CHAPTER 2
Exchange Rate Determination

EASY

2.1 Which of the following is correct? The most likely explanation for the rise of the U.S. dollar during the early 1980s is that the United States'

a. budget deficit lowered U.S. interest rates
b. trade deficit accelerated U.S. inflation
c. economy slowed dramatically
d. budget deficit raised U.S. interest rates

Ans: c
Section: Expectations and the asset market model of exchange rates
Level: Easy

2.2 Which of the following is incorrect? The U.S. dollar weakened during the 1970s for the following reasons EXCEPT

a. U.S. inflation accelerated
b. the U.S. economy weakened
c. foreigners did not want to hold as many U.S. dollars as before
d. foreigners did want to hold many more U.S. dollars than before

Ans: d
Section: Expectations and the asset market model of exchange rates
Level: Easy

2.3 Which of these is correct? Of the following, exchange rates depend the <u>most</u> upon relative

a. monetary systems
b. political systems
c. trade deficits
d. inflation rates between countries

Ans: d
Section: The nature of money and currency values
Level: Easy

2.4 Complete the sentence correctly. _______ is another name for the complete replacement of the local currency with the U.S. dollar.

a. Seignorage
b. Dollarization
c. Depreciation
d. Appreciation

Ans: b
Section: Dollarization
Level: Easy

2.5 Complete the sentence correctly. To some U.S. manufacturers and labor unions, a cheap yuan value gives China's __________ an unfair advantage in the global economy.
a. imports
b. subsidies
c. bankers
d. exporters

Ans: d
Section: Mini-Case: A yen for yuan
Level: Easy

2.6 Which of the following is incorrect? The asset market view of exchange rate determination does NOT state that the spot rate
a. should follow a random walk
b. is affected primarily by a nation's long-run economic prospects
c. is influenced by a nation's annual economic growth
d. should be strongly affected by a nation's balance of trade

Ans: d
Section: Expectations and the asset market model of exchange rates
Level: Easy

2.7 Complete the sentence correctly. When monetary authorities have not insulated their domestic money supplies from the foreign exchange transactions, it is known as ________ intervention.
a. unsterilized
b. sterilized
c. foreign market
d. subsidized

Ans: a
Section: Sterilized versus unsterilized intervention
Level: Easy

2.8 Complete the sentence correctly. When the U.S. Federal Reserve sells or purchases Treasury securities in order to sterilize the impact of their foreign exchange market interventions, it is referred to as a(n) ________ operation.
a. floating currency
b. spot rate
c. revaluation
d. open market

Ans: d
Section: Sterilized versus unsterilized intervention
Level: Easy

2.8 Complete the sentence correctly. During the 1994 peso problem, Mexico made a fundamental error by not allowing the _________ of pesos to fall.
a) demand
b) supply
c) devaluation
d) real exchange rate

Ans: b
Section: The peso problem
Level: Easy

2.10 Complete the sentence correctly. When the U.S. dollar becomes weaker, U.S. exports become more ____ in foreign markets.
a. competitive
b. costly
c. credit worthy
d. productive

Ans: a
Section: How Real Exchange Rates Affect Relative Competitiveness
Level: Easy

2.11 Complete the sentence correctly. Although the mechanics of central bank interventions in the global currency markets may vary from country to country, the goal is always the same, to ____ the demand for one currency by ______ the supply of another.
a. increase, increasing
b. decrease, decreasing
c. increase, decreasing
d. decrease, increasing

Ans: a
Section: Foreign Exchange Market Intervention
Level: Easy

MEDIUM (applied)

2.12 On Friday, September 13, 1992, the Turkish lira was worth €0.0013. Over the weekend the Turkish lira devalued against the euro to €0.0012. By how much had the Turkish lira devalued against the euro?
a. 7.69%
b. 8.33%
c. 5.21%
d. 9.27%

Ans: a
(.0013 - .0012)/.0013 = 7.69%
Section: Setting the equilibrium spot exchange rate
Level: Medium

2.13 Suppose that the Brazilian real devalues by 40% against the U.S. dollar. By how much will the U.S. dollar appreciate against the real?
a. 67%
b. 40%
c. 32%
d. 28%

Ans: a
(1 - .40) – 1 = 67%
Section: Setting the equilibrium spot exchange rate
Level: Medium

2.14 Which of the following is correct? The euro devalued by 17% against the U.S. dollar. This is equivalent to a revaluation of the U.S. dollar against the euro by:
a) 17%
b) 16.31%
c) 20.48%
d) 17.54%

Ans: c
1/(1 -.17) -1 = 20.48%
Section: Setting the equilibrium spot exchange rate
Level: Medium

2.15 Which of the following is correct? If the Australian dollar devalues against the Japanese yen by 10%, the yen will appreciate by
a. 33.32%
b. 25.55%
c. 10.11%
d. 11.11%

Ans: d

1/(1 -.10) -1 = 11.11%
Section: Setting the equilibrium spot exchange rate
Level: Medium

2.16 Which of the following is correct? If the euro depreciates against the U.S. dollar by 50%, the dollar appreciates against the euro by
a. 55%
b. 100%
c. 200%
d. 1,000%

Ans: b
1/(1 -.50) – 1 = 100%
Section: Setting the equilibrium spot exchange rate
Level: Medium

2.17 Which of the following is correct? If the U.S. dollar appreciates against the Nigerian naira by 150%, the naira depreciates against the dollar by
a. 60%
b. 75%
c. 125%
d. 300%

Ans: a
1/2.5 – 1 = 60%
Section: Setting the equilibrium spot exchange rate
Level: Medium

2.18 Which of the following is correct? If the dinar devalues against the U.S. dollar by 45%, the U.S. dollar will appreciate against the dinar by
a. 45%
b. 82%
c. 55%
d. 32%

Ans: b
1/(1 - .45) – 1 = 82%
Section: Setting the equilibrium spot exchange rate
Level: Medium

2.19 Which of the following is correct? If the Mexican peso depreciates against the U.S dollar by 80%, the US dollar will appreciate against the peso by
a. 300%
b. 200%
c. 250%

d. 400%

Ans: d
1/(1 -.80) – 1 = 400%
Section: Setting the equilibrium spot exchange rate
Level: Medium

2.20 Which of the following is correct? If the U.S. dollar appreciates against the euro by 25%, the euro will depreciate against the U.S. dollar by
a. 25%
b. 20%
c. 30%
d. 10%

Ans: b
1/1.25 – 1 = 20%
Section: Setting the equilibrium spot exchange rate
Level: Medium

2.21 Which of the following is correct? If a foreigner purchases a U.S. government security the
a. supply of U.S. dollars rises
b. federal government deficit declines
c. demand for dollars rises
d. U.S. money supply rises

Ans: c
Section: Setting the equilibrium spot exchange rate
Level: Medium

2.22 Which of the following is correct? The foreign currency price of foreign goods in terms of the local currency price of domestic goods is called
a. the real exchange rate
b. the balance of trade
c. the trade-weighted exchange rate
d. purchasing parity

Ans: a
Section: The fundamentals of central bank intervention
Level: Medium

2.23 Which of the following is correct? An increase in the real exchange rate will
a. raise national income
b. lower national income
c. make a country less competitive in international trade

d. lower the cost of foreign goods
e. c and d

Ans: e
Section: The fundamentals of central bank intervention
Level: Medium

2.24 Which of the following is correct? A slowdown in Eurozone economic growth will
a. boost the value of the euro because inflation fears will be calmed
b. boost the value of the euro because the European Central Bank will expand the money supply
c. lower the value of the euro because the Eurozone will be a less attractive place to investors
d. lower the value of the euro because interest rates will rise

Ans: c
Section: The fundamentals of central bank intervention
Level: Medium

2.25 Which of the following is correct? The willingness of people to hold money
a. increases with the interest rate
b. rises with price stability
c. rises with national income
d. b and c only

Ans: d
Section: The fundamentals of central bank intervention
Level: Medium

2.26 Which of the following is correct? Sound economic policies will
a. raise the value of a nation's currency by boosting the economy
b. lower the value of a nation's currency by increasing the precautionary demand for money
c. lower the value of a nation's currency by leading to lower interest rates
d. both b and c

Ans: a
Section: The fundamentals of central bank intervention
Level: Medium

2.27 Which of the following is correct? Large government budget deficits will
a. raise the value of a nation's currency by raising domestic interest rates
b. raise the value of a nation's currency by stimulating the domestic economy
c. lower the value of a nation's currency by leading to higher inflation

d. be irrelevant since historical experience shows no correlation between government budget deficits and the value of the nation's currency

Ans: d
Section: The nature of money and currency values
Level: Medium

2.28 If you were a monetary authority and wanted to neutralize the effects of central bank currency interventions such as interest rate changes, which of the following would be most effective?
a. the sale or purchase of Treasury securities
b. the creation of a currency board
c. pegging the exchange rate to another currency
d. convincing investors that the currencies involved in the intervention are perfect complements to each other

Ans: a
Section: Sterilized versus Unsterilized Intervention
Level: Medium

DIFFICULT (advanced)

2.29 Which type of money is most likely to see its value fluctuate in the foreign exchange market?
a. fiat money
b. commodity money
c. price-indexed money
d. pegged-exchange rate

Ans: a
Section: Central bank reputations and currency values
Level: Difficult

2.30 Which of the following is correct? An increase in the supply of euros by the European Central Bank will
a. raise the external value of the euro because it will stimulate economic growth in the Eurozone
b. raise the external value of the euro because it will lead to higher Eurozone interest rates
c. reduce the external value of the euro because of inflation fears in the Eurozone
d. decrease the external value of the euro because it will force other countries to raise their interest rates

Ans: c

Section: The fundamentals of central bank intervention
Level: Difficult

2.31 On July 19, 1985, the Italian lira devalued by 17% against the U.S. dollar. Which of the following is correct? This is equivalent to a revaluation of the U.S. dollar against the lira of
a. 17%
b. 16.31%
c. 20.48%
d. 17.54%

Ans: c
1/(1 - .17) – 1 = 20.48%
Section: Setting the equilibrium spot exchange rate
Level: Difficult

2.32 Which of the following is an example of foreign exchange market intervention?
a. the U.S. government pays Social Security checks to pensioners living in Poland
b. IBM sells euros it received in international trade
c. the Canadian government pays interest to Saudi Arabian investors
d. the French government sells U.S. dollars in the foreign exchange market to prop up the value of the euro

Ans: d
Section: The fundamentals of central bank intervention
Level: Difficult

2.33 During 1995, the yen went from ¥80.00/$ to ¥105/$. By how much did the U.S. dollar appreciate against the yen?
a. 23.81%
b. 31.25%
c. 15.67%
d. 40.78%

Ans: b
105/80 – 1 = 31.25%
Section: Setting the equilibrium spot exchange rate
Level: Difficult

2.34 Complete the sentence correctly. The _______ for/of foreign currency in the U.S. is derived from the demand for ___________ by American consumers.
a. demand, foreign products
b. demand, tax loopholes
c. supply, lower tariffs
d. supply, local products

Ans: a:
Section: Setting the equilibrium spot exchange rate
Level: Difficult

2.35 Which one of the following is NOT associated with dollarization of a nation's currency?
a. In Panama 30-year mortgages were no longer available
b. central banks may lose the profit on the currency they hold
c. it has been known to provide price stability
d. some capital may return and the economy begin to grow again

Ans: a
Section: Central Bank Reputations and Currency Values – Dollarization
Level: Difficult

2.36 Which one of the following is NOT a disadvantage of a strong U.S. dollar?
a. General Electric's competitiveness diminishes in foreign markets
b. American-made smartphones lose sales to their Chinese counterparts
c. U.S. unemployment levels rise in some sectors
d. Americans will be less prone to buy foreign wines

Ans: d
Section: The Fundamentals of Central Bank Interventions – How Real Exchange Rates Affect Relative Competitiveness
Level: Difficult