MULTIPLE CHOICE. Choose the one alternative that best completes the statement or answers the question.

1) Which one of the following statements is the most true?
   A) If central banks are not sterilizing and the home country has a balance of payments surplus, any associated increase in the home central bank’s foreign asset implies a decreased home money supply.
   B) If central banks are not sterilizing and the home country has a balance of payments surplus, any associated increase in the home central bank’s foreign asset implies an increased home money supply.
   C) If central banks are not sterilizing and the home country has a balance of payments surplus, any associated decreased in the home central bank’s foreign asset implies an increased home money supply.
   D) If central banks are not sterilizing and the home country has a balance of payments surplus, any associated increase in the home central bank’s foreign asset implies an increased home money demand.

2) Under fixed exchange rate, in general,
   A) the domestic and foreign interest rates are equal, \( R = R^* \).
   B) \( R = R^* + (E^e - E)/E \).
   C) There is no relation between the fixed exchange rate and the interest rates both foreign and domestic.
   D) \( E \) is equal to one.

3) Which one of the following statements is the most accurate?
   A) Fiscal policy has the same effect on output under fixed and flexible exchange rate regimes.
   B) Fiscal policy affects output more under fixed than under flexible exchange rate regimes.
   C) Fiscal policy cannot affect output under fixed exchange rate but does affect output under flexible exchange rate regimes.
   D) Fiscal policy affects output less under fixed than under flexible exchange rate regimes.

4) The main reason(s) why governments sometimes chose to devalue their currencies is (are):
   A) devaluation improves in the current account.
   B) devaluation allows the government to fight domestic unemployment despite the lack of effective monetary policy.
   C) devaluation increases foreign reserves held by the central bank.
   D) All of the above.

5) A balance of payments crisis is best described as
   A) a sharp change in foreign reserves sparked by a change in expectations about the level of imports.
   B) a sharp change in interest rates sparked by a change in expectations about the level of exports.
   C) a sharp change in foreign reserves sparked by a change in expectations about the future exchange rate.
   D) a sharp change in interest rates sparked by a change in expectations about the level of imports.
6) The price-specie-flow mechanism
   A) is an automatic mechanism for assuring internal balance under the gold standard.
   B) is an automatic mechanism for assuring external balance under floating exchange rates.
   C) is an automatic mechanism for assuring external balance under the gold standard.
   D) is an automatic mechanism for assuring internal balance under floating exchange rates.

7) A policy of "beggar-thy-neighbor" is a policy that
   A) does not often benefits any country in the long run.
   B) often benefits the foreign country in the long run.
   C) often benefits foreign country in the short run.
   D) often benefits the home country in the long run.

8) Countries with large current account surpluses might be viewed by the market as candidates for
   A) revaluation. B) bankruptcy.
   C) devaluation. D) All of the above.

9) In order to bring about a real depreciation of the dollar, the U.S. can hope for
   A) a rise in foreign price levels.
   B) a fall in the dollar's nominal value in terms of foreign currencies.
   C) a fall in the U.S. price level.
   D) All of the above.

10) Advocates of floating rate suggested it is favorable for economies for the following reasons
    EXCEPT
    A) it helps stabilize the shock effect on unemployment in case of economic changes such as fall in export demand.
    B) it discourages attack from foreign exchange speculators because of the fact that exchange rate adjustment is immediate.
    C) it gives every country the opportunity to guide its own monetary conditions at home.
    D) it automatically matches the domestic inflation with ongoing foreign inflation.

11) Under Bretton Woods,
   A) any foreign country could devalue its currency against the dollar in conditions of "fundamental disequilibrium," and the system’s rules did give the United States the same option of devaluing against foreign currencies.
   B) the U.S. could devalue its currency against the foreign currencies in conditions of "fundamental disequilibrium."
   C) any foreign country could devalue its currency against the dollar in conditions of "fundamental disequilibrium," but the system’s rules did not give the United States the option of devaluing against foreign currencies.
   D) any foreign country cannot devalue its currency against the dollar in conditions of "fundamental disequilibrium."

12) Comparing fixed to flexible exchange rate, the response of an economy to a temporary fall in foreign demand for its exports is
   A) output actually remains the same under fixed rate than under floating rate.
   B) output actually falls more under fixed rate than under floating rate.
   C) output actually falls less under fixed rate than under floating rate.
   D) It is impossible to tell.
13) The case against floating exchange rates is because of
   A) injury to international trade and investment.
   B) uncoordinated economic policies.
   C) discipline and destabilizing speculation and money market disturbances.
   D) All of the above.

14) What are the biggest advantages the U.S. has above the EU in terms of being an Optimum Currency Area?
   A) higher uniformity of population's taste in consumption
   B) high unionization of U.S. Labor force
   C) high mobility of labor force, more transfer payments between regions
   D) low mobility of labor, higher labor productivity, lower level of intra-regional trade

15) Which one of the following statements is true?
   A) The more extensive are factor movements, the greater is the loss from a fixed cross-border exchange rate.
   B) The less extensive are cross-border trade and factor movements, the greater is the gain from a fixed cross-border exchange rate.
   C) The more extensive are cross-border trade and factor movements, the greater is the loss from a fixed cross-border exchange rate.
   D) The more extensive are cross-border trade and factor movements, the greater is the gain from a fixed cross-border exchange rate.

16) Which one of the following statements is true?
   A) A flexible exchange rate does not automatically cushions the economy's output and employment by allowing an immediate change in the relative price of domestic and foreign goods.
   B) A fixed exchange rate automatically cushions the economy's output and employment by allowing an immediate change in the relative price of domestic and foreign goods.
   C) A flexible exchange rate automatically cushions the economy's output and employment by allowing an immediate change in the absolute price of domestic and foreign goods.
   D) A flexible exchange rate automatically cushions the economy's output and employment by allowing an immediate change in the relative price of domestic and foreign goods.

17) A country that joins an exchange rate area
   A) gives up its ability to use the exchange rate and monetary policy for the purpose of stabilizing output and employment.
   B) gives up its ability to use only monetary policy for the purpose of stabilizing output and employment.
   C) does not give up its ability to use the exchange rate and monetary policy for the purpose of stabilizing output and employment.
   D) gives up its ability to use the exchange rate for the purpose of stabilizing output and employment.
18. (Bonus question: 5 points) The Economist article on capital controls “The Reformation” states that the IMF

(a) is suggesting that countries with their currencies at fundamental values and sufficient foreign reserves should invoke prudential capital controls.

(b) is advising that countries should discriminate between inflows from western countries as opposed to Mideast oil rich countries.

(c) is advising emerging markets to ban all capital inflows currently due to lower US interest rates.

(d) none of the above.

19. What is the policy trilemma that a country faces that wants to maintain both internal and external stability by managing its monetary policy, exchange rates, and capital flows? How is China able to effectively manage its internal balances, and yet pretty much fix its exchange rates? (6 points)

Answer: Policy maker can Choose any two of (a) monetary policy independence (b) exchange rate control (c) perfect capital mobility, and not all three.

20. Here is an excerpt from one of the news readings “Dollar’s decline speeds up..” posted online.

“The dollar fell nearly 1% against a broad basket of currencies this week, following a drop of similar size last week. The ICE U.S. Dollar Index closed at its lowest level since August 2008, before the financial crisis intensified. "The dollar just hasn't had anything positive going for it," said Alessio de Longis, who oversees the Oppenheimer Currency Opportunities Fund. The main driver for the dollar's decline is low interest rates in the U.S. compared with higher and rising rates abroad. Lower rates mean a lower return on cash—and the pressure from that factor could intensify next week when the Federal Reserve's rate-setting committee is expected to signal that U.S. short-term rates will likely remain near zero for many months to come.”

Question: Using the money market and interest parity equilibrium explain how a relative increase of foreign interest rate leads to dollar’s depreciation. (6 points)

Answer: The rate of return schedule for foreign deposits shifts outward, thus depreciating the domestic currency.

21. Here is an excerpt from “China Speeds Yuan push”

“Eventually, wider use of the yuan outside China could redefine the balance of power in global currency markets, and in the broader economy, as the rest of the world begins trading more yuan-based assets and settling its bills with China in renminbi instead of the U.S. dollar, the global standard since the end of world War II. Western and Chinese companies would be able to issue bonds or stocks in yuan and invest the proceeds in China without having to convert into or out of dollars, euros or any other currency. Ultimately, greater demand for renminbi could lessen demand for the dollar, raising U.S. interest
rates and borrowing costs for everyone from the federal government to home owners. Further evidence that Beijing is reducing its reliance on the dollar came Monday, when a state-run news agency reported that 7% of China's foreign trade in the first quarter was conducted in yuan, up from 0.5% a year earlier.”

Question”: Highlighted portion is somewhat confusing. Why would a decrease in demand for dollars raise dollar interest rate? Money market equilibrium tells us otherwise. Perhaps it has to do with having dollar reserves, i.e., owning dollar assets. How would a decrease in demand for dollar assets will increase US interest rates? [6 points]

Answer: Less lending to US from the rest of the world means less supply of loans. This will push interest rates up.

22. An open economy’s output is expected to be 100 units forever and it can borrow and lend freely from the rest of the world at an interest rate 10%... There is an unanticipated increase in output in the first period of 11 units. That is, the economy’s output is 111, 100, 100, 100, 100….. on t=0,12,3,4…..Assume initial wealth is zero and there are no unilateral transfers. Assuming that the economy always chooses a smooth consumption such that its present value equals that of the output, what will be the first period consumption? What will be the trade balance? What will be the wealth level at the end of period 0? (6 points)

Answer: before the increase the present value of output is 100 + 100/0.1 = 1100. The present value of consumption is (1+1/0.1) C = 11C, and therefore consumption is also 100. Now after the first period increase in output the present value is 111 + 100/0.1 = 1111. The consumption now will be 1111/11 = 101. First period Trade balance will be 111 – 101 = 10, and the asset level at the end of t = 0 will be 0+ 10 = 10.

23. An open economy’s output is expected to be 100 units forever and it can borrow and lend freely from the rest of the world at an interest rate 5%. Assume that the initial wealth is zero and there are no unilateral transfers. An investment opportunity for this economy arises whereby an investment of 95 units on date t =0 will increase its output by 10 units forever from t = 1 onwards. However, in t = 0 the output will remain at 100. Shall the economy borrow and undertake this investment? If the economy always chooses a smooth consumption, what will be the consumption level that it will choose? What will be the trade balance in period 0? What will be the wealth level at the end of period 0? (8 points)

Answer: The present value of increase in output is 10/0.05 = 200 and the investment is only 95. There is net positive worth of 105 in this investment. Undertake it. Consumption is calculated using (1 + 1/0.05) C = PV(Q) – I = 100 + 110/0.05 – 95 = 2205. Thus 21 C = 2205, C = 105.

TB0 = 100 – 105 – 95 = - 100.
W0 = 0 – 100 = -100.