ANSWERS KEY – ANSWERS AT END

ECONOMICS 353   L. Tesfatsion/Spring Semester 2011
EXERCISE 8: Eight Questions (8 Pts Total)   DUE: Tues., March 29, 12:40pm

PLEASE NOTE: EXERCISES ARE DUE AT THE BEGINNING OF CLASS ON THE DUE DATE. LATE EXERCISES WILL NOT BE ACCEPTED AFTER DISCUSSION OF ANSWERS HAS BEGUN – NO EXCEPTIONS

EXERCISE INSTRUCTIONS:

- (1) Please **fill in your name and student ID number** on Side 1 of your red bubble sheet and write **353 Exercise 8** in the top margin of Side 1. (Red bubble sheets will be handed out in class each Tuesday and can also be obtained from the Econ Undergraduate Office in 174 Heady during normal business hours M-F.)

- (2) Use a number 2 pencil to **mark your answers** on Side 1 of the bubble sheet to the multiple-choice questions Q1 through Q8 below.

- (3) Each question is worth 1 point. Questions Q1 through Q5 can be answered using required online html and ppt course notes for Mishkin Chapter 20 ("Foreign Exchange Market"). Questions Q6 through Q8 on the ongoing eurozone crisis can be answered using these html and ppt notes plus an accompanying link to an additional online reading.

Q1. In a two-country world consisting of HC and ROW, the HC REAL EXCHANGE RATE is defined to be _____.

    A. the HC nominal exchange rate times the ROW aggregate price level divided by the HC aggregate price level.

    B. the HC nominal exchange rate times the HC aggregate price level divided by the ROW aggregate price level.

    C. the HC nominal exchange rate minus the HC inflation rate.

    D. the HC nominal exchange rate plus the ROW inflation rate minus the HC inflation rate.

    E. none of the above.

Q2. All else equal, a DEPRECIATION of the HC's currency _____.

    A. lowers the price of imported ROW goods for HC citizens.

    B. lowers the aggregate price level in the HC as measured by the GDP deflator.

    C. raises the price of imported ROW goods for HC citizens.

    D. raises the aggregate price level in the HC as measured by the GDP deflator.

Q3. According to the LAW OF ONE PRICE, if Malaysian coffee is 4 ringitts per pound and Slovakian coffee is 44 korunas per pound, the coffees are of equal quality, and transport costs are zero, then the exchange rate between the Malaysian ringitt and the Slovakian koruna should approximately be _____.

    A. 0.09 ringitts per 1 koruna

    B. 11 ringitts per 1 koruna

    C. l ringitt per 1 koruna

    D. 4 ringitts per 1 koruna

    E. None of the above.

Q4. Suppose the inflation rate in China is 3 percent during 2011, and the inflation rate in Argentina is 35 percent during 2011. Then the theory of PURCHASING POWER PARITY (in rates of change form) predicts that, during 2011, the value of the Chinese currency (yuan) measured in terms of the Argentinian currency (pesos) - i.e., the number E of pesos per yuan - will _____.

    A. rise by 38 percent.

    B. fall by 32 percent.

    C. rise by 32 percent.

    D. fall by 38 percent.

Q5. If the average nominal interest rate on bank deposit accounts in the ROW is 5 percent, and if the HC nominal exchange rate E with respect to ROW is expected to depreciate by 3 percent, then the INTEREST PARITY CONDITION (in nominal form) predicts that the average nominal interest rate on HC bank deposit accounts should be about _____.

    A. -8 percent.

    B. 8 percent.

    C. -2 percent

    D. 2 percent.

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SEE THE FOLLOWING PAGE FOR Q6-Q8.

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Q6-Q8: Questions on the Eurozone Crisis. Please use the following required online readings to answer Q6-Q8 below.

** [1] L. Tesfatsion, "HTML Notes on Mishkin Chapter 20 (Foreign Exchange Market)"
www.econ.iastate.edu/classes/econ353/tesfatsion/Mish20a.htm

** [2] L. Tesfatsion, "PPT Notes on Mishkin Chapter 20 (Foreign Exchange Market)"
www.econ.iastate.edu/classes/econ353/tesfatsion/Mish20a.pdf

** [3] Pan Pylas, AP Business Writer, "Markets Applaud European Debt Crisis Package," Associated Press, March 14, 2011
www.econ.iastate.edu/classes/econ353/tesfatsion/EuropeanDebtCrisisPackage.AP14March2011.pdf

Q6 (1 Point). According to Ref. [1], European Union member countries seeking membership in the EUROZONE must satisfy the _____.

    A. European Accession Criteria outlining geographical and cultural restrictions on eligibility for membership.

    B. Maastricht Convergence Criteria outlining criteria for price and fiscal stability.

    C. European Central Bank Capital Asset Criteria setting out minimum net worth levels for national central banks as a function of the riskiness of their financial asset portfolios.

    D. Copenhagen Criteria outlining general economic and political requirements for entry, such as the existence of a functioning market economy and adherence to the rule of law.

Q7 (1 Point). According to Refs. [1-2], the eurozone countries Greece, Ireland, Portugal, and Spain are currently at risk of loosing their eurozone membership because _____.

    A. they do not currently conform to criteria requiring protection of minorities.

    B. their unemployment rates are too high.

    C. their government debts and/or deficits (as a percentage of GDP) are too high.

    D. their inflation rates are too high.

    E. their exchange rates are too volatile.

Q8 (1 Point). According to Ref. [3], eurozone leaders have just reached an agreement _____.

    A. to offer bail-out loans to Spain at below-market interest rates.

    B. to increase the size of the bailout fund (European Financial Stability Facility) for eurozone countries in debt trouble, and to lower interest rates on the bail-out loans already made to Greece.

    C. to increase the size of bail-out loans to Ireland and to lower interest rates on these loans.

    D. to reduce the size of bail-out loans to Portugal and increase requirements on Portugal for capital asset requirements.

Multiple Choice Answers: Q1-B, Q2-C Q3-A, Q4-C, Q5-B, Q6-B, Q7-C, Q8-B