central bank increases its inflation target. How does the economy respond? Describe the adjustment process in detail.