

ANSWER OUTLINE – ANSWERS FOR Q1-Q5 AT END

ECONOMICS 353

L. Tesfatsion/Fall 05

EXERCISE 6: Six Questions (8 Points Total) DUE: Tuesday, Oct 19, 2010, 2:10pm

****IMPORTANT REMINDER: LATE ASSIGNMENTS WILL NOT BE ACCEPTED
– NO EXCEPTIONS****

EXERCISE INSTRUCTIONS:

- (1) Please **fill in your name and student ID number** on Side 1 of your bubble sheet and write **353 Exercise 6** in the top margin of Side 1.
- (2) Use a number 2 pencil to **mark your answers** on Side 1 of the bubble sheet to the first five questions Q1 through Q5, below, which are in multiple choice format.
- (3) The sixth question Q6 is a Web browse exercise that asks you to consider a huge experiment underway in parts of Europe involving an attempted movement towards fuller economic and financial integration through the use of a single currency. Please put your **name and student ID number** at the top of your print-out sheet for Q6 along with **353 Exercise 6** and **separately** hand in this print-out sheet for Q6 in addition to your answer bubble sheet for questions Q1 through Q5.
- (4) Each question Q1 through Q5 is worth 1 point, and Q6 is worth 3 points.

Q1 (1 Point). In a world divided between HC and ROW, multiplying any valuation V measured in HC currency units by the HC NOMINAL EXCHANGE RATE _____.

- A. corrects V for changes in the HC price level
- B. transforms V into a valuation measured in ROW currency units
- C. corrects V for changes in the HC inflation rate
- D. transforms V into pure quantity terms

Q2 (1 point). In a world divided between HC and ROW, the HC REAL EXCHANGE RATE is defined to be

- A. the HC nominal exchange rate minus the ROW inflation rate.
- B. the HC nominal exchange rate minus the HC inflation rate.
- C. the HC nominal exchange rate multiplied by the ROW price level and divided by the HC price level.
- D. the HC nominal exchange rate multiplied by the HC price level and divided by the ROW price level

Q3 (1 Point). In order for the PURCHASING POWER PARITY (PPP) CONDITION to reduce to a straightforward application of the Law of One Price, the following conditions need to hold:

- A. the HC and ROW aggregate price levels must equal each other over time
- B. HC and ROW must produce the same bundle of goods and services.
- C. information about availability and prices of goods and services must be freely available to everyone in the HC and ROW, and there must not be any trade barriers between the HC and ROW.
- D. all of the above.
- E. only B and C above.

Q4 (1 Point). Suppose the inflation rate in Portugal is 8 percent during 2010 and the inflation rate in Hungary is 12 percent during 2010. Then the PURCHASING POWER PARITY (PPP) CONDITION IN RATES-OF-CHANGE FORM predicts that, during 2010, the value of the Portuguese currency (escudos) measured in terms of Hungarian currency (forints) – i.e., the number of forints per escudo – will

- A. rise by 4 percent
- B. rise by 20 percent
- C. fall by 4 percent
- D. fall by 20 percent

Q5 (1 Point). Suppose the average nominal interest rate on bank deposit accounts across foreign countries who are major trading partners of the U.S. is 3 percent. Suppose, also, that the U.S. effective exchange rate index for these countries (i.e., a weighted average of their exchange rates measured in foreign currency units per U.S. dollar) is expected to depreciate by 1 percent. Then the INTEREST PARITY CONDITION predicts that, on average, nominal interest rates on U.S. bank deposit accounts should be about

- A. -4 percent
- B. -2 percent.
- C. 4 percent
- D. 2 percent.

**SEE THE FOLLOWING PAGE FOR
Q6: WEB EXERCISE**

Q6: Web Exercise (3 Points Total). In May 1950, French Foreign Minister Robert Schuman formally presented a proposal for a united Europe, now known as the *Schuman declaration*. Since that time, parts of Europe have been attempting to bring this idea to fruition, a grand experiment in economic integration whose ultimate degree of success is still uncertain. This question asks you to consider the current state of economic integration in Europe.

Part A:(1 Point) Explain briefly but carefully what is meant by the **European Union (EU)**? Currently (i.e., as of October 2010), which nations are members of the EU? List briefly but clearly the criteria determined at a 1993 EU meeting in Copenhagen, now referred to as the **Copenhagen criteria**, that a country must satisfy as a precondition for joining the EU. Be sure to indicate any sources you used to acquire this information.

Answer Outline for Part A(i)

The *European Union* is an association of European countries working gradually to unite European countries economically and politically in order to secure lasting peace.

Source: http://europa.eu/about-eu/basic-information/index_en.htm

Answer Outline for Part A(ii) Currently (as of 10/19/2010) the EU has **27 Members**: Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden, and the United Kingdom.

Source: http://europa.eu/about-eu/member-countries/index_en.htm

Answer Outline for Part A(iii) *Copenhagen Criteria*: The **Copenhagen criteria** are the rules developed by EU members in 1993 to help guide the EU enlargement process as additional Central and Eastern European countries have sought to join the EU. Briefly, these rules state that the candidate countries must have achieved:

- stability of institutions guaranteeing democracy, the rule of law, human rights, and respect for and protection of minorities;
- the existence of a functioning market economy as well as the capacity to cope with competitive pressure and market forces within the EU;
- the ability to take on the obligations of membership including adherence to the aims of political, economic, and monetary union.

Sources:

http://ec.europa.eu/enlargement/enlargement_process/accesion_process/criteria/index_en.htm

http://europa.eu/pol/enlarg/index_en.htm

Part B: (1 Point) Euro notes and coins began circulation in January 2002. At the present time, which members of the EU have adopted the euro as their only currency? List briefly but clearly the criteria determined as part of the Maastricht Treaty, now known as the **Maastricht convergence criteria**, that a nation must satisfy as a precondition for joining the *euro area*, i.e., the collection of EU nations that have adopted the euro as their only currency. Be sure to indicate any sources you used to acquire this information.

Answer Outline for Part B:(i) Only 16 of the 27 current EU member countries have reached the “third and final stage of complete economic and monetary union” in which the euro has been adopted as their only currency. These 16 members are as follows: Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, Netherlands, Portugal, Slovakia, Slovenia, and Spain.

Source:

<http://www.ecb.europa.eu/euro/intro/html/map.en.html>

Additional Remark: Currently (as of 10/19/2010), three EU member countries (Denmark, Sweden, and the UK) have chosen not to adopt the euro as their only currency. Denmark and UK obtained special opt-outs exempting them from this transition, and Sweden rejected the adoption of the euro in a referendum vote held on September 14, 2003. The implications of Sweden’s rejection of the euro in terms of its status as a EU member in good standing are still unclear.

Answer Outline for Part B(ii) *Maastricht convergence criteria:* Briefly [1], these criteria set out the following preconditions for “accession” into the third and final stage of the Economic and Monetary Union (EMU), in particular, accession into the euro area: (1) a high degree of price stability (domestic and exchange rates); (2) sustainable government finances (in terms of both government budget deficits and public debt levels); and (3) convergence in long-term interest rates.

Additional Remark: More carefully stated [2], the Maastricht convergence criteria are as follows:

- An **exchange rate with the euro** that fluctuates “without severe tensions” by no more than 15% above and below an agreed “central parity” level in the two years preceding entrance into the euro area.
- An **average annual inflation rate** not exceeding by more than 1.5% that of the “three best-performing Member states in terms of price stability” in the year before the entry decision, and this rate should be judged to be “sustainable.”
- An **annual average nominal interest rate on the 10-year benchmark government bond** no more than 2% above the annual average nominal interest rate in these same three EMU countries (i.e., the three EMU countries with the lowest inflation rates in the year before the entry decision).
- A **government budget deficit** (i.e., an excess of government expenditures over current tax revenues) below 3% of GDP.

- A **public debt** (i.e., an accumulation of government budget deficits) less than 60% of GDP.

Sources:

- [1] www.ecb.int/pub/pdf/scpwps/ecbwp896.pdf
- [2] europa.eu/legislation_summaries/economic_and_monetary_affairs/institutional_and_economic_framework/125014_en.htm

Part C: (1 Point) Turkey has been trying to become a member of the EU since 2007. Currently it is still not officially a member of the EU. Explain briefly but carefully what you think is holding up the acceptance of Turkey as a member of the EU. Do you think Turkey will ultimately be successful? Why or why not.

Sources for Q6:Part C

- [1] newsvote.bbc.co.uk/2/hi/europe/4107919.stm
- [2] ec.europa.eu/enlargement/candidate-countries/turkey/relation/index_en.htm
- [3] en.wikipedia.org/wiki/Cyprus
- [4] www.hurriyetdailynews.com/n.php?n=bagis-says-turkey-expects-fair-eu-talks-process-2010-10-18

Answer Outline for Part C(i): What’s holding up Turkey’s membership?

According to an article appearing in the BBC News online [1], there are two main problems delaying Turkey’s EU membership:

- “The EU says that Turkey must open its ports and airports to traffic from EU member Cyprus. Turkey says it will not do this until the EU takes steps to end the Turkish Cypriot community’s economic isolation.”
- “The EU also says that Turkey’s efforts to bring its laws into line with European standards have slowed down. It has especially called on Turkey to repeal a law which it says undermines freedom of speech.”

The *European Parliament Resolution of 10 February 2010 on Turkey’s progress report 2009* [2] suggests that both of these issues (and many more) remain unresolved. The resolution concludes, in particular, that Turkey has made only “limited progress” on political reforms in 2009. Moreover, for the fourth consecutive year (since 2006), Turkey has still not implemented the required provisions regarding Cyprus.

Answer Outline for Part C(ii): Ultimate success or not?

According to [1], arguments in favor of EU membership for Turkey have been expressed by the UK, the Scandinavian countries, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, and Slovenia. These arguments include:

- It will help forge a bond between the West and the Muslim world;

- It will help stabilize the volatile regions beyond Turkey’s eastern and southern borders (Georgia, Armenia, Iran, Iraq, and Syria);
- It will help Turkey modernize;
- The young and increasingly well educated population of Turkey will help the EU cope with an aging population.

Unfortunately, the Cyprus dispute holding up Turkey’s EU membership seems to be one of those persistently difficult situations that could take decades to resolve, if ever. The following materials are paraphrased from Ref.[3]:

- “In 1974, following 11 years of intercommunal violence and an attempted coup d’état by Greek Cypriot nationalists, Turkey invaded and occupied the northern portion of the island (of Cyprus). The intercommunal violence and subsequent Turkish invasion led to the displacement of hundreds of thousands of Cypriots and the establishment of a separate Turkish Cypriot political entity in the north. These events and the resulting political situation are matters of ongoing dispute.”
- “The Republic of Cyprus has de jure sovereignty over the entire island of Cyprus and its surrounding waters except small portions, Akrotiri and Dhekelia, that are allocated by treaty to the United Kingdom as sovereign military bases. The Republic of Cyprus is de facto partitioned into two main parts, the area under the effective control of the Republic of Cyprus, comprising about 59% of the island’s area and the Turkish-occupied area in the north, calling itself the Turkish Republic of Northern Cyprus, covering about 36% of the island’s area and recognized only by Turkey.”

For the moment the EU is focusing on Turkey’s as-yet unfilled promise to open its ports and airports to Cypriot traffic. However, a declaration of the EU in 2005 stated that Turkey must recognize Cyprus before it becomes a member of the EU; but this Turkey still refuses to do [4]. This is a serious problem greatly diminishing Turkey’s chances for EU membership. In particular, the EU requires current members to ratify new members, and the Republic of Cyprus has been a member of the EU since 2004!

In addition, several EU members (France, Austria, and Denmark) are apparently cool towards Turkey’s membership for reasons other than the Cyprus situation. According to [1], their expressed concerns include:

- Turkey is not culturally “European”;
- EU membership for Turkey will result in a wave of Turkish immigrants;
- EU membership for Turkey will prevent further deepening of European political and economic union;
- Turkey is too big – it will exercise too much power within the EU;
- Turkey is too poor – it will cost the rest of the EU too much.

In view of the above, the near-term likelihood of EU membership for Turkey appears to be very small and the long-term outlook is highly uncertain.

Answers to Exercise 6, questions Q1 through Q5:

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