CHAPTER 2

THE DETERMINATION OF EXCHANGE RATES

EASY

2.1 The explanation for the rise of the U.S. dollar during the early 1980s is that
- a. the U.S. budget deficit lowered U.S. interest rates
- b. the U.S. trade deficit caused more U.S. inflation
- c. the U.S. budget deficit raised U.S. interest rates
- d. the U.S. economy deteriorated dramatically

ANSWER: c: Expectations and the Asset Market Model of Exchange Rates

2.2 The U.S. dollar weakened during the 1970s because
- a. control of Congress changed political parties
- b. the U.S. economy grew
- c. foreigners wanted to hold more dollars than before
- d. U.S. inflation accelerated

ANSWER: d: Expectations and the Asset Market Model of Exchange Rates

2.3 Exchange rates depend on
- a. relative inflation rates
- b. relative interest rates
- c. relative trade deficits
- d. a and b

ANSWER: d: The Nature of Money and Currency Values

2.4 Beginning in 1997, the ruble came under attack by speculators and resulted in accelerating
- a. stock market prices
- b. capital flight
- c. efforts by the Russian government to address the root causes of the crisis
- d. decontrol by the government on the foreign exchange market

ANSWER: b: Illustration The Ruble is Rubble

2.5 During the second half of 1997, currencies and stock market prices plunged in value across Southeast Asia, beginning in
- a. Thailand
- b. Malaysia
- c. Indonesia
- d. South Korea

ANSWER: a: Asian Currencies Sink in 1997

2.6 The asset market view of exchange rate determination says that the spot rate

a. should follow a random walk
b. is affected primarily by a nation's long-run economic prospects
c. both a and b
d. should be strongly affected by a nation's balance of trade

ANSWER: c: Expectations and the Asset Market Model of Exchange Rates

2.7 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

ANSWER: a: Sterilized versus Unsterilized Intervention

2.8 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

ANSWER: d: Sterilized versus Unsterilized Intervention

2.9 Under which one of the following systems is there no central bank?
a. Floating exchange rates
b. Currency board
c. Pegged exchange rates
d. Sterilized intervention

ANSWER: b: Central Bank Reputations

MODERATE

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

ANSWER: a: Setting the Equilibrium Spot Exchange Rate

2.11 Suppose that the Brazilian real devalues by 40% against the U.S. dollar. By how much will the dollar appreciate against the real?

a. 67%
b 40%
c. 32%
d. 28%

ANSWER: a: Setting the Equilibrium Spot Exchange Rate

2.12 If the French euro devalued by 17% against the U.S. dollar, this is equivalent to a revaluation of the dollar against the euro by

a. 17%
b. 16.31%
c. 20.48%
d. 17.54%

ANSWER: c: Setting the Equilibrium Spot Exchange Rate

2.13 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%

ANSWER: d: Setting the Equilibrium Spot Exchange Rate

2.14 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%

ANSWER: b: Setting the Equilibrium Spot Exchange Rate

2.15 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%

ANSWER: a: Setting the Equilibrium Spot Exchange Rate

2.16 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%

ANSWER: b: Setting the Equilibrium Spot Exchange Rate

2.17 If the 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%

ANSWER: d: Setting the Equilibrium Spot Exchange Rate

2.18 If the U.S. dollar appreciates against the euro by 25%, the euro will depreciate against the U.S. dollar

a. 25%
b. 20%
c. 30%
d. 10%

ANSWER: b: Setting the Equilibrium Spot Exchange Rate

2.19 If a foreigner purchases a U.S. government security

a. the supply of dollars rises
b. the federal government deficit declines
c. the demand for dollars rises
d. the U.S. money supply rises

ANSWER: c: Setting the Equilibrium Spot Exchange Rate

2.20 The price of foreign goods in terms of domestic goods is called

a. the real exchange rate
b. the balance of trade
c. the trade-weighted exchange rate
d. purchasing parity

ANSWER: a: The Fundamentals of Central Bank Intervention

2.21 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. raise the cost of foreign goods

ANSWER: c: The Fundamentals of Central Bank Intervention

2.22 A slowdown in U.S. economic growth will
a. boost the value of the dollar because inflation fears will be calmed
b. boost the value of the dollar because the Federal Reserve will expand the money supply
c. lower the value of the dollar because the U.S. will be a less attractive place to invest in
d. lower the value of the dollar because interest rates will rise

ANSWER: c: The Fundamentals of Central Bank Intervention

2.23 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

ANSWER: d: The Fundamentals of Central Bank Intervention

2.24 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

ANSWER: a: The Fundamentals of Central Bank Intervention

2.25 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. lower the value of a nation's currency by leading to added political risk
e. historical experience shows no correlation between government budget deficits and the value of the nation's currency

ANSWER: e: The Nature of Money and Currency Values

DIFFICULT

2.26 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

ANSWER: a: Central Bank Reputations and Currency Values

2.27 An increase in the supply of U.S. dollars by the Federal Reserve will
a. raise the value of the dollar because it will stimulate U.S. economic growth
b. raise the value of the dollar because it will lead to higher U.S. interest rates
c. reduce the value of the dollar because of inflation fears in the United States
d. decrease the value of the dollar because it will force other countries to raise their interest rates

ANSWER: c: The Fundamentals of Central Bank Intervention

2.28 Which one of the following is probably the best advice for governments when it comes to exchange rate arrangements?
a. The complete replacement of the local currency with the U.S. dollar.
b. Currency boards are the next best arrangement after fixed exchange rates.
c. There is no substitute for good macroeconomic policy.
d. Fixed exchange rates are the most completely sound and credible.

ANSWER: c: Central Bank Reputations

2.29 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 Japanese central bank sells yen in the foreign exchange market to prop up the value of the yen

ANSWER: d: The Fundamentals of Central Bank Intervention

2.30 During 1995, the yen went from $0.0125 to $0.0095238. By how much did the dollar appreciate against the yen?
a. 23.81%
b. 31.25%
c. 15.67%
d. 40.78%

ANSWER: b: Setting the Equilibrium Spot Exchange Rate

2.31 Which one of the following effects would MOST likely be caused by a government artificially holding its currency value down?
a. a massive rise in foreign exchange reserves.
b. the value of the nation's exports rises dramatically

c. the outsourcing a the nation's manufacturing jobs to offshore markets
d. a growing trade deficit with foreign economies

ANSWER: a: Central Bank reputation