International Economics
Econ 432
Summer 2004
PS 3 due Sat August 6 - exchange rates

1. If current exchange rates were 100 yen/$ and 2 DM/$, which of the following exchange rates would be indicative of a yen depreciation?
   a. 90 yen/$
   b. 3 DM/$
   c. 55 yen/DM
   d. 40 yen/DM
   e. a, b and c are all consistent with a yen depreciation
2. Covered interest parity means that:
   a. domestic interest rates are always equal to foreign rates
   b. the expected spot exchange rate is always equal to the current exchange rate
   c. the forward rate adjusts to ensure there are no riskless arbitrage profits across currencies
   d. the Central Bank of a country is running a fixed exchange rate
   e. c and d above
3. Today's spot exchange rate between the biberkopf and the reinhold is b100/r1. People believe that in the next 90 days, the reinhold is going to appreciate to b110/r1. The 90-day interest rate in Biberland is 20%; the 90-day interest rate in Reinland is 15%. There are no derivates available at all. Reinlanders are not allowed to borrow from people or banks in Biberland. Use the *approximation formula* (as given on p. 342 for the dollar and euro) of the interest parity condition. Does uncovered interest parity hold?
   a. yes
   b. no
4. If it does not, at what spot rate would it hold (using the approximation formula)?
   a. it does hold
   b. 104.76
   c. 140
   d. 175.2
5. Suppose the numbers were as in problem (3), and there was a risk premium to holding reinholds of 4%. (That is, you had to be compensated to the extent of 4% of your principal for holding reinholds- subtract .04 from the return to reinholds). Are the rate of returns different between holding assets in either currency?
   a. no
   b. yes
6. Now continuing from 5, with a risk premium present, suppose you are from Biberland, and there is also a .5% transaction tax to changing money (each way, so 1% for two way transactions; assume you can only deal with Biberland institutions... no offshore accounts!). There are no other transactions costs. What is the situation now?
   a. interest parity holds at the exchange rate
   b. interest parity still does not hold
   c. impossible to determine
   d. exchange rate will rise
7. U.S. money demand increases unexpectedly as Americans lose confidence in ATM machines reliability. What will happen to the DM/$ exchange rate?
   a. $ will appreciate
   b. $ will depreciate
   c. no change
   d. cannot be determined
8. You learn that in Brazil Big Macs cost the equivalent of $2.99, while in the U.S. they cost $1.99. Few other people seem aware of this fact. Meanwhile, the market exchange rate is $1 per real. You believe in PPP, and decide you would like to make some money off of this information. What transactions would do (see pp 332-3):
   a. Buy real forward
   b. Sell real forward
   c. Borrow dollars and buy real
   d. Buy Big Macs's in Brazil and export them to the U.S. and then take the dollars and turn them into real at the market exchange rate.
9. The Purchasing Power Parity theory of exchange rates is that:
   a. income in all countries will be equalized
   b. the prices of goods in different countries must be equal to the interest differential
   c. the exchange rate adjusts to make goods priced in one currency equivalent in cost to goods priced in another currency
   d. countries with greater purchasing power, in terms of income, will determine exchange rates
   e. None of the above
10. The theory of purchasing power parity holds that exchange rates are determined according to what mechanism?
   a. Countries with high purchasing power will buy higher quality goods

b. Arbitrage in capital markets
c. Arbitrage in goods and services
d. Government action to keep prices at parity

11. How well does the theory of PPP work, in terms of evidence on real world exchange rates?
    a. PPP exchange rates closely match market exchange rates
    b. PPP exchange rates are impossible to attain, given speculation in markets
    c. there is some tendency for exchange rates to move towards the levels implied by PPP over the long run but there are significant short-term deviations from PPP
    d. exchange rates fluctuate to ensure PPP in the short run
12. According to the overshooting model, the effects of an expansionary monetary policy are:
    a. the opposite of an increase in money demand
    b. the opposite of a decrease in money demand
    c. the same as an unexpected and sudden increase in the price level
    d. the opposite of an unexpected and sudden increase in the price level
    e. a and d
13. If the money supply expands, the dollar will depreciate by an extra amount so that there is an expected appreciation equal to:
    a. the interest rate differential
    b. the forward exchange rate
    c. the PPP exchange rate
    d. the rational expectations change in the level of real GDP
14. Which of the underlined words in the following passage is a mistake: An expansionary monetary policy has the immediate effect of lowering interest rates and making the dollar depreciate against foreign currencies. But it also has the effect of changing long-run expectations of the price level in the US. From the Phillips curve, an increase in the money supply leading to an increase in aggregate demand will likely generate inflation (rising prices). The higher future price level of the U.S. means that the long-run exchange rate implied by PPP will be depreciated from the current PPP equilibrium rate. The exchange rate thus will have to appreciate even further in the immediate short-term when these expectations are factored in. Why? Because every one knows that over time interest rates in the U.S. will slowly start to rise as prices rise. This slow change over time in interest rates has to coincide with an appreciation of the dollar. If the dollar is going to be appreciating over time, it must be the case that it has depreciated by 'too much' after the initial change in the money supply. Suppose it depreciated to its long run level, instead of by 'too much'. Then there would be no expected change in the exchange rate, but the U.S. interest rate would be lower than foreign rate. Everyone would want to buy foreign currency, and the dollar would indeed depreciate 'beyond' the long run rate.
    a. LOWERING
    b. HIGHER
    c. DEPRECIATED
    d. APPRECIATE
15. Under floating rates, the effects of a fiscal expansion will be:
    a. no change in GDP in the long run
    b. a depreciated exchange rate
    c. a rise in prices
    d. crowding out of investment spending
16. Under floating rates, the long run effects of an expansionary monetary policy will be:
    a. increase in GDP
    b. an appreciated exchange rate
    c. a rise in prices
    d. crowding out of investment spending
17. Under floating rates, the time path of the exchange rate following an expansionary monetary policy will be:
    a. depreciation and then appreciation
    b. appreciation and then depreciation
    c. staying constant in short run, and then change only in the expected exchange rate
    d. depreciation and then appreciation until reaches same level as when started
18. Which of the following may be the least serious reason for concern regarding a large current account deficit of the United States, even though the media and politicians often focus the most on it:
    a. the financial flow coming into the country may be part of a speculative bubble
    b. the financial flow coming into the country may be used to finance consumption
    c. a current account deficit means foreigners are holding more financial claims against the country
    d. a current account deficit means the government is running an unsustainable fiscal deficit that will lead to a balance of payments crisis

Reading ahead in the textbook: Fixed exchange rates

19. Which of the following is best definition of what it means for a country to have a fixed exchange rate.
    a. Central Bank stands ready to buy and sell foreign exchange at a specified rate
    b. Speculators can 'fix' the exchange rate through use of derivatives
    c. Central Bank stands ready to make loans at the given exchange rate
    d. Central Bank uses sterilization techniques to keep open market operations at the fixed exchange rate
20. Why does a country with a fixed exchange rate lose control over the money supply?
    a. Because Central Bank policy makers are too busy worrying about the exchange rate
    b. Because Central Bank officials decide that they do not need to control money supply
    c. Because if the domestic interest rate differs from the foreign rate, there will be capital inflows or outflows that translate into changes in the domestic money supply
    d. Because prices of goods will fluctuate, changing the value of money in circulation
21. 'Sterilization' means that:
    a. A Central Bank counteracts the effects of purchases or sales of foreign currency through open market operations
    b. A Central Bank counteracts the effects of fiscal policy changes through open market operations
    c. A Central Bank counteracts the effects of foreign interest rate changes through open market operations
    d. A Central Bank counteracts the effects of speculative attacks by imposing capital controls.
22. When country A fixes its exchange rate with regard to another country's currency, one general implication is that:
    a. The interest rate of country A will never change
    b. The interest rate of country A will have to change when the other country's interest rates change
    c. The interest rate in country A will change when its central bank needs to change monetary policy
    d. Country A will lose its foreign reserves in a short period of time
    e. Country A must have controls on capital flows
23. Which of the following is not indicative of a likely future balance of payments crisis:
    a. fluctuating floating exchange rate
    b. appreciation of real exchange rate
    c. increase in short term foreign debt by domestic institutions
    d. large current account deficit well above 5% of GDP