INSTRUCTIONS. Choose the one alternative that best completes the statement or answers the question. Mark your answer in the scantron card. Good luck!

1) Under a flexible-price monetary approach to the exchange rate,
   A) When the domestic money supply falls, the price level would fall right away, keeping the interest rate constant
   B) When the domestic money supply falls, the price level would eventually fall, keeping the interest rate constant
   C) When the domestic money supply falls, the price level would eventually fall, increasing the interest rate.
   D) When the domestic money supply falls, the price level would fall right away, causing an increase in the interest rate.
   E) When the domestic money supply falls, the price level would fall right away, causing a reduction in the interest rate.

2) In the AA-DD model, and in the short-run, a temporary increase in fiscal expenditure causes
   A) A shift of the DD curve to the right, output increases and the currency depreciates
   B) A shift of the DD curve to the left, output decreases and the currency depreciates
   C) A shift of the DD curve to the right, output decreases and the currency appreciates
   D) A shift of the DD curve to the right, output increases and the currency appreciates
   E) A shift of the DD curve to the left, output increases and the currency appreciates

3) If the representative basket of European goods and services costs 40 euros, the representative U.S. basket costs $50, and the dollar/euro exchange rate is $0.90 per euro, then the price of the European basket in terms of U.S. basket is
   A) [(40 euro per a European basket)]/[(50 $/U.S. basket) (0.9 $/euro)]
   B) [(0.9 $/euro) (40 euro per a European basket)]/[(50 $/U.S. basket)]
   C) (0.9 $/euro) (40 euro per a European basket)(50 $/ U.S. basket)
   D) [(50 $/U.S. basket)]
   E) [(0.9 $/euro) (50 $/U.S. basket)]/[(40 euro per a European basket)]

4) Assume that the price level is sticky in the short run. If the domestic money supply increases permanently, what is true during the transition to the long run?
   A) The exchange rate will be constant at its new, long run level
In the AA-DD model, if the economy starts in long-run equilibrium, a permanent fiscal expansion will cause
A) An exchange rate depreciation
B) An increase in output, Y
C) Shifting of the AA curve up and to the right
D) A decrease in output, Y
E) An appreciation of the domestic currency

How is the AA schedule derived?
A) It is the schedule of exchange rate and output combinations that are consistent with equilibrium in the foreign money market and the domestic exchange market.
B) It is the schedule of interest rate and output combinations that are consistent with equilibrium in the domestic money market and the foreign exchange market.
C) It is the schedule of exchange rate and output combinations that are consistent with equilibrium in the domestic money market and the foreign exchange market.
D) It is the schedule of exchange rate and output combinations that are consistent with equilibrium in the domestic bond market and the foreign asset market.
E) None of the above.

In the short run, a permanent increase in the domestic money supply
A) Has stronger effects on output but weaker effects on the exchange rate than an equal temporary increase
B) Has stronger effects only on the exchange rate, not on output, than an equal temporary increase
C) Has weaker effects on the exchange rate and output than an equal temporary increase
D) Has stronger effects on the exchange rate and on output than an equal temporary increase
E) None of the above.

Given the price level and output in the U.S.,
A) An increase in the European money supply causes the euro to appreciate against the dollar, and it creates excess demand for dollars in the U.S. money market.
B) An increase in the European money supply causes the euro to depreciate against the dollar, and it creates excess demand for dollars in the U.S. money market.
C) An increase in the European money supply causes the euro to appreciate against the dollar, but it does not disturb the U.S. money market equilibrium.
D) An increase in the European money supply causes the euro to depreciate against the dollar, but it does not disturb the U.S. money market equilibrium.
E) None of the above statements is true.

Suppose that, due to some shock, the expected future value of the dollar in terms of euros falls. If the interest rates on dollar deposits and euro deposits do not change, the current value of the dollar in terms of euros:
A) It is impossible to tell
B) Must increase
C) Must fall
D) Remains unchanged
10) In the long-run equilibrium, a permanent money-supply increase results in:
   A) An increase in output, Y
   B) A depreciation of the domestic currency
   C) A decrease in output, Y
   D) An appreciation of the domestic currency
   E) Both B and D.

11) In the long run, a permanent increase in a country’s money supply:
   A) leaves its price level constant in long-run equilibrium.
   B) causes a proportional increase in its price level.
   C) causes a less than proportional increase in its price level.
   D) causes a more than proportional increase in its price level.
   E) None of the above.

12) Which of the following statements is most consistent with empirical evidence?
   A) PPP appears to be of limited use even as a long-run explanation of exchange rate movements.
   B) PPP appears to be of limited use as a short-run explanation of exchange rate movements.
   C) PPP appears to be of limited use even as a short-run explanation of exchange rate movements.
   D) Relative PPP appears to be of limited use even as a short-run explanation of exchange rate movements.
   E) None of the above statements is true.

13) If the dollar interest rate is 10 percent and the euro interest rate is 6 percent, and the expected return on dollar depreciation against the euro is eight percent, then
   A) An investor should invest only in dollars.
   B) An investor should be indifferent between dollars and euros.
   C) An investor should invest only in euros.
   D) It is impossible to tell given the information.
   E) All of the above.

14) Which one of the following statements is the most accurate?
   A) Relative price changes could not lead to PPP violations even if trade were free and costless.
   B) Relative price changes could lead to PPP violations only if trade were free and costless.
   C) Relative price changes could lead to PPP violations even if trade were free and costless.
   D) Price changes must always lead to PPP violations if trade were free and costless.
   E) None of the above statements is true.

15) How many British pounds would it cost to buy a pair of American designer jeans costing $45 if the exchange rate is 1.80 dollars per British pound?
   A) 20 British pounds
   B) 10 British pounds
   C) 30 British pounds
   D) 40 British pounds
   E) 25 British pounds
16) A sustained increase in the monetary growth rate will,
   A) eventually affect equilibrium nominal money balances by reducing the money interest rate.
   B) eventually affect equilibrium real money balances by raising the money interest rate.
   C) immediately affect equilibrium real money balances by raising the money interest rate.
   D) eventually affect equilibrium real money balances by raising the real interest rate.
   E) eventually affect equilibrium real money balances by reducing the money interest rate.

17) Which of the following statements is most accurate?
   A) A relative expansion of U.S. output causes a long-run depreciation of the dollar against the euro, while a relative decline of European output causes a long-run real appreciation of the dollar against the euro
   B) A relative decline of U.S. output causes a long-run depreciation of the dollar against the euro, while a relative decline of European output causes a long-run real appreciation of the dollar against the euro
   C) A relative expansion of U.S. output causes a long-run appreciation of the dollar against the euro, while a relative expansion of European output causes a long-run real depreciation of the dollar against the euro
   D) A relative expansion of U.S. output causes a long-run depreciation of the dollar against the euro, while a relative expansion of European output causes a long-run real appreciation of the dollar against the euro
   E) A relative decline of U.S. output causes a long-run depreciation of the dollar against the euro, while a relative expansion of European output causes a long-run real appreciation of the dollar against the euro

18) In the short-run, a temporary increase in the money supply
   A) Shifts the AA curve to the right, increases output and depreciates the currency
   B) Shifts the AA curve to the left, increases output and appreciates the currency
   C) Shifts the AA curve to the left, increases output and depreciates the currency
   D) Shifts the AA curve to the right, increases output and appreciates the currency
   E) Shifts the AA curve to the left, decreases output and depreciates the currency

19) Which major actor is at the center of the foreign exchange market?
   A) Central banks
   B) Corporations
   C) Non-bank financial institutions
   D) Commercial banks
   E) None of the above.

20) If the price level is slow to adjust, after a permanent increase in the domestic money supply,
    A) The exchange rate smoothly depreciates in the short run.
    B) The exchange rate smoothly appreciates in the short run.
    C) The exchange rate overshoots in the short run.
    D) The exchange rate overshoots in the long run.
    E) None of the above.

21) Which one of the following statements is the most accurate?
    A) A depreciation of a country’s currency makes its goods cheaper for foreigners.
    B) A depreciation of a country’s currency makes its goods more expensive for foreigners.
    C) A depreciation of a country’s currency makes its goods cheaper for its own residents.
22) For all the main industrial countries in recent years,
   A) The exchange rate is much less variable than relative price levels.
   B) The exchange rate is as variable as the relative price levels.
   C) The exchange rate is much more variable than relative price levels.
   D) It is hard to tell from the data whether the exchange rate is much more variable than relative price levels.
   E) None of the above.

23) In the short-run, a rise in the exchange rate, i.e. currency depreciation,
   A) Lowers aggregate demand and raises output
   B) Raises aggregate demand and does not affect output
   C) Raises aggregate demand and raises output.
   D) Raises aggregate demand and lowers output
   E) Lowers aggregate demand and lowers output

24) Which of the following statements is most accurate?
   A) The United States price level will place a relatively light weight on commodities produced and consumed in Europe, and the European price level will place a relatively heavy weight on commodities produced and consumed in America
   B) The United States price level will place a relatively heavy weight on commodities produced and consumed in America, and the European price level will place a relatively heavy weight on commodities produced and consumed in Europe
   C) The United States price level will place a relatively light weight on commodities produced and consumed in America, and the European price level will place a relatively light weight on commodities produced and consumed in Europe
   D) The United States price level will place a relatively light weight on commodities produced and consumed in America, while the European price level will place a relatively heavy weight on commodities produced and consumed in Europe
   E) The United States price level will place a relatively heavy weight on commodities produced and consumed in Europe, and the European price level will place a relatively heavy weight on commodities produced and consumed in America

25) An economy’s long-run equilibrium is
   A) The equilibrium that would occur if prices were perfectly fixed at the full employment point.
   B) The equilibrium that would occur if prices were perfectly flexible.
   C) The equilibrium that would occur if prices were perfectly fixed to preserve full employment.
   D) The equilibrium that would occur if prices were perfectly flexible and always adjusted immediately.
   E) The equilibrium that would occur if prices were perfectly flexible and always adjusted immediately to preserve full employment.

26) Under the assumptions of the AA-DD model, in the short-run a fall in the foreign price level, \( P^* \), will cause
   A) An upward shift in the aggregate demand function and an expansion of output
   B) A downward shift in the aggregate demand function and an expansion of output
   C) An upward shift in the aggregate demand function but leaves output intact
D) An downward shift in the aggregate demand function and a reduction in output
E) An upward shift in the aggregate demand function and a reduction in output

27) In a graph with \( Y \) measured along the horizontal axis and \( R \) along the vertical axis, the aggregate real money demand schedule \( L(R,Y) \):
   A) Has a zero slope because a fall in the interest rate keeps constant the desired real money holdings of each household and firm in the economy
   B) Slopes downward because a fall in the interest rate raises the desired real money holdings of each household and firm in the economy
   C) Slopes downward because a fall in the interest rate reduces the desired real money holdings of each household and firm in the economy
   D) Slopes upward because a fall in the interest rate raises the desired real money holdings of each household and firm in the economy
   E) None of the above.

28) Which one of the following statements is the most accurate?
   A) Given \( P_{US} \) and \( Y_{US} \), when the money supply rises, the dollar interest rate declines and the dollar depreciates against the euro.
   B) Given \( P_{US} \) and \( Y_{US} \), when the money supply rises, the dollar interest rate declines and the dollar appreciates against the euro.
   C) Given \( P_{US} \), when the money supply rises, the dollar interest rate declines and the dollar depreciates against the euro.
   D) Given \( Y_{US} \), when the money supply rises, the dollar interest rate declines and the dollar depreciates against the euro.
   E) Given \( P_{US} \) and \( Y_{US} \), when the money supply decreases, the dollar interest rate declines and the dollar depreciates against the euro.

29) Which of the following statements is the most accurate?
   A) Expectations about long–run movements in exchange rates are not important the short run.
   B) Expectations about long–run movements in exchange rates are often not important in the short run.
   C) Expectations about long–run movements in exchange rates are important only in the long run.
   D) Expectations about long–run movements in exchange rates are important even in the short run.
   E) None of the above.

30) In 2004,
   A) 30 percent of foreign exchange transactions involved exchanges of foreign currencies for U.S. dollars.
   B) 40 percent of foreign exchange transactions involved exchanges of foreign currencies for U.S. dollars.
   C) 20 percent of foreign exchange transactions involved exchanges of foreign currencies for U.S. dollars.
   D) 90 percent of foreign exchange transactions involved exchanges of foreign currencies for U.S. dollars.
   E) 10 percent of foreign exchange transactions involved exchanges of foreign currencies for U.S. dollars.

31) Under Purchasing Power Parity,
   A) \( E$/E = P_{US} + P_E \)
   B) \( E$/E = P_E/P_{ES} \)
   C) \( E$/E = P_{US} - P_E \)
   D) \( E$/E = P_{US}/P_E \)
32) Suppose that the expected future price of euros in terms of dollars is equal to $1.113 per euro. Further, assume that the current (spot) exchange rate is $1.05 per euro, and the interest rate on dollar deposits is 10 percent and on euro it is 4 percent. Under these assumptions,
   A) Interest parity does hold.
   B) Interest parity does not hold.
   C) It is hard to tell whether interest parity does or does not hold.
   D) Not enough information is given to answer the question.
   E) None of the above.

33) Under the monetary approach to the exchange rate theory, money supply growth at a constant rate
   A) Eventually results in ongoing price level inflation at the same rate, but changes in this long-run inflation rate do affect the full-employment output level and the long-run relative prices of goods and services
   B) Eventually results in ongoing price level inflation at the same rate, but changes in this long-run inflation rate do not affect the full-employment output level or the long-run relative prices of goods and services
   C) Eventually results in ongoing price level inflation at the same rate, but changes in this long-run inflation rate do not affect the full-employment output level, only the long-run relative prices of goods and services
   D) Eventually results in ongoing price level deflation at the same rate, but changes in this long-run deflation rate do not affect the full-employment output level or the long-run relative prices of goods and services
   E) None of the above statement is true.

34) Which of the following statements is the most accurate? The law of one price states:
   A) In competitive markets free of transportation costs and official barrier to trade, identical goods sold in different countries must sell for the same price.
   B) In competitive markets free of transportation costs and official barrier to trade, identical goods sold in different countries must sell for the same price when their prices are expressed in terms of the same currency.
   C) Identical goods sold in different countries must sell for the same price when their prices are expressed in terms of the same currency.
   D) In competitive markets free of transportation costs and official barrier to trade, identical goods sold in the same country must sell for the same price when their prices are expressed in terms of the same currency.
   E) None of the above.

35) The aggregate money demand depends on
   A) The price level
   B) The interest rate
   C) Real national income
   D) All of the above.
   E) Only A and C.

36) Which one of the following statements is the most accurate?
A) The dollar rate of return on euro deposits is approximately the euro interest rate minus the rate of depreciation of the dollar against the euro.
B) The dollar rate of return on euro deposits is equal to the euro interest rate.
C) The dollar rate of return on euro deposits is approximately the euro interest rate plus the rate of appreciation of the dollar against the euro.
D) The dollar rate of return on euro deposits is approximately the euro interest rate plus the rate of depreciation of the dollar against the euro.
E) The dollar rate of return on euro deposits is the euro interest rate minus the rate of depreciation of the dollar against the euro.

37) The J-curve illustrates which of the following?
   A) The gradual adjustment of home prices to a currency depreciation
   B) The immediate increase in current account caused by a currency depreciation
   C) The effects of depreciation on the home country’s economy
   D) The Keynesian view of international trade dynamics
   E) The short-term effects of an exchange rate depreciation on the current account

38) How is the AA schedule derived?
   A) The AA schedule has a positive slope because an increase in output leads to a depreciation of the currency.
   B) The AA schedule has a negative slope because an increase in output leads to an increase in the domestic interest rate.
   C) The AA schedule has a positive slope because an increase in the money supply leads to an increase in the domestic interest rate.
   D) The AA schedule has a negative slope because an increase in output leads to a decrease in the domestic interest rate.
   E) None of the above.

39) What is the most accurate statement under the monetary approach to the exchange rate?
   A) A rise in the money supply will cause depreciation.
   B) A rise in the money supply will cause immediate currency depreciation.
   C) A reduction in the money supply will cause immediate currency depreciation.
   D) A rise in the money supply will cause currency depreciation.
   E) A rise in the money supply will cause immediate currency appreciation.

40) A main reason why the exchange rate overshooting result is important is that:
   A) It explains why interest rates may differ across countries
   B) It explains why price levels fluctuate so wildly
   C) It explains why output may increase or fall
   D) It explains why exchange rates may react more than proportionately to changes in monetary policy

41) If the dollar interest rate is 10 percent and the euro interest rate is 6 percent, then
   A) An investor should invest only in dollars.
   B) An investor should be indifferent between dollars and euros.
   C) An investor should invest only in euros.
   D) Given the information, it is impossible to tell what investors should do.
   E) All of the above.
42) Which of the following statements is the most accurate?
A) If PPP holds true, then the law of one price holds true for every commodity as long as the reference baskets used to calculate different countries’ price levels are the same.
B) If the law of one price does not hold true for every commodity, PPP cannot be true as long as the reference baskets used to calculate different countries’ price levels are the same.
C) If the law of one price holds true for every commodity, PPP must automatically hold as long as the reference baskets used to calculate different countries’ price levels are the same.
D) If the law of one price holds true for every commodity, PPP must hold automatically.
E) None of the above statements is true.

43) Forward and spot exchange rates
A) The forward exchange rate is always above the spot exchange rate.
B) Are necessarily equal
C) While not necessarily equal, do move closely together.
D) Do not move closely together
E) None of the above.

44) Which of the following statements is the most accurate?
A) A rise in the interest rate paid by euro deposits causes the dollar to depreciate.
B) A rise in the interest rate paid by euro deposits does not affect the value of the dollar.
C) For a given U.S. interest rate and a given expectation with regards to the future exchange rate, a rise in the interest rate paid by euro deposits causes the dollar to depreciate.
D) For a given U.S. interest rate and a given expectation with regards to the future exchange rate, a rise in the interest rate paid by euro deposits causes the dollar to appreciate.
E) None of the above.

45) Which of the following statements is the most empirically accurate?
A) The prices of identical commodity baskets, when converted to a single currency, are often the same across countries.
B) The prices of identical commodity baskets, when converted to a single currency, do not differ substantially across countries.
C) The prices of identical commodity baskets, when converted to a single currency, are the same across countries.
D) The prices of identical commodity baskets, when converted to a single currency, differ substantially across countries.
E) None of the above statements is true.

46) Which one of the following statements is the most accurate?
A) A rise in the average value of transactions carried out by a household or a firm causes its demand for money to fall.
B) A reduction in the average value of transactions carried out by a household or a firm causes its demand for money to rise.
C) A rise in the average value of transactions carried out by a household or a firm causes its demand for nominal money to rise.
D) A rise in the average value of transactions carried out by a household or a firm causes its demand for money to rise.
47) In the short run, with prices fixed, how would an increase in government spending affect the DD-AA schedule?
   A) It will decrease output and appreciate the currency.
   B) It will increase output and appreciate the currency.
   C) It will increase output and depreciate the currency.
   D) It will decrease output and depreciate the currency.
   E) None of the above.

48) If people expect relative PPP to hold,
   A) The difference between the real interest rates offered by dollar and euro deposits will equal the difference between the inflation rates expected, over the relevant horizon, in the United States and Europe.
   B) The difference between the nominal interest rates offered by dollar and euro deposits will equal the difference between the inflation rates expected, over the relevant horizon.
   C) The difference between the nominal interest rates offered by dollar and euro deposits will be above the difference between the inflation rates expected, over the relevant horizon, in the United States and Europe.
   D) The difference between the real interest rates offered by dollar and euro deposits will equal the difference between the inflation rates expected in Europe and the United States.
   E) None of the above statements is true.

49) Under the assumptions of the AA-DD model, which one of the following statements is the most accurate?
   A) A decrease in the real exchange rate and a decrease in disposable income improve the current account.
   B) An increase in the real exchange rate and a decrease in disposable income improve the current account.
   C) An increase in the real exchange rate and an increase in disposable income improve the current account.
   D) A decrease in the real exchange rate and an increase in disposable income improve the current account.
   E) None of the above.

50) Which of the following statements is the most accurate?
   A) Relative PPP implies absolute PPP.
   B) Absolute PPP implies relative PPP.
   C) Absolute PPP does not imply relative PPP.
   D) There is no causality relation between the two.
   E) None of the above statements is true.
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32) As discussed in class, all of you got credit for this question (due to the fact that it was not stated whether interest parity had to hold exactly or approximately).

49) A or B (depending on the meaning of "increase" or "decrease," as discussed in class).

50) B