

UNIVERSITY OF WARWICK

Summer Examination 2015/16

International Economics

Time Allowed: 1.5 hours.

Answer **ALL THREE** questions in **Section A** (48 marks) and **ONE** question from **Section B** (52 marks). Answer Section A questions in one booklet and Section B questions in a separate booklet.

Read carefully the instructions on the answer book provided and make sure that the particulars required are entered on each answer book. If you answer more questions than are required and do not indicate which answers should be ignored, we will mark the requisite number of answers in the order in which they appear in the answer book(s): answers beyond that number will not be considered.

Section A: Answer THREE questions

1. Suppose that the domestic interest rate in the UK is $i=7\%$, the foreign interest rate in the US is $i^*=3\%$, the spot exchange rate is $e=0.5$ pound per US dollar, and the one year expected exchange rate is $e^e=0.51$ pound per US dollar. If you have 100 pounds to invest today, is your expected return higher when investing in the UK, or in the US? **(16 marks)**

2. In the Dornbusch model of Exchange Rate determination with sticky prices, explain why expectations of future exchange rates are crucial to generate overshooting in the exchange rate. **(16 marks)**

3. In the Mundell-Fleming model of Exchange Rate determination with fixed prices and fixed exchange rates, is the effect of a monetary contraction on the current account the same under perfect than under imperfect capital mobility? **(16 marks)**

Section B: Answer ONE questions

4. Consider the two-period model of the intertemporal approach to the current account. Assume that a small economy Home consumes a single good and has endowments equal to $Y_1=3\bar{Y}$ in period 1 and $Y_2=\bar{Y}$ in period 2. The representative consumer maximizes:

$$U=\log(C_1)+\beta\log(C_2)$$

where C_1 and C_2 are the consumption levels in periods 1 and 2, respectively, and β is the subjective discount factor. The real interest rate for borrowing or lending on world capital markets r is given.

- (a) Write down the intertemporal budget constraint and the maximization problem of the representative consumer. Derive the Euler equation. **(13 marks)**
- (b) Derive the consumption levels C_1 and C_2 as a function of r , β , and \bar{Y} . **(13 marks)**
- (c) Assume there is a Foreign country where the representative consumer maximizes $U^*=\log(C_1^*)+\beta\log(C_2^*)$ where C_1^* and C_2^* are the foreign consumption levels and $Y_1^*=\bar{Y}$ and $Y_2^*=3\bar{Y}$ are the endowments in periods 1 and 2, respectively. Derive the consumption levels C_1^* and C_2^* as a function of r , β , and \bar{Y} . **(13 marks)**
- (d) Compute the autarky interest rates for both the Home and Foreign economy. **(13 marks)**

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5. Answer the following two questions:

- (a) Explain the findings of Rauch (1999) regarding the importance of product-specific information costs in explaining trade flows. **(26 marks)**
 - (b) Discuss the evidence that Engel and Rogers (1996) provide on the importance of sticky prices for explaining the border effect on international price dispersion. **(26 marks)**
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