930

Ollscoil na hÉireann, Gaillimh
National University of Ireland, Galway

Semester II Examinations, 2004/2005

Exam Code(s)	4FM2
	1EE1, 1EE2, 1EP1, 2EE2
Exam(s)	
	Financial Mathematics and Economics (EC420)
	M.A. and M.Econ.Sc. (EC525)
Module Code(s)	EC 420, EC 525
Module(s)	International Monetary Economics
	International Macroeconomics
Paper No.	1
Repeat Paper	Special Paper
External Examiner(s)	Professor Vincent Munley
Internal Examiner(s)	Mr. Brendan Kennelly
	Dr. Gerald Pech

Instructions:

Answer any TWO of the following three questions.

Duration	2½ hrs
No. of Answer books	
Requirements:	
Handout	
MCQ	
Statistical Tables	
Graph Paper	
Log Graph Paper	
Other Material	
No. of Pages	1

Examination in international macroeconomics/international monetary economics (EC420/EC525)

Answer any TWO of the following three questions:

Question 1: Explain Dornbusch's sticky price model of the exchange rate. What predictions does it make and what drives those predictions? In how far are the assumptions and implications of the model different from the flexible price model? What are the different empirical implications of the fexible and the sticky price approach? How well have they done in empirical tests?

Question 2: Show how a risk premium can be derived from the utility maximization problem of a speculator. What predictions about the risk premium do you get from the utility maximization model? What is so odd about the following empirical relationship involving the forward price of the Swiss Franc denominated in US dollars which was found by Fama:

$$s_{t+1} - s_t = 0.81 - 1.15\,(f_t - s_t)\ ?$$

f_t is the forward rate, s_t the current exchange rate and s_{t+1} the future exchange rate, all measured in logarithms of level variables denominated in $ per SF.

How can these oddities be explained?

Question 3: The American trade deficit has recently been a cause for concern. Sometimes the issue of a necessary readjustment of exchange rates is being raised.

Briefly outline the argument why the sustainability of the trade balance could be a problem. Discuss the likely effect of an exchange rate adjustment. Use a simple graph to illustrate the relationship between the exchange rate and the trade balance. What can be said about the slopes of the demand and supply curve for foreign currency and what is the consequence for the stability of the foreign exchange market? What does the Marshall-Lerner condition say about the relationship between exchange rate and trade balance? Highlight the impact of the time horizon, of supply elasticities and of market conditions on this relationship.