Problem Set 5. **Deadline:** April 30th

1. If the marginal propensity to consume for a nation is 0.8, it means:
   A) consumers save 80% of their incomes.
   B) consumers spend 80% of their incomes.
   C) consumers pay 20% tax on their earnings.
   D) consumers decrease their spending by $0.80 for each $1 of a decrease in their income.

2. A Keynesian model is one in which prices are sticky:
   A) in the short run only.
   B) in the short run and in the long run.
   C) in the long run only.
   D) so that they never depend on the money supply.

3. With expected inflation equal to zero in the model, investment activity for an economy is:
   A) a positive function of the nominal rate of interest.
   B) a negative function of the nominal rate of interest.
   C) constant in the face of differing nominal rates of interest.
   D) limited to the rate of growth of nominal GDP minus the inflation rate.

4. The TB (X – M) is part of the short-run spending equation. With sticky prices, what would be the effect on the TB with an increase (depreciation) of the home nation's exchange rate?
   A) Consumers in the home nation would find it more expensive to buy domestic goods compared to foreign goods, and the trade balance would decrease.
   B) Consumers in the home nation would cut back on both domestic and foreign goods and the trade balance would decrease.
   C) Consumers in the home nation would increase spending on both domestic and foreign goods, and the trade balance would be unchanged.
   D) Consumers in the home nation would increase spending on domestic goods and decrease spending on foreign goods, causing the trade balance to increase.
5. A major factor in changing levels of imports in an open economy is:
   A) real international rates of interest.
   B) relative international price levels.
   C) a change in a nation's disposable income.
   D) a change in transportation costs.

6. If the trade surplus has fallen, which of the following is a possible explanation?
   A) The real exchange rate depreciated.
   B) Foreign income fell.
   C) Domestic income fell.
   D) The foreign price level rose.

7. If domestic income falls, what must happen to keep the trade balance the same?
   A) The real exchange rate must fall.
   B) Foreign income must rise.
   C) The domestic price level must fall.
   D) Domestic income must fall.

8. The marginal propensity to consume goods and services can be broken out into:
   A) the marginal propensity to invest plus the marginal propensity to save.
   B) the marginal propensity to consume home-produced goods and services plus the marginal propensity to consume imports.
   C) the marginal propensity to spend minus the marginal propensity to save.
   D) the marginal propensity to consume goods plus the marginal propensity to consume services.

9. Suppose the MPC is 0.8 in Canada and the MPCh is 0.55. If income increases by $100 million in Canada, then the increase in consumption of foreign goods will be _____.
   A) $35 million
   B) $25 million
   C) $80 million
   D) $100 million

10. If a proportion of traded goods (such as oil) are priced in a foreign currency, the real exchange rate becomes:
    A) lower.
    B) higher.
    C) less responsive to changes in the nominal exchange rate.
    D) more responsive to changes in the nominal exchange rate.
11. Consider the following information on Mexico's trade. Thirty percent of the trade is conducted with country A; 55% of trade with country B, and 15% of trade with country C. If the peso appreciates 10% against country A, depreciates 30% against country B, and depreciates 10% against country C, then the effective trade-weighted real exchange rate experiences a _______.

A) 15% appreciation  
B) 15% depreciation  
C) 25% depreciation  
D) 20% appreciation  

12. The final market price of imports may not reflect 100% of changes in the real effective exchange rate because:

A) exchange rates in many nations are fixed.  
B) there are restrictions on capital inflows.  
C) domestic price distortions, such as markups or taxes, reduce the impact of the exchange rate change.  
D) the government has instituted price controls.  

13. The J-curve effect means that import prices are higher, thus revenues paid out increase while export prices are lower and incoming revenues decrease. Therefore, after a currency depreciation:

A) the trade balance will improve, then decline, then improve, and then decline, appearing to be a series of J shapes.  
B) the trade balance will increase, then decrease, then jump higher, which economists call the J-curve effect.  
C) the nation will cut back on imports immediately causing the trade balance to improve, which gives the curve an inverted J shape.  
D) the trade balance decreases and then increases over time giving the curve a J shape.  

14. Unlike in the long-run model, in the short-run Keynesian model, we make two critical assumptions: that firms adjust production depending on _______, and that _______.

A) total demand; prices are fixed  
B) resource limitations; prices are flexible  
C) the market rate of interest; consumers maximize utility  
D) consumer spending; there is full employment
15. If the interest rate rises and government spending falls, what will happen to output (if all else is equal)?
   A) It will rise.
   B) It will stay the same.
   C) It will fall.
   D) It is uncertain what will happen.

16. Along the IS curve, which of the following markets are in equilibrium?
   A) the money and forex markets
   B) the goods and forex markets
   C) the goods and money markets
   D) the goods, money, and forex markets

17. Every point on an open-economy IS curve represents:
   A) combinations of interest rates and the supply of money, which result in equilibrium in the money market.
   B) combinations of interest rates and levels of production, which result in equilibrium in the goods market.
   C) combinations of interest rates and levels of production, which result in equilibrium in the money market, the goods market, and the forex market.
   D) combinations of interest rates and levels of production, which result in equilibrium in the goods market and the forex market.

18. Traders operate on the principle that the ______ the value of the nominal exchange rate (E), the ______ it is to purchase foreign currency, and the _____ its return measured in the domestic currency.
   A) higher; more expensive; lower
   B) higher; less expensive; higher
   C) lower; more expensive; higher
   D) higher; more expensive; higher

19. The open-economy IS curve slopes down because any change in the foreign or home interest rate will inversely affect demand, along with a secondary effect from a change in:
   A) the rate of depreciation of assets.
   B) the exchange rate and the trade balance.
   C) the real interest rate.
   D) the growth rate of money.
20. If the central bank in a foreign country increases its interest rate, then the IS curve of the domestic economy will:
   A) shift to the right.
   B) shift to the left.
   C) will not shift.
   D) shift to the right because U.S. exports will decrease.

21. If the demand for money increases, what happens in the IS-LM framework?
   A) The IS curve shifts right.
   B) The LM curve shifts right.
   C) The IS curve shifts left.
   D) The LM curve shifts left.

22. If the LM curve shifts down, this would be consistent with:
   A) a rise in the money supply.
   B) a fall in interest rates.
   C) a rise in interest rates.
   D) both a rise in the money supply and a fall in interest rates.

23. If we start from long-run general equilibrium of goods, forex, and the money markets, and there is a temporary expansion of the money supply, what will be the outcome?
   A) GDP rises, the interest rate falls, and the exchange rate rises (depreciation).
   B) GDP rises, the interest rate rises, and the exchange rate falls (appreciation).
   C) GDP falls, the interest rate falls, and the exchange rate rises (depreciation).
   D) GDP falls, the interest rate rises, and the exchange rate rises (depreciation).

24. If the central bank expands the money supply under floating exchange rates, it potentially stimulates the economy in two ways, namely:
   A) by raising the price level and by increased competition.
   B) by lowering the rate of interest and by causing a depreciation of the currency.
   C) by creating higher spending and by increasing the budget deficit.
   D) by increasing worker productivity and creating R&D incentives for firms.

25. Whenever U.S. government spending increases, thereby increasing the demand for real balances and the rate of interest, the currency will appreciate and there is a potential for:
   A) overshooting.
   B) crowding out.
   C) a Republican backlash.
   D) recession.
26. Under a fixed exchange rate regime, an expansionary fiscal policy would tend to ____ interest rates and GDP, which would cause ____ pressure on the exchange rate, forcing the monetary authority to undertake a(n) ____ monetary policy.
   A) raise; downward (appreciation); expansionary
   B) lower; upward (depreciation); contractionary
   C) raise; upward (depreciation); contractionary
   D) lower; downward (appreciation); expansionary

27. Comparing monetary and fiscal policy under fixed and floating exchange rate regimes, which of the following statements is false?
   A) In a floating exchange rate regime, an expansionary monetary policy is effective by stimulating spending and by depreciating the currency.
   B) In a floating exchange rate regime, an expansionary fiscal policy is effective by stimulating spending, though there may be crowding-out effects due to higher rates of interest and currency appreciation.
   C) In a fixed exchange rate regime, an expansionary monetary policy is effective by stimulating spending; it has no impact on the currency value or trade balance.
   D) In a fixed exchange rate regime, an expansionary fiscal policy is effective by stimulating spending, as long as the parallel expansionary monetary policy keeps exchange rates stable.

28. The financial crisis of 2008 resulted in extreme policy measures by the Federal Reserve. Which of the following is the best characterization of its policy?
   A) It was a complete reversion to the idea that eventually the economy is self-correcting and the best policy is to wait it out.
   B) It was a massive injection of liquidity to banks and major purchases of U.S. government securities, which resulted in a near-zero federal funds rate.
   C) It was a moderate approach that limited monetary growth to the rate of growth of real GDP.
   D) It was based on a realization that the Federal Reserve was ineffective in the face of such a crisis.

29. When the interest rate is so low that the opportunity cost of holding money is zero, then economists say we have reached:
   A) the era of total liquidity.
   B) the zero-lower-bound situation, which means the U.S. economy may be in a liquidity trap.
   C) full monetary saturation.
   D) a situation in which a nation must use caution, since monetary policy is “super” effective.
30. Why wasn't the stimulus passed in 2009 effective in reducing unemployment during the recession of 2009–2010?
   A) Congress cut the size of the final package, it was skewed toward tax cuts, and it was only 25% of the amount needed to restore GDP to full employment.
   B) The administration mismanaged it—and it was much too large.
   C) Fiscal policy is ineffective in a liquidity trap.
   D) Tax cuts and interest rate cuts would have been effective, but they were politically undesirable.

31. Explain why the IS curve slopes down. (Please write your answer in a separate page.)

32. If the government attempts to stimulate the economy under a fixed-rate regime, it must also conduct a parallel expansionary monetary policy. Why? And, what impact would there be on the domestic economy? (Please write your answer in a separate page.)

33. The gold standard system was:
   A) a floating exchange rate system.
   B) a fixed exchange rate system, in which the country's currency was fixed relative to a pound of gold.
   C) a fixed exchange rate system, in which the country's currency was fixed relative to an ounce of gold.
   D) only used by the United States.

34. Beginning in the early 1970s, many nations abandoned their dollar standard and moved toward a system of:
   A) fixed exchange rates based on gold.
   B) fixed exchange rates based on the German deutsche mark.
   C) floating exchange rates.
   D) real money systems in which currencies were backed by government bonds.

35. Reunification of East and West Germany created which sequence of events?
   i. an increase in German rates of interest
   ii. a boom in German output and a shift to the right of the German IS curve
   iii. large reunification costs financed by increased government spending
   iv. an increase in rates of interest in ERM nations
   A) iv, i, iii, i
   B) iii, ii, i, iv
   C) i, ii, iii, iv
   D) iv, iii, ii, i
Use the following scenario to answer questions 36-38:

*Suppose that Canada decides to peg its dollar ($C, or the loonie) to the U.S. dollar at an exchange rate of $C1 = $US1.*

36. Now suppose that the increase in the price of oil in the second half of 2007 causes the IS curve in the United States to shift to the left. If all other things remain unchanged, what will happen to U.S. interest rates?
   A) They will rise.
   B) They will fall.
   C) They will not change.
   D) They will rise dramatically.

37. What might the U.S. Federal Reserve do to offset the macroeconomic effect of the leftward shift in the U.S. IS curve?
   A) It would increase the money supply.
   B) It would decrease the money supply.
   C) It would not change its monetary policy.
   D) It would not change its fiscal policy.

38. What will happen to the Canadian IS curve as a result of the leftward shift of the U.S. IS curve?
   A) It will shift rightward.
   B) It will shift leftward.
   C) It will not change.
   D) The IS curve will show an increase.

39. In 1990, Britain joined the ERM. If the German Bundesbank increased interest rates, assuming Britain maintains its exchange rate peg:
   A) the British would be forced to increase their interest rates.
   B) the British would increase their money supply.
   C) the British would have to lower their interest rates.
   D) the British government would have to use expansionary fiscal policy.

40. During Britain's brief alignment with the ERM from 1990–1992, the trilemma tells us that monetary policy authority no longer existed in Britain. Why?
   A) Britain could print more pounds, but could not increase its gold stock.
   B) Britain kept monetary growth rates at zero.
   C) The British interest rate equaled the German rate to attain uncovered interest parity.
   D) The British could lower unemployment using other means such as fiscal policy.
41. The text compares the macroeconomic performance of Great Britain and France immediately following Great Britain's departure from the ERM in 1992. What does it conclude?
   A) The rate of growth of real GDP was higher in France than in Great Britain.
   B) The rate of growth of real GDP was lower in France than in Great Britain.
   C) The rates of growth of real GDP were equal in France and in Great Britain.
   D) GDP growth of both Great Britain and France increased dramatically after Great Britain withdrew from the ERM.

42. When a nation chooses to fix or float, it should consider:
   A) only its domestic banks, importers, and exporters.
   B) only whether it has a great deal of economic integration.
   C) only whether it has similar circumstances in terms of demand or supply shocks with its trading partners.
   D) both the level of economic integration and the similarity of demand or supply shocks.

43. The greater the degree of economic integration between markets in the home country and the base country:
   A) the greater the volume of transactions and the greater the benefit to the home country of fixed exchange rates.
   B) the smaller the volume of transactions and the lesser the benefit to the home country of fixed exchange rates.
   C) the greater the volume of transactions and the greater the benefit to the home country of flexible exchange rates.
   D) the less important the volume of transactions and the greater the importance of ethnic similarities.

44. The difference between asymmetric and symmetric shocks is that:
   A) the former results in no conflicts in policy goals between countries.
   B) the latter results in policy conflicts between countries.
   C) the latter results in identical policies being implemented.
   D) the former is favored over the latter.
45. Why do symmetric shocks not disturb fixed exchange rate systems?
   A) Symmetric shocks happen only once and cause a one-time shift in interest rates.
   B) Symmetric shocks imply differences in rates of interest, which is irrelevant to fixed exchange rate systems.
   C) A demand shock can easily be dealt with using domestic policies that do not involve other nations.
   D) Symmetric shocks require the same medicine in both economies, so monetary policy will be in a direction to help both situations.

46. The authors of your textbook cite one study that estimated that currency unions _______ trade among member countries by approximately _______ percent.
   A) increase; 100
   B) increase; 40
   C) decrease; 100
   D) decrease; 40

47. Lower transaction costs are a benefit of fixed exchange rates. Therefore, relative prices in two trading nations linked by fixed exchange rates should:
   A) experience more price divergence.
   B) experience more price convergence.
   C) have less arbitrage and more speculation.
   D) have lower costs of production.

48. In fact, several studies focused on Europe concluded that:
   A) higher exchange rate volatility is associated with smaller price differentials.
   B) higher exchange rate volatility is associated with larger price differentials.
   C) higher exchange rate volatility often precedes a return to stability.
   D) higher exchange rate volatility promotes trade and cooperation among nations.

49. What is the most powerful argument against a fixed exchange rate?
   A) The nation must administer the rates at all currency exchange venues, and it is expensive to do.
   B) The nation usually gets opposition from other trading partners who are excluded.
   C) The nation has to have a large store of gold on hand to exchange at fixed rates.
   D) The nation gives up its ability to control its money supply and affect its own interest rates.
50. Whenever a nation has substantial external debts and assets denominated in foreign currency:
   A) it is easier to manage, since changes in value are often offsetting.
   B) there can be large and destabilizing wealth effects.
   C) its interest payments on the debt will be matched by interest earnings on the assets.
   D) the risk of default becomes very large.

Use the following scenario to answer questions 51-53:

Suppose that Argentina's dollar-denominated external assets and liabilities are $10 billion and $100 billion, respectively, and its Argentine peso-denominated external assets and liabilities are each 50 billion pesos (P). Suppose further that Argentina fixes its exchange rate at P1 = $US1.

51. What is the peso value of Argentina's total external wealth?
   A) –60 billion pesos
   B) –150 billion pesos
   C) 0 billion pesos
   D) –90 billion pesos

52. Suppose that Argentina changes its exchange rate to P3 = $US1. Now what is the peso value of Argentina's total external wealth?
   A) –270 billion pesos
   B) –150 billion pesos
   C) 0 billion pesos
   D) –210 billion pesos

53. What is the likely effect of the change in Argentina's external wealth on Argentine aggregate demand?
   A) It will increase Argentine aggregate demand.
   B) It will decrease Argentine aggregate demand.
   C) It will neither increase nor decrease Argentine aggregate demand.
   D) It will first increase, then decrease Argentine aggregate demand.

54. If China has domestic assets of $50 billion, domestic liabilities of $100 billion, and $50 billion in foreign assets, a 10% appreciation of the Chinese yuan will:
   A) cause the Chinese domestic assets to increase in value.
   B) cause the Chinese domestic liabilities to decrease in value.
   C) cause the overall wealth to decrease by 5%.
   D) cause the overall wealth to increase by 5%.
55. An important factor in the choice of an exchange rate regime in low-income nations is:
   A) the credentials of the finance minister.
   B) the extent of liability dollarization, which can cause contractions when the home currency depreciates.
   C) how dependent the nation is on imports, which must be financed by external borrowing.
   D) the price level and how it affects the interest rate level in the nation.

56. A cooperative outcome in a situation where one nation pegs to another would be that:
   A) the center country abandons its own stabilization policy in favor of the home country.
   B) the home country absorbs the losses resulting from the stabilization policy in the center country.
   C) the center country makes concessions, recognizing the impact on the home country, thereby sharing the pain.
   D) the peg is temporarily abandoned.

57. In practice, cooperative agreements are:
   A) the largest single exchange rate format.
   B) easy to maintain because they have little impact on the nations.
   C) often contentious because nations favor their own situations over those of their trading partners.
   D) impossible to maintain because nations have widely differing systems and values.

58. In a reserve currency system (such as the Bretton Woods system or the European ERM), currencies peg to a reserve currency. As a result:
   A) only the reserve currency country has monetary autonomy.
   B) all countries, other than the reserve currency country, have monetary autonomy.
   C) all countries have monetary autonomy.
   D) no country has monetary autonomy.

59. In a noncooperative environment of pegged exchange rates, if the home nation is experiencing high inflation due to excessive demand, it may choose to ______, which would cause______.
   A) forgo the pegged exchange rate; extreme depreciation
   B) devalue its currency; the foreign nation to suffer deficient demand for its products
   C) cut the monetary growth rate; a rise in interest rates
   D) revalue its currency; the foreign nation to suffer excessive demand for its products
60. Under the gold standard:
   A) the United States set the price of gold at $35 per ounce, and other countries then establi
   B) Great Britain and the United States set the price of gold at $35 per ounce and £7 per ounce, and then other countries established their exchange rates against either the British pound or the U.S. dollar.
   C) all countries pegged the values of their currencies to gold.
   D) only gold was used to settle international transactions.

61. Trilemma refers to:
   A) policy conflicts among fixed exchange rate, monetary autonomy, and free capital mobility goals.
   B) policy conflicts among floating exchange rate, monetary autonomy, and free capital mobility goals.
   C) policy conflicts among fixed exchange rate, monetary autonomy, and floating exchange rate goals.
   D) policy conflicts among floating exchange rate, fiscal autonomy, and monetary autonomy goals.

62. Which is the best characterization of the current international payments system?
   A) The World Bank and the IMF approve nations' exchange rate regimes and ensure that financial flows are not hampered by imbalances.
   B) All nations are now operating with floating exchange rates and free capital flows.
   C) The four richest industrial nations have floating exchange rates, while the rest of the nations peg to those currencies.
   D) There is no standard and no rules, and each nation chooses the regime that works best for its individual situation at the time.

63. The average duration for a pegged exchange rate is about:
   A) 5 years.
   B) 10 years.
   C) 2 years.
   D) indefinitely.

64. One economic cost of an exchange rate crisis is:
   A) a decrease in the rate of inflation.
   B) an increase in exports.
   C) a slowing in a country's rate of economic growth.
   D) an increase in employment.
65. Why might a default crisis be associated with an exchange rate crisis?
A) A large depreciation causes a sudden decrease in the local currency value of international debts denominated in other currencies.
B) A government is unable to pay principal or interest on debt owed to banks.
C) A large depreciation causes a sudden increase in the local currency value of international debts denominated in other currencies.
D) Banks close or declare bankruptcy.

66. Typically an exchange rate crisis can be caused by:
A) a government default on debt.
B) a banking crisis, triggered by adverse shocks.
C) sudden infusion of credit into the economy.
D) a government default on debt and a banking crisis, triggered by adverse shocks.

67. A banking crisis often threatens a fixed exchange rate (or peg). Why?
A) Banks have to provide funds to maintain the fixed exchange rate.
B) The central bank may have to bail out insolvent banks by inflating the currency, which could cause a loss of reserves.
C) The central bank has to close relationships with foreign banks, and there is no way to implement the fixed exchange rate system.
D) The banking crisis means that domestic banks hold onto foreign currency reserves rather than exchanging them with the central bank.

68. When maintaining a peg, if the central bank runs out of foreign currency reserves, then:
A) it can always print more of the domestic currency.
B) it can back the money supply by purchasing domestic assets.
C) it can sell its own currency and purchase foreign currency reserves.
D) it must allow the domestic currency to float.

69. Changes in the domestic money supply are a result of:
A) changes in the central bank's holding of domestic credit only.
B) changes in the central bank's holding of foreign reserves only.
C) some combination of changes in the central bank's holdings of domestic credit or foreign reserves.
D) changes in the nation's stock of gold.
70. Saudi Arabia pegs its currency (the riyal, or SAR) to the U.S. dollar. Currently, the exchange rate is SAR\(3.75 = \$US1\). Suppose that the Saudi Arabian money multiplier is 1. By how much will the Saudi Arabian money supply change when the Saudi central bank buys $1 million of additional reserves?
   A) +SAR 1 million
   B) –SAR 1 million
   C) +SAR 3.75 million
   D) –SAR 3.75 million

71. Which of the following methods would the central bank NOT use to keep the exchange value of its currency fixed?
   A) It would purchase its own currency for foreign reserves when the domestic credit expanded.
   B) It would sell its own currency for foreign reserves when domestic credit contracted.
   C) It would ensure that the domestic money supply stayed constant to maintain uncovered interest and PPP.
   D) It would ensure that the domestic money supply increased to maintain PPP.

72. When a country adopts a currency board system:
   A) it no longer needs to hold any reserves.
   B) its reserves equal 100% of its money supply.
   C) it can create money by lending to domestic borrowers.
   D) its reserves must equal 50% of its money supply.

73. If the price level is fixed, the demand for money depends on changes in:
   A) the exchange rate with trading partners.
   B) government purchases of domestic bonds.
   C) GDP and/or the domestic rate of interest.
   D) the total value of assets held by the central bank.

74. With a credible peg, whenever there is a rise in the foreign interest rate:
   A) there is a drop in the domestic interest rate.
   B) the exchange rate changes.
   C) there is an equal rise in the domestic interest rate.
   D) there will be no change in the domestic interest rate.
75. Consider an economy with a fixed exchange rate and money supply equal to 2 billion pesos. The country has 1 billion in reserves and 1 billion in domestic credit. If there is a sudden decline in the demand for money, then:
   A) the country needs to reduce its reserves to maintain the exchange rate.
   B) the country needs to increase its reserves to maintain the exchange rate.
   C) the country will face rising interest rates and, thus, a sharp appreciation of the peso.
   D) the country will see a sharp increase in demand for loans.

76. Assume the money supply is backed by bonds and reserves, and the exchange rate is pegged. If the demand for money rises, how might the central bank maintain the peg?
   A) by selling back domestic bonds and foreign currency reserves
   B) by selling domestic bonds equal to the increase in demand
   C) by purchasing reserves equal to the increase in demand
   D) by selling reserves equal to the increase in demand

77. A ratio indicating how safe the peg is from breaking is calculated by ______ and is called ________.
   A) foreign reserves as a percent of GDP; the safety margin
   B) foreign reserves as a percent of the total money supply; the backing ratio
   C) money demand as a percent of money supply; the financial adequacy quotient
   D) foreign reserves as a percent of domestic credit; the marginal propensity to break

78. Investors in emerging markets often require ______ added to their return because they are concerned about defaults and exchange rate volatility.
   A) collateral deposits
   B) credit swap default insurance
   C) a risk premium
   D) compensation for their executives

79. When other emerging market nations experience an exchange rate crisis, it affects healthy emerging market economies (raises risk premia) because of investor worry. This phenomenon is known as:
   A) emerging market dysfunction.
   B) the law of like outcomes.
   C) experiential judgment.
   D) contagion.
80. When the central bank offsets a fall in interest rates with the sale of foreign currency reserves, the action is called:
   A) an offsetting movement.
   B) a foreign reserve counteraction.
   C) a central bank inside-out operation.
   D) a nonsterilized intervention.

81. When the central bank engages in sterilization of reserves, it is:
   A) buying reserves to offset the purchase of government bonds.
   B) selling reserves to offset the sale of government bonds.
   C) selling reserves to offset the purchase of government bonds.
   D) printing more money.

82. A danger to the peg is a situation in which the central bank lends to insolvent private financial institutions to bail them out of crises. Why might this cause a problem?
   A) The private financial institutions are often corrupt and should not be bailed out.
   B) Foreign investors are helped and domestic investors harmed.
   C) It requires a drawdown of foreign reserves to maintain the peg, lowering the backing ratio.
   D) The central bank is assuming more than its share of political power, which can cause problems down the road.

83. A central bank can change the composition of the money supply and increase the backing ratio by:
   A) confiscating any foreign currency held by private citizens.
   B) borrowing from the public and investing in foreign currency assets.
   C) bailing out insolvent banks.
   D) expanding the money supply.

84. With pegged exchange rates, in the case of fiscal dominance, if investors are unaware of pending problems as the central bank continuously monetizes government bonds, then at some point:
   A) the IMF will step in and take over management of the currency.
   B) the nation will reverse course and begin accumulating foreign currency reserves.
   C) reserves will run out, the money supply and inflation will rise, and after that point the fixed exchange rate cannot be sustained.
   D) the government will be forced to give up control of the central bank.
85. Because of speculative attacks due to the belief a fixed rate will fail, pegged exchange rates:
   A) usually exhibit a long, lingering decline and eventual failure.
   B) often collapse suddenly.
   C) will be revived as the central bank has a wake-up call from the financial sector.
   D) are usually not a good idea in the first place.

86. In general, when there is a large shock to domestic output, the government finds that:
   A) it is less difficult to maintain the peg.
   B) maintaining the peg carries a higher present and future cost, especially if credibility is low.
   C) it is impossible to maintain the peg.
   D) central bankers are insensitive to the concerns of the population.

87. Whenever the market believes there will be a depreciation (the peg will break) then:
   A) the benefits of pegging are greater than the costs of maintaining the peg.
   B) the benefits of depreciation increase relative to the costs of depreciation.
   C) the benefits of pegging are negative.
   D) there are never any benefits from depreciation.

88. A recent phenomenon is the tendency of emerging market economies to accumulate excess foreign currency reserves so that their backing ratios exceed 100%. What possible reasons could explain this activity? Is it a sound economic policy? Why or why not? (Please write your answer in a separate page.)

89. Some remedies and preventive measures have been put forth to slow or forestall currency crises, such as capital controls and intermediate regimes. Discuss these measures and comment on whether they would be effective—why or why not. (Please write your answer in a separate page.)