MIDTERM II / Practice

I. Short Answer Questions (there will be 10 questions).

1. In the sixties, Europe needed dollars to use as the main settlement currency for international transactions. What was the effect on the US balance of payments and why was this called "the confidence problem"?

2. What is the difference between the EMS and the ERM?

3. Why are the continental Europeans so keen on a fixed exchange rate?

4. Explain why the removal of capital controls in the late 80ies were so destabilizing for a number of European economies.

5. What are the two main fiscal criteria that must be met for a country to join EMU.
II Theory.

Using an IS-LM-BP=0 graph, explain succinctly the effect on the economy of expansionary monetary policy with flexible exchange rate and full capital mobility in the short run.

III Problem

1. The Lira and the Belgium Franc are participating in the ERM with the +/- 2.25% band.

Assume that the bilateral central parity between the Belgium Franc and the Lira is 31.5 Lira per BF and that, within a year, the market exchange rate between the two currencies increases from 31.8 Lira per BF to 32.3 Lira per BF.

   a. Which of the two currencies has appreciated? lira or BF

   b. Calculate whether this new exchange rate (32.3 Lira/BF) is still within the acceptable band for these two ERM currencies. (Show your calculations to prove your point).

   Within band or not within band

   c. If the currencies are out of the acceptable band, how does compulsory intervention take place to bring the two currencies back into the band. (Answer in terms of foreign reserves for each Central Bank)

   The Central bank of Belgium buys or sells BF or lira
The Central bank of Italy buys or sells BF or lira

d. Assuming that the movements in the exchange rates are due to different rate of inflation, which country has the lowest rate of inflation? Italy or Belgium

e. What happens to the real exchange rate of the country that has the lowest rate of inflation?
   a real depreciation or a real appreciation

what is the effect on its international competitiveness?
   an improvement or a deterioration

2. If on a point along the BP curve net exports\(^1\) are equal to: - $1billion
   i. does the country experience net capital outflows or net capital inflows
   ii. equal to $2 billion or $1 billion?
   iii. In the case of some capital mobility: is the BP curve downward sloping or vertical or upward sloping or horizontal?

IV Essay. (choose one) 15 lines

What were the main pitfalls of the Bretton Woods system that had to be avoided in the design of the ERM? 10 to 15 lines

\(^1\) current account balance