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| **Exercises from old exams to chapters in B & W with solutions.** |

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| **Chapter 5** |

**Exercise 1**

1. Define the real exchange rate and explain how it can appreciate. When do the nominal and real exchange rates move in tandem?
2. Explain the logic behind the principle of purchasing power parity.
3. In what way can a Central Bank cause high inflation?
4. Suppose during ten years that the yearly average GDP growth rate is 5 % and the average money growth rate is 8 %. What will happen to the nominal exchange rate if yearly inflation on average abroad has been 7 % in the same period?

**Answer:**

1. The real exchange rate is an index. It equals nominal exchange rate (British term = units of foreign currency per domestic unit) multiplied with domestic price, divided by foreign price. It can appreciate for two reasons: 1. when the nominal exchange rate appreciates and inflation rates at home and abroad are equal and 2. when the nominal exchange rate is stable but inflation is higher at home. Nominal and real exchange rates move in tandem when inflation is the same at home and abroad.
2. The principle of purchasing power parity is about the idea that in the long run the real exchange rate is constant. Explained: Suppose the monetary policy is permanently more expansionary at home than abroad. Then we expect inflation to be higher at home. If the nominal exchange rate remains unchanged, the real exchange rate appreciates. This mean that domestic goods and services become expensive related to foreign goods and services. As a result, domestic producers gradually lose competitiveness. The nominal exchange rate will depreciate and this will work towards restoring competitiveness.
3. High inflation is the consequence of excessive monetary growth.
4. If the yearly average GDP growth rate is 5 % and the average money growth rate is 8 % then domestic inflation will be 3 %. Nominal exchange rate = inflation abroad (7 %) – domestic inflation (3 %) = 4 %. Yearly appreciation by 4 %.

**Exercise 2**

Explain the economic situation in a country if the real exchange rate increases while the foreign inflation rate is higher than the domestic inflation rate.

**Answer:**

Then the nominal appreciation (british term) must be greater than the difference between the inflation rates (the inflation differential).

**Exercise 3**

Explain the principle of money neutrality.

**Answer:**

The principle that the money supply does not affect real variables such as real output or unemployment, but rather the price level, in the long run.

**Exercise 4**

What is correct?

1. The real exchange rate:

a) depends on the nominal exchange rate, house prices and inflation abroad.

b) depends on the nominal exchange rate, domestic inflation and inflation abroad.

c) is independent of the nominal exchange rate due to money neutrality.

d) does not depend on inflation due to money neutrality.

**Answer:**

b) depends on the nominal exchange rate, domestic inflation and inflation abroad.