Midterm 2

1. (30p) i. Using AA-DD-XX model show and explain what might happen to output, E, money supply, price level, and the CA in the short run and in the long run if you have a permanent decrease in government spending.

ii. How would your analysis change if you had a fixed exchange rate regime?
2. (15p) What happens to the nominal exchange rate $E$ if there is an increase in relative output supply?

3. The Economist reported in 2009:

“Our January update found that a Big Mac cost 48% less in China than in America, which might suggest that the yuan is 48% undervalued against the dollar. But by this gauge, the currencies of virtually all low-income countries are undervalued, since prices are generally lower in these countries than in rich ones.”

(15p) Explain why prices are lower in poorer countries.
4. (10p) According to the 2010 OECD statistics the official exchange rate between the Korean won and US dollar is $E_{KW/\$}$ = 1276 (Korean won per USD) and the Purchasing Power Parity Conversion factor is $E_{PPP}$ = 803.

How much would you have to pay in the US to buy the goods and services that you could acquire in Korea for the equivalent in Korean won of $100?

5. (20p) What are “self fulfilling currency crises”? Show graphically and explain in words.
6. (10p) Explain what a Reserve Currency Standard is and describe some of its characteristics.