International Balance of Payments
Homework 4

Name___________________________________

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

1) Barbados
   A) pegs its exchange rate to the French franc.
   B) pegs its exchange rate to the German DM.
   C) pegs its exchange rate to the British pound.
   D) pegs its exchange rate to the U.S. dollar.
   E) does not peg its currency.

2) 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 an increased home money demand.
   B) 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.
   C) 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.
   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 supply.
   E) None of the above statement is true.

3) By fixing the exchange rate, the central bank gives up its ability to
   A) influence the economy through fiscal policy
   B) increase government spending
   C) influence the economy through monetary policy
   D) depreciate the domestic currency
   E) adjust taxes
4) Australia and Poland managed their exchange rates
   A) under a currency board exchange rate regime
   B) under a flexible exchange rate regime
   C) under a managed floating exchange rate regime
   D) under a fixed exchange rate regime
   E) None of the above.

5) From 1837 and up until the Civil War, the United States adhered to a
   A) silver standard
   B) bimetallic standard
   C) gold standard
   D) bronze standard
   E) None of the above.

6) After introducing the Real as its new currency in 1994, Brazil
   A) experienced high domestic interest rates
   B) experienced bank failures
   C) lost competitiveness in foreign markets since the Real experienced a real appreciation
   D) reduced its annual rate of inflation
   E) All of the above.

7) Senegal
   A) pegs its exchange rate to the German DM.
   B) pegs its exchange rate to the British pound.
   C) pegs its exchange rate to the U.S. dollar.
   D) pegs its exchange rate to the French franc.
   E) does not peg its currency.

8) Why is the reserve center in the reserve currency fixed rate system asymmetric?
   A) The center country has to intervene all the time and regulate the balance of payments.
   B) Other countries fix their exchange rate to the reserve currency, and there is no exchange rate
      left for the reserve center to fix.
   C) The reserve center fixes its exchange rate against the reserve currency, and all other countries
      are subject to that rate.
   D) The center country never has to intervene and bears none of the burden of financing its
      balance of payments.
   E) Both B and D.
9) Under fixed exchange rate, which one of the following statements is the most accurate?
   A) Devaluation has no effect on output.
   B) Devaluation causes a decrease in output and in official reserves.
   C) Devaluation causes a decrease in output.
   D) Devaluation causes a rise in output.
   E) Devaluation causes a rise in output and a decrease in official reserves.

10) When a country’s currency is devalued:
    A) The money supply decreases.
    B) Output increases.
    C) Output decreases.
    D) The money supply increases.
    E) Both B and D.

11) Under fixed rates, which one of the following statements is the most accurate?
    A) Monetary policy can not affect international reserves.
    B) Monetary policy can affect only international reserves.
    C) Monetary policy can affect only output.
    D) Monetary policy can affect only employment.
    E) None of the above statements is true.

12) We study the system of fixed exchange rate because,
    A) Regional currency arrangements use fixed exchange rates.
    B) Many developing and countries in transition use fixed exchange rates.
    C) As lessons of the past for the future.
    D) Most exchange systems are not clean floats but dirty floats.
    E) All of the above statements are true.

13) Currency crises may result from
    A) speculative attacks on the currency
    B) excessive purchases of government bonds by central banks
    C) an increase in foreign reserves
    D) A and B.
    E) A and C.
14) Which one of the following statements is the most accurate?

A) Appreciation is a fall in E when the exchange rate floats while revaluation is a fall in E when the exchange rate is fixed.

B) Appreciation is a rise in E when the exchange rate floats while revaluation is a fall in E when the exchange rate is fixed.

C) Appreciation is a fall in E when the exchange rate is fixed while revaluation is a fall in E when the exchange rate is flexible.

D) Appreciation is a fall in E when the exchange rate floats while revaluation is a rise in E when the exchange rate is fixed.

E) None of the above.

15) During the Great depression of the 1930s,

A) The real interest rate hit zero in the United States.

B) The nominal interest rate hit 2 percent in the United States.

C) The nominal interest rate hit one percent in the United States.

D) The real interest rate hit 2 percent in the United States.

E) The nominal interest rate hit zero in the United States.

16) A balance of payments crisis is best described as a

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

E) None of the above.

17) The signaling effect of foreign exchange intervention

A) never has any affect on exchange rates

B) can cause an immediate exchange rate change even when bonds denominated in different currencies are perfect substitutes

C) can alter the market's view of future monetary or fiscal policies

D) A and B.

E) B and C.
18) Argentina, Bulgaria, China and Hong Kong managed their exchange rates
   A) under a managed floating exchange rate regime
   B) under a fixed exchange rate regime
   C) under a currency board exchange rate regime
   D) under a flexible exchange rate regime
   E) None of the above.

19) A central bank's international reserves include
   A) only foreign and domestic assets
   B) any silver that it owns
   C) any silver that it owns and foreign and domestic assets
   D) any gold that it owns
   E) any gold that it owns and foreign and domestic assets

20) In the interest rate parity condition with imperfect substitutes and a risk premium of \( \rho \)
   A) An increased stock of domestic government debt will have no effect on the difference between the expected returns on domestic and foreign currency bonds
   B) A decreased stock of domestic government debt will raise the difference between the expected returns on domestic and foreign currency bonds
   C) An increased stock of domestic government debt will raise the difference between the expected returns on domestic and foreign currency bonds
   D) An increased stock of domestic government debt will reduce the difference between the expected returns on domestic and foreign currency bonds
   E) None of the above.

21) Perfect asset substitutability is the assumption that
   A) the foreign exchange market is in equilibrium only when expected returns on domestic assets are greater than returns on foreign currency bonds
   B) the foreign exchange market is in equilibrium only when domestic assets are risk-free
   C) the foreign exchange market is in equilibrium only when expected returns on domestic assets are equal to returns on foreign currency bonds
   D) the foreign exchange market is in equilibrium only when expected returns on foreign currency bonds are greater than returns on domestic assets
   E) the foreign exchange market is in equilibrium only when expected returns on all assets are negative
22) Under fixed exchange rate, which one of the following statements is the most accurate?

A) Devaluation causes a rise in output, a rise in official reserves, and an expansion of the money supply.
B) Devaluation causes a rise in official reserves, and an expansion of the money supply.
C) Devaluation causes a rise in output and an expansion of the money supply.
D) Devaluation causes a rise in output and a rise in official reserves.
E) Devaluation causes a decrease in output, a decrease in official reserves, and a contraction of the money supply.

23) The liabilities side of a central bank include

A) currency in circulation
B) deposits held by the private banks, foreign assets, and currency in circulation
C) deposits held by the private banks
D) deposits held by the private banks and currency in circulation
E) None of the above

24) Which one of the following statements is the most accurate?

A) Devaluation reflects a deliberate government decision.
B) Devaluation and depreciation have the same meaning and the same causes.
C) Devaluation reflects a deliberate government decision while depreciation is an outcome of government actions and market forces acting together.
D) Depreciation reflects a deliberate government decision while devaluation is an outcome of government actions and market forces acting together.
E) Depreciation reflects a deliberate government decision.

25) Under fixed exchange rate, in general which one of the following statements is the most accurate?

A) The following condition should hold for domestic money market equilibrium: \( M^s/P = L(R, Y) \).
B) The following condition should hold for domestic money market equilibrium: \( M^d/P = L(R^*, Y) \).
C) The following condition should hold for domestic money market equilibrium: \( M^s = L(R^*, Y) \).
D) The following condition should hold for domestic money market equilibrium: \( M^s/P = L(R^*, Y) \).
E) The following condition should hold for domestic money market equilibrium: \( P = L(R^*, Y) \).
26) Which one of the following statements is the most accurate?

A) Fiscal policy cannot affect employment under fixed exchange rate but does affect output under flexible exchange rate regimes.

B) Fiscal policy has the same effect on employment under fixed and flexible exchange rate regimes.

C) Fiscal policy affects employment more under fixed than under flexible exchange rate regimes.

D) Fiscal policy affects employment less under fixed than under flexible exchange rate regimes.

E) None of the above statements is true.

27) Which one of the following statements is the most accurate?

A) Under a fixed exchange rate, fiscal policy tools are powerless to affect the economy's money supply or its output.

B) Under a dirty float exchange rate, central bank monetary tools are powerless to affect the economy’s money supply or its output.

C) Under a flexible exchange rate, central bank monetary tools are powerless to affect the economy’s money supply or its output.

D) Under a fixed exchange rate, central bank monetary tools are powerless to affect the economy’s money supply.

E) Under a flexible exchange rate, central bank monetary tools are powerful and do affect the economy's output.

28) Which one of the following statements is most true?

A) Any central bank purchase of assets results in an increase in the domestic money supply, while any central bank sale of assets causes the money supply to decline.

B) Any central bank purchase of assets automatically results in an increase in the domestic money supply, while any central bank sale of assets automatically causes the money supply to decline.

C) Any central bank purchase of assets automatically results in a decrease in the domestic money supply, while any central bank sale of assets automatically causes the money supply to decline.

D) Any central bank purchase of assets automatically results in a decrease in the domestic money supply, while any central bank sale of assets automatically causes the money supply to increase.
SHORT ANSWER. Write the word or phrase that best completes each statement or answers the question.

29) Examine this graph and comment on the trends of foreign reserves and interest rates in Brazil within the context of the Real’s devaluation in January of 1999.

30) Using a figure, show how devaluation affects an economy.

31) Using a figure show the simultaneous equilibrium of the foreign exchange and domestic money markets when the exchange rate is fixed at E₀ and is expected to remain fixed at E₀ in the future. Assume both P and Y are constants. Now, study the effect of an increase in income, Y.

32) Under fixed exchange rate, show using a figure, the effects of an expansionary fiscal policy. Show the equilibrium under a flexible exchange rate. Discuss the difference in the two regimes.
29) When Brazil devalued the Real in January, 1999, Brazilian exports became cheaper for the rest of the world. The restored export competitiveness helped to alleviate Brazil's balance of payments crisis and improve its trade deficit. With confidence in the economy restored, foreign investment in the country began to pick up again, leading to a rise in foreign reserves. At the same time, the increased investor confidence and belief in the stability of Brazil meant that the government no longer had to keep its interest rates high in order to attract foreign investment. Consequently, interest rates started to fall shortly after the devaluation.
30) When a currency is devalued from $E^0$ to $E^1$, the equilibrium shifts from point 1 to 2. Both output and money supply increase.

31) See figure. The $L(R^*, Y)$ will shift down and to the right, which will necessitate an increase in $M$ to $M_2$. This will require the domestic central bank to purchase foreign assets and thereby increase the money supply, leaving $E$ at $E^0$. Note that $R = R^*$ at the new equilibrium as before.
32) An expansionary fiscal policy shifts the DD curve to the right. Under flexible exchange rate, point 2 in the figure is the equilibrium, e decreases (appreciates) and Y goes up. The picture is more complicated under fixed exchange rate, however, since E cannot change. Output is going up as a result of the fiscal expansion, and thus the demand for domestic money increases. To prevent the increased money demand from increase domestic interest rate above $R^*$, and with the appreciation of the currency, the central bank must buy foreign assets with domestic money and thereby increase the money supply. The AA shifts to the right until E is restored to the initial fixed exchange rate, $E^0$, at point 3 in the figure. So under fixed exchangerate, Y will increase by more than under flexible exchange rate regime. Unlike monetary policy, fiscal policy can be used to affect output under a fixed exchange rate. A central bank is forced to expand the money supply through foreign exchange purchases.