ECON10003
Introductory Macroeconomics
Semester 1, 2021

Review Session 5

Questions to be discussed

1. Given the supply and demand model of exchange rate determination, which of the following will not increase the supply of Australian dollars in the foreign exchange market?

a) An increase in Australian interest rates relative to foreign interest rates.
b) An increase in foreign interest rates relative to Australian interest rates.
c) An increase in prices in Australia, relative to foreign prices.
d) An increased preference for foreign goods.

2. In an open economy if imports exceed exports, then it must be the case that

a) national saving is greater than investment
b) national saving is less than investment
c) the nominal exchange rate is depreciating
d) the nominal exchange rate is appreciating

3. If the real exchange rate in Australia appreciates, then

a) the nominal exchange rate in Australia must also be appreciating
b) the rate of domestic inflation in Australia must be greater than the rate of inflation overseas
c) the price of goods and services in Australia must be becoming relatively more expensive than the price of goods and services overseas
d) none of the above

4. Suppose a government decides to implement a fixed exchange rate with the value of domestic currency above its equilibrium value. Further, assume that it does not restrict capital flows. In that case, we would expect

a) a decrease in foreign currency reserves held by the government
b) an increase in foreign currency reserves held by the government
c) a high level of inflation in the domestic economy
d) a low level of cyclical unemployment

5. Suppose Buranda produces and consumes agricultural and manufacturing products and has a comparative advantage in producing agricultural products relative to the rest of the world. Assume that in trade equilibrium with the rest of the world Buranda is not fully specialised. When trading with the rest of the world,

a) workers in both the agricultural and manufacturing sectors will benefit from trade
b) workers in the agricultural sector will benefit but workers in the manufacturing sector will be harmed by trade
c) workers in the manufacturing sector will benefit but workers in the agricultural sector will be harmed by trade
d) workers in both the agricultural and manufacturing sectors will be harmed by trade

6. Please refer to Table 1 below.

Table 1: Number of minutes to produce one unit of a good. Assume an 8-hour day for both workers.

	Beer	Nuts
Elain	10	15
Jerry	15	30

________________ has the absolute advantage in producing nuts and ________________has the comparative advantage in producing nuts.

a) Elaine, Elaine
b) Elaine, Jerry
c) Jerry, Elaine
d) Jerry, Jerry

7. Suppose there is an increase in demand for goods and services produced in Australia by consumers in foreign countries. We would expect the quantity of transactions involving the Australian dollar on the foreign exchange market to and the Australian dollar to.

a) increase, appreciate
b) increase, depreciate
c) decrease, appreciate
d) decrease, depreciate

8. The equations for the demand for and supply of a currency named the ‘Real’ in the foreign exchange market is

Demand = 40 – 5e

Supply = 20 + 15e

where the nominal exchange rate (e) is expressed as Dollars per Real. If the value of the Real is fixed at 1.30 Dollars then we would say that the Real was:

a) undervalued

b) overvalued

c) neither undervalued or overvalued

d) none of the above

9. Imagine only two countries (Country A whose currency is ‘Dollars’ and country B whose currency is ‘Marks’) in the world. Both currencies are floating freely in foreign exchange markets. The rate of inflation in A is +10% pa and it is +5% pa in country B. If we treat country A as the ‘home country’ and PPP holds what will happen to its real exchange rate?

    a) it will rise by 5%

    b) it will fall by 5%

    c) it will fall by 15%

    d) it will be unchanged

10. Short discussion questions:

    a) Compare and contrast fixed and flexible exchange rates. Discuss the short-run and long-run determination of the exchange rate in both cases.
    b) To achieve a particular monetary policy outcome, what is more favourable to have – a flexible exchange rate or a fixed exchange rate regime? Explain.

    c) In the context of balance of payment theory, if national saving is less than domestic invest demand what would you expect for the domestic trade balance ? What would be the nature of capital flow and which type of exchange rate will ensure the balance of payment is balanced.

11. During the last decade, the debt crisis in Europe has meant that many people have sought to invest funds in Swiss banks and other Swiss investments. Use a supply and demand framework to describe the effect of the debt crisis on the value of the Swiss franc. What effect will this change in the value of the Swiss franc have upon the real economy? Suppose the Swiss central bank wanted to limit the macroeconomic effects of this change in the value of the currency. Explain what actions the central bank could undertake to reduce any negative macroeconomic effects.