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CHAPTER 2
The Determination of Exchange Rates

2.1 The most likely explanation for the rise of the U.S. dollar during the early 1980s is that the U.S.
a. budget deficit lowered U.S. interest rates
b. trade deficit accelerated U.S. inflation
c. economy slowed dramatically
d. budget deficit raised U.S. interest rates

Ans: d
Section: Expectations and the asset market model of exchange rates
Level: Easy

2.2 The U.S. dollar weakened during the 1970s for the following reasons EXCEPT
a. U.S. inflation accelerated
b. the U.S. economy weakened
c. foreigners didn't want to hold as many dollars as before
d. foreigners wanted to hold more dollars than before

Ans: d
Section: Expectations and the asset market model of exchange rates
Level: Easy

2.3 Of the following, exchange rates depend the most upon relative
a. monetary systems
b. political systems
c. trade deficits
d. inflation rates between nations

Ans: d
Section: The nature of money and currency values
Level: Easy

2.4 _____ is another name for the complete replacement of the local currency with the U.S. dollar.
a. Seignorage
b. Dollarization
c. Depreciation
d. Appreciation

Ans: b
Section: Currency Substitution/Dollarization
Level: Easy

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2.5 A cheap yuan relative to other currencies would give China's _____ an unfair advantage in the global economy.
a. imports
b. subsidies
c. bankers
d. exporters

Ans: d
Section: How Real Exchange Rates Affect Relative Competitiveness
Level: Easy

2.6 The asset market view of exchange rate determination does NOT state that the spot rate
a. should follow a random walk
b. is affected primarily by a nation's long-run economic prospects
c. is influenced by a nation's annual economic growth
d. should be strongly affected by a nation's balance of trade

Ans: d
Section: Expectations and the asset market model of exchange rates
Level: Easy

2.7 When monetary authorities have not insulated their domestic money supplies from the foreign exchange transactions, it is known as _____ intervention.
a. unsterilized
b. sterilized
c. foreign market
d. subsidized

Ans: a
Section: Sterilized versus unsterilized intervention
Level: Easy

2.8 When the U.S. Federal Reserve sells or purchases Treasury securities in order to sterilize the impact of their foreign exchange market interventions, it is referred to as a(n). _____ operation.
a. floating currency
b. spot rate
c. revaluation
d. open market

Ans: d
Section: Sterilized versus unsterilized intervention
Level: Easy

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2.9 During the 1994 peso problem, Mexico made a fundamental error by not allowing the _____ of pesos to fall.
a) demand
b) supply
c) devaluation
d) real exchange rate

Ans: b
Section: Sterilized versus unsterilized intervention
Level: Easy

2.10 When the U.S. dollar becomes weaker, U.S. exports become more ____ in foreign markets.
a. competitive
b. costly
c. credit worthy
d. productive

Ans: a
Section: How Real Exchange Rates Affect Relative Competitiveness
Level: Easy

2.11 Although the mechanics of central bank interventions in the global currency markets may vary from country to country, the goal is always the same, to ____ the demand for one currency by _____ the supply of another.
a. increase, increasing
b. decrease, decreasing
c. increase, decreasing
d. decrease, increasing

Ans: a
Section: Foreign Exchange Market Intervention
Level: Easy

2.12 On Friday, September 13, 1992, the lira was worth DM 0.0013. Over the weekend the lira devalued against the DM to DM 0.0012. By how much had the lira devalued against the DM?
a. 7.69%
b. 8.33%
c. 5.21%
d. 9.27%

Ans: a
Section: Setting the equilibrium spot exchange rate
Level: Medium

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2.13 Suppose that the Brazilian real devalues by 40% against the U.S. dollar. By how much will the dollar appreciate against the real?
a. 67%
b. 40%
c. 32%
d. 28%

Ans: a
Section: Setting the equilibrium spot exchange rate
Level: Medium

2.14 The French euro devalued by 17% against the U.S. dollar. This is equivalent to a revaluation of the dollar against the euro by
a) 17%
b) 16.31%
c) 20.48%
d) 17.54%

Ans: c
Section: Setting the equilibrium spot exchange rate
Level: Medium

2.15 If the Australian dollar devalues against the Japanese yen by 10%, the yen will appreciate by
a. 33.32%
b. 25.55%
c. 10.11%
d. 11.11%

Ans: d
Section: Setting the equilibrium spot exchange rate
Level: Medium

2.16 If the euro depreciates against the U.S. dollar by 50%, the dollar appreciates against the euro by
a. 55%
b. 100%
c. 200%
d. 1,000%

Ans: b
Section: Setting the equilibrium spot exchange rate
Level: Medium

2.17 If the U.S. dollar appreciates against the Nigerian naira by 150%, the naira depreciates against the dollar by

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a. 60%
b. 75%
c. 125%
d. 300%

Ans: a
Section: Setting the equilibrium spot exchange rate
Level: Medium

2.18 If the dinar devalues against the U.S. dollar by 45%, the U.S. dollar will appreciate against the dinar by
a. 45%
b. 82%
c. 55%
d. 32%

Ans: b
Section: Setting the equilibrium spot exchange rate
Level: Medium

2.19 If the peso depreciates against the U.S dollar by 80%, the US dollar will appreciate against the peso by
a. 300%
b. 200%
c. 250%
d. 400%

Ans: d
Section: Setting the equilibrium spot exchange rate
Level: Medium

2.20 If the U.S. dollar appreciates against the euro by 25%, the euro will depreciate against the U.S. dollar
a. 25%
b. 20%
c. 30%
d. 10%

Ans: b
Section: Setting the equilibrium spot exchange rate
Level: Medium

2.21 If a foreigner purchases a U.S. government security the
a. supply of dollars rises
b. federal government deficit declines
c. demand for dollars rises

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d. U.S. money supply rises

Ans: c
Section: Setting the equilibrium spot exchange rate
Level: Medium

2.22 The foreign currency price of foreign goods in terms of the local currency price of domestic goods is called
a. the real exchange rate
b. the balance of trade
c. the trade-weighted exchange rate
d. purchasing parity

Ans: a
Section: The fundamentals of central bank intervention
Level: Medium

2.23 An increase in the real exchange rate will
a. raise national income
b. lower national income
c. make a country less competitive in international trade
d. lower the cost of foreign goods
e. c and d

Ans: e
Section: The fundamentals of central bank intervention
Level: Medium

2.24 A slowdown in U.S. economic growth will
a. boost the value of the dollar because inflation fears will be calmed
b. boost the value of the dollar because the Federal Reserve will expand the money supply
c. lower the value of the dollar because the U.S. will be a less attractive place to investors
d. lower the value of the dollar because interest rates will rise

Ans: c
Section: The fundamentals of central bank intervention
Level: Medium

2.25 The willingness of people to hold money
a. increases with the interest rate
b. rises with price stability
c. rises with national income
d. b and c only

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Ans: d
Section: The fundamentals of central bank intervention
Level: Medium

2.26 Sound economic policies will
a. raise the value of a nation's currency by boosting the economy
b. lower the value of a nation's currency by increasing the precautionary demand for money
c. lower the value of a nation's currency by leading to lower interest rates
d. both b and c

Ans: a
Section: The fundamentals of central bank intervention
Level: Medium

2.27 Large government budget deficits will
a. raise the value of a nation's currency by raising domestic interest rates
b. raise the value of a nation's currency by stimulating the domestic economy
c. lower the value of a nation's currency by leading to higher inflation
d. be irrelevant since historical experience shows no correlation between government budget deficits and the value of the nation's currency

Ans: d
Section: The nature of money and currency values
Level: Medium

2.28 If you were a monetary authority and wanted to neutralize the effects of central bank currency interventions such as interest rate changes, which of the following would be most effective?
a. the sale or purchase of Treasury securities
b. the creation of a currency board
c. pegging the exchange rate to another currency
d. convincing investors that the currencies involved in the intervention are perfect complements to each other

Ans: a
Section: Sterilized versus Unsterilized Intervention
Level: Medium

2.29 Which type of money is most likely to see its value fluctuate in the foreign exchange market?
a. fiat money
b. commodity money
c. price-indexed money
d. pegged-exchange rate

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Ans: a
Section: Central bank reputations and currency values
Level: Difficult

2.30 An increase in the supply of U.S. dollars by the Federal Reserve will
a. raise the value of the dollar because it will stimulate U.S. economic growth
b. raise the value of the dollar because it will lead to higher U.S. interest rates
c. reduce the value of the dollar because of inflation fears in the United States
d. decrease the value of the dollar because it will force other countries to raise their interest rates

Ans: c
Section: The fundamentals of central bank intervention
Level: Difficult

2.31 On July 19, 1985, the Italian lira devalued by 17% against the U.S. dollar. This is equivalent to a revaluation of the dollar against the lira of
a. 17%
b. 16.31%
c. 20.48%
d. 17.54%

Ans: c
Section: Setting the equilibrium spot exchange rate
Level: Difficult

2.32 Which of the following is an example of foreign exchange market intervention?
a. the U.S. government pays Social Security checks to pensioners living in Poland
b. IBM sells euros it received in international trade
c. the Canadian government pays interest to Saudi Arabian investors
d. the French government sells dollars in the foreign exchange market to prop up the value of the euro

Ans: d
Section: The fundamentals of central bank intervention
Level: Difficult

2.33 During 1995, the yen went from $0.0125 to $0.0095238. By how much did the dollar appreciate against the yen?
a. 23.81%
b. 31.25%
c. 15.67%
d. 40.78%

Ans: b
Section: Setting the equilibrium spot exchange rate
Level: Difficult

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2.34 The _____ for/of foreign currency in the U.S. is derived from the demand for _____ by American consumers.
a. Demand, foreign products
b. Demand, tax loopholes
c. Supply, lower tariffs
d. Supply, local products

Ans: a:
Section: Setting the equilibrium spot exchange rate
Level: Difficult

2.35 Which one of the following is NOT associated with dollarization of a nation's currency?
a. In Panama 30-year mortgages were no longer available
b. central banks may lose the profit on the currency they hold
c. it has been known to provide price stability
d. some capital may return and the economy begin to grow again

Ans: a
Section: Central Bank Reputations and Currency Values – Dollarization
Level: Difficult

2.36 Which one of the following is NOT a disadvantage of a strong dollar?
a. Ford Corporation's competitiveness diminishes in foreign markets
b. American-made Dell computers lose sales to their Chinese counterparts
c. U.S. unemployment levels rise in some sectors
d. Americans will be less prone to buy foreign wines

Ans: d
Section: The Fundamentals of Central Bank Interventions – How Real Exchange Rates Affect Relative Competitiveness
Level: Difficult

2.37 The value of the euro was $0.84 on October 27, 2000. On March 23, 2008 the same euro was worth $1.58. By how much did the value of the dollar depreciate vis-à-vis the euro?

a) 88.10%
b) -88.10%
c) -67.13%
d) -46.84%
Ans: d
Section: Setting the equilibrium spot exchange rate
Level: Difficult

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2.38. In the two years after Brexit the pound depreciated sharply by 17.81%. If the British pound two years after was worth $1.20, what was it worth before Brexit?

a) $1.17
b) $1.46
c) $1.81
d) $1.92

Ans: b
Section: Setting the equilibrium spot exchange rate
Level: Difficult

2.39. On September 11, 2019, President Trump tweeted that the Federal Reserve should cut interest rates to zero or less. If financial markets view the Federal Reserve as being completely independent from the executive branch. Then what would be the likely market reaction on the value of the dollar relative to the euro.

a) There should be no reaction based on that tweet
b) The value of the dollar would drop
c) The value of the euro would drop
d) The value of the dollar would increase

Ans: a
Section: Central bank reputations and currency values
Level: Medium

2.40 In response to a falling Turkish lira the President of Turkey Recep Tayyip Erdogan on May 11, 2018 called for lower interest rates and described interest rates as the "mother and father of all evil." If markets believe the President of Turkey has influence on the central bank then what is the likely market reaction on that day?

a) The Turkish lira will appreciate relative to the euro
b) The Turkish lira will depreciate relative to the euro
c) The dollar will appreciate relative to the euro and the Turkish lira
d) There should be no market reaction based on this statement

Ans: b
Section: Central bank reputations and currency values
Level: Medium

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