Econ 203 Tutorial #10
Date: Week 12
Coverage: Chapter 12 Exchange Rate, Monetary Policy, and Fiscal Policy

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Part I: Multiple Choice Questions

1. Which of the following is (are) likely to lead to increased capital inflow into Canada?
   A) The Bank of Canada cuts interest rates
   B) Foreign countries cut their interest rates
   C) Canadian government increases business taxes
   D) All of the answers are correct

2. Which of the following transactions will give rise to a demand for the Euro?
   A) Germans buy Canadian beef
   B) Canadians buy German stocks
   C) Germans come to visit Montreal
   D) All of the answers are correct

3. Where does the supply of US$ in the Canadian foreign exchange market come from?
   A) Canadian tourists going to the U.S
   B) Canadian exports of goods, services and securities to the U.S
   C) Canadian imports of goods, services and securities from the U.S
   D) All of the answers are correct

4. If the Canadian dollar is pegged against the U.S. dollar, and the Japanese Yen depreciates against the U.S. dollar, what will happen to Canada?
   A) Our Canadian dollar depreciates against the Yen
   B) Our Canadian dollar appreciates against the Yen
   C) Our Canadian dollar depreciates against the U.S. dollar
   D) None of the answers is correct

5. When the central bank sells foreign exchange and buys domestic currency to finance a balance of payments ________, domestic money supply ______.
   A) Deficit; falls
   B) Surplus; falls
   C) Deficit; rises
   D) Surplus; rises

6. If exchange rates were flexible, a decrease in exports due to a weaker U.S. GDP can be partially offset by
   A) A higher Canadian inflation rate
   B) A higher Canadian interest rate
   C) The depreciation of the Canadian dollar
   D) The appreciation of the Canadian dollar

7. Suppose in the London market, one U.S. dollar can buy 0.3 British pound, or US$1 = 0.3 £. In the Tokyo market, the conversion rate is US$1 = 3 Pesos. In the Toronto market, the conversion rate is £1 = 12 Pesos. For simplicity, there is no transaction cost for currency trading. If financial traders can buy and sell currencies freely to make profits, what must be the equilibrium conversion rate in the Toronto market?
   A) £1 = 9 Pesos

B) £1 = 8 Pesos
C) £1 = 10 Pesos
D) £1 = 7 Pesos

8. Under __ exchange rates, a fiscal contraction that pushes interest rates ___ will crowd ___ net exports through ________ of the domestic currency.
   A) Flexible; down; in; a depreciation
   B) Flexible; down; in; an appreciation
   C) Flexible; up; out; an appreciation
   D) Flexible; up; out; a depreciation

9. As the U.S. economy recovers from a recession, it is likely that the Canadian dollar will ______ because our exports to them will _______. In response, the Bank of Canada should ____ the target overnight interest rate if it wants to minimize fluctuations in the Canadian dollar.
   A) Appreciate; decrease; decrease
   B) Depreciate; decrease; decrease
   C) Depreciate; decrease; increase
   D) Appreciate; increase; decrease

10. Suppose it costs C$1.2 to buy one US$, and the price level or index in the US is 115. The price level or index in Canada is 112. The real exchange rate from Canada's perspective is:
   A) 1.30
   B) 1.23
   C) 1.14
   D) 1.10

11. Why do economists argue that fiscal policy is weak when a country has a flexible exchange rate regime?
   A) Increases in G tend to crowd out private investment
   B) Increases in G tend to lead to a decrease in the interest rate
   C) Increases in G tend to lead to a depreciation of the domestic currency
   D) All of the answers are correct

12. Which of the following describe(s) a country's balance of payments?
   A) It can be negative or positive
   B) It is a record of the country's receipts from and payments to other countries
   C) It is a record of government expenditure and tax revenues
   D) All of the answers are correct

13. Which of the following choices is INCORRECT?
   A) If KA<0, then this country is a lender
   B) If CA is +5, KA is -3, then this central bank has accumulated more foreign exchange reserves
   C) If CA is –5, KA is +3, then this central bank has sold some of its foreign exchange reserves
   D) If CA is +5 and KA is -3, then this country's currency will depreciate under a flexible exchange rate regime

14. If the purchasing power parity holds, then the real exchange rate is equal to ____. If the inflation rate in the U.S. is 1% and Canada's inflation rate is 3%, then the nominal exchange rate of the Canadian dollar (C$), from Canada's perspective, will _____.
   A) One; increase by approximately 2%, which is a C$ depreciation
   B) Any number; increase by approximately 2%, which is a C$ depreciation
   C) One; decrease by approximately 2%, which is a C$ appreciation

D) Any number; decrease by approximately 2%, which is a C$ appreciation

15. Suppose a panic causes financial traders to sell off C$. Under a fixed exchange rate system with the US$, the Bank of Canada would have to
    A) Buy C$, and the Canadian money supply would rise
    B) Sell C$, and the Canadian money supply would rise
    C) Buy US$ reserves, and the Canadian money supply would drop
    D) Sell US$ reserves, and the Canadian money supply would drop

II. Short Questions Only

1. Real Exchange Rates, Nominal Exchange Rates, and Net Exports:
Suppose that, in 1991, the price levels in Argentina and the US were 100. By 2000, the price level in Argentina has increased to 200, while the price level in the US rose to 150. Suppose the exchange rate between two countries was US$1 = Peso$1 in 1991.

(i) Find the inflation rates of the two countries.

(ii) What was the 1991 real exchange rate?

(iii) What must the new nominal exchange rate have been in 2000 if the real exchange rate remained constant?

(iv) In reality, Argentina has a fixed exchange rate system against the US$. The initial nominal exchange rate is fixed. As a result, did Argentina's real exchange rate appreciate or depreciate?

(v) Would you expect Argentina's net exports to rise or fall as a result?

(vi) Is the Argentina Peso overvalued or undervalued?

2. Interest Rate Parity:
Suppose you have C$1,000. You can either buy a Canadian asset that pays 10% after one year, or a U.S. asset that pays 12% after one year. Both assets are equally safe, and it is certain that you would receive your invested money plus interest payments one year from now. The exchange rate between Canadian dollars and the U.S. dollars is flexible, and the current *e* = C$/US$ is equal to 1.2.

(i) State the interest rate parity condition.

(ii) Use the interest rate parity condition to find the expected future depreciation or appreciation in the C$.

(iii) Explain intuitively why the Canadian dollar is expected to appreciate or depreciate.