Quiz 10 – Answers

Question 1

A currency is said to appreciate against a foreign currency when the nominal exchange rate goes

A. down, meaning the domestic currency now buys less of the foreign currency.
B. down, meaning the domestic currency now buys more of the foreign currency.
C. up, meaning the domestic currency now buys less of the foreign currency.
D. up, meaning the domestic currency now buys more of the foreign currency.

Define exchange rate and explain.

Question 2

How does a flexible exchange rate differ from a managed exchange rate?

A. A flexible exchange rate involves government intervention, while a managed exchange rate does not.
B. A flexible exchange rate is set at a longrun value determined by the government, while a managed exchange rate can vary day to day depending on government actions.
C. A managed exchange rate involves government intervention, while a flexible exchange rate does not.
D. A managed exchange rate is set at a longrun value determined by the government, while a flexible exchange rate can vary day to day depending on direct government actions.

Question 3

How does a fixed exchange rate differ from a managed exchange rate?

A. A fixed exchange rate involves government intervention, while a managed exchange rate does not.
B. A fixed exchange rate is set at a longrun value determined by the government, while a managed exchange rate can vary day to day depending on direct government actions.
C. A managed exchange rate involves government intervention, while a fixed exchange rate does not.

D. A managed exchange rate is set at a longrun value determined by the government, while a fixed exchange rate can vary day to day depending on government actions.

Question 4

The demand curve for dollars slopes downward because when the dollar

A. appreciates in value, U.S. goods become relatively less expensive abroad, causing more people to buy dollars.
B. depreciates in value, U.S. goods become relatively more expensive abroad, causing fewer people to buy dollars.
C. depreciates in value, U.S. goods become relatively less expensive abroad, causing more people to buy dollars.
D. depreciates in value, U.S. goods become relatively less expensive abroad, causing fewer people to buy dollars.

Use this question to discuss partial equilibrium model in slide 21 of Handout 18

Question 5

What does it mean to say that, at an exchange rate of 1 USD = 40 INR, the U.S. dollar is undervalued and the Indian rupee is overvalued?

A. The dollar is worth less rupee than it would be under a flexible exchange rate system; thus, the quantity of dollars supplied exceeds the quantity of dollars demanded.
B. The dollar is worth less rupee than it would be under a flexible exchange rate system; thus, the quantity of dollars supplied is less than the quantity of dollars demanded.
C. The dollar is worth more rupee than it would be under a flexible exchange rate system; thus, the quantity of dollars supplied exceeds the quantity of dollars demanded.
D. The dollar is worth more rupee than it would be under a flexible exchange rate system; thus, the quantity of dollars supplied is less than the quantity of dollars demanded.

Use this question to discuss what this implies: Reserve Bank of India would have to sell dollars in excess demand and buy rupees to keep exchange rate stable. Discuss how this might be unsustainable in the long run and compare it to sterling crisis of 1992.

Question 6

How does a change in a country's real exchange rate affect its net exports?

A. The real exchange rate does not impact a country's net exports.
B. When a country's real exchange rate appreciates, it imports less and exports more, causing its net exports to fall.
C. **When a country's real exchange rate appreciates, it imports more and exports less, causing its net exports to fall.**
D. When a country's real exchange rate appreciates, it imports more and exports less, causing its net exports to rise.

Define real exchange rate (handout 19, slide 6) and what it implies on demand for domestic and foreign goods.

Question 7

The EvidenceBased Economics feature in the chapter discusses how George Soros's hedge fund made money by betting on the devaluation of the British pound. Interestingly, Soros also made money betting against the Thai baht. In 1997, the baht had been continually falling against the U.S. dollar. The Bank of Thailand attempted to defend its overvalued exchange rate—the Thai baht (THB) was pegged to the U.S. dollar at a rate of 1 USD = 25 THB.

How did a very high level of corporate debt and debt repayment in Thailand denominated in U.S. dollars impact the efforts of the Thai authorities to defend their exchange rates?

A. **In order to make payments or pay off debts, borrowers had to sell baht and buy dollars. This increased the demand for dollars, which made it more difficult for the Thai authorities to defend the pegged currency.**
B. In order to make payments or pay off debts, borrowers had to buy baht and sell dollars. This increased the supply of dollars, which made it more difficult for the Thai authorities to defend the pegged currency.
C. It put extra pressure on the Thai authorities, since allowing the baht to appreciate relative to the dollar would result in borrowers needing significantly more baht to pay off their dollar denominated debt.
D. It took some pressure off of the Thai authorities, since allowing the baht to appreciate relative to the dollar would result in borrowers needing significantly less baht to pay off their dollar denominated debt.

Question 8

How can an increase in the real interest rate affect a country's current account and financial account?

A. It causes both the current account and the financial account to strengthen.
B. It causes both the current account and the financial account to weaken.
C. It causes the current account to strengthen and the financial account to weaken.
D. **It causes the current account to weaken and the financial account to strengthen.**

An increase in the real interest rate will increase demand for domestic financial assets, thus increasing demand for domestic currency (show shift in demand on partial equilibrium graph) and causing an appreciation of the domestic currency, leading to lower net exports and worse current account. The financial will strengthen as it moves in the opposite direction.

Question 9

Over the last 10 years, the dollar has depreciated sharply vis-à-vis the euro. Suppose that in the short run the Fed wanted both to defend the dollar (that is, stop its decline and/or cause it to appreciate) and stimulate investment. Can it achieve both of these goals simultaneously through monetary policy?

A. **No, to stimulate investment the Fed will use expansionary policy that will lower interest rates. The lower interest rates, however, will reduce investment into the United States, which will increase the supply of dollars and cause a depreciation of the dollar.**
B. No, to stimulate investment the Fed will use expansionary policy that will raise interest rates. The higher interest rates, however, will reduce investment into the United States, which will increase the demand for dollars and cause a depreciation of the dollar.
C. Yes, to stimulate investment the Fed will use expansionary policy that will raise interest rates. The higher interest rates will reduce investment into the United States, which will decrease the demand for dollars and cause an appreciation of the dollar.
D. Yes, the policy tools needed to stabilize the currency are not related to the policy tools that are used to stimulate investment.

Question 10

Suppose instead that the European Central Bank (ECB) conducts expansionary monetary policy.
What is the short run effect, if any, of this policy on the euro/dollar nominal exchange rate and on the real exchange rate between the United States and the European Monetary Union?

A. **The nominal dollars per euro exchange rate will decrease and the real exchange rate will decrease as long as inflation in the Euro-**

pean Monetary Union is not significantly lower than inflation in the United States.

B. The nominal dollars per euro exchange rate will decrease and the real exchange rate will decrease as long as inflation in the European Monetary Union is higher than inflation in the United States.
C. The nominal dollars per euro exchange rate will increase and the real exchange rate will increase as long as inflation in the European Monetary Union is higher than inflation in the United States.
D. The nominal dollars per euro exchange rate will increase and the real exchange rate will increase as long as there is no inflation in either country.

The question is aimed at discussing two things: first, the decrease in the real interest rate in the Euro Area leads to higher relative demand for dollar denominated assets and lower demand for euro-denominated ones, lowering the equilibrium nominal exchange rate. This effect will also hold for the real exchange rate $E=e*P_{US}/P_{EMU}$ as long as P_{US}/P_{EMU} does not significantly increase, which would happen if inflation where much lower in the EMU than in the US.