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Financial Markets and International Finance
IK Finanzmärkte und internationale Währungsbeziehungen

PROBLEM SET 5**INSTRUCTIONS:** answer the questions.....

QUESTION

- (1) 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

- (2) Which of the following best defines an *optimum currency area*?
- (a) a group of nations sharing the same currency
 - (b) a group of regions with economies closely linked by trade in goods and services
 - (c) a group of regions with economies closely linked by factor mobility
 - (d) (b) and (c)
 - (e) (a) and (c)

Answer: D

- (3) 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

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- (4) Under ERM 2 rules, the national central bank of an EU member with its own currency can suspend euro intervention operations
- (a) if there is a civil war
 - (b) if they result in money supply changes that threaten to destabilize the domestic price level
 - (c) if there is a current account deficit
 - (d) if there is a current account surplus
 - (e) None of the above

Answer: B

- (5) The 1991 Maastricht Treaty can be best described as
- (a) a peace treaty between Europe and the United States
 - (b) an agreement for the accession of the Netherlands into the EU
 - (c) an agreement for the creation of a free trade area
 - (d) a provision for the introduction of a single European currency and European central bank
 - (e) the beginning of a floating exchange rate European monetary system

Answer: D

- (6) Which one of the following statements is true?
- (a) By *devaluing* its currency, that is, by *lowering* the domestic currency price of foreign currency, a country *can* insulate itself completely from an inflationary increase in foreign prices.
 - (b) By *revaluing* its currency, that is, by *increasing* the domestic currency price of foreign currency, a country can insulate itself completely from an inflationary increase in foreign prices.
 - (c) By *revaluing* its currency, that is, by lowering the domestic currency price of foreign currency, a country *cannot* insulate itself completely from an inflationary increase in foreign prices.
 - (d) By *revaluing* its currency, that is, by *lowering* the domestic currency price of foreign currency, a country *can* insulate itself completely from an inflationary increase in foreign prices.
 - (e) None of the above.

Answer: D

- (7) A country seeking to maintain internal balance would be most concerned with:
- (a) Attaining low levels of unemployment
 - (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: A, C

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- (8) East Asia's crisis was relatively long lived because
- (a) East Asia's financial institutions had encouraged borrowing all together
 - (b) East Asia's financial institutions had encouraged heavy borrowing in local currency
 - (c) East Asia's financial institutions had extended low-interest loans
 - (d) East Asia's financial institutions had extended high-interest loans
 - (e) East Asia's financial institutions had encouraged heavy borrowing in dollars

Answer: E

- (9) Mexico's peso crisis was a result of
- (a) heavy borrowing short term by the government of Mexico in dollars
 - (b) the signing of the North American Free Trade Agreement
 - (c) loss of investor confidence in the sustainability of the exchange rate
 - (d) Mexico's decision to join the World Trade Organization
 - (e) both a and c

Answer: E

- (10) A trend that has been observed in the 1990s and early 2000s in many developing and transition countries was privatization. Privatization refers to:
- (a) Selling large state-owned enterprises to private owners in key areas such as electricity
 - (b) Selling large state-owned enterprises to private owners in key areas such as telecommunications
 - (c) Selling large state-owned enterprises to private owners in key areas such as petroleum
 - (d) (a) and (b) only
 - (e) All of the above

Answer: E

- (11) In the early 1960's South Korea was an extremely poor country. However, in 1963, the country began a remarkable economic ascent. What was a direct cause of this?
- (a) A shift in strategy that emphasized exports rather than imports
 - (b) An increase in wages
 - (c) An increase in the labor force
 - (d) All of the above
 - (e) None of the above

Answer: A

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- (12) What weakness in the economic structures of Asian countries contributed to the severe financial crisis that Asian economies experienced in 1997?
- (a) Productivity; while production inputs increased rapidly, the increase in output per unit of input
 - (b) Banking regulation; banks were not subject to effective government supervision
 - (c) Legal Framework; lack of good legal system to deal with companies in financial trouble
 - (d) (b) and (c) only
 - (e) All of the above
- Answer: E
- (13) As a country begins to liberalize its capital account, what would you expect to happen to the difference between the interest rates for similar assets in this country and another country with open capital markets?
- (a) get larger
 - (b) get smaller
 - (c) stay the same
 - (d) none of the above
 - (e) not enough information
- Answer: B
- (14) The European Economic and Monetary Union
- (a) Set up a single currency and sole bank for European economic monetary policy
 - (b) Eliminated all barriers to trade such as tax differentials between borders
 - (c) Produced a single government for handling European affairs
 - (d) Created the Common Agricultural Pact
 - (e) None of the above.
- Answer: A
- (15) Under the EMS, Germany set the system's
- (a) monetary policy while the other European countries pegged their currencies to the DM.
 - (b) fiscal policy while the other European countries pegged their currencies to the DM.
 - (c) monetary policy while the other European countries kept their currencies fluctuating relative to the DM.
 - (d) fiscal policy while the other European countries kept their currencies fluctuating relative to the DM.
 - (e) None of the above.
- Answer: A
- (16) Which one of the following statements is true?
- (a) A fixed exchange rate automatically cushions the economy's output and employment by allowing an immediate change in the *relative* price of domestic and foreign goods.
 - (b) A flexible exchange rate does not automatically cushion the economy's output and employment by allowing an immediate change in the *relative*

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price of domestic and foreign goods.

- (c) A flexible exchange rate automatically cushions the economy's output and employment by allowing an immediate change in the *relative* price of domestic and foreign goods.
- (d) A flexible exchange rate automatically cushions the economy's output and employment by allowing an immediate change in the *absolute* price of domestic and foreign goods
- (e) None of the above.

Answer: C

(17) Fiscal federalism in the EU refers to

- (a) one nation's control of the monetary policy of all the other nations
- (b) freedom of member countries to leave the EU at any time
- (c) the transfer of economic resources from members with healthy economies to those suffering economic setbacks
- (d) one nation's freedom to abandon the Euro and use its own currency
- (e) None of the above

Answer: C

(18) What event started the Asian financial crisis in 1997?

- (a) Indonesia's inability to pay its debts
- (b) Devaluation of Indonesia's currency
- (c) Thailand's inability to pay its debts
- (d) Devaluation of Thailand's currency
- (e) Devaluation of Malaysia's currency

Answer: D

(19) 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

Answer: C

(20) The term Original Sin by two economists Barry Eichengreen and Ricardo Hausmann is used to describe what?

- (a) Low-income economy
- (b) Developing countries' inability to borrow in their own currencies
- (c) A sin that is part of the Ten Commandments.
- (d) Borrowers not able to receive loans.
- (e) Not diversifying economies portfolios

Answer: B