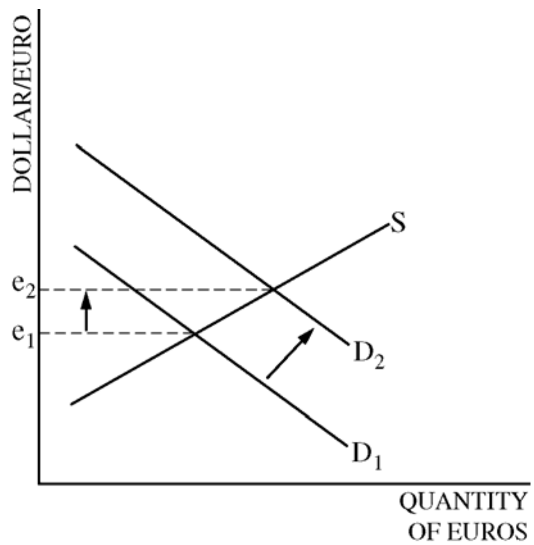
Question 3

7 points (5 + 2)



(a) 5 points:

One point is earned for stating that capital will flow out from the United States to European Union countries.

One point is earned for the explanation that the higher interest rate in the European Union attracts investment funds from the United States.

One point is earned for a correctly labeled graph of the foreign exchange market for the euro.

One point is earned for shifting the demand curve for the euro to the right.

One point is earned for concluding that the euro would appreciate.

(b) 2 points:

One point is earned for concluding that the European Union’s net exports would fall.

One point is earned for the explanation that due to the appreciating euro, the European Union’s goods would become relatively expensive to consumers in the United States, and exports to the United States would decrease but the European Union’s imports from the United States would increase.

3

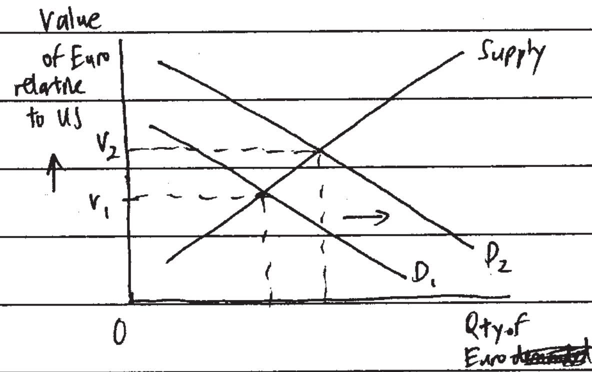
Write in the box the number of the question you are answering on this page as it is designated in the exam.

3A

3 a)(i) United States will experience an outward flow of financial capital to the European Union (EU)

This occurs as businesses will find it more profitable to buy European Union financial assets as they can receive a higher real interest rate (4.5%) ~~in the~~ as compared to the United States, which has a lower real interest rate of 3.75%.

(ii)



The value of the euro will appreciate relative to the United States dollar from V_1 to V_2 in a flexible exchange rate system.

b) European Union's net exports will ~~falls~~ decrease.

Net exports in EU = Exports — Imports

Since an appreciation in the value of the euro will result in ~~the~~ the increase in prices of European Union products internationally, demand for EU products will fall both domestically and internationally. Since this also makes imports relatively cheaper, the quantity of imports demanded will increase. Thus it can be concluded from the above equation that EU's net exports will ~~falls~~ decrease.

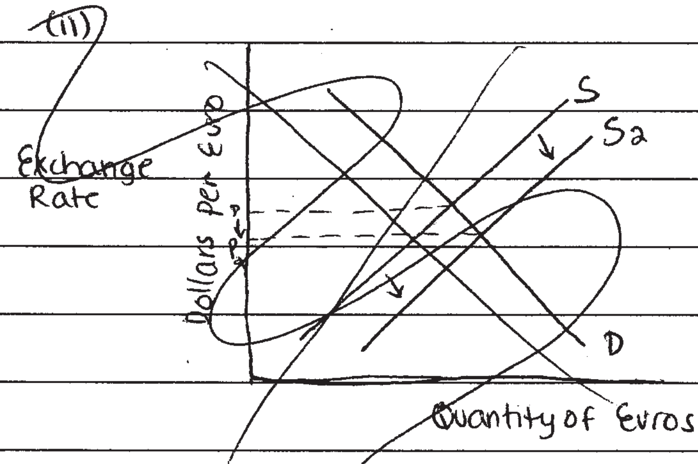
3

Write in the box the number of the question you are answering on this page as it is designated in the exam.

3B1

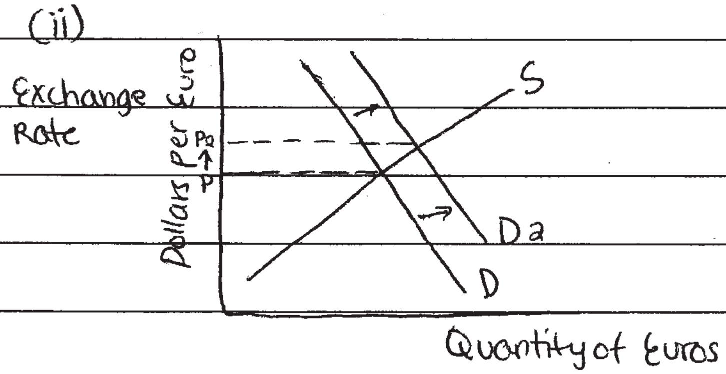
(a) (I) Because the real interest rate is now relatively greater in the European Union, financial capital will flow more to the European Union. When a country's interest rate increases or is higher than another country's, other ~~country~~ countries will invest more in the country with the higher interest rate because the economic prospect ~~of~~ are good, and they will receive higher returns on their investments.

~~(II)~~



~~The supply of Euros would increase because~~

(ii)



The demand for Euros will increase because the United States will want to invest more in Europe due to higher interest

Write in the box the number of the question you are answering on this page as it is designated in the exam.

3

3B 2

rates. They will need to convert more dollars to euros, so the value of the euro would increase and the value of the dollar would decrease.

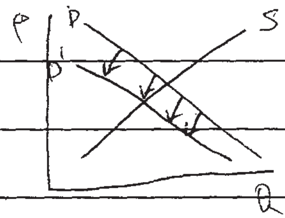
(b) The Euro will appreciate due to an increased demand for euros. This will cause other countries to import more goods from the European Union so the EU's net exports will rise. They will be exporting more than they are importing.

Write in the box the number of the question you are answering on this page as it is designated in the exam.

3

3C

(a) (i) The flow of financial capital between the United States and the European Union will ~~slow down~~ speed up, as United States' real interest rate falls.

(ii) 

As the demand for Euro decreases, the value of the Euro ~~would~~ will decrease.

(b) As the value of the euro decreases, the European Union's net exports will increase.

Question 3

Sample: 3A
Score: 7

The student earned all points in this question.

Sample: 3B
Score: 5

The student earned all 5 points in part (a) and lost both points in part (b).

Sample: 3C
Score: 3

Part (a) earned 1 point for the graph and 1 consistency point for the conclusion on the value of the euro. Part (b) earned a consistency point for the conclusion on net exports.