Assessment guidelines SØK2009 fall 2021

The compulsory readings are chosen chapters from the textbooks “International Economics” by Krugman, Obstfeld and Melitz (11th edition) and “Economics of Monetary Union” by De Grauwe (12th edition), as well as lecture notes. The exam is arranged as a digital home exam with all support material available (textbooks, lecture notes etc.). Because of the availability of material to present models and figures, the grading of the exam will emphasize economic intuition, understanding, and explanations of relevant mechanisms.

<u>Question 1 (60%)</u>

Question 1 is based on the Krugman et al. textbook.

a) The equilibria in the foreign exchange market and the money market are explained in chapters 14 and 15, respectively. The explanation of the two equations must include the rate of return on domestic and foreign assets, how money supply is decided, and relevant factors determining money demand. The two equilibria are illustrated graphically in Figure 15-6 in the textbook. The discussion should include the economic intuition behind the slopes of all curves and an explanation of why the two equilibria are stable.

b) Calculations show that the rate of return equals 2% and 0.67% for dollar- and euro-investments, respectively. All else equal, it is best to invest in dollar. The interest rates are equal, but since the dollar is expected to strengthen against the euro during the year, the rate of return is higher for dollar investments.

c) The short-run and long-run effects of a permanent increase in the money supply are illustrated graphically by Figure 15-12 in the textbook. Economic intuition must be explained, with particular emphasis on exchange rate overshooting. Time paths of the involved variables are given by Figure 15-13.

d) The implications of a fixed exchange rate regime for a country’s economic policy: the central bank must give up its monetary policy, while fiscal policy becomes more effective and devaluation/revaluation enters as new policy instruments compared to a regime with floating exchange rate. The situation with strong expectations of devaluation is given in Figure 18-5 in the textbook. The challenges of trying to defend the fixed exchange rate should also be discussed (lack of foreign reserves, too high interest rate).

e) The AA-curve shows all combinations of output and the exchange rate where the domestic money market and the foreign exchange market are in equilibrium. The curve can be derived graphically by analyzing the impact of an exogenous increase in income on the exchange rate, as illustrated in Figures 17-6 and 17-7 in the textbook. The slope of the curve is derived analytically in the lecture notes. The AA-curve is downward sloping because increased income gives higher money demand, which pushes up the interest rate and in turn leads to exchange rate appreciation. The economic intuition behind these mechanisms must be explained.

f) An increase in the expected exchange rate increases the expected return on foreign assets, which decreases the demand for domestic assets and gives an exchange rate depreciation (for given income level). The AA-curve therefore shifts upwards. The underlying shift in the foreign exchange market should also be illustrated.

Question 2 (40%)

Question 2 is based on the De Grauwe textbook.

a) A monetary union implies common currency and common central bank among member countries.

b) Brief explanations of the differences between the regimes are expected. It could be noted that a monetary union can choose a floating or fixed exchange rate regime towards other currencies.

c) Relevant factors for the discussion include (but are not limited to):

Challenge: Handling of asymmetric shocks

- Automatic adjustment depends on the degree of labor market mobility and the degree of wage flexibility
- Monetary policy does not work in this setting, while the potential of fiscal policy depends on the government's public debt

Advantage: Handling inflation

- The preferences of the central bank (inflation vs. unemployment)
- Incentives for surprise inflation
- How the monetary union can help solve the inflation problem of a country