

- (1) Under perfect capital mobility and fixed exchange rates,
- (a) Monetary policy is not an effective policy.
 - (b) Fiscal policy is not an effective policy.
 - (c) Monetary policy and fiscal policy are not effective.
 - (d) Both monetary and fiscal policies are effective.
 - (e) None of the above.

Answer: A

- (2) A fixed exchange rate regime may be forced to collapse by
- (a) excessive purchases of government bonds by central banks
 - (b) speculative attacks on the currency
 - (c) an increase in foreign reserves
 - (d) (a) and (b)
 - (e) (a) and (c)

Answer: D

- (3) In theory, under flexible exchange rates,
- (a) No country would be forced to import only inflation from abroad.
 - (b) No country would be forced to import only deflation from abroad.
 - (c) No country would be forced to import inflation and deflation from abroad.
 - (d) Flexible exchange rates are not able to halt importing inflation from abroad.
 - (e) Flexible exchange rates are not able to halt importing deflation from abroad.

Answer: C

- (4) In an optimum currency area, candidates for a single currency should
- (a) share a common language
 - (b) share a common history
 - (c) have well integrated factor and goods markets
 - (d) have limits on capital flows to prevent contagion

Answer: c

- (5) When countries have a single currency
- (a) they are unable to run fiscal deficits
 - (b) speculative attacks on the currency may cause the exchange rate to be abandoned
 - (c) unemployment will be the same in both countries
 - (d) they must also share a common government
 - (e) they will be unable to run independent monetary policies

Answer: E

(6) Under strict purchasing power parity,

- (a) Exchange rates *immediately* move to offset *exactly* national differences in *inflation*.
- (b) Exchange rates eventually move to offset *exactly* national differences in *inflation*.
- (c) Exchange rates eventually move to offset *to some extent* national differences in *inflation*.
- (d) Exchange rates eventually move to offset exactly national differences in *unemployment*.
- (e) None of the above.

Answer: A

(7) The expectation of future devaluation causes a balance of payments crisis marked by

- (a) a sharp rise in reserves and a fall in the home interest rate below the world interest rate
- (b) a sharp fall in reserves and an even bigger fall in the home interest rate below the world interest rate
- (c) a sharp fall in reserves and a rise in the home interest rate above the world interest rate
- (d) a sharp rise in reserves and an even greater rise in the home interest rate above the world interest
- (e) None of the above

Answer: C

(8) The AA schedule shows

- (a) Interest rate and output pairs at which the foreign exchange market and the domestic money market are in equilibrium.
- (b) Exchange rate and output pairs at which the foreign exchange market and the domestic money market are in equilibrium.
- (c) Interest rate and output pairs at which only the foreign exchange market is in equilibrium.
- (d) Exchange rate and output pairs at which only the foreign exchange market is in equilibrium.
- (e) None of the above.

Answer: B

(9) Under Bretton Woods,

- (a) Any foreign country cannot devalue its currency against the dollar in conditions of "fundamental disequilibrium."
- (b) Any foreign country could devalue its currency against the dollar in conditions of "fundamental disequilibrium," but the system's rules did not give the United States the option of devaluing against foreign currencies.
- (c) Any foreign country could devalue its currency against the dollar in conditions of "fundamental disequilibrium," and the system's rules did give the United States the same option of devaluing against foreign currencies.
- (d) The U.S. could devalue its currency against the foreign currencies in conditions of "fundamental disequilibrium."
- (e) None of the above.

Answer: B

(10) The DD schedule shows

- (a) Interest rate and output pairs for which aggregate demand equals aggregate output.
- (b) Exchange rate and output pairs for which aggregate demand equals aggregate output.
- (c) Exchange rate and output pairs for which aggregate supply equals aggregate output.
- (d) Interest rate and output pairs for which aggregate supply equals aggregate output.
- (e) None of the above is true.

Answer: B

(11) A country seeking to maintain internal balance would be most concerned with:

- (a) Attaining low levels of employment
- (b) Ensuring that savings is weighted more towards domestic investment than the current account
- (c) Large fluctuations in output
- (d) An adequate stock of gold reserves
- (e) None of the above.

Answer: C

(12) Due to macroeconomics interdependence between large countries, the effect of a permanent monetary policy expansion by Home is as follows:

- (a) Home output rises, Home's currency depreciates, and Foreign output may rise or fall.
- (b) Home output falls, Home's currency depreciates, and Foreign output may rise or fall.
- (c) Home output rises, Home's currency appreciates, and Foreign output may rise or fall.
- (d) Home output rises, Home's currency depreciates, and Foreign output rises.
- (e) None of the above.

Answer: A

(13) 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 expected returns on foreign currency bonds are greater than returns on domestic assets
- (c) the foreign exchange market is in equilibrium only when expected returns on all assets are negative
- (d) the foreign exchange market is in equilibrium only when expected returns on domestic assets are exactly equal to returns on foreign currency bonds
- (e) the foreign exchange market is in equilibrium only when domestic assets are risk-free

Answer: D

(14) A sterilized foreign exchange intervention carried out by a central bank

- (a) leads to wild fluctuations in the domestic money supply
- (b) leaves the domestic money supply unchanged
- (c) involves no transactions of assets
- (d) All of the above
- (e) None of the above

Answer: B

(15) A country that joins an exchange rate area

- (a) only gives up its ability to use the exchange rate for the purpose of stabilizing output *and* employment.
- (b) does not give up its ability to use the exchange rate and monetary policy for the purpose of stabilizing output *and* employment.
- (c) gives up its ability to use the exchange rate *and* also gives up its ability to use monetary policy for the purpose of stabilizing output *and* employment.
- (d) gives up its ability to use only monetary policy for the purpose of stabilizing output and employment.
- (e) does not give up its ability to use only monetary policy for the purpose of stabilizing output *and* employment.

Answer: C

(16) The *theory of optimum currency areas* predicts that

- (a) floating exchange rates are most appropriate for areas closely integrated through international trade and factor movements
- (b) fixed exchange rates are most appropriate for areas that are loosely integrated through international trade and factor movements
- (c) fixed exchange rates are most appropriate for areas closely integrated through international trade and factor movements
- (d) floating exchange rates are most appropriate for all countries in Europe
- (e) fixed exchange rates are most appropriate for all countries in Europe

Answer: C

(17) Under a fixed exchange rate, the response of an economy to a temporary fall in foreign demand for its exports is

- (a) The currency appreciates, and output falls.
- (b) The currency depreciates, and output falls.
- (c) The currency remains the same, and output decreases.
- (d) The currency depreciates, and output remains constant.
- (e) None of the above.

Answer: C

(18) Under a *fixed* rate regime pegged to the dollar, foreign countries could hold their dollar exchange rates constant by

- (a) Using tight monetary policy.
- (b) Using expansionary fiscal policy.
- (c) Negotiating with the central bank of the United States.
- (d) Setting their domestic interest rate equal to the U.S. interest rate.
- (e) Holding their exchange rates constantly pegged to the euro and yen.

Answer: D

(19) During economic downturns, the ability of factors to migrate abroad

- (a) reduces the severity of unemployment and the fall in the rate of return available to investors.
- (b) increases the severity of unemployment and the fall in the rate of return available to investors.
- (c) reduces the severity of unemployment but increases the fall in the rate of return available to investors.
- (d) cannot change the severity of unemployment and the constant rate of return available to investors.
- (e) None of the above.

Answer: A

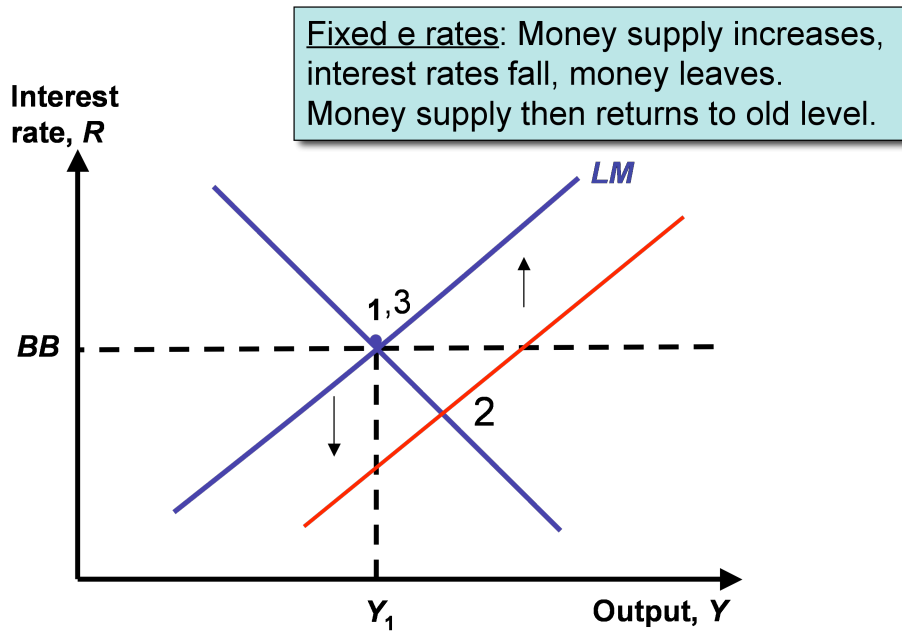
(20) The term *contagion* refers to:

- (a) A government's complete control over its banking system
- (b) A drop in interest rates across industrialized countries
- (c) The vulnerability of healthy economies to crises generated by events elsewhere
- (d) None of the Above
- (e) All of the Above

(21) Using the IS-LM system, describe the economy's short-run equilibrium and then explain why monetary policy is either effective or ineffective under a fixed exchange rate system.

Answer:

Using the IS-LM system, the economy starts at point 1. Because we maintain a fixed exchange rate, monetary expansion forces interest rates below world rates. With no change in expectations, money leaves the system and the central bank is forced to sell foreign assets for domestic currency, restoring the rate of interest and the money supply and returning us to point 1 (also point 3).



CONCEPTS YOU SHOULD KNOW:

- Risk premium
- Overshooting
- Balance of Payments Crisis
- Currency Reserves
- Fixed Exchange Rates
- Flexible Exchange Rates
- Contagion
- Optimum Currency Area
- Currency Union
- Internal Balance
- External Balance
- AA, DD, and XX curves
- Mundell-Fleming model