1. What is the advantage of a pegged exchange rate in comparison to a flexible exchange rate?

2. In each case below you are first told about a country’s exchange rate regime – whether its exchange rate is floating or pegged, and also whether it is sterilizing the effects of any exchange-market intervention that it may do. You are then given, in each subpart, several events that might occur. For each of these events (separately) indicate the requested effects of that event by circling the appropriate answer from among those provided.

a. The UK is allowing its currency, £, to float against the US dollar, US$. It does not sterilize.

i. The interest rate in the UK rises. As a result:

|  |  |  |  |
| --- | --- | --- | --- |
| the £ | appreciates | depreciates | does not change. |
| US exports to the UK | increase | decrease | do not change. |

ii. The UK central bank makes a large purchase of dollars in the foreign exchange market. As a result:

|  |  |  |  |
| --- | --- | --- | --- |
| the £ | appreciates | depreciates | does not change. |

Assume in b and c that peg is initially at equilibrium, i.e., neither under- nor over-valued.

b. China is pegging its currency, CN¥, to the US dollar, US$. It does sterilize.

i. A new type of Chinese clothing, made of soybeans, becomes popular in the US, and trade in it is not restricted. As a result:

|  |  |  |  |
| --- | --- | --- | --- |
| the CN¥ | appreciates | depreciates | does not change. |
| Chinese foreign exchange reserves | increase | decrease | do not change. |

ii. Wealthy Chinese households, previously holding wealth in dollars, switch back to CN¥-denominated assets. As a result:

|  |  |  |  |
| --- | --- | --- | --- |
| Chinese foreign exchange reserves | increase | decrease | do not change. |
| the Chinese money supply | rises | falls | is unchanged. |

c. Venezuela is pegging its currency, VEF, to the US dollar, US$. It does not sterilize.

i. Venezuelans, having invested heavily in the US, find themselves earning and taking home a larger flow of income on those investments. As a result:

|  |  |  |  |
| --- | --- | --- | --- |
| Venezuelan foreign exchange reserves | increase | decrease | do not change. |
| the Venezuelan money supply | increases | decreases | does not change. |

ii. Political instability in Venezuela causes international investors to fear a Venezuelan devaluation. As a result:

|  |  |  |  |
| --- | --- | --- | --- |
| Venezuelan foreign exchange reserves | increase | decrease | do not change. |
| the Venezuelan money supply | increases | decreases | does not change. |

3. Which of the following is FDI?

|  |  |  |
| --- | --- | --- |
|  | i: | A US investor buys 1,000 shares of stock of BMW AG, the German automobile company. |
|  | ii: | Intel builds a plant in Brazil and sends all American workers to operate it.  |
|  | iii: | Procter and Gamble lends US$2 million to a firm in Japan. |
|  | iv: | Mattel contracts a Mexican firm to do some of the Barbie processing. |
|  | v: | Whirlpool buys a Chinese firm that produces washer and dryers, and adapts it to produce its own products. |

4. Identify each of the following transactions by whether it belongs in the current account or in the financial account of the United States.

|  |  |  |  |
| --- | --- | --- | --- |
|  |  | Current Account | Financial Account  |
| a.  | Warren Buffet buys a Chinese software company.  |  |  |
| b.  | The California governor buys an Italian-made suit.  |  |  |
| c.  | The Facebook CEO collects interest on a saving account in a Swiss bank.  |  |  |
| d.  | Australian Prime Minister pays his son’s Harvard tuition.  |  |  |
| e. | A French farmer on vacation in Florida buys admission to Disneyworld.  |  |  |
| f.  | Your English professor wins the California Lottery and uses his winnings to buy stock in a Mexican cement company.  |  |  |
| g.  | Barak Obama buys a New York office building from Nelson Mandela (a South African).  |  |  |
| h.  | Richard Gere (an American) gives $10,000 to the Dalai Lama (in India).  |  |  |
| i.  | The Facebook CEO withdraws $50,000 from his account in a Swiss bank.  |  |  |
| j.  | Your little brother (an American) acquires a one euro note for his collection of foreign money.  |  |  |

5. Indicate whether each of the following items represents a debit or a credit o the US balance of payments.

a. A US importer purchases a shipload of French wine.

b. A British manufacturer exports machinery to Taiwan on a US vessel.

c. A US college student spends a year studying in Switzerland.

d. Japanese investors collect interest income on their holdings of US government securities.

e. A German resident sends money to her relatives in the United States.

f. Llyods of London sells an insurance policy to a US business firms.

g. A Swiss resident receives dividends on her IBM stock.

**6.** Figure 2 shows domestic supply and demand for a good in a small country, together with several prices and quantities labeled on the axes. Initially, with free trade, the country faces a world price equal to *P*1. Using the prices, quantities, and areas labeled in the figure, answer the following.

a. Consider first a tariff on imports, set at a level that will raise the domestic price to *P*2.

|  |  |
| --- | --- |
| How much will producer gain from this tariff?  |  |
| How much will consumers lose from this tariff?  |  |
| How much is the dead weight loss due to this tariff?  |  |

**Figure 2**



b. Now suppose that, instead of the tariff, the country provides a domestic subsidy equal to (*P*2–*P*1) per unit supplied.

|  |  |
| --- | --- |
| How much will producers gain from this subsidy? |  |
| How much will consumers lose from this subsidy? |  |
| How much does the country as a whole (including its government) lose from this subsidy? |  |

**Multiple Choice Questions**

1. If a country’s currency is undervalued, and if its central bank is pegging its exchange rate but **not** sterilizing the effects of its intervention, then which of the following will happen?
2. Its central bank will sell its own currency on the foreign exchange market.
3. Its central bank will gain reserves of foreign currency.
4. The country’s money supply will expand.
5. All of the above.
6. Under a crawling peg
7. The exchange rate moves, but by amounts too little to notice.
8. The exchange rate is permitted to change only slowly within the band.
9. The par value of the currency is kept secret and changed slowly over time.
10. The central value of a pegged exchange rate is changed frequently, by small amounts, and with advance notice.
11. Developing countries have often chosen to establish pegged exchange rates because
12. this prevents the depreciation that would otherwise occur due to their high inflation.
13. with small economies, it is easier for them to peg their currency than it would be for a large country.
14. a pegged rate imposes discipline on their government and central bank, helping to prevent inflation.
15. economists advise that countries with pegged exchange rates are able to grow faster than countries with floating exchange rates.
16. a pegged exchange rate can be used to make their exports more competitive on world markets.
17. Which of the following **is** included in the current account?
18. Interest payments
19. Gifts
20. Imports of services
21. All of the above

Use the information in the following table to answer the following question.

Exports of goods and services 1000

Imports of goods and services 800

Net change in assets owned abroad 500

Net change in foreign owned assets at home 400

Unilateral transfers received 100

Unilateral transfers paid 200

Investment income paid to foreigners 300

Investment income received from foreigners 400

1. Based on the table above, the balance on the current account is
2. 0.
3. +200.
4. +100.
5. -200.
6. People sometimes worry that American trade with other countries will lead to large US trade deficits and the movement of massive amounts of American capital out of the country. This worry is unfounded because countries **cannot**
7. have both current account and financial account deficits at the same time.
8. increase savings at the same time that a trade deficit grows.
9. increase their trade with other countries without increasing their savings.
10. invest more than they save.
11. If a country pegs its exchange rate at a level that is, and continues to be, overvalued, then it will eventually be the case that
12. Its exports will expand as foreign markets recognize the high value.
13. It will run out of foreign reserves.
14. People will engage in smuggling to avoid the official exchange rate.
15. Prices in the country will rise.

1. Based on the Big Mac Index and because of the fact that burgers are not traded internationally, “emerging economies” tend to have

a. Over-valued exchange rates because their wages are low.

b. Over-valued exchange rates because their wages are high.

c. Under-valued exchange rates because their wages are low.

d. Under-valued exchange rates because their wages are high.

1. A depreciation of the U.S. dollar leads to a higher volume of U.S. exports.

True False

1. According to the theory of purchasing power parity, if inflation in the rest of the world is lower than inflation in Brazil, Brazil's currency (the real) would tend to depreciate.

True False

1. If Mexicans increasingly lose confidence in their domestic financial markets and move their assets to other countries, the peso will depreciate.

True False

1. Imports tend to fall whenever a nation's currency appreciates because foreign products become more expensive to domestic consumers.

True False

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