B.Sc. International Business and Politics
International Economics
Copenhagen Business School

Final Exam
October 22, 2010

Note: Your grade depends not just on the right answer but on ***the quality of the explanation and illustrations*** *you provide. Write as clearly as possible, but keep it concise and to the point. When you draw diagrams, make sure you clearly label them.*

Problem 1 (Total points: 25; 5 points each)
Assess whether the following statements are true or false, and explain briefly why.

a) When GDP per capita is measured by PPP, generally you observe people in developing countries have higher living standards than the level when GDP per capita is measured by nominal exchange rate.

b) When a country has $200 billion surplus on its current account, it implies that it also has $200 billion surplus on its financial account because that's the amount of money it earned through net exports.

c) The interest rate in Brazil is 10%, and the interest rate in the US is 0.25%. The current spot exchange rate between US and Brazil is 1.60 Brazilian real per US $, and the forward contract in 6 months is traded at 1.80 Brazilian real per $. According to the information provided above, investors will make money within 6 months by borrowing US $ and invest in Brazilian real.

d) The current interest rate in the US is 0.25%, and the current interest rate for the EU is 1%. When the Fed is expected to raise interest rate sooner than the ECB (European Central Bank), US dollar will appreciate against the Euro.

e) Under the gold standard, when the US lowers its interest rate, every other country under the gold standard has to lower their interest rate too.

Problem 2 (Total points: 15)

The following table shows you the unit labor requirements for producing wine and car in the US and France. Assume there is no wage difference between the two countries, and there is no quality difference for the products that both countries produce.

Unit labor requirements		
	Wine	Car
The U.S.	0.5 hour/L	0.1 hour/unit
France	0.8 hour/L	0.2 hour/unit

1) What's the opportunity cost of producing TEN liters of wine in the US? What's the opportunity cost of producing TEN liters of wine in France? And in which industry does the US enjoy the comparative advantage? (5 points)

2) First convert the table above into a table of labor productivity, i.e., instead of expressing the numbers in unit labor requirements, express them in terms of quantity of products that can be produced using 1 labor hour. Then, decide in which industry France enjoys relatively higher labor productivity. (5 points)

3) From your answers above, in which industry does the US enjoy the absolute advantage? And briefly explain why the US can benefit from free trade. (5 points)

Problem 3 (Total points: 20)

Home country's demand curve for banana is $D = 100 - 2P$, and its supply curve for banana is $S = 20 + 2P$. Home country is also one of the largest importers of bananas in the world. Its import demand curve is $MD = 90 - 5P$; and it faces the following export supply curve: $XS = -10 + 5P$.

a) With free trade, determine the equilibrium price and trade volume. (5 points)

b) Now home country imposes an <u>ad valorem tariff</u> of 20% on foreign banana imports. Determine the new trade volume and how the tariff by home country has changed the world banana price. (5 points)

c) Finally, by imposing the import tariff, has home country improved or reduced its net welfare? Draw graph(s) to illustrate and make sure to show your work. (10 points)

Problem 4 (Total points: 20)

Denmark pegs its currency, Danish Kroner (or DKK), to the Euro, at roughly 7.45 DKK per euro. Denmark's neighboring country, Norway, does not.

a) When European Central Bank (or ECB) lowered its interest rate sharply during the recent global recession, how did it affect the monetary policy in Denmark? And how did this monetary expansion by ECB further affect the output level in Denmark? Draw graph(s) to help you explain. (5 points)

b) To increase output and reduce unemployment, both Denmark and Norway engaged in expansionary fiscal policies during the recession. Compare and contrast the effects of fiscal policy on the output in both countries. Make sure you use diagram(s) to help you illustrate. (10 points)

c) During the recent recession, Nordic countries, including Denmark, have had much better economic performance when compared to other member countries in the EU. Let's assume that this diverging economic performance is likely to persist over time and the difference is largely due to the different economic structures between the Nordic countries and other EU countries. Given the information provided above, discuss the potential drawbacks of fixing DKK to the Euro. (5 points)

Problem 5 (Total points: 20)

Read the article from the New York Times (NYT) on the next page and answer the following questions.

a) According to the article, it is estimated that so far in 2010, "$825 billion will flow into developing countries this year, 42% more than in 2009". Without knowing interest rates in advanced and emerging economies, how would you adjust the theory of *Interest Parity Condition* (or UIP) you've leaned in class to explain the large capital inflow to the emerging economies? Draw graph(s) if necessary to illustrate. (8 points)

b) According to the article, what are the chief concerns regarding the large capital inflows to emerging economies? (2 points)

c) One of the concerns is that large capital inflow is likely to cause inflation to rise and result in an overheated economy. Explain why this is likely to happen. (5 points)

d) To fight inflation, some propose that emerging economies raise their interest rates. Do you think the policy proposal will work as intended? Why or why not? What's the policy dilemma here? (5 points)

The New York Times

October 13, 2010

The Next Bubble

It seems premature to start worrying about the next financial crisis. Yet amid the current gloom, Wall Street is snapping up assets of the "emerging economies" that are growing faster. According to recent IMF economic forecast, in 2011, advanced economies are projected to grow by only 2.4%, while emerging and developing economies are expected to grow by 6.3%.

The Institute of International Finance, which lobbies for big banks, estimates that $825 billion will flow into developing countries this year, 42 percent more than in 2009. Investments in debt of emerging economies alone is expected to triple, to $272 billion.

While developing countries often benefit from foreign investments, huge inflows of capital complicate their macroeconomic management. They push up the value of their currency, boosting imports and slowing exports, and they promote fast credit expansion — which can cause inflation, inflate asset bubbles and usually leave a pile of bad loans. This money turns tail at the first sign of trouble, tipping countries into crisis.

Those are the dynamics behind Mexico's 1994 "tequila crisis," the 1997 Asian crisis, the 1998 Russian catastrophe, the 1999 Brazilian debacle and the 2002 Argentine collapse. The housing bubble that burst here in 2008 was painfully similar, with irrational investments and then a sudden flight.

A collapse in emerging market bonds would further damage the weak balance sheets of American banks. Still, it is not time to panic. Developing countries are in relatively good economic shape, while interest rates in the wealthy countries are likely to stay low for years. Yet the financial system remains fragile. And a shock — say a default in Ireland or Greece — could prompt a fast U-turn away from emerging markets.

There is little policy makers in the rich world can do to stop these flows. Governments in the developing world must prepare now for when the money masters change their minds.

That means they cannot let their budgets get out of hand. And they have to keep a very close eye on their own banks. This might also be a good time to consider capital controls to slow inflows. Chile managed them successfully in the 1990s. Even the International Monetary Fund — long a foe of anything that got in the way of money — acknowledged this year that controls should be part of the toolkit.