

TEST BANK

To accompany

International Economics: Theory and Policy

Sixth Edition

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Chapter 1: Introduction

Multiple Choice Questions

1. Historians of economic thought often describe _____ written by _____ and published in _____ as the first real exposition of an economic model.
- A. "Of the Balance of Trade," David Hume, 1776
 - B. "Wealth of Nations," David Hume, 1758
 - C. "Wealth of Nations," Adam Smith, 1758
 - D. "Wealth of Nations," Adam Smith, 1776
 - E. "Of the Balance of Trade," David Hume, 1758

Answer: E

2. From 1959 to 2000,
- A. the U.S. economy roughly tripled in size.
 - B. U.S. imports roughly tripled in size.
 - C. the share of US Trade in the economy roughly tripled in size.
 - D. U.S. Imports roughly tripled as compared to U.S. exports.
 - E. U.S. exports roughly tripled in size.

Answer: C

3. The United States is less dependent on trade than most other countries because
- A. the United States is a relatively large country.
 - B. the United States is a "Superpower."
 - C. the military power of the United States makes it less dependent on anything.
 - D. the United States invests in many other countries
 - E. many countries invest in the United States.

Answer: A

4. Ancient theories of international economics from the 18th and 19th Centuries are:
- A. not relevant to current policy analysis.
 - B. are only of moderate relevance in today's modern international economy.
 - C. are highly relevant in today's modern international economy.
 - D. are the only theories that actually relevant to modern international economy.
 - E. are not well understood by modern mathematically oriented theorists.

Answer: C

5. An important insight of international trade theory is that when countries exchange goods and services one with the other it
- A. is always beneficial to both countries.
 - B. is usually beneficial to both countries.
 - C. is typically beneficial only to the low wage trade partner country .
 - D. is typically harmful to the technologically lagging country.
 - E. tends to create unemployment in both countries.

Answer: B

6. If there are large disparities in wage levels between countries, then
- A. trade is likely to be harmful to both countries.
 - B. trade is likely to be harmful to the country with the high wages.
 - C. trade is likely to be harmful to the country with the low wages.
 - D. trade is likely to be harmful to neither country.
 - E. trade is likely to have no effect on either country.

Answer: D

7. Benefits of international trade are limited to
- A. tangible goods.
 - B. intangible goods.
 - C. all goods but not services.
 - D. services.
 - E. None of the above.

Answer: E

8. Attempts to explain the pattern of international trade
- A. have been a major focus of international economists.
 - B. have proven to be hopeless.
 - C. have proven to be a trivial exercise.
 - D. have been the preoccupation of economic development theorists.
 - E. None of the above.

Answer: A

9. Which of the following does not belong?
- A. NAFTA
 - B. Uruguay Round
 - C. World Trade Organization
 - D. None Tariff Barriers

E. None of the above.

Answer: D

10. Cost-benefit analysis of international trade
- A. is basically useless.
 - B. is empirically intractable.
 - C. focuses attention on conflicts of interest within countries.
 - D. focuses attention on conflicts of interests between countries.
 - E. None of the above.

Answer: C

11. An improvement in a country's balance of payments means a decrease in its balance of payments deficit, or an increase in its surplus. In fact we know that a surplus in a balance of payments
- A. is good.
 - B. is usually good.
 - C. is probably good.
 - D. may be considered bad.
 - E. is always bad.

Answer: D cuuduongthancong.com

12. The study of exchange rate determination is relatively
- A. difficult.
 - B. new and mathematical.
 - C. old.
 - D. obtuse.
 - E. None of the above.

Answer: B

13. The GATT was
- A. an international treaty.
 - B. an international U.N. agency.
 - C. an international IMF agency.
 - D. a U.S. government agency.
 - E. a collection of tariffs.

Answer: A

14. The international debt crisis of early 1982 was precipitated when _____ could not pay its international debts.
- A. Russia
 - B. Mexico
 - C. Brazil
 - D. Malaysia
 - E. China

Answer: B

15. International economics can be divided into two broad sub-fields:
- A. macro and micro.
 - B. developed and less developed.
 - C. monetary and barter.
 - D. international trade and international money.
 - E. static and dynamic.

Answer: C

16. A primary reason why nations conduct international trade is because of differences in
- A. historical perspective.
 - B. location.
 - C. resource availabilities.
 - D. tastes.
 - E. incomes.

Answer: C

17. International trade is sometimes used as a substitute for all of the following except
- A. international movements of capital.
 - B. international movement s of labor.
 - C. domestic production of the same goods or services.
 - D. domestic production of different goods and services.
 - E. None of the above.

Answer: D

18. International trade forces domestic firms to become more competitive in terms of
- A. the introduction of new products.
 - B. product design and quality.
 - C. product reliability.
 - D. product price.
 - E. All of the above.

Answer: E

19. The movement to free international trade is most likely to generate short-term unemployment in which industries?
- A. Industries producing non-tradable goods
 - B. Import-competing industries
 - C. Export industries
 - D. Import sectors
 - E. None of the above.

Answer: B

20. International trade is logically associated with which assumption?
- A. Resources are less mobile internationally than domestically.
 - B. Resources are more mobile internationally than are goods.
 - C. Imports should exceed exports.
 - D. Exports should exceed imports.
 - E. None of the above.

Answer: A

21. Arguments for free trade are sometimes disregarded by the political process because
- A. economists tend to favor highly protected domestic markets.
 - B. economists have a universally accepted decisive power over the political decision mechanism.
 - C. maximizing consumer welfare may not be a chief priority for politicians.
 - D. the gains of trade are of paramount concern to typical consumers.
 - E. None of the above.

Answer: C

22. Increased foreign competition tends to
- A. increase profits of domestic import-competing industries.
 - B. place constraints on the wages of domestic workers.
 - C. induce falling output per worker for domestic workers.
 - D. intensify inflationary pressures at home
 - E. None of the above.

Answer: B

23. _____ is the ability of a firm to design, produce, and market goods and services that are better and/or cheaper than those of other firms.
- A. Competitiveness
 - B. Protectionism
 - C. Comparative advantage
 - D. Interventionism
 - E. None of the above.

Answer: A

24. For a country to maximize its productivity in a global economy, it requires
- A. only imports.
 - B. only exports.
 - C. both exports and imports.
 - D. neither exports nor imports.
 - E. foreign direct investment.

Answer: C

25. Proponents of free trade claim all of the following as advantages except
- A. relatively high wage levels for all domestic workers.
 - B. a wider selection of products for consumers
 - C. increased competition for world producers.
 - D. the utilization of the most efficient production processes.
 - E. None of the above.

Answer: A

26. A firm's _____, relative to that of other firms, is generally regarded as the most important determinant of competitiveness.
- A. income level
 - B. tastes
 - C. preferences
 - D. productivity

- E. environmental regulation

Answer: D

27. One likely effect of moving to free international trade is that
- A. a monopoly in the home market becomes an oligopoly in the world market.
 - B. an oligopoly in the home market becomes a monopoly in the world market.
 - C. a purely competitive firm becomes an oligopolist.
 - D. a purely competitive firm becomes a monopolist.
 - E. None of the above.

Answer: A

28. International trade in goods and services tends to
- A. increase all domestic costs and prices.
 - B. keep all domestic costs and prices at the same level.
 - C. lessen the amount of competition facing home manufactures.
 - D. increase the amount of competition facing home manufacturers.
 - E. None of the above.

Answer: D cuuduongthancong.com

29. The real income of domestic producers and consumers may be increased by
- A. technological progress, but not international trade.
 - B. international trade, but not technological progress.
 - C. neither technological progress nor international trade.
 - D. both technological progress and international trade.
 - E. None of the above.

Answer: D

30. A sudden shift from import tariffs to free trade may cause short-term unemployment in
- A. import competing industries.
 - B. exporting industries.
 - C. industries that neither import nor export.
 - D. service industries
 - E. None of the above.

Answer: A

31. Empirical studies indicate that productivity performance is
- A. directly related to globalization of industries.
 - B. inversely related to globalization of industries.
 - C. not related to globalization of industries.
 - D. Any of the above.
 - E. None of the above.

Answer: A

32. A closed economy is one in which
- A. imports exactly equal exports.
 - B. domestic firms invest in foreign countries.
 - C. the home economy is isolated from foreign trade or investment.
 - D. All of the above.
 - E. None of the above.

Answer: C

33. The dominant trading nation in the world market since World War II was
- A. the United Kingdom.
 - B. the United States.
 - C. Japan.
 - D. Germany.
 - E. China.

Answer: B

34. Empirical studies indicate that _____ best enhances productivity growth for local industries
- A. local competition
 - B. cut-throat competition
 - C. destabilizing competition
 - D. global competition
 - E. None of the above.

Answer: D

35. High levels of openness are most likely associated with a country's
- A. political orientation.
 - B. size.
 - C. resource availability.
 - D. historical association with foreign entangling alliances.
 - E. None of the above.

Answer: B

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Essay Questions

1. It is argued that small countries tend have more open economies than large ones. Is this empirically verified? What are the logical underpinnings of this argument?

Answer: Yes. They do not have sufficient resources to satisfy consumption needs; and also do not have a sufficiently large market to enable their industries to avail themselves of scale economy possibilities.

Another answer would rely on a location argument. Assume that the "natural" market for any given plant is a circle with a radius of n miles with the plant at its center. Assuming that the production plants are located randomly throughout the country, then the probability that the typical circular market will encompass some foreign country is greater the smaller is the country.

2. It is argued that if a rich high wage country such as the United States were to expand trade with a relatively poor and low wage country such as Mexico, then U.S. industry would migrate south, and U.S. wages would fall to the level of Mexico's. What do you think about this argument?

Answer: The student may think anything. The purpose of the question is to set up a discussion, which will lead to the models in the following chapters.

3. Some patterns of international trade are easier to explain than others. Give several examples and explain.

Answer: Historical circumstance can explain some patterns such as the relatively large trade flows from West Africa to France. The relatively sparse trade between countries within South America seems curious.

4. International trade tends to prove that international trade is beneficial to all trading countries. However, casual observation notes that official obstruction of international trade flows is widespread. How might you reconcile these two facts?

Answer: Like question 2, this is meant to allow students to offer preliminary discussions of issues, which will be explored in depth later in the book.

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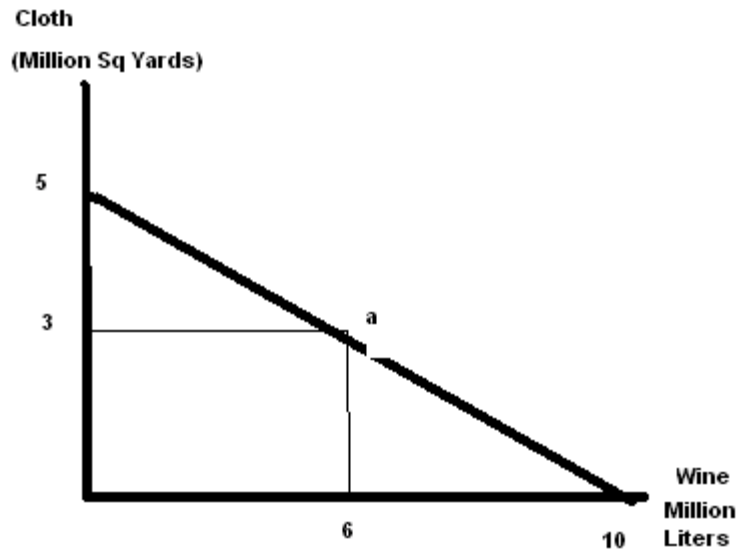
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Answer: Like question 2, this is meant to allow students to offer preliminary discussions of issues, which will be explored in depth later in the book.

9. International Trade theory is one of the oldest areas of applied economic policy analysis. It is also an area for which data was relatively widely available very early on. Why do you suppose this is the case?

Answer: In ancient times, public finance was not well developed. Most of the population was not producing and consuming within well-developed market economies, so that income and sales taxes were not efficient. One of the most convenient ways for governments to obtain resources was to set up custom posts at borders and tax. Hence international trade was of great policy interest to princes and kings, as was precise data of their main tax base.

Quantitative/Graphing Problems



1. The figure above is the Production Possibility Frontier (PPF) of Bacalia, where only two products are produced, clothing and wine. In fact Bacalia is producing on its PPF at point A. By and large the people of Bacalia are content, as both their external and internal needs for warmth are satisfied in the most economically efficient manner possible, given their available productive resources (and known technology). How much wine is being produced? How much cloth? If a person in this country wanted to purchase a liter of wine, what would be the price he or she would have to pay?

Judging from what you learned in the previous paragraph, can you indicate at which point (if at all) the Community Indifference Curve is tangent to the Production Possibility Frontier? Explain your reasoning.

Answer:

6 million liters of wine are being produced.

3 million square yards of cloth are being produced.

The price of 1 liter of wine is one half of a square yard of cloth.

The tangency is at point A. We know this because otherwise the country would not be producing at the point of maximum economic efficiency.

2. One day, Baccalia joined the WTO and joined the Global Village. They discovered that in the LWE (London Wine Exchange), 1 liter of wine is worth 1 square yard of cloth. What is the logical production point they should strive for?



Answer: 10 million liters of wine.

3. They wish to enjoy to the fullest from the gains from trade, but are not willing to give up imbibing even one drop of wine from the 6 million liters they consumed in their original autarkic state. If their new consumption point is a point we shall designate as point b, describe where this point would be found.

Answer: Vertically above point a

4. Where is the Community Indifference Curve family of curves tangent to their new Consumption Possibility Frontier?

Answer: At point b.

5. How can you prove that Baccalia has in fact gained from the availability of trade, and that their new situation is superior to the pre-trade situation (with which they were quite content)?

Answer: The country was consuming at point a before trade. It is now consuming at point b with trade. Point b represents a superior welfare combination of goods as compared to point a, since at b the country has more of each of the goods.

Chapter 2: Labor Productivity and Comparative Advantage - The Ricardian Model

Multiple Choice Questions

1. Countries trade with each other because they are _____ and because of _____.
A. different, costs
B. similar, scale economies
C. different, scale economies
D. similar, costs
E. None of the above.

Answer: C

2. Trade between two countries can benefit both countries if
A. each country exports that good in which it has a comparative advantage.
B. each country enjoys superior terms of trade.
C. each country has a more elastic demand for the imported goods.
D. each country has a more elastic supply for the supplied goods.
E. Both C and D.

Answer: A

3. The Ricardian theory of comparative advantage states that a country has a comparative advantage in widgets if
A. output per worker of widgets is higher in that country.
B. that country's exchange rate is low.
C. wage rates in that country are high.
D. the output per worker of widgets as compared to the output of some other product is higher in that country.
E. Both B and C.

Answer: D

4. In order to know whether a country has a comparative advantage in the production of one particular product we need information on at least _____ unit labor requirements
A. one
B. two
C. three
D. four
E. five

Answer: D

4. A country engaging in trade according to the principles of comparative advantage gains from trade because it
- A. is producing exports indirectly more efficiently than it could alternatively.
 - B. is producing imports indirectly more efficiently than it could domestically.
 - C. is producing exports using fewer labor units.
 - D. is producing imports indirectly using fewer labor units.
 - E. None of the above.

Answer: B

5. Given the following information:

	Unit Labor Requirements	
	Cloth	Widgets
Home	10	20
Foreign	60	30

- A. Neither country has a comparative advantage.
- B. Home has a comparative advantage in cloth.
- C. Foreign has a comparative advantage in cloth.
- D. Home has a comparative advantage in widgets.
- E. Home has a comparative advantage in both products.

Answer: B

6. If it is ascertained that Foreign uses prison-slave labor to produce its exports, then home should
- A. export cloth.
 - B. export widgets.
 - C. export both and import nothing.
 - D. export and import nothing.
 - E. All of the above.

Answer: A

7. If the Home economy suffered a meltdown, and the Unit Labor Requirements in each of the products quadrupled (that is, doubled to 30 for cloth and 60 for widgets) then home should
- export cloth.
 - export widgets.
 - export both and import nothing.
 - export and import nothing.
 - All of the above.

Answer: A

8. If wages were to double in Home, then Home should:
- export cloth.
 - export widgets.
 - export both and import nothing.
 - export and import nothing.
 - All of the above.

Answer: A

9. If the world equilibrium price of widgets were 4 Cloths, then
- both countries could benefit from trade with each other.
 - neither country could benefit from trade with each other.
 - each country will want to export the good in which it enjoys comparative advantage.
 - neither country will want to export the good in which it enjoys comparative advantage.
 - both countries will want to specialize in cloth.

Answer: A

10. Given the following information:

	Number of Units Produced by one Unit of Labor	
	Cloth	Widgets
Home	10	20
Foreign	60	30

- Neither country has a comparative advantage.
- Home has a comparative advantage in cloth.
- Foreign has a comparative advantage in cloth.
- Foreign has a comparative advantage in widgets.
- Home has a comparative advantage in both products.

Answer: C

11. The opportunity cost of cloth in terms of widgets in Foreign is if it is ascertained that Foreign uses prison-slave labor to produce its exports, then home should
- A. export cloth.
 - B. export widgets.
 - C. export both and import nothing.
 - D. export and import nothing.
 - E. All of the above.

Answer: B

12. If wages were to double in Home ,then Home should
- A. export cloth.
 - B. export widgets.
 - C. export both and import nothing.
 - D. export and import nothing.
 - E. All of the above.

Answer: B

13. If the world equilibrium price of widgets were 4 Cloths, then
- A. both countries could benefit from trade with each other.
 - B. neither country could benefit from trade with each other.
 - C. each country will want to export the good in which it enjoys comparative advantage.
 - D. neither country will want to export the good in which it enjoys comparative advantage.
 - E. both countries will want to specialize in cloth.

Answer: A

14. If the world equilibrium price of widgets were 40 cloths, then
- A. both countries could benefit from trade with each other.
 - B. neither country could benefit from trade with each other.
 - C. each country will want to export the good in which it enjoys comparative advantage.
 - D. neither country will want to export the good in which it enjoys comparative advantage.
 - E. both countries will want to specialize in cloth.

Answer: A

15. In a two product two country world, international trade can lead to increases in
- A. consumer welfare only if output of both products is increased.
 - B. output of both products and consumer welfare in both countries.
 - C. total production of both products but not consumer welfare in both countries
 - D. consumer welfare in both countries but not total production of both products.
 - E. None of the above.

Answer: B

16. As a result of trade, specialization in the Ricardian model tends to be
- A. complete with constant costs and with increasing costs.
 - B. complete with constant costs and incomplete with increasing costs.
 - C. incomplete with constant costs and complete with increasing costs.
 - D. incomplete with constant costs and incomplete with increasing costs.
 - E. None of the above.

Answer: B

17. A nation engaging in trade according to the Ricardian model will find its consumption bundle
- A. inside its production possibilities frontier.
 - B. on its production possibilities frontier.
 - C. outside its production possibilities frontier.
 - D. inside its trade-partner's production possibilities frontier.
 - E. on its trade-partner's production possibilities frontier.

Answer: C

18. In the Ricardian model, if a country's trade is restricted, this will cause all except which?
- A. Limit specialization and the division of labor.
 - B. Reduce the volume of trade and the gains from trade
 - C. Cause nations to produce inside their production possibilities curves
 - D. May result in a country producing some of the product of its comparative disadvantage
 - E. None of the above.

Answer: C

19. If a very small country trades with a very large country according to the Ricardian model, then
- A. the small country will suffer a decrease in economic welfare.
 - B. the large country will suffer a decrease in economic welfare.
 - C. the small country will enjoy gains from trade.
 - D. the large country will enjoy gains from trade.
 - E. None of the above.

Answer: C

20. If the world terms of trade for a country are somewhere between the domestic cost ratio of H and that of F, then
- A. country H but not country F will gain from trade.
 - B. country H and country F will both gain from trade.
 - C. neither country H nor F will gain from trade.
 - D. only the country whose government subsidizes its exports will gain.
 - E. None of the above.

Answer: B

21. If the world terms of trade equal those of country F, then
- A. country H but not country F will gain from trade.
 - B. country H and country F will both gain from trade.
 - C. neither country H nor F will gain from trade.
 - D. only the country whose government subsidizes its exports will gain.
 - E. None of the above.

Answer: A

22. If the world terms of trade equal those of country F, then
- A. country H but not country F will gain from trade.
 - B. country H and country F will both gain from trade.
 - C. neither country H nor F will gain from trade.
 - D. only the country whose government subsidizes its exports will gain.
 - E. None of the above.

Answer: E

23. If a production possibilities frontier is bowed out (concave to the origin), then production occurs under conditions of
- A. constant opportunity costs.
 - B. increasing opportunity costs.
 - C. decreasing opportunity costs.
 - D. infinite opportunity costs.
 - E. None of the above.

Answer: B

24. If two countries have identical production possibility frontiers, then trade between them is not likely if
- A. their supply curves are identical.
 - B. their cost functions are identical.
 - C. their demand conditions identical.
 - D. their incomes are identical.
 - E. None of the above.

Answer: E

25. If two countries have identical production possibility frontiers, then trade between them is not likely if
- A. their supply curves are identical.
 - B. their cost functions are identical.
 - C. their demand functions differ.
 - D. their incomes are identical.
 - E. None of the above.

Answer: C

26. The earliest statement of the principle of comparative advantage is associated with
- A. David Hume.
 - B. David Ricardo.
 - C. Adam Smith.
 - D. Eli Heckscher.
 - E. Bertil Ohlin.

Answer: B

27. If one country's wage level is very high relative to the other's (the relative wage exceeding the relative productivity ratios), then if they both use the same currency
- A. neither country has a comparative advantage.
 - B. only the low wage country has a comparative advantage.
 - C. only the high wage country has a comparative advantage.
 - D. consumers will still find trade worth while from their perspective.
 - E. None of the above.

Answer: E

28. If one country's wage level is very high relative to the other's (the relative wage exceeding the relative productivity ratios), then
- A. it is not possible that producers in each will find export markets profitable.
 - B. it is not possible that consumers in both countries will enhance their respective welfares through imports.
 - C. it is not possible that both countries will find gains from trade.
 - D. it is possible that both will enjoy the conventional gains from trade.
 - E. None of the above.

Answer: D

29. The Ricardian model is based on all of the following except
- A. only two nations and two products.
 - B. no diminishing returns.
 - C. labor is the only factor of production.
 - D. product quality varies among nations.
 - E. None of the above.

Answer: D

30. Ricardo's original theory of comparative advantage seemed of limited real-world value because it was founded on the
- A. labor theory of value.
 - B. capital theory of value.
 - C. land theory of value.
 - D. entrepreneur theory of value.
 - E. None of the above.

Answer: A

31. According to Ricardo, a country will have a comparative advantage in the product in which its
- A. labor productivity is relatively low.
 - B. labor productivity is relatively high.
 - C. labor mobility is relatively low.
 - D. labor mobility is relatively high.
 - E. None of the above.

Answer: B

32. In a two-country, two-product world, the statement "Germany enjoys a comparative advantage over France in autos relative to ships" is equivalent to
- A. France having a comparative advantage over Germany in ships.
 - B. France having a comparative disadvantage compared to Germany in autos and ships.
 - C. Germany having a comparative advantage over France in autos and ships.
 - D. France having no comparative advantage over Germany.
 - E. None of the above.

Answer: A

33. Assume that labor is the only factor of production and that wages in the United States equal \$20 per hour while wages in Japan are \$10 per hour. Production costs would be lower in the United States as compared to Japan if
- A. U.S. labor productivity equaled 40 units per hour and Japan's 15 units per hour.
 - B. U.S. productivity equaled 30 units per hour whereas Japan's was 20.
 - C. U.S. labor productivity equaled 20 and Japan's 30.
 - D. U.S. labor productivity equaled 15 and Japan's 25 units per hour.
 - E. None of the above.

Answer: A

34. If the United States' production possibility frontier was flatter to the widget axis, whereas Germany's was flatter to the butter axis, we know that
- A. the United States has no comparative advantage
 - B. Germany has a comparative advantage in butter.
 - C. the U.S. has a comparative advantage in butter.
 - D. Not enough information is given.
 - E. None of the above.

Answer: B

35. Suppose the United States' production possibility frontier was flatter to the widget axis, whereas Germany's was flatter to the butter axis. We now learn that the German mark is sharply depreciated against the U.S. dollar. We now know that
- A. the United States has no comparative advantage
 - B. Germany has a comparative advantage in butter.
 - C. the United States has a comparative advantage in butter.
 - D. Not enough information is given.
 - E. None of the above.

Answer: B

36. Suppose the United States' production possibility frontier was flatter to the widget axis, whereas Germany's was flatter to the butter axis. We now learn that the German wage doubles, but U.S. wages do not change at all. We now know that
- A. the United States has no comparative advantage.
 - B. Germany has a comparative advantage in butter.
 - C. the United States has a comparative advantage in butter.
 - D. Not enough information is given.
 - E. None of the above.

Answer: B [cuu duong than cong. com](http://cuuduongthancong.com)

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Essay Questions

1. Many countries in Sub-Saharan Africa have very low labor productivities in many sectors, in manufacturing and agriculture. They often despair of even trying to attempt to build their industries unless it is done in an autarkic context, behind protectionist walls because they do not believe they can compete with more productive industries abroad. Discuss this issue in the context of the Ricardian model of comparative advantage.

Answer: The Ricardian model of comparative advantage argues that every country must have a comparative advantage in some product (assuming there are more products than countries).

2. In 1975, wage levels in South Korea were roughly 5% of those in the United States. It is obvious that if the United States had allowed Korean goods to be freely imported into the United States at that time, this would have caused devastation to the standard of living in the United States.,because no producer in this country could possibly compete with such low wages. Discuss this assertion in the context of the Ricardian model of comparative advantage.

Answer: Regardless of relative wage levels, the United States would be able to provide its populace with a higher standard of living than would be possible without trade. Also, low wages tend to be associated with low productivities.

3. The evidence cited in the chapter using the examples of the East Asia New Industrializing Countries suggests that as international productivities converge, so do international wage levels. Why do you suppose this happened for the East Asian NICs? In light of your answer, what do you think is likely to happen to the relative wages (relative to those in the United States) of China in the coming decade? Explain your reasoning.

Answer: Following the logic of the Ricardian model of comparative advantage, the East Asian countries played to their respective comparative advantages. This allowed the world demand to provide excess demands for their relatively abundant labor, which in turn tended to raise these wages. If China follows the same pattern, their wages levels should also be expected over time to converge to those in their industrialized country markets.

4. When we examine the 2 Good 2 Country version of the Ricardian model of comparative advantage, we note that comparative advantage is totally determined by physical productivity ratios. Changes in wage rates in either country cannot affect these physically determined comparative advantages, and hence cannot affect, which product will be exported by which country. However, when more than 2 goods are added to the model (still with 2 countries), changes in wage rates in one or the other country can in fact determine which good or goods each of the countries will export. How can you explain this anomaly?

Answer: This is not really an anomaly. As long as only two goods exist, then as long as trade takes place, each country must have a comparative advantage in one of them (or none). However, if there are more goods than countries, then the physical productivity definition of comparative advantage becomes ambiguous. Changes in relative wage rates will shift the international competitiveness along the "chain of comparative advantage."

5. An examination of the Ricardian model of comparative advantage yields the clear result that trade is (potentially) beneficial for each of the two trading partners since it allows for an expanded consumption choice for each. However, for the world as a whole the expansion of production of one product must involve a decrease in the availability of the other, so that it is not clear that trade is better for the world as a whole as compared to an initial situation of non-trade (but efficient production in each country). Are there in fact gains from trade for the world as a whole? Explain.

Answer: If we were to combine the production possibility frontiers of the two countries to create a single world production possibility frontier, then it is true that any change in production points (from autarky to specialization with trade) would involve a tradeoff of one good for another from the world's perspective. In other words, the new solution cannot possibly involve the production of more of both goods. However, since we know that each country is better off at the new solution, it must be true that the original points were not on the trade contract curve between the two countries, and it was in fact possible to make some people better off without making others worse off, so that the new solution does indeed represent a welfare improvement from the world's perspective.

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Quantitative/Graphing Problems

1. Given the following information:

	Unit Labor Requirements	
	Cloth	Widgets
Home	100	200
Foreign	60	30

1. What is the opportunity cost of Cloth in terms of Widgets in Foreign?

Answer: One half a widget.

2. Given the following information:

	Unit Labor Requirements	
	Cloth	Widgets
Home	100	200
Foreign	60	30

If these two countries trade these two goods in the context of the Ricardian model of comparative advantage, then what is the lower limit of the world equilibrium price of widgets?

Answer: 2 Cloths.

3. Given the following information:

	Unit Labor Requirements	
	Cloth	Widgets
Home	100	200
Foreign	60	30

If these two countries trade these two goods with each other in according to the Ricardian model of comparative advantage, what is the lower limit for the price of cloth?

Answer: One half a widget.

4. Given the following information:

	Units Produced by One Worker/Hour	
	Cloth	Widgets
Home	100	200
Foreign	60	30

What is the opportunity cost of cloth in terms of Widgets in Foreign?

Answer: 2 widgets.

5. Given the following information:

	Units Produced by One Worker/Hour	
	Cloth	Widgets
Home	100	200
Foreign	60	30

If these two countries trade these two goods with each other in the following the Ricardian model of comparative advantage, then what is the lower limit for the world equilibrium price of cloth?

Answer: 2 widgets. cuuduongthancong.com

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Chapter 3: Specific Factors and Income Distribution

Multiple Choice Questions

1. International trade has strong effects on income distributions. Therefore, international trade
- A. is beneficial to everyone in both trading countries.
 - B. will tend to hurt one trading country.
 - C. will tend to hurt some groups in each trading country.
 - D. will tend to hurt everyone in both countries.
 - E. will be beneficial to all those engaged in international trade.

Answer: C

2. Factors tend to be specific to certain uses and products
- A. in countries lacking comparative advantage.
 - B. in the short run.
 - C. in capital-intensive industries.
 - D. in labor-intensive industries.
 - E. in countries lacking fair labor laws.

Answer: B

3. In an economy described by the Specific Factors Model, the production possibility frontier will be
- A. linear.
 - B. concave to the origin.
 - C. convex to the origin.
 - D. parabolic with one root.
 - E. collapsed to a point.

Answer: B

4. At the point of production, the production possibility frontier will be tangent to
- A. the origin.
 - B. a line whose slope is the relative quality of the two goods.
 - C. a line whose slope is the relative quantity of the two goods.
 - D. a line whose slope is the relative price of the two goods.
 - E. None of the above.

Answer: D

5. If the price of the capital intensive product rises more than does the price of the land intensive product, then
- A. demand will shift away from the capital-intensive product, and its production will decrease.
 - B. demand will shift away from the capital-intensive product, and its production will decrease relative to that of the land intensive product.
 - C. the production of the capital-intensive product will indeed decrease, but not for the reasons mentioned in A or B.
 - D. the countries exporting the capital-intensive good will lose its comparative advantage.
 - E. None of the above.

Answer: E

6. If the price of the capital intensive product rises, wages will
- A. rise but by less than the price of the capital-intensive product.
 - B. rise by more than the rise in the price of the capital-intensive product.
 - C. remain proportionally equal to the price of the capital-intensive product.
 - D. fall, since higher prices cause less demand.
 - E. None of the above.

Answer: A

7. If Australia has relatively more land per worker, and Belgium has relatively more capital per worker, then if trade were to open up between these two countries,
- A. the relative price of the capital-intensive product would rise in Australia.
 - B. the world price of the land-intensive product would be higher than it had been in Belgium.
 - C. the world price of the land intensive product would be higher than it had been in Australia.
 - D. the relative price of the land intensive product would rise in Belgium.
 - E. None of the above.

Answer: C

8. If Australia has more land per worker, and Belgium has more capital per worker, then if trade were to open up between these two countries,
- A. Australia would export the land-intensive product.
 - B. Belgium would import the capital-intensive product.
 - C. Both countries would export some of each product.
 - D. trade would not continue since Belgium is a smaller country.
 - E. None of the above.

Answer: A

9. If Australia has more land per worker, and Belgium has more capital per worker, then if trade were to open up between these two countries,
- A. the real income of capital owners in Australia would rise.
 - B. the real income of labor in Australia would clearly rise.
 - C. the real income of labor in Belgium would clearly rise.
 - D. the real income of landowners in Belgium would fall.
 - E. the real incomes of capital owners in both countries would rise.

Answer: D

10. If trade opens up between the two formerly autarkic countries, Australia and Belgium, then
- A. the real income of Australia and of Belgium will increase.
 - B. the real income of Australia but not of Belgium will increase.
 - C. the real income of neither country will increase.
 - D. the real income of both countries may increase.
 - E. the real income of both countries will increase.

Answer: D cuuduongthancong.com

11. The marginal product of labor in manufacturing slopes downward because of
- A. diseconomies to scale.
 - B. discontinuities in the production function.
 - C. diminishing returns.
 - D. gross substitution with the food sector.
 - E. None of the above.

Answer: C

12. In the Specific Factors model, each of the two sectors
- A. employs the same factors used by the other.
 - B. employs different factors than those employed in the other.
 - C. employs a fixed coefficient production function.
 - D. shares one factor of production with the other sector.
 - E. None of the above.

Answer: D

13. The Specific Factors model assumes
- A. imperfections in the labor market.
 - B. imperfections in the land market.
 - C. imperfections in the capital market.
 - D. imperfections in the entrepreneurship market.
 - E. None of the above.

Answer: E

14. At the production point the production possibility frontier is tangent to a line whose slope is
- A. the price of manufactures.
 - B. the relative wage.
 - C. the real wage.
 - D. the relative price of manufactures.
 - E. None of the above.

Answer: D

15. If the price of manufactures and the price of food increase by 25%, then
- A. the economy moves down its aggregate supply curve.
 - B. the economy moves back along its aggregate demand curve.
 - C. the relative quantities of manufactures and food remain unchanged.
 - D. the relative quantities of products change by 25%.
 - E. None of the above.

Answer: C

16. If the price of manufactures rises, then
- A. the price of food also rises.
 - B. the quantity of food produced falls.
 - C. the quantity of both manufactures and food falls.
 - D. the purchasing power of labor in terms of food falls.
 - E. None of the above.

Answer: B

17. In the model described in this chapter, if the price of manufactures rises, then
- A. the real income of capital rises.
 - B. the real income of land rises.
 - C. the purchasing power of landowners rises.
 - D. the production of both products falls.
 - E. None of the above.

Answer: A

18. If the price of food rises , then the income of capital owners will fall because
- A. capital owners consume only food.
 - B. the real wage in terms of manufactures rises.
 - C. they must pay higher wages to maintain subsistence levels.
 - D. food is an element of organic capital for capitalists.
 - E. None of the above.

Answer: B

19. If additional land were to be brought into cultivation in the Specific Factor model, the output of manufactures would fall because of
- A. lower marginal productivity of labor in this sector.
 - B. lower marginal productivity of labor in food production.
 - C. higher marginal productivity of labor in manufacture sector.
 - D. lower labor input in manufacture sector.
 - E. None of the above.

Answer: D

20. If Japan is relatively capital rich and the United States is relatively land rich, then trade between these two, formerly autarkic countries will
- A. lead to perfect specialization with Japan alone producing manufactures.
 - B. create a world relative price of food that is lower than that of the U.S.
 - C. lower the price of food in both countries.
 - D. raise the price of food in both countries.
 - E. None of the above.

Answer: E

21. If Japan is the land-rich country, then international trade will clearly
- A. raise the real income of all factor owners in that country.
 - B. lower the real income of workers.
 - C. lower the real income of capital owners.
 - D. lower the real income of landowners.
 - E. None of the above.

Answer: D

22. The reason trade clearly benefits a country is that
- A. it raises the real income of the more productive elements in society.
 - B. it lowers the real income of the less productive elements in society.
 - C. it increases the levels of consumption of everyone.
 - D. it increases society's consumption choices.
 - E. None of the above.

Answer: D

23. Those who stand to lose from trade
- A. are likely to migrate to another country.
 - B. tend to be more effectively organized politically.
 - C. tend to reject compensation as smacking of socialism.
 - D. are universally opposed by economists who consider them parasites.
 - E. None of the above.

Answer: B

24. Those who stand to gain from trade
- A. do not really care about the issue of income redistribution.
 - B. could not compensate losers since there are so many poor people.
 - C. could compensate losers but would rather not in modern industrial economies.
 - D. compensate losers at least partially through such legislation as unemployment compensation.
 - E. None of the above.

Answer: D

25. Groups that lose from trade tend to lobby the government to
- A. shift the direction of comparative advantage.
 - B. abolish the Specific Factor model from practical application.
 - C. provide public support for the relatively efficient sectors.
 - D. provide protection for the relatively inefficient sectors.
 - E. None of the above.

Answer: D

26. It is known that the existence of the sugar quota causes several billion dollars of added expenses to U.S. consumers, while paying much less in benefits to U.S. sugar producers. The continued existence of this quota for many years to the present is attributable to the fact that
- A. as a growing proportion of the U.S. population develops Type II Diabetes, no one is really interested in making sugar even cheaper than it is.
 - B. obviously the quota will be removed now that it has been calculated that the costs exceed the benefits.
 - C. the per-capita harm to the public is so small that it is not worth the time for anyone to fight this quota.
 - D. it is understood that the sugar quota is an important weapon in keeping Communism from sweeping the Caribbean.
 - E. None of the above.

Answer: C

27. It was found that when the United States imposed steel quotas, this caused harm not only to steel consumers, but also to many producers for whom steel is an important input. This insight
- A. suggests that general equilibrium models of tariffs will demonstrate that the partial equilibrium deadweight loss triangles tend to overstate the tariff harm.
 - B. suggests that the deadweight loss triangles from partial equilibrium models tend to understate the harm to society of protectionism.
 - C. suggests that it is quite sensible that producers tend to support quotas.
 - D. suggests that steel production is an infant industry in the U.S.
 - E. None of the above.

Answer: B

28. It was found that when the United States placed quotas on imported Japanese semiconductors, this harmed the international competitiveness of U.S. computer manufacturers. This is a good illustration of the principle that
- A. trade benefits the factor that is specific to the export sector.
 - B. protectionism helps manufacturers but harms consumers.
 - C. protectionism harms the factor that is specific to the export sector.
 - D. effective protection is not the same as a nominal tariff or tariff equivalent.
 - E. None of the above.

Answer: D

29. The specific factor model argues that if land can be used both for food production and for manufacturing, then a quota that protects food production will
- A. clearly help landowners.
 - B. clearly hurt landowners.
 - C. clearly help manufacture but hurt food production.
 - D. have an ambiguous effect on the welfare of landowners.
 - E. None of the above.

Answer: D

30. Ricardo's model of comparative advantage demonstrated no harm to any group in the economy as a result of free trade. This was probably because
- A. Ricardo did not understand the concept of diminishing returns.
 - B. the specific factor model had not yet been invented.
 - C. Heckscher and Ohlin had not yet been born.
 - D. a model, which demonstrated such harm, was counter-productive to Ricardo's political or polemical aims.
 - E. None of the above.

Answer: D cuuduongthancong.com

31. When the Napoleonic Wars were over, the Corn Laws were enacted in England. This may be understood in terms of the following:
- A. The Specific Factors model.
 - B. The intra-trade model.
 - C. The monopolistic competition model
 - D. The scale economies model
 - E. None of the above.

Answer: A

32. The production function may be analyzed using calculus. For example, the total product may be calculated as being equal to
- A. the first derivative of the total product curve.
 - B. the second derivative of the marginal product curve.
 - C. the integral summed up under the total product curve.
 - D. the integral summed up under the marginal product curve.
 - E. None of the above.

Answer: D

33. If Gambinia has many workers but very little land and even less productive capital, then, following the specific factor model, we know that Gambinia has a comparative advantage in
- A. manufactures.
 - B. food.
 - C. both manufactures and food.
 - D. neither manufactures nor food.
 - E. Not enough information given.

Answer: E

34. If, relative to its trade partners, Gambinia has many workers but very little land and even less productive capital, then, following the specific factor model, in order to help the country's economic welfare, the Gambinian government should
- A. protect the manufacturing sector.
 - B. protect the agricultural sector.
 - C. protect both sectors.
 - D. not resort to protectionism
 - E. None of the above.

Answer: D

35. If, relative to its trade partners, Gambinia has many workers but very little land and even less productive capital, then, following the specific factor model, we know that Gambinia has a comparative advantage in
- A. manufactures.
 - B. food.
 - C. both manufactures and food.
 - D. neither manufactures nor food.
 - E. None of the above.

Answer: B

Essay Questions

1. The *Specific Factors model* makes a distinction between general-purpose factors that can move between sectors and factors that are specific to particular uses. How do differences in the availabilities of the specific factors form the basis for international trade? Identify factors, which are specific, and explain in what sense or context they are specific.

Answer: This model posits a zero elasticity of technical substitution of a "specific" factor" between the two products. Hence, if the supply of one of these is (relatively) small, then the marginal product of labor in that industry will be low. Since each country is producing some of each, the wage rate must be equal in both sectors. Hence, the country will not be able to produce and sell the product competitively.

An example of a specific factor might be an engineer trained to operate and maintain a certain type of machine. Or land which can be used to raise only one type of crop.

2. The *Specific Factors model* clearly illustrates how the expansion of trade can have significant distributional effects on the relative incomes of different factors of production. Why do economists object to using trade protectionist policy to mitigate or reverse these effects? If mitigating such effects were considered to be a reasonable goal, would economists then favor do this via the use of trade policy? Why or why not?

Answer: Economists note that in general such remedies are inefficient. That is, there is almost always an alternative policy that can provide the same sectoral protection with a lower cost to the rest of the economy. In any case, such policy would also be inefficient in that they would divert scarce resources away from the country's area of comparative advantage.

3. It is claimed that the persistence of protectionism is often the result of the fact that those who lose from trade are usually a much more informed, cohesive and motivated a group than those who gain. Give a specific example from "real life" that supports this claim.

Answer: The shift of shipbuilding comparative advantage in shipbuilding away from the U.S. has caused economic damage to trained shipbuilders, as well as to owners of shipyards, and to peripheral businesses located near such shipyards. These groups, and their Congressional representatives will be very much aware of the damage being done. The gainers would be those who pay somewhat lower shipping charges, or lower retail prices due to the use of cheaper (foreign built) ships. Since shipping is typically a very small component of total retail cost, this gain will hardly be noticeable by any one single group in the economy.

4. One reason international trade has a powerful effect on the distribution of income within countries is that some factors are "specific", and therefore cannot move costlessly from one industry to another. What is another necessary condition for international trade to have such a strong effect on intra-country income distributions?

Answer: It is necessary that the relative factor intensities differ from industry to industry.

5. Even though it is very clear in the context of the *Specific Factors* model that an expansion of international trade will create losers as well as winners, economists still claim that the country as a whole gains. The general claim that a country gains even though some identifiable group within it systematically loses requires subjective judgements concerning the relative importance or weights to be given the economic welfares of individuals or groups. Do you believe that this is, in general scientifically or ethically possible to do? Explain your answer. In what sense, then, do economists nevertheless claim that the country as a whole gains?

Answer: This could be considered to be an intractable issue, for which modern welfare economics really has no solution. For example, in the early 1980s, it was decided not to subject blood supplies to (at that time) very expensive tests for positive HIV factors, since it was decided that this would cause blood shortages for large numbers of people, and that the number of people who might gain from applying the stringent tests was very small. That is, the good of the many was deemed superior to the good of the few. Unfortunately, the few happened to be just about every person suffering from Hemophilia at that time. Almost all of these people died as a result. Was their need really less than the needs of the many???

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Quantitative/Graphing Problems

1. In 1986, the price of oil on world markets dropped sharply. Since the United States is an oil-importing country, this was widely regarded as good for the U.S. economy. Yet in Texas and Louisiana, 1986 was a year of economic decline. Why?

Answer: The major exporting industry located in these two States is Oil extraction and refining. Since the factors of production specific to the oil industry could not shift out of them smoothly and quickly, their real income suffered.

2. An Economy can produce good 1 using labor and capital and good 2 using labor and land. The total supply of labor is 100 units. Given the supply of capital, the outputs of the two goods depends on labor input as follows:

Labor Input to Good 1	Output of Good 1	Labor input to Good 2	Output of Good 2
0	0	0	0
10	25	10	40
20	38	20	53
30	49	30	62
40	58	40	70
50	66	50	77
60	73	60	83
70	79	70	88
80	84	80	92
90	87	90	95
100	89	100	96

- A. Graph the production functions for good 1 and good 2
- A. Graph the production possibility frontier. Why is it curved?

Answer: The production possibility frontier is curved because of the diminishing returns associated with the expansion of output in the short run in each of the two industries.

3. Calculate the marginal product of labor for each product, for different labor inputs.

Answer: e.g. at 50 workers, the marginal product for 1 is 0.75
For product 2 it is 0.65
At 90 workers, the marginal product for 1 is 0.25
For product 2 it is 0.15

4. Suppose the relative price of good 1 falls relative to the price of 2. What happens to the wage rate?

Answer: The labor component of the price of 1 is larger than that of product 2. Hence, a fall in the relative price of 1 will lower the demand for labor and will result in a decrease in the wage rate.

5. Calculate the effects of the fall in the relative price of good 2 on the income of the specific factors capital and land.

Answer: Because good 2 uses land, a fall in its relative price will result in a fall in rental rates on land, and an increase in the return to capital.

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Chapter 4: Resources and Trade: The Heckscher-Ohlin Model

1. In the 2-factor, 2 good Heckscher-Ohlin model, an influx of workers from across the border would
- A. move the point of production along the production possibility curve.
 - B. shift the production possibility curve outward, and increase the production of both goods.
 - C. shift the production possibility curve outward and decrease the production of the labor-intensive product.
 - D. shift the production possibility curve outward and decrease the production of the capital-intensive product.
 - E. None of the above.

Answer: D

2. In the 2-factor, 2 good Heckscher-Ohlin model, the two countries differ in
- A. tastes.
 - B. military capabilities.
 - C. size.
 - D. relative availabilities of factors of production.
 - E. labor productivities.

Answer: D cuuduongthancong.com

3. In the 2-factor, 2 good Heckscher- Ohlin model, a change from autarky (no trade) to trade will benefit the owners of
- A. capital.
 - B. the relatively abundant factor of production.
 - C. the relatively scarce factor of production.
 - D. the relatively inelastic factor of production
 - E. the factor of production with the largest elasticity of substitution.

Answer: B

4. In the 2-factor, 2 good Heckscher- Ohlin model, a change from autarky (no trade) to trade
- A. will tend to make the wages in both countries more similar.
 - B. will equalize the wages in both countries.
 - C. will tend to make the wages in both countries less similar.
 - D. will tend to make wages equal to returns to capital.
 - E. will tend to make rents equal to interest rates.

Answer: A

5. The Leontieff Paradox
- A. supported the validity of the Ricardian theory of comparative advantage.
 - B. supported the validity of the Heckscher-Ohlin model.
 - C. failed to support the validity of the Ricardian theory.
 - D. failed to support the validity of the Heckscher-Ohlin model.
 - E. proved that the U.S. economy is different from all others.

Answer: D

6. The Leontieff Paradox
- A. refers to the finding that U.S. exports were more labor intensive than its imports.
 - B. refers to the finding that US. Exports were more capital intensive than its exports.
 - C. refers to the finding that the U.S. produces outside its Edgeworth Box.
 - D. still accurately applies to today's pattern of U.S. international trade.
 - E. refers to the fact that Leontieff - an American economist – had a Russian name.

Answer: A

7. The 1987 study by Bowen, Leamer and Sveikauskas
- A. supported the validity of the Leontieff Paradox.
 - B. supported the validity of the Heckscher-Ohlin model.
 - C. used a two-country and two-product framework.
 - D. demonstrated that in fact countries tend to use different technologies.
 - E. proved that the U.S.'s comparative advantage relied on skilled labor.

Answer: A

8. Empirical observations on actual North-South trade patterns tend to
- A. support the validity of the Leontieff Paradox.
 - B. support the validity of the Heckscher-Ohlin model.
 - C. support the validity of the Rybczynski Theorem.
 - D. support the validity of the wage equalization theorem.
 - E. support the validity of the neo-imperialism exploitation theory.

Answer: B

9. The Case of the Missing Trade refers to
- A. the 9th volume of the Hardy Boys' Mystery series.
 - B. the fact that world exports does not equal world imports.
 - C. the fact that factor trade is less than predicted by the Heckscher-Ohlin theory.
 - D. the fact that the Heckscher Ohlin theory predicts much less volume of trade than actually exists.
 - E. None of the above.

Answer: C

10. If the United States had relatively more capital per worker than Mexico, and if the Leontieff Paradox applied to this trade, then a successful expansion of trade under NAFTA between Mexico and the United States would tend to benefit which group in the United States?
- A. Environmentalists
 - B. Capitalists
 - C. Workers
 - D. Land owners
 - E. Skilled labor with relatively high levels of human capital

Answer: C

11. According to the Heckscher-Ohlin model, the source of comparative advantage is a country's
- A. technology.
 - B. advertising.
 - C. human capital.
 - D. factor endowments.
 - E. Both A and B.

Answer: D

12. The Heckscher-Ohlin model states that a country will have a comparative advantage in the good or service whose production is relatively intensive in the _____ with which the country is relatively abundant.
- A. tastes.
 - B. technology.
 - C. factor of production.
 - D. opportunity cost.
 - E. scale economy.

Answer: C

13. One way in which the Heckscher-Ohlin model differs from the Ricardo model of comparative advantage is by assuming that _____ is (are) identical in all countries.
- A. factor of production endowments
 - B. scale economies
 - C. factor of production intensities
 - D. technology
 - E. opportunity costs

Answer: D

14. According to the Heckscher-Ohlin model,
- A. everyone automatically gains from trade
 - B. the scarce factor necessarily gains from trade
 - C. the gainers could compensate the losers and still retain gains.
 - D. a country gains if its exports have a high value added.
 - E. None of the above.

Answer: C

15. The Heckscher-Ohlin model assumes that _____ are identical in all trading countries
- A. tastes
 - B. technologies
 - C. factor endowments
 - D. Both A. and B.
 - E. None of the above.

Answer: B

16. As opposed to the Ricardian model of comparative advantage, the assumption of diminishing returns in the Heckscher-Ohlin model means that the probability is greater that with trade
- A. countries will not be fully specialized in one product.
 - B. countries will benefit from free international trade.
 - C. countries will consume outside their production possibility frontier.
 - D. comparative advantage is primarily supply related.
 - E. None of the above.

Answer: A

17. Starting from an autarky (no-trade) situation with Heckscher-Ohlin model, if Country H is relatively labor abundant, then once trade begins
- A. wages and rents should rise in H
 - B. wages and rents should fall in H
 - C. wages should rise and rents should fall in H.
 - D. wages should fall and rents should rise in H.
 - E. None of the above.

Answer: C

18. Which of the following is false (for the Heckscher-Ohlin model)?
- A. If tastes are not identical in both countries, wages may still equalize.
 - B. Differences in technologies could be the source of gains from trade.
 - C. Some groups may gain and some may lose due to trade.
 - D. Gains for the trade-related winners will tend to be larger than losses of losers.
 - E. None of the above.

Answer: B

19. If tastes differed between countries, this could affect
- A. wage equalization due to trade with no specialization.
 - B. the direction of trade (who exports what to whom).
 - C. the fact that some groups in a country might lose welfare due to trade.
 - D. the fact that the country as a whole will gain from trade.
 - E. None of the above.

Answer: B

20. Suppose that there are two factors, capital and land, and that the United States is relatively land endowed while the European Union is relatively capital-endowed. According to the Heckscher-Ohlin model,
- A. European landowners should support US-European free trade.
 - B. European capitalists should support US-European free trade.
 - C. all capitalists in both countries should support free trade.
 - D. all landowners should support free trade.
 - E. None of the above.

Answer: B

21. According to the Heckscher-Ohlin model, if the United States is richly endowed in human-capital relative to Mexico, then as NAFTA increasingly leads to more bilateral free trade between the two countries,
- A. the United States will find its industrial base sucked into Mexico.
 - B. Mexico will find its relatively highly skilled workers drawn to the United States.
 - C. The wages of highly skilled U.S. workers will be drawn down to Mexican levels.
 - D. The wages of highly skilled Mexican workers will rise to those in the United States.
 - E. The wages of highly skilled Mexican workers will fall to those in the United States.

Answer: E

22. Assume that only two countries, A and B, exist.

Consider the following data:

Factor Endowments	<u>Countries</u>	
	A	B
<u>Labor Force</u>	45	20
<u>Capital Stock</u>	15	10

If good S is capital intensive, then following the Heckscher-Ohlin Theory,

- A. country A will export good S.
- B. country B will export good S.
- C. both countries will export good S.
- D. trade will not occur between these two countries.
- E. Insufficient information is given.

Answer: B

23. Continuing from Question #22, if you are told that Country B is **very** much richer than Country A, then the correct answer is:

- A. country A will export good S.
- B. country B will export good S.
- C. both countries will export good S.
- D. trade will not occur between these two countries.
- E. insufficient information is given.

Answer: B

24. Continuing from Question #22, you are told that Country B is very much larger than country A. The correct answer is:
- A. country A will export good S.
 - B. country B will export good S.
 - C. both countries will export good S.
 - D. trade will not occur between these two countries.
 - E. insufficient information is given.

Answer: B

25. Continuing from Question #22, you are told that Country B has no minimum wage or child labor laws. Now the correct answer is:
- A. country A will export good S.
 - B. country B will export good S.
 - C. both countries will export good S.
 - D. trade will not occur between these two countries.
 - E. Insufficient information is given.

Answer: B

26. Continuing from Question #22, you now are told that the labor unions representing the workers in each of the two respective countries are considering lobbying against the opening of international trade between these two countries. Note that workers' income is derived solely from wages.
- A. This would be a misguided decision from the viewpoint of the workers in both countries, since trade is always better than autarky.
 - B. This would be a good decision from the viewpoint of workers in Country A since international trade helps the capitalists and hurts the workers.
 - C. This would be a good decision from the viewpoint of workers in Country B since international trade helps the capitalists and hurts the workers.
 - D. This would be a good decision for both unions since trade hurts workers wherever they live.
 - E. None of the above.

Answer: C

27. We are now told that the information given us in Question #22 was not exactly accurate, and that in fact S is relatively capital intensive only when relative wages are high, but becomes relatively labor intensive when relative wages are low. Given this information:
- A. country A will export good S.
 - B. country B will export good S.
 - C. both countries will export good S.
 - D. trade will not occur between these two countries.
 - E. Insufficient information is given.

Answer: E

28. The following are all assumptions that must be accepted in order to apply the Heckscher-Ohlin Theory, except for one:
- A. countries differ in their endowments of factors of production.
 - B. countries differ in their technologies.
 - C. there are two factors of production.
 - D. production is subject to constant returns to scale.
 - E. one product always requires more machines per worker in its production than does the other product.

Answer: B

29. In international-trade equilibrium in the Heckscher-Ohlin model,
- A. the capital rich country will charge less for the capital intensive good than the price paid by the capital poor country for the capital-intensive good.
 - B. the capital rich country will charge the same price for the capital intensive good as that paid for it by the capital poor country.
 - C. the capital rich country will charge more for the capital intensive good than the price paid by the capital poor country for the capital-intensive good.
 - D. the workers in the capital rich country will earn more than those in the poor country.
 - E. the workers in the capital rich country will earn less than those in the poor country.

Answer: B

30. If two countries were very different in their relative factor availabilities, then we would not expect which of the following to be empirically supported?
- A. The Heckscher - Ohlin Theorem
 - B. The Factor Price Equalization Theore.
 - C. The Law of One Price
 - D. The Law of Demand
 - E. None of the above.

Answer: B

31. When Country A produces both goods more efficiently than Country B, then
- A. country A should produce both goods and not trade.
 - B. country A should specialize in its good of least absolute disadvantage.
 - C. both countries would benefit from autarky.
 - D. both countries may not benefit from trade.
 - E. None of the above.

Answer: E

32. The minimum information required to determine Country A's comparative advantage is
- A. the number of hours of labor in the economy of A.
 - B. ratio of labor inputs for products S and T in A.
 - C. total available labor, labor required per unit of S, and labor required per unit of T in A.
 - D. total available labor and the ratio of labor inputs for S and T in A.
 - E. None of the above.

Answer: E

33. The slope of a country's PPF reflects
- A. the opportunity cost of product S in terms of product T.
 - B. the opportunity cost of T in terms of money prices.
 - C. the opportunity cost of S or T in terms of S.
 - D. Both A and B.
 - E. Both A and C.

Answer: A

34. The Heckscher-Ohlin model predicts all of the following except:
- A. which country will export which product.
 - B. which factor of production within each country will gain from trade.
 - C. the volume of trade.
 - D. that wages will tend to become equal in both trading countries.
 - E. None of the above.

Answer: C

35. The Heckscher-Ohlin model differs from the Ricardian model of Comparative Advantage in that the former
- A. has only two countries.
 - B. has only two products.
 - C. has two factors of production.
 - D. has two production possibility frontiers (one for each country).
 - E. None of the above.

Answer: C

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Essay Questions

1. “A good cannot be both land- and labor-intensive.” Discuss.

Answer: In a two good, two factor model, such as the original Heckscher-Ohlin framework, the factor intensities are *relative* intensities. Hence, the relevant statistic is either workers per acre (or acres per worker); or wage per rental unit (or rental per wage). In order to illustrate the logic of the statement above, let us assume that the production of a broom requires 4 workers and 1 acre. Also, let us assume that the production of one bushel of wheat requires 40 workers and 80 acres. In this case the acres per person required to produce a broom is one quarter, whereas to produce a bushel of wheat requires 2 acres per person. The wheat is therefore (relatively) land intensive, and the broom is (relatively) labor intensive.

2. “No country is abundant in everything.” Discuss.

Answer: the concept of relative (country) factor abundance is (like factor intensities) a *relative* concept. When we identify a country as being capital intensive, we mean that it has more capital per worker than does the other country. If one country has more capital worker than another, it is an arithmetic impossibility that it also has more workers per unit capital.

3. There is frequently a conflict between short-term and long-term interests in trade. Discuss.

Answer: In trade models, the short term is typically defined as that (conceptual) period of time in which both the technology and the amount of factors of production are given and cannot be changed. When we state that free trade can be shown to be an optimal policy under certain circumstances, we mean that in the short run, this policy can bring a country to an optimum level of consumption.

However, there is no inconsistency in the proposition that the optimum short run solution may not be the solution, which maximizes the likelihood of economic expansion or growth (the long run). For example, a policy which maximizes consumption may not take into account inter-temporal preferences, and hence may "short-change" future generations (or those who care for future generations).

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4. International trade leads to complete equalization of factor prices. Discuss.

Answer: This statement is typically "true...but". Under a strict and limited set of assumptions, such as the original Heckscher-Ohlin model which excludes country specific technologies; non-homothetic tastes; factor intensity reversals; large country differences in (relative) factor abundances, and more factors than goods, then it may be demonstrated that internal consistency demands that the above stated sentence is "true". However, the minute one relaxes any of the above listed assumptions one may easily identify solutions, which contradict the factor price equalization theorem.

5. Countries that are willing to tolerate an unusually high quantity of pollution relative to their supplies of other factors would tend to export "pollution-intensive" goods. Discuss using the Heckscher-Ohlin (H.O.) model.

Answer: This statement is badly crafted. It seems to imply that pollution per say is a proper factor of production. That is, just as if you add a worker, you get additional product, so the marginal product of pollution is positive. The problem here is that pollution is not really a factor of production, but rather an externality, which may be more typical of imported goods than exported ones. In such a case, the statement above is false.

6. Countries do not in fact export the goods the H.O. theory predicts. Discuss.

Answer: This statement is not true. Although one may find many cases where it seems to be true (e.g. the *Leontieff Paradox*), all one needs to do in order to render the above statement not (generally) true is to find one counter example. In fact, one can find large subsets of agricultural and commodity products in which the H.O predictions are generally fulfilled. Labor-intensive countries such as Bangladesh do in fact export relatively labor-intensive goods. Capital-intensive countries such as Germany do in fact export capital-intensive products (at least to South countries). Countries such as Costa Rica ("sunshine abundant") tend to export bananas (sunshine-intensive products). The U.S. (a wheat-land -abundant country) does indeed export wheat (a wheat-land intensive product). In fact, since the early 1980s, the *Leontieff Paradox* was not found to describe the U.S. trade data (hence ratifying the H.O. theory).

7. Why is the H.O. model called the factor-proportion theory?

Answer: The H.O. model explores the nature and the limitations of assuming that the sole determinant of comparative advantage is inter-country differences in (relative) factor proportions.

8. Why do we observe the Leontief paradox?

Answer: There are many possible answers. They may be classified into three groups. One would argue that the model, or theory is wrong. The other would argue that the theory is correct (internally consistent and descriptive of real world data), but the real world data is incorrectly perceived, defined or measured. The third would argue that the statement itself is wrong, and that in fact the Leontieff paradox itself is not actually observed, but rather is due to faulty logical rendering of the original model.

9. Why are prices of factors of production not equalized?

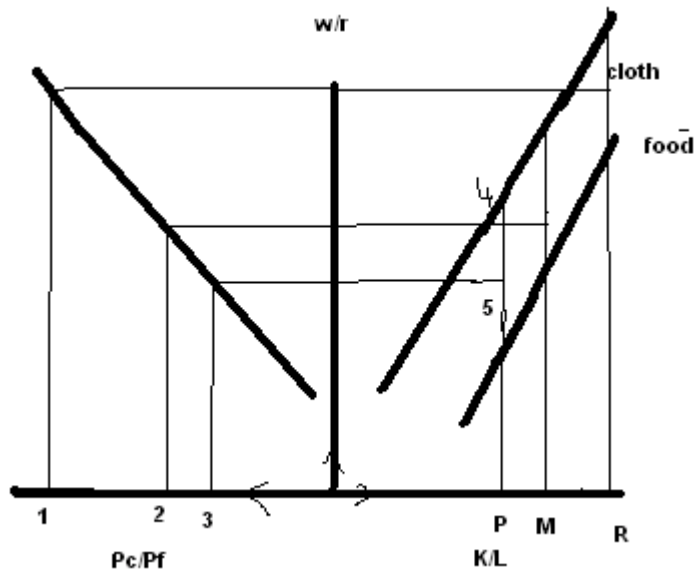
Answer: Again this statement may or may not be argued to be true. On the one hand, the large volume and growth in world trade between the United States and other OECD countries during the 50 years since World War II has clearly been related to a near universal (average) convergence in real wage levels in these countries, whereas the most obvious cases in which such a convergence did not take place (North-South countries) also happened to be cases in which trade was relatively small and "missing".

There are many theoretical reasons why factor price equalization may not occur. If the relative country relative abundances are very different, then the theory itself does not predict that the wage equalization will occur. The same is true of factor intensity reversals exist within relevant relative wage ranges. Dynamic migration models such as Harris-Todaro are another class of theory that may suggest that even if the static equilibrium solution does include the factor-price equalization, the dynamic path of the model may never reach this solution, so that when observed within any finite time frame, it a lack of equalization would exist.

10. "The H.O. model remains useful as a way to predict the income distribution effects of trade." Discuss.

Answer: The Stolper-Samuelson theorem, one of the basic theorems arising from the Heckscher-Ohlin model yields an elegant demonstration of the fact that changes in product prices (such as will occur when trade is expanded or curtailed) *telescopes* its effects onto factor prices, so that not only do relative factor returns mirror product prices, but that actual returns to factors may either rise or fall in real terms. Hence, as a policy framework, the disproportionate effect trade may have on real incomes of sectors, such as skilled-labor is quite useful both theoretically and practically (or polemically).

Quantitative/Graphing Problems



- Two countries exist in this model, **P** and **R**. **P** is relatively labor (**L**) abundant, as is evident in the bottom right horizontal axis. If Country **P** were to be completely specialized in the labor-intensive product, **C**, it would be producing at point 4. In fact, it produces both **C** and **P**, at point 5. The (autarky) relative price of **C** (in terms of **F**) of Country **P** is at point 3; and of Country **R** at point 1. If trade were to open up between these two countries, which would export **C** and which would export **F**? Is this consistent with the Heckscher-Ohlin model? Explain.

Answer: Country **R** would export **F**. This is consistent with the H-O model. The country which is relatively capital abundant exports the product which is relatively capital intensive.

- If trade were to open up between **P** and **R**, where would the world terms of trade locate in the figure above (somewhere on the P_C/P_F axis)? Would relative wages (w/r) in the two countries become equal? Is this consistent with the Heckscher-Ohlin model? Explain.

Answer: The terms of trade would settle somewhere between the two autarky relative prices on the P_C/P_F axis. The relative wages (w/r) will be lower than the highest and higher than the lowest on the vertical axis above, but will not coincide. This last result is in contradiction to the factor price equalization expectation we have from the model.

3. Now repeat the exercise but substitute country **M** for country **R**. How do the answers differ from those in question 2 above? Explain the reason for any differences you note.

Answer: All the answers are the same except that one single relative wage will be established for both countries. This happens because the two countries do not differ in relative factor availability by much, and hence a zone of overlap exists which allows for this result.

4. In autarky, Country **P** was producing at point 5. With trade, would its production point be found above or below point 5? Explain why. What must happen in the **K/L** intensity ratio in the production of each of the products in this country when moving from autarky to free trade?

Answer: The point of production with trade will be above point 5. The country will be shifting its production composition to be more heavily weighted in labor intensive good, C. Within each industry, the production technique will be more capital intensive, since with the rising relative wage, the optimal point of production will involve sliding around the isoquants in the direction of saving on the now relatively more expensive labor.

5. Using the answers to question 4, can you guess which group of producers in Country **P** might lobby against free trade?

Answer: In Country **P**, the owners of the relatively scarce factor of production are the owners of capital. Their relative and real incomes will decrease, and so they may well attempt to lobby for protectionism, which may prevent the country from moving to a free trade equilibrium.

Chapter 5: The Standard Trade Model

1. The concept “terms of trade” means
- A. the amount of exports sold by a country.
 - B. the price conditions bargained for in international markets.
 - C. the price of a country's exports divided by the price of its imports.
 - D. the quantities of imports received in free trade.
 - E. None of the above.

Answer: C

2. A country cannot produce a mix of products with a higher value than where
- A. the isovalue line intersects the production possibility frontier.
 - B. the isovalue line is tangent to the production possibility frontier.
 - C. the isovalue line is above the production possibility frontier.
 - D. the isovalue line is below the production possibility frontier.
 - E. the isovalue line is tangent with the indifference curve.

Answer: B

3. Tastes of individuals are represented by
- A. the production possibility frontier.
 - B. the isovalue line.
 - C. the indifference curve.
 - D. the production function.
 - E. None of the above.

Answer: C

4. If P_C / P_F were to increase in the international marketplace, then
- A. all countries would be better off.
 - B. the terms of trade of cloth exporters improve.
 - C. the terms of trade of food exporters improve.
 - D. the terms of trade of all countries improve.
 - E. None of the above

Answer: B

5. If P_C / P_F were to increase,
- A. the cloth exporter would increase the quantity of cloth exports.
 - B. the cloth exporter would increase the quantity of cloth produced.
 - C. the food exporter would increase the quantity of food exports.
 - D. Both A and C.
 - E. None of the above.

Answer: B

6. If P_C / P_F were to increase,
- A. world relative quantity of cloth supplied and demanded increases.
 - B. world relative quantity of cloth supplied and demanded decreases.
 - C. world relative quantity of cloth supplied increases..
 - D. world relative quantity of cloth demanded decreases .
 - E. None of the above.

Answer: C

7. When the production possibility frontier shifts out relatively more in one direction, we have
- A. biased growth.
 - B. unbiased growth.
 - C. immiserizing growth.
 - D. balanced growth.
 - E. imbalanced growth.

Answer: A

8. Export-biased growth in Country H will
- A. improve the terms of trade of Country H.
 - B. trigger anti-bias regulations of the WTO.
 - C. worsen the terms of trade of Country F (the trade partner).
 - D. improve the terms of trade of Country F.
 - E. decrease economic welfare in Country H.

Answer: D

9. Immiserizing growth is
- A. likely to occur if the exporting country is poor.
 - B. likely to occur if the exporting country is rich.
 - C. likely to occur when terms of trade change.
 - D. likely to occur if relative supplies are elastic.
 - E. None of the above.

Answer: E

10. If the U.S. Agency for International Development transfers funds to poor countries in Sub-Saharan Africa, this must
- A. worsen the U.S. terms of trade.
 - B. improve the U.S. terms of trade.
 - C. worsen the terms of trade of the African aid recipients.
 - D. improve the terms of trade of the African aid recipients.
 - E. None of the above.

Answer: E

11. If the poor AID recipient countries have a higher marginal propensity to consume each and every product than does the United States, then such aid will
- A. worsen the U.S. terms of trade.
 - B. improve the U.S. terms of trade.
 - C. leave the world terms of trade unaffected.
 - D. worsen the terms of trade of both donor and recipient countries.
 - E. None of the above.

Answer: B

12. If a large country imposes a tariff on its imported good, this will tend to
- A. have no effect on terms of trade.
 - B. improve the terms of trade of all countries.
 - C. improve the terms of trade of the United States.
 - D. cause a deterioration of U.S. terms of trade.
 - E. raise the world price of the good imported by the United States.

Answer: C

13. A country will be able to consume a bundle which is not attainable solely from domestic production only if
- A. the world terms of trade differ from its domestic relative costs.
 - B. the country specializes in one product.
 - C. the country avoids international trade.
 - D. the world terms of trade equal the domestic relative costs.
 - E. None of the above.

Answer: A

14. Terms of trade refers to
- A. what goods are imported.
 - B. what goods are exported.
 - C. the volume of trade.
 - D. the prices at which trade occurs.
 - E. None of the above.

Answer: D

15. If points a and b are both on the production possibility frontier of a country, then
- A. consumers are indifferent between the two bundles.
 - B. producers are indifferent between the two bundles.
 - C. at any point in time, the country could produce both.
 - D. Both cost the same.
 - E. The country could produce either of the two bundles.

Answer: E

16. If the economy is producing at point a on its production possibility frontier, then
- A. all of the country's workers are specialized in one product.
 - B. all of the county's capital is used for one product.
 - C. all of the county's workers are employed.
 - D. all of its capital is used, but not efficiently.
 - E. None of the above.

Answer: C

17. If at point A on the production possibility frontier, and the community indifference curve cuts through point a from northwest to southeast, then the optimal autarky production bundle is
- A. at point A.
 - B. to the right of point A.
 - C. to the left of point A.
 - D. to the northeast of point A.
 - E. to the southwest of point A.

Answer: B

18. A bundle indicated by a point to the northeast of the production possibility frontier is
- A. unattainable at a point in time.
 - B. unattainable at a point in time without international trade.
 - C. unattainable at a point in time without domestic trade.
 - D. unattainable as a consumption point.
 - E. None of the above.

Answer: B

19. If two countries with diminishing returns and different marginal rates of substitution between two products were to engage in trade, then
- A. the shapes of their respective production possibility frontiers would change.
 - B. the marginal rates of substitution of both would become equal.
 - C. the larger of the two countries would dominate their trade.
 - D. the country with relatively elastic supplies would export more.
 - E. None of the above.

Answer: B

20. If a country began exporting product A and importing product B, then, as compared to the autarky (no-trade) situation, the marginal cost of product A will
- A. increase.
 - B. decrease.
 - C. shift outward.
 - D. shift inward.
 - E. None of the above.

Answer: A

21. If, beginning from a free trade equilibrium, the terms of trade improve for a country, then it will
- A. increase production of its import competing good.
 - B. increase consumption of its export good.
 - C. increase the quantity of its imports.
 - D. experience an export-biased shift in its production possibility frontier.
 - E. None of the above.

Answer: C

22. An increase in a country's net commodity terms of trade will always
- A. increase the country's economic welfare.
 - B. increase the country's real income.
 - C. increase the country's quantity of exports.
 - D. increase the country's production of its import competing good.
 - E. None of the above.

Answer: E

23. After WWI, Germany was forced to make large reparations - transfers of real income- to France. If the marginal propensity to consume was equal in both countries, and if France's demand was biased toward food (relative to Germany's demand pattern) then we would expect to find
- A. the world's relative price for food remains unchanged.
 - B. the world's relative price for food increase.
 - C. the world's relative price for food decrease.
 - D. the world relative price for both food and non-food rise.
 - E. None of the above.

Answer: B

24. If we add to Question 23 that France exported manufactures, whereas Germany exported food, then the reparations from Germany to France would
- A. improve France's international terms of trade.
 - B. cause France' terms of trade to deteriorate.
 - C. cause both France' and Germany's terms of trade to deteriorate.
 - D. cause both France' and Germany's terms of trade to improve.
 - E. None of the above.

Answer: B

24. If a country lent money to another, this must
- A. lower the terms of trade of the recipient country.
 - B. lower the terms of trade of both countries.
 - C. improve the terms of trade of the recipient country.
 - D. improve the terms of trade of the donor country
 - E. None of the above.

Answer: E

25. During the 19th Century, economic growth of the major trading countries was biased toward manufactures and away from food. The less developed countries of that time were net exporters of food. From this information, we would expect to have observed
- A. falling terms of trade for the less developed countries.
 - B. improving (rising) terms of trade for the less developed countries.
 - C. no change at all in the terms of trade of the less developed countries.
 - D. a decrease in the relative price of food.
 - E. None of the above.

Answer: B

26. Immiserizing growth could occur to
- A. a poor country experiencing export-biased economic growth.
 - B. a poor country experiencing import-biased economic growth.
 - C. a poor country experiencing growth in its non-traded sector.
 - D. a poor country experiencing capital-intensive biased growth.
 - E. None of the above.

Answer: A

27. A large country experiencing import-biased economic growth will tend to experience
- A. positive terms of trade.
 - B. deteriorating terms of trade.
 - C. improving terms of trade.
 - D. immiserizing terms of trade.
 - E. None of the above.

Answer: C

28. In the period preceding the recent Financial Crisis in Asia, the South East Asian countries were receiving large inflows of financial capital. Following John Maynard Keynes' theory, this should have caused
- A. a glut in their banking asset situation.
 - B. an improvement in their terms of trade.
 - C. deterioration in their terms of trade.
 - D. a fluctuation upward and then downward in their terms of trade.
 - E. None of the above.

Answer: B

29. If Slovenia is a small country in world trade terms, then if it imposes a large series of tariffs on many of its imports, this would
- A. have no effect on its terms of trade.
 - B. improve its terms of trade.
 - C. deteriorate its terms of trade.
 - D. decrease its marginal propensity to consume.
 - E. None of the above.

Answer: A

30. If Slovenia is a large country in world trade, then if it imposes a large set of tariffs on many of its imports, this would
- A. have no effect on its terms of trade.
 - B. improve its terms of trade.
 - C. deteriorate its terms of trade.
 - D. decrease its marginal propensity to consume.
 - E. None of the above.

Answer: B

31. If Slovenia were a large country in world trade, then if it imposes a large set of tariffs on its imports, this must
- A. cause retaliation on the part of its trade partners.
 - B. harm Slovenia's real income.
 - C. improve Slovenia's real income.
 - D. improve the real income of its trade partners.
 - E. None of the above.

Answer: E

31. If Slovenia were a large country in world trade, then if it instituted a large set of subsidies for its exports, this must
- A. have no effect on its terms of trade.
 - B. improve its terms of trade.
 - C. deteriorate its terms of trade.
 - D. decrease its marginal propensity to consume.
 - E. None of the above.

Answer: C

32. If Slovenia were a large country in world trade, then if it instituted a large set of subsidies for its exports, this must
- A. cause retaliation on the part of its trade partners.
 - B. harm Slovenia's real income.
 - C. improve Slovenia's real income.
 - D. improve the real income of its trade partners.
 - E. None of the above.

Answer: D

33. If the United States exports skilled-labor intensive products and services, then we should expect unions representing skilled labor to
- A. lobby in favor of tariffs.
 - B. lobby against the imposition of tariffs.
 - C. be indifferent to the issue of tariffs.
 - D. lobby in favor of improved terms of trade.
 - E. Not enough information.

Answer: E

34. If the United States exports skilled-labor intensive products and services, then we should expect unions representing unskilled labor to
- A. lobby in favor of tariffs.
 - B. lobby against the imposition of tariffs.
 - C. be indifferent to the issue of tariffs.
 - D. lobby in favor of improved terms of trade.
 - E. Not enough information.

Answer: B

35. If there are no international loans or capital flows, then if a country's terms of trade improve, we would find that
- A. the value of its exports exceeds the value of its imports.
 - B. the value of its exports becomes less than that of its imports.
 - C. the value of its exports exactly equals that of its imports.
 - D. the quantity of its exports equals that of its imports.
 - E. None of the above.

Answer: C

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Essay Questions

1. Other things being equal, a rise in a country's terms of trade increases its welfare. What would happen if we relax the *ceteris paribus* assumption, and allow for the law of demand to operate internationally?

Answer: Let us assume that the terms of trade (or technically the net commodity terms of trade) improve, thus the relative price of a country's exports increase. This would, logically, lead to a shift away by world consumers to substitute goods. If the demand for a country's exports is elastic, the quantity decrease would be proportionally larger than the per unit price increase. This term of trade effect would actually lower the country's real income and economic welfare.

2. If a country's growth is biased in favor of its import, this should unequivocally improve its terms of trade and its economic welfare. Discuss.

Answer: Suppose Japan experiences economic growth biased in favor of its import substitutes. For example, assume that Japan imports components and exports final goods, but that it experiences a major growth in its components manufacture sector. Since Japan is internationally a large country in these markets, this would tend to hurt its component supplier's terms of trade (and hurt Japan's). However, such a bias in economic growth may tend to lessen the volume of international trade. At an extreme, Japan may become an exporter of components and an importer of final goods. If the result is a lessening of specialization and of the volume of trade, then this effect will lower Japan's welfare associated with gains from trade. If an actual change in the pattern of comparative advantage occurs (a possibility) this may cause dynamic dislocations whose harm overpowers static gains for a relatively long period of time.

3. It is impossible for economic growth in a small country to lower that country's economic welfare, regardless of the bias of the growth. Explain.

Answer: This is a true statement. The reason economic growth may hurt a country is if the terms of trade effect counters and dominates the growth effect. In the case of the small country there is no terms of trade effect.

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4. At the conclusion of World War I, Germany, as a punishment, was obliged to make a large transfer to France in the form of reparations. Is it possible that the actual reparations may have improved Germany's economic welfare?

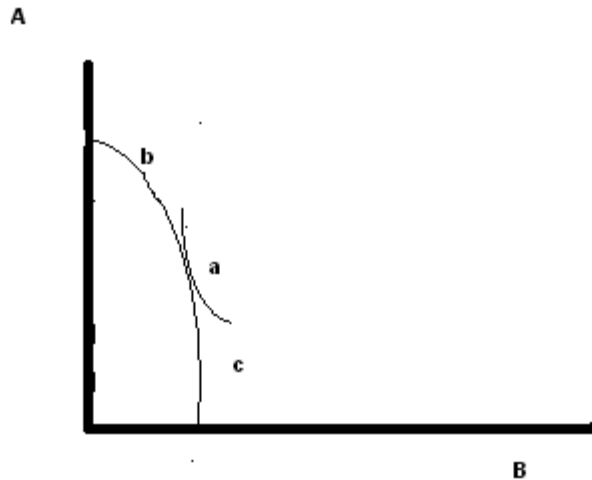
Answer: Such a result is not likely. However, theoretically, if France's income elasticity of demand for Germany's exports was higher than Germany's income elasticity of demand for its own exportable, then the real income transfer associated with these reparations may have improved Germany's terms of trade, and improved its balance of payments, thus helping Germany in manner unanticipated in the Treaty of Versailles. Explain.

5. An export subsidy has the opposite effect on terms of trade to the effect of an import tariff. Domestically a tariff will raise the price of the import good, deteriorating the domestic terms of trade. A production subsidy for the export product will lower the local price of the export good, lowering the domestic terms of trade for the country. Hence the export subsidy and the import tariff have the same effect. This analysis seems to contradict the first sentence in this paragraph. Discuss this paradox.

Answer: While this (Lerner) equivalence may well occur domestically, internationally the tariff will improve a country's terms of trade. An export subsidy on the other hand will in fact lower the international price of the (now readily available) export good, hence hurting a country's terms of trade.

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Quantitative/Graphing Problems



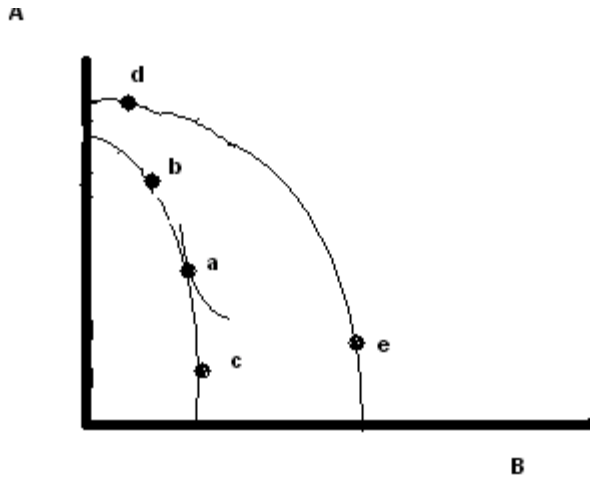
1. Albania refused to engage in international trade for ideological reasons. To maximize its economic welfare it would choose to produce at which point in the diagram above? Suppose the P_A/P_B at point **a** was equal to 1. Given this information, in which good (A or B) does Albania enjoy a comparative advantage?
Now that the Cold War is over, Albania is interested in obtaining economic welfare gains from trade. The relevant international relative price is $P_A/P_B = 2$. Albania would therefore choose to produce at which point (a, b, or c)? Given this additional information, in which good does Albania enjoy a comparative advantage?

Answers: Albania would choose to produce at point a. With no reference to world terms of trade, one cannot establish Albania's comparative advantage.

Later, when Albania discovers that the relative price of A equals twice the price of B, it knows that it has a comparative advantage in A. Therefore Albania would produce at production point b.

2. Now, suppose that the relative price of A is actually not higher than Albania's autarkic level of 1, but quite the opposite (e.g. $P_A/P_B = 0.5$). Would Albania still be able to gain from trade? If so, where would be its production point? Given the information in this question, where is Albania's comparative advantage?

Answer: Yes. As long as the world's terms of trade differed from those of Albania, that country stands to gain from international trade. In this particular case, its point of production with trade would be at point c.



3. Suppose, as a result of various dynamic factors associated with exposure to international competition, Albania's economy grew, and is now represented by the rightmost production possibility frontier in the Figure above. If its point of production with trade was point **c**, would you consider this growth to be export-biased or import biased? If Albania were a *large country* with respect to the world trade of A and B, how would this growth affect Albania's terms of trade? Its real income?

Answer: If point **c** is the production point with trade, then Albania has a comparative advantage in good B. Therefore, from the shape of the new production possibility frontier (as compared to the original one), this is clearly an export-biased growth. This *ceteris paribus* would tend to worsen Albania's terms of trade. The terms of trade effect would, again *ceteris paribus*, worsen its real income. However, the growth itself acts in the opposite direction.

4. Suppose, as a result of various dynamic factors associated with exposure to international competition, Albania's economy grew, and is now represented by the rightmost production possibility frontier in the Figure above. If its point of production with trade was point **b**, would you consider this growth to be export-biased or import biased? If Albania were a *large country* with respect to the world trade of A and B, how would this growth affect Albania's terms of trade? Its real income? What if Albania were a *small country*?

Answer: If the production with trade point was point **b**, then the observed growth is a case of import-biased growth, and would improve Albania's terms of trade. If Albania were a small country, the world's terms of trade would not change at all. In such a case, economic growth (with no induced change in income distributions) would always increase its real income.

5. Suppose Albania is exporting product **B**, and experienced economic growth biased in favor of product **B** as seen in the Figure above. We are also told that Albania's new consumption point is at point **d**. Would you still consider the economic growth, which took place biased in favor of **B**? If Albania were a *large country* how would this growth affect its terms of trade?

Answer: This is a relatively difficult case. On the one hand, the growth is still technically export biased. However, Albania's consumption clearly shifted in favor of its import product, A. In this case, the deterioration in the terms of trade would be much more pronounced than before, and may lead to a case of immiserizing growth. However, for this to occur, there must have been a major shift in the taste patterns (the old community indifference map is not longer applicable). Therefore, when we try to judge the direction and magnitude of the welfare change, we are comparing the old versus new taste preferences, which raises the classic index number problem.

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Chapter 6: Economies of Scale, Imperfect Competition, and International Trade

1. External economies of scale arise when the cost per unit
- A. rises as the industry grows larger.
 - B. falls as the industry grows larger rises as the average firm grows larger.
 - C. falls as the average firm grows larger.
 - D. remains constant.
 - E. None of the above.

Answer: B

2. Internal economies of scale arise when the cost per unit
- A. rises as the industry grows larger.
 - B. falls as the industry grows larger.
 - C. rises as the average firm grows larger.
 - D. falls as the average firm grows larger.
 - E. None of the above.

Answer: D

3. External economies of scale
- A. may be associated with a perfectly competitive industry.
 - B. cannot be associated with a perfectly competitive industry.
 - C. tends to result in one huge monopoly.
 - D. tends to result in large profits for each firm.
 - E. None of the above.

Answer: A

4. Internal economies of scale
- A. may be associated with a perfectly competitive industry.
 - B. cannot be associated with a perfectly competitive industry.
 - C. are associated only with sophisticated products such as aircraft.
 - D. cannot form the basis for international trade .
 - E. None of the above.

Answer: B cuuduongthancong.com

5. A monopolistic firm
- A. can sell as much as it wants for any price it determines in the market.
 - B. cannot determine the price, which is determined by consumer demand.
 - C. will never sell a product whose demand is inelastic at the quantity sold.
 - D. cannot sell additional quantity unless it raises the price on each unit.
 - E. None of the above.

Answer: C

6. Monopolistic competition is associated with
- A. cut-throat price competition.
 - B. product differentiation.
 - C. explicit consideration at firm level of the feedback effects of other firms' pricing decisions.
 - D. high profit margins.
 - E. None of the above.

Answer: B

7. The most common market structure is
- A. perfect competition.
 - B. monopolistic competition.
 - C. small-group oligopoly.
 - D. perfectly vertical integration.
 - E. None of the above.

Answer: C

8. Modeling trade in monopolistic industries is problematic because
- A. there is no one generally accepted model of oligopoly behavior.
 - B. there are no models of oligopoly behavior.
 - C. it is difficult to find an oligopoly in the real world.
 - D. collusion among oligopolists makes usable data rare.
 - E. None of the above.

Answer: A

9. Where there are economies of scale, the scale of production possible in a country is constrained by
- A. the size of the country.
 - B. the size of the trading partner's country.
 - C. the size of the domestic market.
 - D. the size of the domestic plus the foreign market.
 - E. None of the above.

Answer: D

10. Where there are economies of scale, an increase in the size of the market will
- A. increase the number of firms and raise the price per unit.
 - B. decrease the number of firms and raise the price per unit.
 - C. increase the number of firms and lower the price per unit.
 - D. decrease the number of firms and lower the price per unit.
 - E. None of the above.

Answer: C

11. The simultaneous export and import of widgets by the United States is an example of
- A. increasing returns to scale.
 - B. imperfect competition.
 - C. intra-industry trade.
 - D. inter-industry trade.
 - E. None of the above.

Answer: C

12. If output more than doubles when all inputs are doubled, production is said to occur under conditions of
- A. increasing returns to scale.
 - B. imperfect competition.
 - C. intra-industry trade.
 - D. inter-industry trade.
 - E. None of the above.

Answer A

13. Intra-industry trade can be explained in part by
- A. transportation costs within and between countries.
 - B. problems of data aggregation and categorization.
 - C. increasing returns to scale.
 - D. All of the above.
 - E. None of the above.

Answer: D

14. If some industries exhibit internal (firm specific) increasing returns to scale in each country, we should not expect to see
- A. intra-industry trade between countries.
 - B. perfect competition in these industries.
 - C. inter-industry trade between countries.
 - D. high levels of specialization in both countries.
 - E. None of the above.

Answer: B

15. Intra-industry trade is most common in the trade patterns of
- A. developing countries of Asia and Africa.
 - B. industrial countries of Western Europe.
 - C. all countries.
 - D. North-South trade.
 - E. None of the above.

Answer: B

16. International trade based on scale economies is likely to be associated with
- A. Ricardian comparative advantage.
 - B. comparative advantage associated with Heckscher-Ohlin factor-proportions.
 - C. comparative advantage based on quality and service.
 - D. comparative advantage based on diminishing returns.
 - E. None of the above.

Answer: E

17. International trade based on external scale economies in both countries is likely to be carried out by a
- A. relatively large number of price competing firms.
 - B. relatively small number of price competing firms.
 - C. relatively small number of competing oligopolists.
 - D. monopoly firms in each country/industry.
 - E. None of the above.

Answer: A

18. International trade based solely on internal scale economies in both countries is likely to be carried out by a
- A. relatively large number of price competing firms.
 - B. relatively small number of price competing firms.
 - C. relatively small number of competing oligopolists.
 - D. monopoly firms in each country/industry.
 - E. None of the above.

Answer: D

19. A monopoly firm engaged in international trade will
- A. equate average to local costs.
 - B. equate marginal costs with foreign marginal revenues.
 - C. equate marginal costs with the highest price the market will bear.
 - D. equate marginal costs with marginal revenues in both domestic and in foreign markets.
 - E. None of the above.

Answer: D

20. A monopoly firm will maximize profits by
- A. charging the same price in domestic and in foreign markets.
 - B. producing where the marginal revenue is higher in foreign markets.
 - C. producing where the marginal revenue is higher in the domestic market.
 - D. equating the marginal revenues in domestic and foreign markets.
 - E. None of the above.

Answer: D

21. A firm in monopolistic competition
- A. earns positive monopoly profits because each sells a differentiated product.
 - B. earns positive oligopoly profits because each firm sells a differentiated product.
 - C. earns zero economic profits because it is in perfectly or pure competition.
 - D. earns zero economic profits because of free entry.
 - E. None of the above.

Answer: D

22. The larger the number of firms in a monopolistic competition situation,
- A. the larger are that country's exports.
 - B. the higher is the price charged.
 - C. the fewer varieties are sold.
 - D. the lower is the price charged.
 - E. None of the above.

Answer: D

23. The monopolistic competition model is one in which there is/are
- A. a monopoly.
 - B. perfect competition.
 - C. economies of scale.
 - D. government intervention in the market.
 - E. None of the above.

Answer: C

24. In industries in which there are scale economies, the variety of goods that a country can produce is constrained by
- A. the size of the labor force.
 - B. anti-trust legislation
 - C. the size of the market.
 - D. the fixed cost.
 - E. None of the above.

Answer: C

25. An industry is characterized by scale economies, and exists in two countries. Should these two countries engage in trade such that the combined market is supplied by one country's industry, then
- A. consumers in both countries would suffer higher prices and fewer varieties.
 - B. consumers in the importing country would suffer higher prices and fewer varieties.
 - C. consumers in the exporting country would suffer higher prices and fewer varieties.
 - D. consumers in both countries would enjoy fewer varieties available but lower prices.
 - E. None of the above.

Answer: E

26. An industry is characterized by scale economies and exists in two countries. In order for consumers of its products to enjoy both lower prices and more variety of choice,
- A. each country's marginal cost must equal that of the other country.
 - B. the marginal cost of this industry must equal marginal revenue in the other.
 - C. the monopoly must lower prices in order to sell more.
 - D. the two countries must engage in international trade one with the other.
 - E. None of the above.

Answer: D

27. A product is produced in a monopolistically competitive industry with scale economies. If this industry exists in two countries, and these two countries engage in trade one with the other, then we would expect
- A. the country in which the price of the product is lower will export the product.
 - B. the country with a relative abundance of the factor of production in which production of the product is intensive will export this product.
 - C. each of the countries will export different varieties of the product to the other.
 - D. neither country will export this product since there is no comparative advantage.
 - E. None of the above.

Answer: C

28. The reason why one country may export a product which is produced with positive scale economies is
- A. its labor productivity will tend to be higher.
 - B. it enjoys a relative abundance of the factor intensely used in the product's production.
 - C. its demand is biased in favor of the product.
 - D. its demand is biased against the product.
 - E. None of the above.

Answer: E

29. Two countries engaged in trade in products with no scale economies, produced under conditions of perfect competition, are likely to be engaged in
- A. monopolistic competition.
 - B. inter-industry trade.
 - C. intra-industry trade.
 - D. Heckscher-Ohlin trade.
 - E. None of the above.

Answer: B

30. Two countries engaged in trade in products with scale economies, produced under conditions of monopolistic competition, are likely to be engaged in
- A. price competition.
 - B. inter-industry trade.
 - C. intra-industry trade.
 - D. Heckscher-Ohlinean trade.
 - E. None of the above.

Answer: C

31. History and accident determine the details of trade involving
- A. Ricardian and Classical comparative advantage.
 - B. Heckscher-Ohlin model consideration.
 - C. taste reversals.
 - D. scale economies.
 - E. None of the above.

Answer: D

32. We often observe intra-industry North-South trade in "computers and related devices." This is due to
- A. classification and aggregation ambiguities.
 - B. monopolistic competition.
 - C. specific factors issues.
 - D. scale economies.
 - E. None of the above.

Answer: A

33. We often observe "pseudo-intra-industry trade" between the United States and Mexico. Actually, such trade is consistent with
- A. oligopolistic markets.
 - B. comparative advantage associated with Heckscher-Ohlin model.
 - C. optimal tariff issues.
 - D. huge sucking sound.
 - E. None of the above.

Answer: B

34. Intra-industry trade will tend to dominate trade flows when which of the following exists?
- A. Large differences between relative country factor availabilities
 - B. Small differences between relative country factor availabilities
 - C. Homogeneous products that cannot be differentiated
 - D. Constant cost industries
 - E. None of the above.

Answer: B

35. The most common form of price discrimination in international trade is
- A. non-tariff barriers.
 - B. Voluntary Export Restraints.
 - C. dumping.
 - D. preferential trade arrangements.

E. None of the above.

Answer: C

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Essay Questions

1. Why is it that an industry is operating under conditions of domestic internal scale economies (applies to firm in the country) - then the resultant equilibrium cannot be consistent with the pure competition model?

Answer: Because once one firm became bigger than another, or if one firm began the industry, then no other firm would be able to match its per unit cost, so that they would be driven out of the industry.

2. Is it possible that if positive scale economies characterize an industry, that its equilibrium may be consistent with purely competitive conditions ? Explain how this could happen.

Answer: Yes. If the scale economies were external to the firm, then there is no reason why the firms may not be in perfect competition.

3. If a scale economy is the dominant technological factor defining or establishing comparative advantage, then the underlying facts explaining why a particular country dominates world markets in some product may be pure chance, or historical accident. Explain, and compare this with the answer you would give for the Heckscher-Ohlin model of comparative advantage.

Answer: This statement is true, since the reason the seller is a monopolist may be that it happened to have been the first to produce this product in this country. It may have no connection to any supply or demand related factors; nor to any natural or man-made availability. This is all exactly the opposite of the Heckscher-Ohlin Neo-Classical model's explanation of the determinants of comparative advantage.

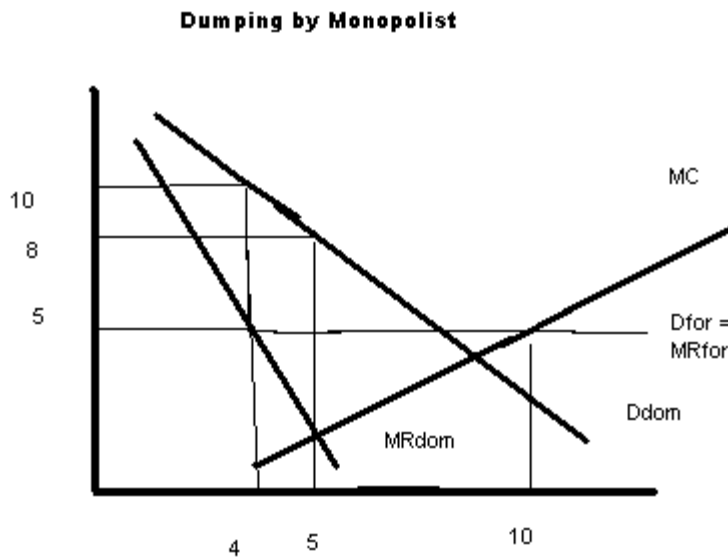
4. It is possible that trade based on external scale economies may leave a country worse off than it would have been without trade. Explain how this could happen.

Answer: One answer is that the terms of trade effects may dominate any other factors.

5. If scale economies were not only external to firms, but were also external to individual countries. That is, the larger the worldwide industry (regardless of where firms or plants are located), the cheaper would be the per-unit cost of production. Describe what world trade would look like in this case.

Answer: Presumably each country would specialize in some component of the final product. This would result in much observed intra-industry trade.

Quantitative/Graphing Problems



1. The figure above represents the demand and cost functions facing a Brazilian Steel producing monopolist. If it were unable to export, and was constrained by its domestic market, what quantity would it sell at what price?

Answer: It would sell 5 (million tons) at a price of \$8/ton.

2. Now the monopolist discovers that it can export as much as it likes of its steel at the world price of \$5/ton. It will therefore expand for- export production up to the point where its marginal cost equals \$5. How much steel will the monopolist sell, and at what price?

Answer: It would sell 10 million tons at \$5/ton.

3. Given the opportunity to sell at world prices, the marginal (opportunity) cost of selling a ton domestically is what?

Answer: \$5/ton.

4. While selling exports it would also maximize its domestic sales by equating its marginal (opportunity) cost to its marginal revenue of \$5. How much steel would the firm sell domestically, and at what price?

Answer: 4 million tons at \$10/ton.

5. The Brazilian firm is charging its foreign (U.S.) customers one half the price it is charging its domestic customers. Is this good or bad for the real income or economic welfare of the United States? Is the Brazilian firm engaged in *dumping*? Is this predatory behavior on the part of the Brazilian steel company?

Answers: Good. Yes, if you define dumping as selling abroad at a price lower than domestically. No, if by dumping you mean selling below marginal cost. No - this is not being done in order to capture market shares, but rather is "mere" static profit maximization behavior, as is expected of any self-respecting monopolist.

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Chapter 7: International Factor Movements

Multiple Choice Questions

1. Which of the following differs in its essential analytical framework?
 - A. International trade in goods
 - B. International conflict resolution
 - C. International trade in services
 - D. International trade in factors of production
 - E. International borrowing and lending

Answer: B

2. The slope of the production function measures
 - A. the physical increase in output as country grows.
 - B. the dollar-value increase in output as a country grows.
 - C. the increase in number of workers as immigration proceeds.
 - D. the marginal product of labor.
 - E. the marginal product of capital.

Answer: D

3. International free labor mobility will under all circumstances
 - A. increase total world output.
 - B. improve the economic welfare of everyone.
 - C. improve the economic welfare of workers everywhere.
 - D. improve the economic welfare of landlords (or capital owners) everywhere.
 - E. None of the above.

Answer: E

4. If the world attained a perfect Heckscher-Ohlin model equilibrium with trade, then
 - A. workers in the labor abundant country would migrate to the capital abundant country.
 - B. workers in the labor abundant country would wish to migrate to the capital abundant country.
 - C. workers in the labor abundant country would have no desire to migrate to the capital abundant country.
 - D. workers in the capital abundant country would wish to migrate to the labor abundant country.
 - E. workers in the capital abundant country would migrate to the labor abundant country.

Answer: C

5. During the mass migration period of late 19th-early 20th centuries,
- A. wages rose in the origin countries and fell in the destination countries.
 - B. wages fell in the origin countries and rose in the destination countries.
 - C. wages generally rose faster in the origin countries.
 - D. wages generally rose faster in the destination countries.
 - E. wages generally fell faster in the origin countries.

Answer: C

6. International borrowing and lending may be interpreted as one form of
- A. intermediate trade.
 - B. inter-temporal trade.
 - C. trade in services.
 - D. unrequited international transfers.
 - E. None of the above.

Answer: B

7. The relative price of future consumption is
- A. the interest rate.
 - B. unknown at any given time.
 - C. the real interest rate.
 - D. the relative interest rate.
 - E. None of the above.

Answer: C

8. A country that has a comparative advantage in future production of consumption goods
- A. will tend to be an international borrower.
 - B. will tend to have low real interest rates.
 - C. will tend to be an international investor or lender.
 - D. will tend to have good work ethics.
 - E. None of the above.

Answer: A

9. A U.S. multinational corporation
- A. has a controlling share in a foreign subsidiary and is not itself foreign controlled.
 - B. is foreign controlled and has no controlling share in a foreign company.
 - C. has a controlling share in a foreign subsidiary and may itself be foreign controlled by a foreign company.
 - D. is a U.S. company whose major markets are outside the United States.
 - E. None of the above.

Answer: C

10. Why a good is produced in two different countries is known as the question of
- A. internalization.
 - B. vertical integration.
 - C. exploitation.
 - D. location.
 - E. None of the above.

Answer: D

11. The home location of most of the world's large multinational companies is
- A. North America and Europe.
 - B. North America and Asia.
 - C. Europe and South America.
 - D. Europe and Asia.
 - E. None of the above.

Answer: A

12. Which of the following best refers to the outright construction or purchase abroad of productive facilities by domestic residents?
- A. Foreign direct investment
 - B. Portfolio Investment
 - C. Short-term capital investment.
 - D. Long-term capital investment
 - E. None of the above.

Answer: A

13. Most direct investment in the United States has come from
- A. Japan.
 - B. Canada.
 - C. Western Europe.
 - D. South America.
 - E. Asia.

Answer: C

14. Most U.S. direct foreign investment occurs in
- A. communications.
 - B. agriculture.
 - C. petroleum.
 - D. manufacturing.
 - E. None of the above.

Answer: D

15. Most foreign direct investment in the United States occurs in
- A. communications.
 - B. agriculture.
 - C. petroleum.
 - D. manufacturing.
 - E. None of the above.

Answer: D

16. Multinational corporations may provide benefits to their home countries for the following reasons except which one?
- A. Secure raw materials for the source country
 - B. Allow for exports of products, which involve company-specific trade secrets
 - C. Allow domestic firms to secure timely deliveries of commodities or products, which do not enjoy a stable or deep market internationally
 - D. Shift home country technology overseas via licensing
 - E. None of the above.

Answer: D

17. Trade analysis involving multinational corporations differs from our conventional trade analysis because multinational corporation analysis involves
- A. absolute cost differentials rather than comparative cost differentials.
 - B. the international movement of factor inputs as well as that of finished goods.
 - C. purely competitive markets rather than imperfectly competitive markets.
 - D. portfolio investments rather than direct foreign investment.
 - E. None of the above.

Answer: B

18. Direct foreign investment may take any of the following forms except
- A. investors buying bonds of an existing firm overseas.
 - B. the creation of a wholly owned business overseas.
 - C. the takeover of an existing company overseas.
 - D. the construction of a manufacturing plant overseas.
 - E. None of the above.

Answer: A

19. Which of the following could logically explain why foreign direct investment might be attracted to the United States?
- A. U.S. wage rates exceeding the productivity of U.S. labor
 - B. U.S. price ceilings that hold down the price of energy
 - C. Especially high price/earning ratios associated with the stock of U.S. firms
 - D. Anticipations of future reductions in U.S. non-tariff barriers
 - E. None of the above.

Answer: B

20. The market power of an international company operating wholly owned subsidiaries in the United States may lead to welfare losses for the United States unless offset by cost reductions or positive externalities. Which type of cost reduction would not lead to offsetting welfare gains for the whole U.S. economy?
- A. R&D generating improved technology.
 - B. Introduction or development of more productive machinery
 - C. New work rules promoting worker efficiency
 - D. Lower wages extracted from workers
 - E. None of the above.

Answer: D

21. Multinational corporations
- A. increase the transfer of technology between nations.
 - B. make it harder for nations to foster activities of comparative advantage.
 - C. always enjoy political harmony in host countries in which their subsidiaries operate.
 - D. require governmental subsidies in order to conduct worldwide operations.
 - E. None of the above.

Answer: A

22. American labor unions have recently maintained that U.S. multinational corporations have been
- A. exporting American jobs by investing overseas.
 - B. exporting American jobs by keeping investment in the United States.
 - C. importing cheap foreign labor by shifting U.S. investment overseas.
 - D. importing cheap foreign workers by keeping U.S. investment at home.
 - E. None of the above.

Answer: A

23. Multinational corporations
- A. always produce primary goods.
 - B. always produce manufactured goods.
 - C. always produce services.
 - D. may produce primary or manufactured goods.
 - E. None of the above.

Answer: D

24. _____ refers to highly educated and skilled people who migrate from poor developing countries to wealthy industrial countries.
- A. Direct investment
 - B. Portfolio investment
 - C. Transfer pricing
 - D. Brain drain
 - E. None of the above.

Answer: D

25. International labor mobility
- A. leads to wage convergence by raising wages in destination country and lowering in source country.
 - B. is in accordance with the specific factors model
 - C. is in accordance with the Heckscher-Ohlin factor proportions model.
 - D. leads to wage convergence by raising wages in source and lowering them in destination country.
 - E. is in accordance with scale economy model.

Answer: D

26. In practice, international labor mobility is
- A. a complete complement to trade flows.
 - B. a partial complement to trade flows.
 - C. a complete substitute for trade flows.
 - D. a partial substitute for trade flows.
 - E. None of the above.

Answer: D

27. If one observes that Japan was traditionally a net foreign lender, one could conclude that relative to its international trade and financial partners
- A. Japan's inter-temporal production possibilities are biased toward future consumption.
 - B. Japan's inter-temporal production possibilities are larger than that of the other countries.
 - C. Japan's inter-temporal production possibilities are biased toward present consumption.
 - D. Japan's inter-temporal production possibilities are not biased.
 - E. None of the above.

Answer: C

28. Rapidly growing developing countries tend to be borrowers on the international capital markets. From this information we may surmise that they have a comparative advantage in
- A. capital goods.
 - B. future income.
 - C. disposable income.
 - D. consumer goods.
 - E. present income.

Answer: B

29. It may be argued that theoretically, international capital movements
- A. tend to hurt the donor countries.
 - B. tend to hurt the recipient countries.
 - C. tend to hurt labor in donor countries.
 - D. tend to hurt labor in recipient countries.
 - E. None of the above.

Answer: C

30. Transactions between branches of the same multinational corporations account for _____ of U.S. imports.
- A. one quarter
 - B. one third
 - C. one half
 - D. three quarters
 - E. all

Answer: C

31. The shift of labor-intensive assembly operations from the United States to Mexican *maquiladora* may be best explained in terms of a theory of
- A. location.
 - B. vertical integration.
 - C. horizontal integration
 - D. internalization.
 - E. None of the above.

Answer: A

32. When comparing the United States to the United Kingdom, between 1985 and 1990, the relative growth of foreign-owned firms in manufacturing
- A. grew faster in the U.K., whose proportion of foreign-owned firms is larger.
 - B. grew faster in the U.S., whose proportion of foreign-owned firms is larger.
 - C. grew faster in the U.S., whose proportion of foreign-owned firms is smaller.
 - D. grew faster in the U.K., whose proportion of foreign-owned firms is smaller.
 - E. None of the above.

Answer: C

33. The inflow of foreign direct investment into the United States has always been perceived
- A. with trepidation.
 - B. with resentment.
 - C. with equanimity.
 - D. with satisfaction.
 - E. None of the above.

Answer: E

34. The purchase by Germany's Daimler-Benz of America's Chrysler corporation is generally viewed as
- A. direct foreign investment typical of trends in the 1980s.
 - B. a capital outflow from the United States, since Daimler-Benz "milked" the assets of Chrysler.
 - C. a major success story of globalization.
 - D. an example of international vertical integration.
 - E. None of the above.

Answer: E

35. In a typical short-run production function, as labor increases
- A. the marginal product of capital decreases.
 - B. the overall product of labor decreases.
 - C. the average product of labor decreases.
 - D. the marginal product of labor decreases.
 - E. None of the above.

Answer: D

36. American labor unions accuse U.S. multinational corporations of all except which?
- A. They enjoy unfair advantages in taxation.
 - B. They export jobs by shifting technology overseas.
 - C. They export jobs by shifting investment overseas.
 - D. They operate at output levels where scale economies occur.
 - E. None of the above.

Answer: D

Essay Questions

1. The Heckscher-Ohlin model is famous for being elegant and mathematically sophisticated, yet failing to describe reality. One manifestation of this fact is Treffer's Case of Missing Trade. Explain what exactly is missing. In what sense is it missing? How would you explain why it is missing? How can a relaxation of the identical production functions explain the case of the missing trade?

Answer: Treffer demonstrated that the actual volume of world trade is significantly less than that which would be predicted by the Heckscher-Ohlin model. One explanation is that North-South trade is especially less than would be predicted by a factor proportions model. If technologies differ in the poorer countries, then it is possible that the cost of producing a product, which uses relatively much of their abundant factor may still be higher than the cost of producing it in the other country.

2. *Factor-intensity reversals* describe a situation in which the production of a product may be land-intensive in one country, and relatively labor intensive in another (at given relative wage levels). For example, cotton may be land intensive in the U.S., and labor intensive in Egypt where land is relatively scarce and expensive. Suppose *factor-intensity reversals* were common. How would that affect the conclusion that a country in which land is relatively scarce will not be the country with a comparative advantage in the land-intensive product?

Answer: The answer here is straightforward (though it has various interesting implications). In this case we cannot define or identify a product in terms of its relative factor intensity (at all or any relative wage level). Therefore, the Heckscher-Ohlin Theorem is ipso-facto inapplicable.

1. Why is it that North-South trade in manufactures seems to be consistent with the results or expectations generated by the factor-proportions theory of international trade, whereas North-North trade is not?

Answer: There is a clear difference in relative factor availabilities between North and South countries, no matter how we define and measure the factors of production. Hence, the factor-proportions theory of trade may be sensibly expected to explain the pattern (though not the volume) of trade between these two groups of countries. However, the North North trade partners do not vary significantly in their relative factor availabilities, so that other forces, such as scale economies play a relatively large role in determining trade patterns.

2. One of the commonly used assumptions in deriving the Heckscher-Ohlin model is that tastes are homothetic, or that if the per capita incomes were the same in two countries, the proportions of their expenditures allocated to each product would be the same as it is in the other country. Imagine that this assumption is false, and that in fact, the tastes in each country are strongly biased in favor of the product in which it has a comparative advantage. How would this affect the relationship between relative factor abundance between the two countries, and the nature (factor-intensity) of the product each exports? What if the taste bias favored the imported good?

Answer: If in fact national tastes were strongly biased in favor of the product in which the country enjoyed a comparative advantage, then we would expect a bias in favor of rejecting the Heckscher-Ohlin Theorem in actual trade data. The engine driving the H-O model is that a country should be expected to have a relatively low cost of producing the good in which it has a comparative advantage. However, the respective demand forces would tend to raise the price of this good, so that the expected pattern would not generally be observed. However, if the tastes were biased in favor of the imported good, then the predictions of the Heckscher-Ohlin Theorem would be expected to be generally observed.

3. Why do you suppose that South-South trade does not conform in volume, but does conform in pattern with expectations generated by the Heckscher-Ohlin model?

Answer: The pattern of trade is generally observed to conform to the Heckscher-Ohlin model's expectations. That is, the developing countries tend to export labor-intensive goods, such as textiles, and import capital-intensive goods such as machinery. The volume however is quite lower than what would be expected from the Neoclassical model. There are many possible reasons, such as financial crises necessitating premia in the financing of this trade.

Quantitative/Graphing Problems

1. In Home and Foreign there are two factors of production, land and labor, used to produce only one good. The land supply in each country and the technology of production are exactly the same. The marginal product of labor in each country depends on employment as follows:

Number of Workers Employed	Marginal product of Last Worker
1	30
2	29
3	28
4	27
5	26
6	25
7	24
8	23
9	22
10	21
11	20

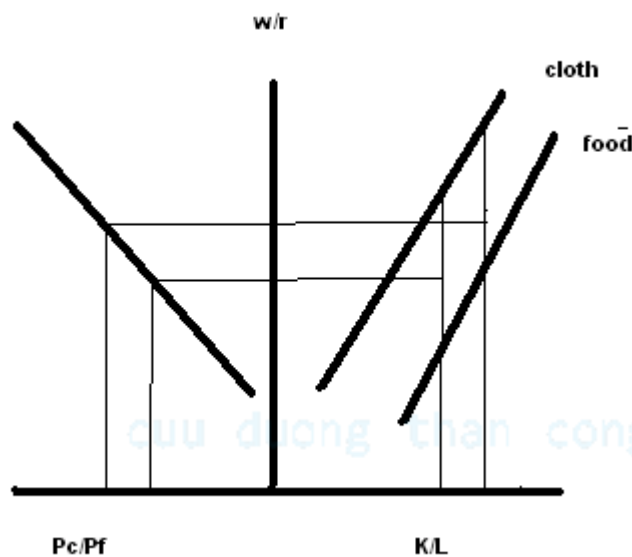
Initially there are 11 workers employed in Home but only 3 workers in Foreign. Find the effect of free movement of labor from the high wage to the low wage country. When such economic migration ceases, what will be the levels of production, real wages and the income of landowners in each country?

Answer: The total production in the world will increase, since the addition to production (the marginal product of labor) in the target country is larger for each worker than the loss of production (also the marginal product of workers) in the emigration country. The real wages will rise in the emigration country and fall in the immigration country. Landlord incomes will rise in the immigration country and fall in the emigration country.

2. Suppose Australia, a land (**K**)-abundant country and Sri-Lanka, a labor(**L**)-abundant country both produce labor and land intensive goods with the same technology. Following the logic of the Heckscher-Ohlin model from Chapter 4, what will be the incentive for migration once trade is established between these two countries? Then, using the analysis in Chapter 5, show that a tariff by one country will create an incentive for labor migration. From which country to which country will be the migration? Explain how you arrived at your answer.

Answer: Once trade is established, there is no longer any incentive for (economic-based) immigration, since the real wages will be equalized in both. If a tariff is established in Australia, then the price of the labor intensive good will be higher in Australia, as will be the marginal product of labor and hence the real wage of workers there. Hence, workers will immigrate from Sri-Lanka to Australia until the two domestic prices are equalized.

3. Use the diagram below derived from Figure 4-4 to identify the pre-trade situation for Australia and Sri-Lanka, as discussed in question 2 above. Where on the **K/L** axis will you find each of the two countries? Which of the two countries has a higher relative wage, w/r ? Which product is the labor intensive, and which is the land intensive one? Show where the relative price of cloth to food will be found once trade opens between these two countries. Show where the relative wages of each will appear.



Answer: You will find Sri-Lanka to the left of Australia on the **K/L** axis.

Australia has a higher relative wage.

Food is the land intensive product.

The relative price P_C/P_F is found between the two autarkic prices.

The post trade relative wage is between the two autarkic ones on the vertical axis.

4. Using the figure above from question 3, demonstrate what happens to the composition of production (that is quantity of cloth per 1 unit of food) in Australia once trade is established between the two countries. Which country will export cloth? What happens to the relative income of workers in Australia as a result of trade? Does it increase or decrease? Would land owners in Australia lobby for or against free trade?

Answer: The proportion of food to cloth will increase in the production of Australia. Sri Lanka will export cloth. The relative (and real) incomes of workers will fall in Australia as a result of trade. Land Owners in Australia should lobby in favor of trade.

5. Imagine that the relative capital abundance of Australia was so much greater than that of Sri-Lanka, that we would have to locate Australia far to the right on the K/L axis. If this were so far to the right that there was no area of overlap on the w/r axis, then what product would Australia export? Is this answer different from that in question 4 above? Will the relative wages as calculated now be the same or different from those calculated in question 4?

Answer: Australia would still export food, which is the same as in question 4. As a result of trade, wages will fall in Australia and will rise in Sri-Lanka. However, in this case, the wages in Australia will remain higher than in Sri-Lanka, creating an incentive for migration from the latter to the former country.

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Chapter 8: The Instruments of Trade Policy

Multiple Choice Questions

1. Specific tariffs are
 - A. import taxes stated in specific legal statutes.
 - B. import taxes calculated as a fixed charge for each unit of imported goods.
 - C. import taxes calculated as a fraction of the value of the imported goods.
 - D. the same as import quotas.
 - E. None of the above.

Answer: B

2. Ad valorem tariffs are
 - A. import taxes stated in ads in industry publications.
 - B. import taxes calculated as a fixed charge for each unit of imported goods.
 - A. import taxes calculated as a fraction of the value of the imported goods.
 - B. the same as import quotas
 - C. None of the above.

Answer: C

3. The excess supply curve of a product we (H) import from foreign countries (F) increases as
 - A. excess demand of country H increases.
 - B. excess demand of country F increases.
 - C. excess supply of country H increases.
 - D. excess supply of country F increases.
 - E. None of the above.

Answer: D

4. If a good is imported into (large) country H from country F, then the imposition of a tariff in country H
 - A. raises the price of the good in both countries ("the "Law of One Price").
 - B. raises the price in country H and cannot affect its price in country F.
 - C. lowers the price of the good in both countries.
 - D. lowers the price of the good in H and could raise it in F.
 - E. raises the price of the good in H and lowers it in F.

Answer: E

5. If a good is imported into (small) country H from country F, then the imposition of a tariff in country H
- A. raises the price of the good in both countries ("the "Law of One Price").
 - B. raises the price in country H and cannot affect its price in country F.
 - C. lowers the price of the good in both countries.
 - D. lowers the price of the good in H and could raise it in F.
 - E. raises the price of the good in H and lowers it in F.

Answer: B

6. If a good is imported into (large) country H from country F, then the imposition of a tariff in country H in the presence of the Metzler Paradox,
- A. raises the price of the good in both countries ("the "Law of One Price").
 - B. raises the price in country H and cannot affect its price in country F.
 - C. lowers the price of the good in both countries.
 - D. lowers the price of the good in H and could raise it in F.
 - E. raises the price of the good in H and lowers it in F.

Answer: C

7. The effective rate of protection measures
- A. the "true" ad valorem value of a tariff.
 - B. the quota equivalent value of a tariff.
 - C. the efficiency with which the tariff is collected at the customhouse.
 - D. the protection given by the tariff to domestic value added.
 - E. None of the above.

Answer: D

8. If the tariff on computers is not changed, but domestic computer producers shift from domestically produced semiconductor to imported components, then the effective rate of protection in the computer industry will
- A. increase.
 - B. decrease
 - C. remain the same.
 - D. depend on whether computers are PCs or "Supercomputers".
 - E. None of the above.

Answer: A

9. If the tariff on computers is not changed, but the government then adds hitherto nonexistent tariffs on imported semi-conductor components, then the effective rate of protection in the computer industry will
- A. increase.
 - B. decrease
 - C. remain the same.
 - D. depend on whether computers are PCs or "Supercomputers".
 - E. None of the above.

Answer: B

10. If a small country imposes a tariff, then
- A. the producers must suffer a loss.
 - B. the consumers must suffer a loss.
 - C. the government revenue must suffer a loss.
 - D. the demand curve must shift to the left.
 - E. None of the above.

Answer: B

11. If a small country imposes a tariff, then
- A. the producers must suffer a loss.
 - B. the consumers must suffer a loss.
 - C. the government revenue must suffer a loss.
 - D. the demand curve must shift to the left.
 - E. None of the above.

Answer: E

12. The imposition of tariffs on imports results in deadweight (triangle) losses. These are
- A. production and consumption distortion effects.
 - B. redistribution effects.
 - C. revenue effects
 - D. efficiency effects.
 - E. None of the above.

Answer: E

13. Suppose the United States eliminates its tariff on ball bearings. Ball bearing prices in the United States would be expected to
- A. increase, and the foreign demand for U.S. exports would increase.
 - B. decrease, and the foreign demand for U.S. exports would increase.
 - C. increase, and the foreign demand for U.S. exports would decrease.
 - D. decrease, and the foreign demand for U.S. exports would decrease.
 - E. None of the above.

Answer: C

14. A specific tariff provides home producers more protection when
- A. the home market buys cheaper products rather than expensive products.
 - B. it is applied to a commodity with many grade variations.
 - C. the home demand for a good is elastic with respect to price changes.
 - D. it is levied on manufactured goods rather than primary products.
 - E. None of the above.

Answer: A

15. A lower tariff on imported steel would most likely benefit
- A. foreign producers at the expense of domestic consumers.
 - B. domestic manufacturers of steel.
 - C. domestic consumers of steel.
 - D. workers in the steel industry.
 - E. None of the above.

Answer: C

16. When a government allows raw materials and other intermediate products to enter a country duty free, this generally results in a(an)
- A. effective tariff rate less than the nominal tariff rate.
 - B. nominal tariff rate less than the effective tariff rate.
 - C. rise in both nominal and effective tariff rates.
 - D. fall in both nominal and effective tariff rates.
 - E. None of the above.

Answer: B

17. Of the many arguments in favor of tariffs, the one that has enjoyed significant economic justification has been the
- A. cheap foreign labor argument.
 - B. infant industry argument.
 - C. even playing field argument.
 - D. balance of payments argument
 - E. domestic living standard argument.

Answer: B

18. The main redistribution effect of a tariff is the transfer of income from
- A. domestic producers to domestic buyers.
 - B. domestic buyers to domestic producers.
 - C. domestic producers to domestic government.
 - D. domestic government to domestic consumers.
 - E. None of the above.

Answer: B

19. The principle benefit of tariff protection goes to
- A. domestic consumers of the good produced.
 - B. foreign consumers of the good produced.
 - C. domestic producers of the good produced.
 - D. foreign producers of the good produced.
 - E. None of the above.

Answer: C

20. As globalization tends to increase the proportion of imported inputs relative to domestically supplied components,
- A. the nominal tariff automatically increases.
 - B. the rate of (effective) protection automatically increases.
 - C. the nominal tariff automatically decreases.
 - D. the rate of (effective) protection automatically decreases.
 - E. None of the above.

Answer: D

21. Which of the following policies permits a specified quantity of goods to be imported at one tariff rate and a higher tariff rate to imports above this quantity?
- A. Import tariff
 - B. Voluntary exports restraint
 - C. Tariff quota
 - D. Ad valorem tariff
 - E. None of the above.

Answer: C

22. Should the home country be "large" relative to its trade partners, its imposition of a tariff on imports would lead to an increase in domestic welfare if the terms of the trade rectangle exceed the sum of the
- A. revenue effect plus redistribution effect.
 - B. protective effect plus revenue effect.
 - C. consumption effect plus redistribution effect.
 - D. protective distortion effect plus consumption distortion effect.
 - E. None of the above.

Answer: D

23. A problem encountered when implementing an "infant industry" tariff is that
- A. domestic consumers will purchase the foreign good regardless of the tariff.
 - B. the industry may never "mature".
 - C. most industries require tariff protection when they are mature.
 - D. the tariff may hurt the industry's domestic sales.
 - E. None of the above.

Answer: B

24. Which of the following is a fixed percentage of the value of an imported product?
- A. Specific tariff
 - B. Ad valorem tariff
 - C. Nominal tariff
 - D. Effective protection tariff
 - E. None of the above.

Answer: B

25. A tax of 20 cents per unit of imported garlic is an example of a(n)
- A. specific tariff.
 - B. ad valorem tariff.
 - C. nominal tariff.
 - D. effective protection tariff.
 - E. None of the above.

Answer: A

26. A tax of 20 percent per unit of imported garlic is an example of a(n)
- A. specific tariff.
 - B. ad valorem tariff.
 - C. nominal tariff.
 - D. effective protection tariff.
 - E. None of the above.
 - F.

Answer: B

26. Which type of tariff is forbidden in the United States on Constitutional grounds?
- A. Import tariff
 - B. Export tariff
 - C. Specific tariff
 - D. Prohibitive tariff
 - E. None of the above.

Answer: B

27. The deadweight loss of a tariff
- A. is a social loss because it promotes inefficient use of national resources.
 - B. is a social loss because it reduces the revenue of the government.
 - C. is not a social loss because it merely redistributes revenue from one sector to another.
 - D. is not a social loss because it is paid for by rich corporations.
 - E. None of the above.

Answer: A

28. Tariffs are not defended on the ground that they
- A. improve the terms of trade of foreign nations.
 - B. protect jobs and reduce unemployment.
 - C. promote growth and development of young industries.
 - D. prevent over-dependence of a country on only a few industries.
 - E. None of the above.

Answer: A

29. The most vocal political pressure for tariffs is generally made by
- A. consumers lobbying for export tariffs.
 - B. consumers lobbying for import tariffs.
 - C. consumers lobbying for lower import tariffs.
 - D. producers lobbying for export tariffs.
 - E. producers lobbying for import tariffs.

Answer: E

30. A policy of tariff reduction in the computer industry is
- A. in the interest of the United States as a whole and in the interest of computer producing regions of the country.
 - B. in the interest of United States as a whole but not in the interest of computer producing regions of the country.
 - C. not in the interest of the United States as a whole but in the interests of computer producing regions of the country.
 - D. not in the interest of the United States as a whole and not in the interests of computer consumers.
 - E. None of the above.

Answer: B [cuu duong than cong. com](http://cuuduongthancong.com)

31. The fact that industrialized countries levy very low or no tariff on raw materials and semi processed goods
- A. helps developing countries export manufactured products.
 - B. has no effect on developing country exports.
 - C. hurts developing country efforts to export manufactured goods.
 - D. hurts developing country efforts to export raw materials.
 - E. None of the above.

Answer: C

32. The *Metzler Paradox*
- A. explains why the United States uses both specific and ad valorem tariffs.
 - B. explains why the United States uses many none-tariff barriers to imports.
 - C. refers to the fact that the United States exported labor-intensive goods.
 - D. is not considered to be of practical application in the real world.
 - E. None of the above.

Answer: D

33. The *Metzler Paradox*
- A. could theoretically happen when a small country levies a tariff.
 - B. refers to a situation when an Optimal Tariff hurts a country's economic welfare.
 - C. refers to a situation when the imposition of a tariff lowers domestic prices.
 - D. refers to a situation when the imposition of a tariff helps foreign exporters.
 - E. None of the above.

Answer: C

34. An *Optimal Tariff*
- A. could theoretically happen when a small country levies a tariff.
 - B. refers to a situation when a tariff hurts a country's economic welfare.
 - C. refers to a situation when the imposition of a tariff lowers domestic prices.
 - D. refers to a situation when the imposition of a tariff helps foreign exporters.
 - E. None of the above.

Answer: E

35. An *Optimal Tariff* is considered unlikely to be observed in the real world because of
- A. The *Metzler Paradox*.
 - B. it is practically impossible to define optimality in trade policy terms.
 - C. the likelihood of foreign repercussions.
 - D. real countries are considered to be "small" in the world trade context.
 - E. None of the above.

Answer: C

Essay Questions

1. Economic theory in general, and trade theory in particular are replete with equivalencies. For example, it is argued that for any *specific tariff* one can find an equivalent *ad valorem* tariff; and that for any quota one can calculate a tariff equivalent. Discuss conditions or situations under which a *specific* and an *ad valorem* tariff are not equivalent. Discuss conditions or situations when a tariff and a quota are not equivalent.

Answer: E.g., during a period of price inflation, an *ad valorem* tariff would become increasingly more effective. The government does not receive any of the quota revenues, unless the import licenses are sold or auctioned.

2. The *Metzler Paradox* is a special case of the *optimum tariff* concept. Discuss this assertion. Would the *optimum tariff* tend to be a high one or a low one in the case where this paradox exists? What conditions would be needed in the international markets for a country's exports for this paradox to exist? Why do you suppose empirical support for the existence of this paradox has not been forthcoming to date?

Answer: The *Metzler Paradox* describes an unlikely situation in which the imposition of a tariff not only improves a country's welfare, but also improves that of its domestic consumers. If this paradox were present then the magnitude of the *optimum tariff* would tend to be large, since the welfare decreasing decrease in imports is not present in this case (the imports actually increase, as world prices drastically drop). The *Metzler Paradox* could occur only if the foreign offer curves are inelastic. It is not likely to be observed because trade elasticities tend to be relatively large. Also, were it to exist, its activation by a large country would tend to evoke foreign retaliation.

3. Some argue that tariffs always hurt the imposing country's economic welfare, and are typically designed to shift resources from one sector to another, protected or preferred one, within an economy. Find and discuss a counterexample to this argument.

Answer: The *optimum tariff* is theoretically a first-best trade policy.

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4. The effective rate of protection is a weighted average of nominal tariffs and tariffs on imported inputs. It has been noted that in most industrialized countries, the nominal tariffs on raw materials or intermediate components or products are lower than on final-stage products meant for final markets. Why would countries design their tariff structures in this manner? Who tends to be helped, and who is harmed by this *cascading tariff* structure?

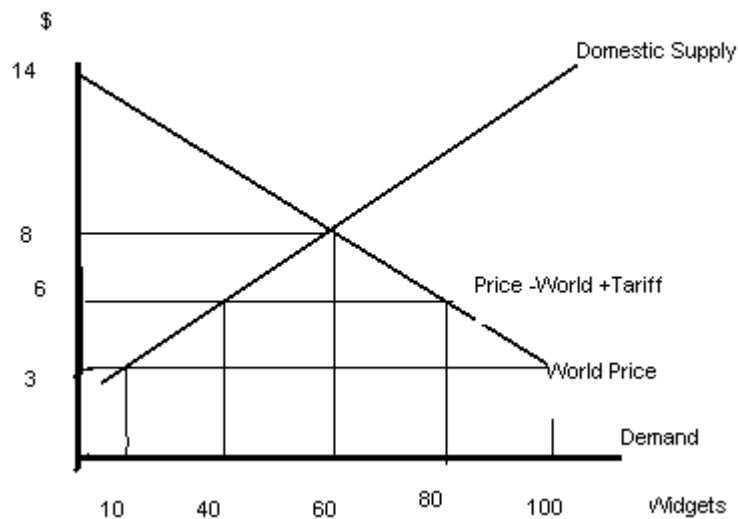
Answer: The *cascading tariff* structure is probably the result of systematic lobbying on the part of manufacturing interests and lobbies to lower costs of production (in terms of imported inputs). The end result is in fact to create effective rates of protection for downstream, or final manufacturing processes that are often much higher than nominal tariffs on these products. An important group, which is hurt by this are exporters of raw materials and components in developing countries.

5. The two deadweight triangles are the *Consumption distortion* and *Production distortion* losses. It is easy to understand why the *Consumption distortion* constitutes a loss for society. After all it raises the prices of goods to consumers, and even causes some consumers to drop out of the market altogether. It seems paradoxical that the *Production distortion* is considered an equivalent burden on society. After all, in this case, profits increase, and additional production (with its associated employment) comes on line. This would seem to be an offset rather than an addition to the burden or loss borne by society. Explain why the *Production distortion* is indeed a loss to society, and what is wrong with the logic that leads to the apparent paradox.

Answer: The *Production distortion* is a loss to society because it constitutes a loss to consumer surplus, which is not recouped by any other group in society. The actual triangle here represents an inefficient shift of society's resources to produce a good, which it could not sell profitably at world prices. Since (with full employment assumed) these resources were formerly used to produce export goods, which could compete profitably, the net result is a loss in real income to the country.

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Quantitative/Graphing Problems



1. In the Figure above, in the absence of Trade how many Widgets does this country produce and consume?

Answer: 60

2. In the absence of trade what is the country's consumer plus producer surplus?

Answer: \$180, \$180

3. With free trade and no tariffs, what is the quantity of Widgets imported?

Answer: 100

4. With a specific tariff of \$3 per unit, what is the quantity of Widget imports?

Answer: 80

5. The loss of Consumer Surplus due to the tariff equals

Answer: \$230

6. The lowest specific tariff which would be considered prohibitive is

Answer: \$5

Chapter 9: The Political Economy of Trade Theory

Multiple Choice Questions

1. The efficiency case made for free trade is that as trade distortions such as tariffs are dismantled and removed,
 - A. government tariff revenue will decrease, and therefore national economic welfare will decrease.
 - B. government tariff revenue will decrease, and therefore national economic welfare will increase.
 - C. deadweight losses for producers and consumers will decrease, hence increasing national economic welfare.
 - D. deadweight losses for producers and consumers will decrease, hence decreasing national economic welfare.
 - E. None of the above.

Answer: C

2. The opportunity to exploit economies of scale is one of the gains to be made from removing tariffs and other trade distortions. These gains will be found by a decrease in
 - A. world prices of imports.
 - B. the consumption distortion loss triangle.
 - C. the production distortion loss triangle.
 - D. Both B and C.
 - E. None of the above.

Answer: E

3. It is argued that special interest groups are likely to take over and promote protectionist policies, which may lead to an increases in national economic welfare. This argument leads to
 - A. a presumption that in practice a free trade policy is likely to be better than alternatives.
 - B. a presumption that trade policy should be shifted to Non-Governmental Organizations, so as to limit taxpayer burden.
 - C. a presumption that free trade is generally a second-best policy, to be avoided if feasible alternatives are available.
 - D. a presumption that free trade is the likely equilibrium solution if the government allows special interest groups to dictate its trade policy.
 - E. None of the above.

Answer: A

4. The *optimum tariff* is
- A. the best tariff a country can obtain via a WTO negotiated round of compromises.
 - B. the tariff, which maximizes the terms of trade gains.
 - C. the tariff, which maximizes the difference between terms of trade gains and terms of trade losses.
 - D. not practical for a small country due to the likelihood of retaliation.
 - E. not practical for a large country due to the likelihood of retaliation.

Answer: E

5. The *optimum tariff* is most likely to apply to
- A. a small tariff imposed by a small country.
 - B. a small tariff imposed by a large country.
 - C. a large tariff imposed by a small country.
 - D. a large tariff imposed by a large country.
 - E. None of the above.

Answer: B

6. The *prohibitive tariff* is a tariff that
- A. is so high that it eliminates imports.
 - B. is so high that it causes undue harm to trade-partner economies.
 - C. is so high that it causes undue harm to import competing sectors.
 - D. is so low that the government prohibits its use since it would lose an important revenue source.
 - E. None of the above.

Answer: A

7. The existence of marginal social benefits which are not marginal benefits for the industry producing the import substitutes
- A. is an argument supporting free trade and non-governmental involvement.
 - B. is an argument supporting the use of an optimum tariff.
 - C. is an argument supporting the use of market failures as a trade-policy strategy.
 - D. is an argument rejecting free trade and supporting governmental involvement.
 - E. None of the above.

Answer: D

8. The domestic market failure argument is a particular case of the theory of
- A. the optimum, or first-best.
 - B. the second best.
 - C. the third best.
 - D. the *sufficing principle*.
 - E. None of the above.

Answer: B

9. The difficulty of ascertaining the right *second-best* trade policy to follow
- A. reinforces support for the *third-best* policy approach.
 - B. reinforces support for increasing research capabilities of government agencies.
 - C. reinforces support for abandoning trade policy as an option.
 - D. reinforces support for free-trade options.
 - E. None of the above.

Answer: D

10. The author of the text believe that
- A. second-best policy is worse than optimal policy.
 - B. special interest groups generally enhance national welfare.
 - C. national welfare is likely to be enhanced by the imposition of an optimal tariff.
 - D. market Failure arguments tend to support free-trade policy.
 - E. there is no such thing as national welfare.

Answer: E

11. The simple model of competition among political parties long used by political scientists tends to lead to the practical solution of selecting the
- A. optimal tariff.
 - B. prohibitive tariff.
 - C. zero (free-trade) tariff.
 - D. the tariff rate favored by the median voter.
 - E. None of the above.

Answer: D

12. The median voter model
- A. works well in the area of trade policy.
 - B. is not intuitively reasonable.
 - C. tends to result in biased tariff rates.
 - D. does not work well in the area of trade policy.
 - E. None of the above.

Answer: D

13. The fact that trade policy often imposes harm on large numbers of people, and benefits only a few may be explained by
- A. the lack of political involvement of the public.
 - B. the power of advertisement.
 - C. the problem of collective action.
 - D. the basic impossibility of the democratic system to reach a fair solution.
 - E. None of the above.

Answer: C

14. Protectionism tends to be concentrated in two sectors:
- A. agriculture and clothing.
 - B. high tech and national security sensitive industries.
 - C. capital and skill intensive industries.
 - D. industries concentrated in the South and in the Midwest of the country.
 - E. None of the above.

Answer: A

15. Judging by the changes in the height of tariff rates in major trading countries, the world has been experiencing a great
- A. trade liberalization.
 - B. surge of protectionism.
 - C. lack of progress in the trade-policy area.
 - D. move towards regional integration.
 - E. None of the above.

Answer: A

16. The World Trade Organization (WTO) was organized as a successor to the
- A. IMF.
 - B. UN.
 - C. UNCTAD.
 - D. GATT.
 - E. The World Bank.

Answer: D

17. The WTO was established by the _____ of multilateral trade negotiations.
- A. Kennedy Round
 - B. Tokyo Round
 - C. Uruguay Round
 - D. Dillon Round
 - E. None of the above.

Answer: C

18. The Smoot-Hawley Tariff Act of 1930 has generally been associated with
- A. falling tariffs.
 - B. free trade.
 - C. intensifying the worldwide depression.
 - D. recovery from the worldwide depression
 - E. Non-tariff barriers.

Answer: C

19. A trade policy designed to alleviate some domestic economic problem by exporting it to foreign countries is known as a(n)
- A. international dumping policy.
 - B. countervailing tariff policy.
 - C. beggar thy neighbor policy.
 - D. trade adjustment assistance policy.
 - E. None of the above.

Answer: C

20. The General Agreement on Tariffs and Trade and the World Trade Organization have resulted in
- A. termination of export subsidies applied to manufactured goods.
 - B. termination of import tariffs applied to manufactures.
 - C. termination of import tariffs applied to agricultural commodities.
 - D. termination of international theft of copyrights.
 - E. None of the above.

Answer: E

21. The General Agreement on Tariffs and Trade and the World Trade Organization have resulted in
- A. the establishment of universal trade adjustment assistance policies.
 - B. the establishment of the European Union.
 - C. the reciprocal trade clause.
 - D. reductions in trade barriers via multilateral negotiations.
 - E. None of the above.

Answer: D

22. Trade theory suggests that Japan would gain from a subsidy the United States provides its grain farmers if the gains to Japanese consumers of wheat products more than offsets the losses to Japanese wheat farmers. This would occur as long as Japan
- A. is a net importer in bilateral trade flows with the United States.
 - B. is a net importer of wheat.
 - C. has a comparative advantage in wheat.
 - D. has an absolute advantage in producing wheat.
 - E. None of the above.

Answer: B cuuduongthancong.com

23. Countervailing duties are intended to neutralize any unfair advantage that foreign exporters might gain because of foreign
- A. tariffs.
 - B. subsidies.
 - C. quotas.
 - D. Local-Content legislation
 - E. None of the above.

Answer: B

24. Throughout the post-World War II era, the importance of tariffs as a trade barrier has
- A. increased.
 - B. decreased.
 - C. remained the same.
 - D. fluctuated wildly.
 - E. demonstrated a classic random walk with a mean-reversion tendency.

Answer: B

25. In 1980 the United States announced an embargo on grain exports to the Soviet Union in response to the Soviet invasion of Afghanistan. This embargo was mainly resisted by
- A. U.S. grain consumers of bread.
 - B. U.S. grain producers.
 - C. foreign grain producers.
 - D. U.S. communists.
 - E. None of the above.

Answer: B

26. Export embargoes cause greater losses to consumer surplus in the target country
- A. the lesser its initial dependence on foreign produced goods.
 - B. the more elastic is the target country's demand schedule.
 - C. the more elastic is the target country's domestic supply.
 - D. the more inelastic the target country's supply.
 - E. None of the above.

Answer: D

27. The strongest political pressure for a trade policy that results in higher protectionism comes from
- A. domestic workers lobbying for import restrictions.
 - B. domestic workers lobbying for export restrictions.
 - C. domestic workers lobbying for free trade.
 - D. domestic consumers lobbying for export restrictions.
 - E. domestic consumers lobbying for import restrictions.

Answer: A

28. The average tariff rate to data on dutiable imports in the United States is approximately
- A. 5 % of the value of imports.
 - B. 15% of the value of imports.
 - C. 20 % of the value of imports.
 - D. 25% of the value of imports.
 - E. more than 25% of the value of imports.

Answer: A

29. In 1990 the United States imposed trade embargoes on Iraq's international trade. This would induce smaller losses in Iraq's consumer surplus the
- A. less elastic Iraq's demand schedule.
 - B. more elastic Iraq's demand schedule.
 - C. greater is Iraq's dependence on foreign products.
 - D. more inelastic is Iraq's supply schedule.
 - E. None of the above.

Answer: B

30. The World Trade Organization provides for all of the following except
- A. the usage of the most favored nation clause.
 - B. assistance in the settlement of trade disagreements.
 - C. bilateral tariff reductions.
 - D. multilateral tariff reductions.
 - E. None of the above.

Answer: C

31. Which organization determines procedures for the settlement of international trade disputes?
- A. World Bank
 - B. World Trade Organization
 - C. International Monetary Organization
 - D. International Bank for Reconstruction and Development
 - E. The League of Nations

Answer: B

32. The WTO's intervention against clean air standards
- A. has earned it universal approval.
 - B. was done in order to limit national sovereignty.
 - C. has resulted in much criticism.
 - D. has resulted in much criticism among professional economists.
 - E. None of the above.

Answer: C

33. Under U.S. commercial policy, the escape clause results in
- A. temporary quotas granted to firms injured by import competition.
 - B. tariffs that offset export subsidies granted to foreign producers.
 - C. a refusal of the U.S. to extradite anyone who escaped political oppression.
 - D. tax advantages extended to minority-owned exporting firms.
 - E. tariff advantages extended to certain Caribbean countries in the U.S. market.

Answer: A

34. Under U.S. commercial policy, which clause permits the modification of a trade liberalization agreement on a temporary basis if serious injury occurs to domestic producers as a result of the agreement?
- A. Adjustment assistance clause
 - B. Escape clause
 - C. Most favored nation clause
 - D. Prohibitive tariff clause
 - E. None of the above.

Answer: B

35. Today U.S. protectionism is concentrated in
- A. high tech industries.
 - B. labor-intensive industries.
 - C. industries in which Japan has a comparative advantage.
 - D. computer intensive industries.
 - E. capital-intensive industries.

Answer: B

36. The reason protectionism remains strong in the United States is that
- A. economists can produce any result they are hired to produce.
 - B. economists cannot persuade the general public that free trade is beneficial.
 - C. economists do not really understand how the real world works.
 - D. the losses associated with protectionism are diffuse, making lobbying by the public impractical.
 - E. None of the above.

Answer: D

Essay Questions

1. Developing countries have often attempted to establish cartels so as to counter the actual or perceived inexorable downward push on the prices of their exported commodities. OPEC is the best well known of these. How are such cartels expected to help the developing countries? At times importing countries profess support for such schemes. Can you think of any logical basis for such support? How are cartels like monopolies, and how are they different from monopolies. Why is there a presupposition among economists that such schemes are not likely to succeed in the long run?

Answer: Such cartels are expected to shift the exporters' terms of trade in their favor. Also they are expected to produce the maximum profit, which the market will bear. Importing countries may benefit from the price stability generated by the cartel. Cartels are like monopolies in that their total output is the same as that which would be generated by a single monopoly. They differ from monopolies in that the monopoly profits need to be divided among the producing countries, which have different cost structures.

2. The United States appears at times to have a totally schizophrenic attitude toward protectionism. The United States was the country that proposed the establishment of the World Trade Organization as early as the late 1940s, and was also the only industrialized country, which refused to ratify this at that time. The United States has consistently argued on the side of multinational free trade in GATT Rounds, and yet maintains many protectionist laws such as those which reserve oil shipments from Alaska to U.S. flag carriers. How can you explain this apparent lack of national consistency on this issue?

Answer: This reflects the fact that international trade typically has many winners and relatively fewer, but politically powerful losers. Short of guaranteed (constitutional?) non-conditional compensatory mechanisms, the basic conflict between these two groups will always be there.

3. Presumably, since the United States is a *large country* in many of its international markets, a positive optimum tariff exists for this country. It follows therefore that when any legislator or government official who promotes zero-tariff free trade policies, is by definition not acting in the public's best interest. Discuss.

Answer: Technically this is true. However, this is true only within the context of a generally myopic view of international relations. If the tariff imposing country is large enough to make a substantial difference in its welfare by seeking an optimum tariff, then it cannot hope to remain invisible, as its policies are substantially harming its trade partners. Foreign repercussions are almost a certainty. In such a "game" it is not at all certain that seeking the optimum tariff dominates alternative strategies.

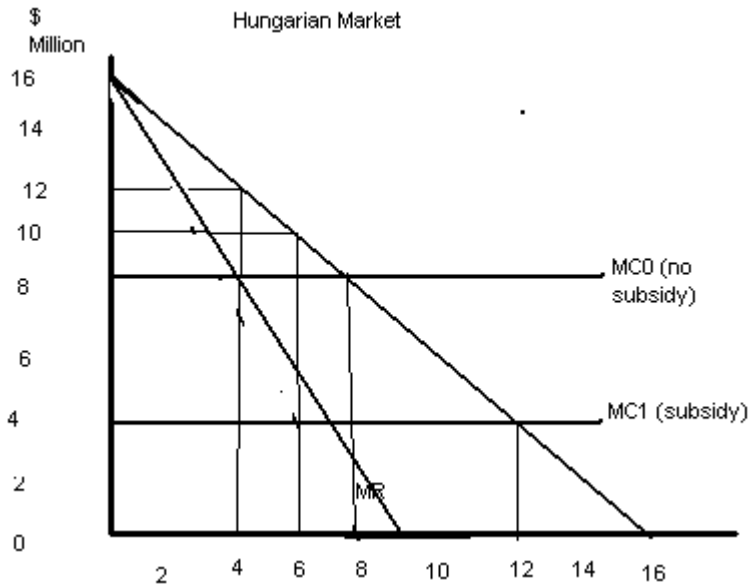
4. It may be demonstrated that any protectionist policy, which effectively shifts real resources to import competing industries or sectors will harm export industries or sectors. This may, for example, happen by the strengthening U.S. dollar in the foreign exchange market. Would you propose therefore that export industries lobby against protectionism in International Trade Commission proceedings? What of consumer advocates? Discuss the pros and the problems of such a suggestion.

Answer: Actually this is an interesting idea. It is well known that the public interest is put on hold as the ITC considers only the squeaky wheels of those allegedly hurt by trade. While "consumers" may be too amorphous a group to successfully organize and pursue a political agenda, the exporters and consumer advocates may be able to form a counter weight to the import competing industries.

5. It is argued that the United States would be foolish to maintain a free-trade stance in a world in which all other countries exploit child or prisoner labor, or are protectionist. On the other hand, Ricardo's classic demonstration of the sources and effects of comparative advantage cogently demonstrates that regardless of other country policy, free trade remains the first best policy for a country to follow, since it will maximize its consumption possibilities (conditional upon other country policies). Explain. Discuss the contradiction with the argument in the preceding paragraph.

Answer: In the context of the Ricardian model, it is true that gains from trade are strictly a result of world terms of trade, which differ from domestic marginal rates of substitution. In such a world, the reason why foreign goods are cheap is of no concern to domestic consumers. However, in a world which allows for large-scale labor migration, ignoring labor conditions abroad may ultimately result in living standards for domestic workers to be dragged down.

Quantitative/Graphing Problems



Assume that Boeing (U.S.) and Airbus (European Union) both wish to enter the Hungarian market with the next new generation airliner. They both have identical cost and demand conditions (as indicated in the graph above).

1. Assume that Boeing is the first to enter the Hungarian market. Without a government subsidy what price would they demand, and what would be their total profits?

Answer: \$12 Million, \$16)

2. What is the consumer surplus enjoyed by Hungarian consumers of Boeing aircraft in the above situation?

Answer: \$8 Million

3. Suppose the European government provides Airbus with a subsidy of \$4 for each airplane sold, and that the subsidy convinces Boeing to exit the Hungarian market. Now Airbus would be the monopolist in this market. What price would they charge, and what would be their total profits?

Answer: \$10 Million, and \$36 Million

4. What would be the cost of the subsidy to European taxpayers?

Answer: \$24 Million

5. What happens to the Consumer Surplus of Hungarian customers as a result of this subsidy?

Answer: An increase of \$10 Million.

6. What is the revenue gain or loss for Europe as a whole (including taxpayers)?

Answer: A gain of \$12 Million.

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Chapter 10: Trade Policy in Developing Countries

1. The infant industry argument was an important theoretical basis for
 - A. Neo-colonialist theory of international exploitation.
 - B. Import - substituting industrialization.
 - C. Historiography of the industrial revolution in Western Europe.
 - D. East-Asian miracle.
 - E. None of the above.

Answer: B

2. Sophisticated theoretical arguments supporting import-substitution policies include
 - A. Terms of trade effects.
 - B. Scale economy arguments.
 - C. Learning curve considerations.
 - D. The problem of appropriability.
 - E. None of the above.

Answer: D

3. General equilibrium considerations lead to the realization that import-substituting policies have an effect of
 - A. Discouraging exports.
 - B. Encouraging exports.
 - C. Encouraging an efficient use of a country's resources.
 - D. Generating large tariff revenues for the government
 - E. None of the above.

Answer: A

4. Historically those few developing countries which have succeeded in significantly raising their per-capita income levels
 - A. Did not accomplish this with import-substituting industrialization.
 - B. Did accomplish this with import-substituting industrialization.
 - C. Tended to provide heavy protection to domestic industrial sectors.
 - D. Favored industrial to agricultural or service sectors.
 - E. None of the above.

Answer: A

5. Statistical evidence suggests that
- A. Free trade policies promote economic growth more effectively than do import substitution policies.
 - B. Import substituting policies tend to promote effective exploitation of scale economies.
 - C. Import substitution tends to lead to relatively low effective rates of protection.
 - D. Import substitution is to this day the preferred growth strategy promoted by the World Bank.
 - E. None of the above.

Answer: A

6. The wage differential theory which argued that shifting resources from agriculture to manufacturing entailed positive social benefits implied that
- A. Free trade policies would promote competitiveness.
 - B. Free trade policies would promote economic growth for both static and dynamic reasons.
 - C. Protectionism was likely to lead to economic stagnation.
 - D. Protectionism and import substitution was likely to promote economic growth.
 - E. None of the above.

Answer: D

7. The Harris-Todaro model
- A. Lead to a rejection of the import substitution strategy for economic development.
 - B. Supported the protectionist strategy for economic growth.
 - C. Implied that the free trade approach was not likely to promote economic growth.
 - D. Both b and c
 - E. None of the above.

Answer: A

8. The growth successes of the high performance Asian economies
- A. Supports the belief that economic development requires import substitution policies.
 - B. Rejects the belief that export-oriented industrialization is likely to promote economic development.
 - C. Rejects the belief that economic development requires import substitution policies.
 - D. Suggests that free trade policies are required for successful economic development.
 - E. None of the above.

Answer: C

9. The high correlation between rapid growth in exports and rapid economic growth observed in several East Asia countries in recent decades proves that
- A. Export promoting trade policy leads to relatively rapid economic growth.
 - B. A free-trade orientation of trade policy results in rapid economic growth.
 - C. Exports help growth, whereas imports impede growth.
 - D. Trade policy is perhaps the most important policy area for promotion of economic development.
 - E. None of the above.

Answer: E

10. The relatively rapid economic growth experienced by Chile in the late 1980s
- A. Supported the conventional Latin American reliance on import substitution.
 - B. Relied on the Harris-Todaro model to explain this growth.
 - C. Rejected the conventional Latin American reliance on import substitution.
 - D. Demonstrated the importance of market failure as a reason for import substitution.
 - E. None of the above.

Answer: C

11. Which of the following could explain why the terms of trade of developing countries might deteriorate over time?
- A. Developing country exports consist mainly of manufactured goods
 - B. Developing country exports consist mainly of primary products.
 - C. Commodity export prices are determined in highly competitive markets.
 - D. Commodity export prices are solely determined by developing countries.
 - E. None of the above.

Answer: C

12. Which trade strategy have developing countries used to restrict imports of manufactured goods so that the domestic market is preserved for home producers, who thus can take over markets already established in the country?
- A. International commodity agreement.
 - B. Export promotion.
 - C. Multilateral contract.
 - D. Import substitution.
 - E. None of the above.

Answer: D

13. To help developing countries expand their industrial base, some industrial countries have reduced tariffs on designated manufactured imports from developing countries below the levels applied to imports from industrial countries. This policy is called
- A. Export-led growth.
 - B. Generalized system of preferences.
 - C. Most Favored Nation.
 - D. Reciprocal trade agreement.
 - E. None of the above.

Answer: B

14. Which industrialization policy used by developing countries places emphasis on the comparative advantage principle as a guide to resource allocation?
- A. Export promotion.
 - B. Import substitution.
 - C. International commodity agreements.
 - D. Infant Industry promotion.
 - E. None of the above.

Answer: A

15. Taiwan and South Korea are examples of developing nations that have recently pursued these industrialization policies
- A. Import substitution.
 - B. Export promotion.
 - C. Commercial dumping.
 - D. Multilateral contract.
 - E. None of the above.

Answer: B

16. To help developing nations strengthen their international competitiveness, many industrial nations have granted tariff reductions to developing nations under the
- A. International commodity agreements program.
 - B. Multilateral contract program.
 - C. Generalized system of preferences program.
 - D. Export led growth program
 - E. None of the above.

Answer: C

17. A reason why it is difficult for developing countries to maintain a cartel is that
- A. The elasticity of demand for a cartel's output decreases over time.
 - B. Producers in the cartel have an economic incentive to cheat.
 - C. Economic profits discourage other producers from entering the industry.
 - D. Producers in the cartel have the motivation to lower prices but not to raise prices.
 - E. None of the above.

Answer: B

18. Import substitution policies make use of
- A. Tariffs that discourage goods from entering a country.
 - B. Quotas applied to goods that are shipped abroad.
 - C. Production subsidies granted to industries with comparative advantage.
 - D. Tax breaks granted to industries with comparative advantage.
 - E. None of the above.

Answer: A

19. Export-led growth tends to
- A. Discourage competition in the global economy.
 - B. Exploit domestic comparative advantages.
 - C. Lead to unemployment among domestic workers.
 - D. Help firms benefit from diseconomies of large-scale production
 - E. None of the above.

Answer: B

20. All the following nations except _____ have recently utilized export-led growth policies.
- A. Hong Kong
 - B. South Korea
 - C. Argentina
 - D. Singapore
 - E. None of the above.

Answer: C

21. The development of countries like South Korea has been supported by all of the following except.
- A. High domestic interest rates.
 - B. Diseconomies of scale occurring at low output levels.
 - C. Large endowments of human capital
 - D. High levels of labor productivity.
 - E. None of the above.

Answer: A

22. For most developing countries
- A. Productivity is high among domestic workers.
 - B. Population growth and illiteracy rates are low.
 - C. Saving and investment levels are high
 - D. Agricultural goods and raw materials constitute a high proportion of domestic output.
 - E. None of the above.

Answer: D

23. In 1999, the per-capita income in China was roughly _____ of that in the U.S.
- A. one hundredth
 - B. One ninth
 - C. One half
 - D. The same as
 - E. None of the above.

Answer: B

24. The "East Asian Miracle" is
- A. The ability of so many people to live in such small areas.
 - B. The fact that so many Influenza varieties originate from this region.
 - C. The fact that poor dualistic economies managed to escape the vicious circle of poverty.
 - D. The ability to maintain large positive trade balances with the U.S.
 - E. None of the above.

Answer: C

25. The infant industry argument is that
- A. Comparative advantage is irrelevant to economic growth
 - B. Developing countries have a comparative advantage in agricultural goods.
 - C. Developing countries have a comparative advantage in manufacturing.
 - D. Developing countries have a potential comparative advantage in manufacturing.
 - E. None of the above.

Answer: D

26. The infant industry argument calls for active government involvement
- A. Only if the government forecasts are accurate.
 - B. Only if some market failure can be identified.
 - C. Only if the industry is not one already dominated by industrial countries.
 - D. Only if the industry has a high value added.
 - E. None of the above.

Answer: B

27. The imperfect capital market justification for infant industry promotion
- A. Assumes that new industries will tend to have low profits.
 - B. Assumes that infant industries will soon mature.
 - C. Assumes that infant industries will be in products of comparative advantage.
 - D. Assumes that banks can allocate resources efficiently.
 - E. None of the above.

Answer: A

28. Brazil's export record in 1999 illustrates the principle that
- A. A large country will tend to have few exports.
 - B. A small country will tend to have a high export ratio.
 - C. Protectionist policies tend to discourage exports.
 - D. Export-promoting policies do not tend to work.
 - E. None of the above.

Answer: C

29. The disappointment with import-substitution policies is in part because
- A. The rapid and continuous growth record of South American countries.
 - B. Many countries pursuing this strategy experienced stagnation in their growth.
 - C. This policy is inconsistent with sophisticated economic growth models.
 - D. This policy tended to create world-class industrial competitors.
 - E. None of the above.

Answer: B

30. Import substitution policies have over time tended to involve all but the following
- A. Overlapping import quotas.
 - B. Exchange controls.
 - C. Domestic content rules.
 - D. Simple tariffs.
 - E. Multiple exchange rate schemes.

Answer: D

31. A dual economy is one in which
- A. Class warfare takes on the form of tournament duels.
 - B. Minority groups dominate political power.
 - C. Sophisticated high-wage industrial sectors coexist with low-wage traditional sectors.
 - D. A country exports both traditional and sophisticated non-traditional products.
 - E. None of the above.

Answer: C

32. In a typical dual economy
- A. Labor is paid the same wage throughout the economy.
 - B. Capital earns the same return throughout the economy.
 - C. Capital often earns higher returns in the sophisticated high-wage sector.
 - D. Capital often earns higher returns in the traditional low-wage sector.
 - E. None of the above.

Answer: D

33. The symptoms of dualism are an indication that the economy is not working well, especially in its
- A. Labor market.
 - B. Capital market.
 - C. Land market.
 - D. Educational structure.
 - E. None of the above.

Answer: A

34. An efficient economy would set the marginal product in the traditional sector
- A. Lower than that in the modern non-traditional sector.
 - B. Higher than that in the modern sophisticated sector.
 - C. Equal to that in the modern sophisticated sector.
 - D. Lower in the relatively capital intensive sector.
 - E. Higher in the relatively capital intensive sector.

Answer: C

35. The HPAAE (High Performance Asian Economies) countries
- A. Have all consistently supported free trade policies.
 - B. Have all consistently maintained import-substitution policies.
 - C. Have all consistently maintained non-biased efficient free capital markets.
 - D. Have all maintained openness to international trade.
 - E. None of the above.

Answer: D

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Essay Questions

1. It is argued that import substitution is a misguided trade policy if the intent is to promote long-term economic growth. Explain the reasons underlying this argument.

Answer: Import substitution promotes that economic activity in which the country is relatively inefficient. This lowers the real income at any given time and decreases the resources which can be used for investment purposes, hence lower growth rates. An additional answer is that import substitution by creating a protected domestic market fails to provide incentives to produce high, or world class quality - which means this country cannot market in foreign countries. With such a (perceived) limited market, endogenous economic growth will not be forthcoming. Finally, it may be that exposure to world competition has its own dynamic effect promoting economic growth.

2. The United States, as it began its long and successful growth in the early 19th Century, consciously promoted domestic production through such activities as tariffs, Clay's American System, and many direct subsidies to railroads, canal companies, farmers (free land) etc. Today we view this blatant example of large scale and extensive import-substitution industrialization as having been very successful. Comment and relate to your answer to question 1.

Answer: This is an interesting point and emphasizes that economic models tend to be a-historical. That is, they lack the historic perspective; and thus may be misleading as guides to long run issues, such as economic growth.

3. Classical and Neoclassical trade theory makes the case that free trade can bring a country to an optimum and economically efficient use of its resources; and hence is an optimal trade-policy, if the objective is maximizing long term economic growth. There are those who argue that the experience of the *Asian Miracle* countries, such as Taiwan, South Korea and Singapore verify this argument in the real world. Explain. There are others who argue that the experience of these countries cannot be used to verify or support the argument above. Explain.

Answer: Both arguments may indeed be made. These countries did in fact tend to promote exports in a consistent set of policies. However, they tended to do this via conscious National industrial-policy (e.g., South Korea using "the Japanese system"), and hence (with the possible exception of Hong Kong) do not provide a good test-tube for the long run effects of a free-trade stance.

4. It has been argued that *economic dualism* that typifies relatively poor less developed countries, is a barrier to participation in the global village, and lessens the probability that such countries can take their place in the economic growth race. Explain this argument.

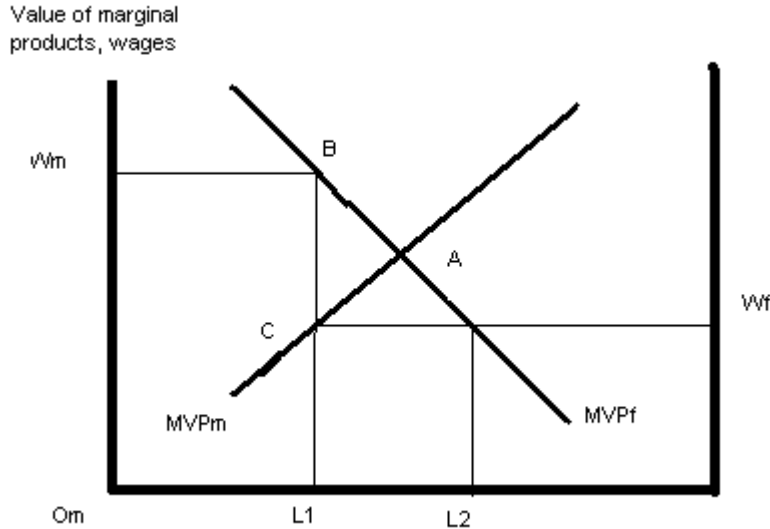
Answer: *Economic dualism*, first systematically explored by Lewis, describes economies in which the marginal cost of shifting labor from the traditional to the modern sector is zero. This means that the modern sector enjoys a perfectly elastic labor supply, and two wage levels exist simultaneously. The latter is typical of a distorted labor market, and indicates that the country is not on its production possibility frontier. However, it does not indicate that such a country cannot partake in international trade. The traditional sector can produce commodities very cheaply (the wage is close to zero); and the modern sector can respond flexibly to demand patterns abroad because of its elastic (and inexpensive) supply of labor.

5. The migration model of Harris and Todaro provided an important theoretical critique of the manufacturing-biased import-substitution trade-policy stance. Explain.

Answer: The Lewis model, as indicated in the previous question, provided a rationale for manufacturing-biased import substitution trade policy, since the marginal cost of expanding manufactures is close to zero (just high enough to induce a worker to migrate from the farm to the city). However, Harris and Todaro identified an important negative social (and economic) externality associated with this process, namely the problems associated with unplanned and very rapid urbanization combined with rapidly rising expectations of urban migrants.

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Graphical/Numerical Problems



1. If $O_m L_1$ workers are employed in manufacturing then what is the marginal productivity of labor in manufacturing?

Answer: $O_m W_m$

2. If $O_m L_1$ workers are employed in manufacturing then what is the marginal productivity of labor in agriculture?

Answer: $O_f W_f$

3. If manufacturing labor were to increase to $O_m L_2$, how much value would the economy as a whole gain?

Answer: the triangle ABC.

4. Why would workers not shift from agriculture to manufacturing in the initial situation where wages are higher in the latter?

Answer: imperfections in the labor market

5. If the economy were in the initial position (where $O_m L_1$ workers were in manufacturing, what trade policy might gain ABC of economic welfare?

Answer: import-substitution giving protection to manufacturing.

Chapter 11: Controversies in Trade Theory

1. The existence of positive externalities due to the impossibility of full appropriability
 - A. Supports the conclusions of the Heckscher-Ohlin model.
 - B. Rejects the usefulness of government protectionism.
 - C. Supports the concept that the government should support only high tech industries.
 - D. Provides support for government protectionism.
 - E. None of the above.

Answer: D

2. The United States
 - A. Does not provide more support for R&D as compared to other forms of investment.
 - B. Provides support for R&D by imposing high tariffs on R&D intensive products.
 - C. Provides support for R&D by providing direct subsidies for such activities.
 - D. Provides support for R&D through tax legislation.
 - E. None of the above.

Answer: D

3. The Brander-Spencer model identified market failure in certain industries due to
 - A. Unfair competition.
 - B. Wildcat destructive competition.
 - C. Environmental negative externalities associated with pollution.
 - D. Limited competition.
 - E. None of the above.

Answer: D

4. In the Brander-Spencer model the subsidy raises profits by more than the subsidy because of
 - A. The "multiplier" effect of government expenditures.
 - B. The military-industrial complex.
 - C. The forward and backward linkage effects of certain industries.
 - D. The deterrent effect of the subsidy on foreign competition.
 - E. None of the above.

Answer: D

5. Criticisms of the Brander-Spencer model include all except which of the following?
- A. The problem of insufficient information.
 - B. The problem of likely foreign retaliation.
 - C. The problem of harm to interests of consumers.
 - D. The problem of adverse effects of trade policy politics.
 - E. None of the above.

Answer: C

6. Japan's protection of its semiconductor (RAM) producers is today seen as an object lesson in
- A. How strategic planning may backfire and cause a large waste of resources.
 - B. How externalities may be successfully exploited by protectionist policies.
 - C. How excess returns may be successfully exploited by protectionist policies.
 - D. How government intervention may create a meaningful comparative advantage.
 - E. None of the above.

Answer: A

7. In today's world markets, poor developing countries tend to rely primarily on exports of
- A. Agricultural products.
 - B. Primary products.
 - C. Mineral products.
 - D. Manufactured products.
 - E. None of the above.

Answer: D

8. In the second half of the 1990s a rapidly growing movement focused on the harm caused by international trade to
- A. Land owners in poor countries.
 - B. Capital owners in rich industrialized countries.
 - C. Land owners in rich industrialized countries.
 - D. Production workers in both rich and poor countries.
 - E. None of the above.

Answer: D

9. The Ricardian model of comparative advantage lends support to the argument that
- A. Trade tends to worsen the conditions of unskilled labor in rich countries.
 - B. Trade tends to worsen the conditions of owners of capital in rich countries.
 - C. Trade tends to worsen the conditions of workers in poor countries.
 - D. Trade tends to worsen the conditions of workers in rich countries.
 - E. None of the above.

Answer: E

10. The Heckscher-Ohlin, factor-proportions model lends support to the argument that
- A. Trade tends to worsen the conditions of unskilled labor in rich countries.
 - B. Trade tends to worsen the conditions of owners of capital in rich countries.
 - C. Trade tends to worsen the conditions of workers in poor countries.
 - D. Trade tends to worsen the conditions of workers in rich countries.
 - E. None of the above.

Answer: A

11. Most developing countries oppose including labor standards in trade agreements because
- A. They believe this would involve a loss of their national sovereignty.
 - B. They believe this would limit their ability to export to rich markets.
 - C. They believe this would create an uneven playing field.
 - D. Multinational corporations control them.
 - E. None of the above.

Answer: A

12. Free trade and globalization is generally argued
- A. To cause a degradation in the world's environment.
 - B. To improve the environment by correcting for distortions caused by import competing policies.
 - C. To help spread the best of each country's culture, so as to uplift global cultural standards.
 - D. To help each country safeguard the best of its own culture.
 - E. None of the above.

Answer: A

13. If firms in an industry are generating knowledge that other firms can use with paying for it, this industry is characterized by
- A. Social costs that exceed private costs.
 - B. Social benefits that exceed private benefits.
 - C. Social costs that exceed social benefits.
 - D. Private benefits that exceed social benefits.
 - E. None of the above.

Answer: B

14. It is argued that high-tech industries typically generate new technologies but cannot fully appropriate the commercial benefits associated with their inventions or discoveries. If this is true then in order to maximize a country's real income, the government should
- A. Tax the high-tech firms.
 - B. Subsidize the high-tech firms.
 - C. Protect the high-tech firms.
 - D. Both B and C
 - E. None of the above.

Answer: B

15. In effect, the U.S. does subsidize high-tech firms by subsidizing R&D. This is done through
- A. The budget of the Department of Education.
 - B. Systematic protection through the levying of tariffs.
 - C. Systematic protection through the establishment of NTBs.
 - D. Relatively accelerated "depreciation" of R&D investment in the Federal tax codes.
 - E. None of the above.

Answer: D

16. The best economic case one can make for an active industrial policy involves
- A. The national security argument.
 - B. The technological spillover argument.
 - C. The environment preservation argument.
 - D. The high value added argument.
 - E. None of the above.

Answer: E

17. Spencer and Brander's model highlights the existence of
- A. Aircraft industries.
 - B. Excess returns present in highly competitive markets.
 - C. Excess returns, or rents, available in non-competitive markets.
 - D. The futility of government bureaucrats' attempts to build an airplane.
 - E. None of the above.

Answer: C

18. Spencer and Brander's model highlights the conventional assumption that
- A. Government involvement in business or in the economy tends to fail.
 - B. Government subsidies tend to waste taxpayer's money.
 - C. Government subsidies cannot create a successfully competing export.
 - D. Government tends to distort when it displaces Adam Smith's *Invisible Hand*.
 - E. None of the above.

Answer: E

19. The reason Airbus succeeded in the Brander Spencer example is that
- A. Boeing made the first move in this strategic game.
 - B. Europeans tend to be better strategists than corn-fed Americans.
 - C. The airbus actually was a better plane than the Boeing 747.
 - D. U.S. laws actually prohibit U.S. exporters from bribing foreign officials.
 - E. None of the above.

Answer: E

20. The reason Airbus succeeded in the Brander Spencer example is that
- A. The European government made an explicit subsidy offer, but the U.S. government did not.
 - B. Airbus' prices were better when adjusted for quality and warranty services.
 - C. Boeing traditionally refused to undertake any exchange rate risk in its transactions.
 - D. The U.S. acted in accordance with its ideological reliance on market solutions, whereas the Europeans ignored market and technological factors.
 - E. None of the above.

Answer: A

21. The argument that strategic planning is not likely to be practical due to insufficient information means that
- A. Because of trade secrets, the government does not know true cost relationships in any given industry.
 - B. If the government had all the relevant information in a given industry then it could decide whether a subsidy would enhance the public's welfare.
 - C. Even if the government had all the relevant information in a given industry, it still could not decide whether a subsidy would enhance the public's welfare.
 - D. Due to recent cuts in the Department of the Census' sampling budgets, industry surveys are no longer reliable, so that there is no way to determine if a subsidy is in the public's interest.
 - E. None of the above.

Answer: C

22. The invocation of *beggar-thy-neighbor* arguments with respect to industrial policies
- A. Strengthens the argument for subsidies.
 - B. Makes sense if the international Keynesian multipliers exceed unity.
 - C. Applies only to rich countries most of whose trade partners are very poor countries.
 - D. Weakens the argument for subsidies.
 - E. None of the above.

Answer: D

23. The belief that U.S. subsidies will evoke foreign repercussions is called the _____ argument.
- A. Technological spillover
 - B. Foreign multiplier
 - C. *Beggar-thy-neighbor*
 - D. Positive externality
 - E. None of the above.

Answer: C

24. When Japan's MITI (Ministry of International Trade and Industry) focused resources on the semiconductor industry, this was seen as a typically successful Japanese foray into a new dynamic strategic sector. The results, as viewed by the late 1990s
- A. Justified this view.
 - B. Led to similar structuring of industrial policy in the U.S.
 - C. Lent support to the Brander - Spencer model.
 - D. Helped shift the focus of economists away from Japanese-style industrial policy.
 - E. None of the above.

Answer: D

25. Low wages and poor working conditions in many of the U.S.' trade partners
- A. Prove that the *gains-from-trade* arguments of the Ricardian model are false.
 - B. May be a fact of life, but economists don't care.
 - C. Are facts emphasized by U.S. labor in its contract negotiations.
 - D. Prove that the *gains-from-trade* arguments of the Ricardian model are true.
 - E. None of the above.

Answer: C [cuu duong than cong. com](http://cuuduongthancong.com)

26. The fact that clothing sold in Wal-Mart are produced by very poorly paid workers in Honduras, is a fact that if taken into account
- A. Would prove to economists that the Ricardian model of comparative advantage is false.
 - B. Would prove to economists that the equal-value in trade concept summed up in the trade triangles is incorrect.
 - C. Proves to economists that trade is a negative sum game.
 - D. Proves to the Anti-Globalization Movement that trade is a negative sum game.
 - E. None of the above.

Answer: D

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27. When the WTO met in Seattle to initiate a further move towards free international trade, thousands of activists met
- A. In order to promote the WTO's goals of "Trade - not Aid".
 - B. In order to laud the WTO policy orientation which would bust local monopolies and therefore help ordinary relatively poor consumers everywhere.
 - C. In order to laud the WTO policy of disallowing government sweetheart deals, which typically meant that corrupt governments subsidized their in-laws' conglomerates on the backs of poor taxpayers.
 - D. In order to support the WTO efforts of bringing about a universal shift of resources in poor countries to higher efficiency and productivity uses, which would raise the real incomes of everyone.
 - E. None of the above.

Answer: E

28. When one applies the Heckscher-Ohlin model of trade to the issue of trade-related income redistributions, one must conclude that North South trade, such as US.-Mexico trade,
- A. Must help low skill workers on both sides of the border.
 - B. Is likely to hurt high-skilled workers in the U.S.
 - C. Is likely to hurt low-skilled workers in the U.S.
 - D. Is likely to hurt low-skilled workers in Mexico.
 - E. None of the above.

Answer: C

29. The evidence usually cited to prove that globalization hurts workers in developing countries
- A. Is inconclusive due to poor statistical design of the underlying samples.
 - B. Is inconclusive due to the poorly funded Central Statistical Office of Mexico.
 - C. Is inconclusive due to the ambiguous theoretical implications of the findings.
 - D. Is conclusive.
 - E. None of the above.

Answer: C

30. Faced with the evidence of poor working conditions and low wages in the border *maquiladoras*, Economists
- A. Shrug their shoulders and ignore the issue.
 - B. Agree that trade theory is thus proven hollow and internally inconsistent.
 - C. Argue that U.S. consumers should not consume lettuce.
 - D. Argue that the poor conditions and low wages are actually improvements for the Mexican workers, and may be cited as *gains-from-trade*.
 - E. None of the above.

Answer: D

31. The proposal that trade agreements should include a system which monitors worker conditions and make the results available to consumers in the rich importing country
- A. Is consistent with the *Invisible Hand* paradigm.
 - B. Is consistent with the market failure approach.
 - C. Is consistent with the Ricardian theory of comparative advantage.
 - D. Is consistent with the scale economies approach to trade theory.
 - E. None of the above.

Answer: B

32. Labor standards in trade are typically opposed by most developing countries who believe that they will be used
- A. To further neo-imperialist colonial exploitation.
 - B. To charge these countries with crimes against child-labor standards at the Hague.
 - C. As a protectionist tool by import-competing producers in industrial countries.
 - D. As a means of spreading U.S. Corporate Values and destroying local cultures.
 - E. None of the above.

Answer: C

33. The WTO seems at times to be interfering in domestic policy since
- A. The line between domestic policies and de factor protectionism is often fuzzy.
 - B. It is a supra-national organization with the power to overturn governments.
 - C. It determines which nations may trade what with whom.
 - D. It punishes naughty nations.
 - E. None of the above.

Answer: A

34. The Shipbreakers of Alang are
- A. A metaphysical representation of the WTO, deriving from Edgar Rice Burroughs' *Princess of Mars*.
 - B. An early version of the Russian Ice-breaker of the *Dnieper-Alang* class.
 - C. A capital-intensive industry.
 - D. Competing with capital-intensive industries in countries outside of India.
 - E. None of the above.

Answer: D

35. The Shipbreakers of Alang utilize much labor and little capital, thereby supporting the applicability of the
- A. Factor proportions explanation of the sources of comparative advantage.
 - B. Specific factor theory of comparative advantage.
 - C. Monopolistic competition theory of comparative advantage.
 - D. Scale economies theory of comparative advantage.
 - E. None of the above.

Answer: A

36. The Shipbreakers of Alang arouse the ire of Greenpeace because of
- A. India's non-repentant nuclear stance.
 - B. India's import-competing industrialization policies.
 - C. The difficulty of avoiding ship accidents between Greenpeace's sailboat and the reconstructed Container ships of Alang.
 - D. The large amount of pollution associated with the operations at Alang.
 - E. None of the above.

Answer: D

37. The Shipbreakers of Alang represent a perfect example of how a developing country can apply the principles of the Heckscher-Ohlin model, since
- A. Shipbreaking is generally considered to be a capital-intensive operation and India, being a large country has much capital.
 - B. Shipbreaking is a labor-intensive operation in India, and India has many workers since it is such a large country.
 - C. Shipbreaking is a labor-intensive operation in India, and India's availability of capital per worker is less than that of its trade partners.
 - D. Shipbreaking is a capital-intensive operation elsewhere in the world, and therefore represents a case of a factor intensity reversal.
 - E. None of the above.

Answer: C

Essay Questions

1. It may be argued that Japan's explicit promotion of its microchip industry was an excellent example of successful *industrial policy*. What criteria would you apply to determine whether such a policy is or is not successful? Judging from your own stated criteria, was Japan's exercise successful? Why or why not? What information would a government require in order to increase the probability that its *industrial policy* would promote long term self-generated economic growth?

Answer: It is argued that Japan's subsidies to its nascent microchip industry was an important factor in putting Japan on the world map in this area. However, a minimal criteria for a successful *industrial policy* would be that the infant industry mature, and that it prove to be a profitable area of the country's comparative advantage. In this case, one might argue that the latter part of the above statement was not fulfilled, since the microchip industry was adopted by so many countries, that it became a "commodity". That is, it became a product with a very low profit margin, which was not really a good use of Japan's resources, given their alternative uses.

2. In recent cases, the U.S. placed quotas or protectionist tariffs on imported steel and imported microchips. In both cases the damage to "downstream" industries was obvious to all and relatively easy to quantify and demonstrate. Assuming that the U.S. lawmakers are not plain dumb, why did they enact these protectionist policies?

Answer: The system by which these protectionist policies are set into law is biased in favor of the producers of import competitive goods. Other sectors of the economy that may be affected are not parties in the petitions made to the ITC seeking redress.

3. The U.S. is probably the most open international market among the industrialized countries. What then does the U.S. have to gain by joining the WTO?

Answer: There are two answers. First, the U.S. exporters stand to gain profitable markets if foreign protectionism in areas of U.S. comparative advantage (e.g. soy) is removed due to WTO efforts. The second is that the WTO offers the U.S. government administration a counterweight to regional and sectoral interests demanding protection. It is always politically easier to bring about more efficient resource allocations of the complaints of the losers may be deflected by the presence of a binding treaty with an international organization ("out hands are tied").

4. It has been claimed that the Chinese burst of modernization which has been propelling its manufactured exports throughout the world at an unprecedented rate, is made possible by the use of slave (penal) labor. If this is true should China have been accepted as a full fledged member of the WTO? Why (or why not)?

Answer: If the answer to Essay Question #3 is correct, then it follows that the answer here is Yes.

5. It is still the conventional wisdom in the U.S. that compliance with NAFTA requirements is having a deleterious effect on U.S. highway safety standards, on U.S. pollution and other environmental standards, and on U.S. jobs. What facts would proponents of an expansion of NAFTA (e.g. to include all of Central and South American countries) need to marshal in order to convince you?

Answer: The answer is subjective. Presumably the answer should include reasonable and objective counter-factual scenarios (what would be the job or pollution situation with and without NAFTA).

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Graphic/Numerical Problems

1. Suppose Airbus is set to produce the aircraft before Boeing. Which company will enter the market?

Answer: Airbus will produce and Boeing will not.

		Airbus	
		Produce	Don't produce
Boeing	Produce	-5 / -5	0 / 100
	Don't produce	0 / 100	0 / 0

2. Suppose both governments offer their respective company a subsidy of \$4(million).

Answer: Only Airbus will produce since it knows that the subsidy would not be sufficiently large to entice Boeing to also enter the market.

3. Suppose both governments offer their respective company a \$10 million subsidy.

Answer: Both companies would enter the market, since each knows that regardless of the other's decision, it will make some profit here.

4. Suppose the U.S. government (but not Europe) offers a \$10 million subsidy?

Answer: In this case Airbus would decide not to enter the market since it knows Boeing will, and that therefore its own production will entail a loss of \$5 million.

5. How could the U.S. government justify its decision to offer a subsidy to a profitable and successful business?

Answer: It could point out that this \$10 million pump-priming expenditure results in a profit of \$110 million. If Boeing paid a marginal income tax of 20%, this would net the government \$55 million, which is more than 5 times the original subsidy, so that the

decision may be justified not only in terms of benefit/cost considerations, but even in terms of pure budgetary terms.

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Chapter 12: National Income Accounting and the Balance of Payments

Multiple Choice Questions

1. Over the decade from 1991 to 2000,
 - A. Japan's national product grew at an annual average rate of only 3.0 percent while that of the United States grew by nearly 3.5 percent per year.
 - B. Japan's national product grew at an annual average rate of only 1.5 percent while that of the United States grew by nearly 3.5 percent per year.
 - C. The United States' national product grew at an annual average rate of only 1. percent while that of Japan grew by nearly 3.5 percent per year.
 - D. Japan's national product grew at the same annual average rate as that of the United States.
 - E. Japan's national product grew at an annual average rate of 3.5 percent while that of the United States grew only by 1.5 percent per year.

Answer: B

2. Over the decade from 1991 to 2000,
 - A. Japan's unemployment rate rose, reaching nearly 3 percent.
 - B. Japan's unemployment rate rose, reaching nearly 4 percent.
 - C. Japan's unemployment rate rose, reaching nearly 5 percent.
 - D. Japan's unemployment rate rose, reaching nearly 5 percent and overtaking that of the United States for the first time in fifty years.
 - E. Japan's unemployment rate rose, reaching nearly 8 percent and overtaking that of the United States for the first time in fifty years.

Answer: D

3. A country's gross national product (GNP) is
 - A. the value of all final goods and services produced by its factors of production and sold on the market in a given time period.
 - B. the value of all intermediate goods and services produced by its factors of production and sold on the market in a given time period.
 - C. the value of all final goods produced by its factors of production and sold on the market in a given time period.
 - D. the value of all final goods and services produced by its factors of production and sold on the market.
 - E. the value of all final goods and services produced by its factors of production, excluding land, and sold on the market in a given time period.

Answer: A

4. For most macroeconomists,
- A. national income accounts and national output accounts are equal to each other.
 - B. national income accounts exceed national output accounts.
 - C. national output accounts exceed national income accounts.
 - D. it is impossible to tell whether national income accounts are equal to national output accounts.
 - E. None of the above.

Answer: A

5. For most macroeconomists,
- A. gross national income and gross national product are the same.
 - B. gross national income exceeds gross national product.
 - C. gross national product exceeds gross national product.
 - D. it is hard to tell whether gross national income equals gross national product.
 - E. None of the above.

Answer: A

6. The highest component of GNP is
- A. the current account.
 - B. investment.
 - C. government purchases.
 - D. consumption.
 - E. None of the above.

Answer: D

7. The GNP of the United States in 2000 was about
- A. 7 trillion dollars.
 - B. 1 trillion dollars.
 - C. 5 trillion dollars.
 - D. 6 trillion dollars.
 - E. 10 trillion dollars.

Answer: E

8. In 2000, the United States had
- A. a surplus in the current account.
 - B. a balanced current account.
 - C. a deficit in the current account.
 - D. It is hard to tell from the data whether in 2000 the United States had a deficit or a surplus in the current account.
 - E. None of the above.

Answer: C

9. In order to move from units expressed in trillion to units expressed in billions, you need to multiple the number in billions by
- A. 100.
 - B. 10,000.
 - C. 100,000.
 - D. 1,000,000.
 - E. 1,000.

Answer: E

10. The sale of
- A. a used textbook does enter GNP.
 - B. a used textbook does not enter GNP, but the sale of a used house does.
 - C. both a used textbook and a used house do not enter GNP.
 - D. a used house does not enter GNP, but the sale of a used book does.
 - E. None of the above.

Answer: C

11. Which one of the following statements is the most accurate?
- A. The sale of a used textbook does generate income for factors of production.
 - B. The sale of a used textbook does not generate income for any factor of production.
 - C. The sale of a used textbook sometimes does and sometimes does not generate income for factors of production.
 - D. It is hard to tell whether a sale of a used textbook does or does not generate income for factors of production.
 - E. None of the above.

Answer: B

12. Which one of the following statements is the most accurate?
- A. GNP plus depreciation is called net national product (NNP).
 - B. GNP less depreciation is called net national product (NNP).
 - C. GNP less depreciation is called net factor product (NFP).
 - D. Answers A and C are both correct.
 - E. None of the above.

Answer: B

13. National income equals GNP
- A. less depreciation, less net unilateral transfers, less indirect business taxes.
 - B. less depreciation, plus net unilateral transfers, plus indirect business taxes.
 - C. less depreciation, less net unilateral transfers, plus indirect business taxes.
 - D. plus depreciation, plus net unilateral transfers, less indirect business taxes.
 - E. less depreciation, plus net unilateral transfers, less indirect business taxes.

Answer: E

14. The United States began to report its gross domestic product (GDP) only since
- A. 1900
 - B. 1921
 - C. 1931
 - D. 1941
 - E. 1991

Answer: E

15. GDP is supposed to measure
- A. the volume of production within a country's borders.
 - B. the volume of services generated within a country's borders.
 - C. the volume of production of a country's output.
 - D. GNP plus depreciation.
 - E. None of the above.

Answer: A

16. GNP equals GDP
- A. minus net receipts of factor income from the rest of the world.
 - B. plus receipts of factor income from the rest of the world.
 - C. minus receipts of factor income from the rest of the world.
 - D. plus net receipts of factor income from the rest of the world.
 - E. None of the above.

Answer: D

17. Movements in GDP
- A. and GNP usually do not differ greatly.
 - B. and GNP usually do not differ greatly, as a practical matter.
 - C. and GNP usually do differ greatly.
 - D. are usually smaller than those of GNP movements, in practice.
 - E. None of the above.

Answer: B

18. In open economies,
- A. saving and investment are necessarily equal.
 - B. as in a closed economy, saving and investment are not necessarily equal.
 - C. saving and investment are not necessarily equal as they are in a closed economy.
 - D. saving and investment are necessarily equal contrary to the case of a closed economy.
 - E. None of the above.

Answer: C

19. In the United States since the Korean War, the fraction of GNP devoted to consumption has fluctuated in a range of about
- A. 42 to 49 percent.
 - B. 32 to 39 percent.
 - C. 22 to 29 percent.
 - D. 82 to 89 percent.
 - E. 62 to 69 percent.

Answer: E

20. Purchases of inventories by
- A. firms are not counted in investment spending.
 - B. firms are also counted in investment spending.
 - C. households are also counted in investment spending.
 - D. households and firms are also counted in investment spending.
 - E. None of the above.

Answer: B

21. Investment is usually
- A. more variable than consumption.
 - B. less variable than consumption.
 - C. as variable as consumption.
 - D. It is hard to tell from the data whether investment is more or less variable than consumption.
 - E. None of the above.

Answer: A

22. Any goods
- A. purchased by federal, state, or local governments are classified as government purchases.
 - B. and services purchased only by federal government are classified as government purchases.
 - C. and services purchased only by federal or state governments are classified as government purchases.
 - D. and services purchased by federal, state, or local governments are classified as government purchases.
 - E. None of the above.

Answer: D

23. Government transfer payments such as social security and unemployment benefits are
- A. included in government purchases.
 - B. not included in government purchases.
 - C. not included in government purchases, but they are included in the consumption component of GNP.
 - D. not included in government purchases, but they are part of the investment component of GNP.
 - E. None of the above.

Answer: B

24. Government purchases currently take up about
- A. 18 percent of U.S. GNP, and this share has not changed much since the late 1950s.
 - B. 38 percent of U.S. GNP, and this share has not changed much since the late 1950s.
 - C. 18 percent of U.S. GNP, and this share has been increasing since the late 1950s.
 - D. 18 percent of U.S. GNP, and this share has been decreasing since the late 1950s.
 - E. None of the above.

Answer: A

25. In 1929, government purchases accounted for
- A. only 18.5 percent of U.S. GNP.
 - B. only 8.5 percent of U.S. GNP.
 - C. 28.5 percent of U.S. GNP.
 - D. 38.5 percent of U.S. GNP.
 - E. 48.5 percent of U.S. GNP.

Answer: B

26. Which one of the following expressions is the most accurate?
- A. $CA = EX - IM$.
 - B. $CA = IM - EX$.
 - C. $CA = EX = IM$.
 - D. $CA = EX + IM$.
 - E. None of the above.

Answer: A

27. A country's current account
- A. balance equals the change in its net foreign wealth.
 - B. balance equals the change in its foreign wealth.
 - C. surplus equals the change in its foreign wealth.
 - D. deficit equals the change in its foreign wealth.
 - E. None of the above.

Answer: A

28. The CA is equal to
- A. $Y - (C-I+G)$.
 - B. $Y + (C+I+G)$.
 - C. $Y - (C+I+G)$.
 - D. $Y - (C+I-G)$.
 - E. $Y - (C+I+G) = -CA$, (i.e., minus the CA).

Answer: C

29. Which one of the following statements is the most accurate?
- A. It is not hard to measure accurately a country's net foreign wealth.
 - B. It is surprisingly hard to measure accurately a country's net foreign wealth.
 - C. It is surprisingly hard to measure a country's foreign wealth.
 - D. It is surprisingly hard to measure accurately a country's foreign transactions.
 - E. None of the above.

Answer: B

30. Over the 1980s,
- A. there is no question that a large increase in U.S. foreign assets did occur.
 - B. there is a question whether a large decrease in U.S. foreign assets did occur.
 - C. there is no question that a large decrease in U.S. foreign assets did occur.
 - D. there is no question that there was almost no change in U.S. foreign assets.
 - E. None of the above.

Answer: C

31. In a closed economy, national saving
- A. sometimes equals investment.
 - B. always equals investment.
 - C. is always less than investment.
 - D. is always more than investment.
 - E. None of the above.

Answer: B

32. For open economies,

- A. $S = I$.
- B. $S = I + CA$.
- C. $S = I - CA$.
- D. $S > I + CA$.
- E. $S < I + CA$.

Answer: B

33. An open economy

- A. can save only by building up its capital stock.
- B. can save only by acquiring foreign wealth.
- C. cannot save either by building up its capital stock or by acquiring foreign wealth.
- D. can save either by building up its capital stock or by acquiring foreign wealth.
- E. None of the above.

Answer: D

34. A closed economy

- A. can save either by building up its capital stock or by acquiring foreign wealth.
- B. can save only by building up its capital stock.
- C. can save only by acquiring foreign wealth.
- D. cannot save either by building up its capital stock or by acquiring foreign wealth.
- E. None of the above.

Answer: B

35. When economists refer to the word government, they usually mean

- A. only the federal government.
- B. only the federal and state governments.
- C. the federal, state, and local governments.
- D. only the federal and local governments.
- E. None of the above.

Answer: C

36. Disposable income is National income
- A. less taxes collected from households and firms by the government.
 - B. plus net taxes collected from households and firms by the government.
 - C. less net taxes collected from households and firms by the government
 - D. less net taxes collected from households by the government.
 - E. less net taxes collected from households and firms by the government.

Answer: E

37. Government savings, S^g , is equal to
- A. $T - G$.
 - B. $T + G$.
 - C. $T = G$.
 - D. $T + G - I$.
 - E. None of the above.

Answer: A

38. In a closed economy, private saving, S^p , is equal to
- A. $I - (G - T)$.
 - B. $I + (G - T)$.
 - C. $I + (G + T)$.
 - D. $I - (G + T)$.
 - E. $I + (G - T) + C$.

Answer: B

39. In an open economy, private saving, S^p , is equal to
- A. $I - CA + (G - T)$.
 - B. $I + CA - (G - T)$.
 - C. $I + CA + (G - T)$.
 - D. $I - CA - (G - T)$.
 - E. $I + CA + (G + T)$.

Answer: C

40. Ricardian equivalence argues that when the government cuts taxes and raises its deficit,
- A. consumers anticipate that they will face lower taxes later to pay for the resulting government debt.
 - B. consumers anticipate that they will receive better services from the government.
 - C. consumers anticipate that they will face higher taxes later to pay for the resulting government debt.
 - D. consumers anticipate it will affect their future taxes, in general in the direction of lowering future taxes.
 - E. None of the above.

Answer: C

41. Ricardian equivalence argues that when the government
- A. increases taxes and raises its deficit, consumers anticipate that they will face higher taxes later to pay for the resulting government debt, thus people will raise their own private saving to offset the fall in government saving.
 - B. cuts taxes and decreases its deficit, consumers anticipate that they will face higher taxes later to pay for the resulting government debt, thus people will raise their own private saving to offset the fall in government saving.
 - C. cuts taxes and raises its surplus, consumers anticipate that they will face higher taxes later to pay for the resulting government debt, thus people will raise their own private saving to offset the fall in government saving.
 - D. cuts taxes and raises its deficit, consumers anticipate that they will face lower taxes later to pay for the resulting government debt, thus people will raise their own private saving to offset the fall in government saving.
 - E. cuts taxes and raises its deficit, consumers anticipate that they will face higher taxes later to pay for the resulting government debt, thus people will raise their own private saving to offset the fall in government saving.

Answer: E

42. Every international transaction automatically enters the balance of payments
- A. once either as a credit or as a debit.
 - B. twice, once as a credit and once as a debit.
 - C. once as a credit.
 - D. twice, both times as debit.
 - E. None of the above.

Answer: B

Essay Questions

1. What are the main aspects of economic life that macroeconomics analysis is most concerned with?

Answer: There are four main aspects: unemployment, saving, trade imbalances, and money and the price level.

2. What is the national income identity for a closed economy?

Answer: $Y = C + I + G$.

3. What is the national income identity for an open economy?

Answer: $Y = C + I + G + EX - IM$.

4. Discuss the values of private saving in closed and open economies.

Answer: In a closed economy, private saving, S^p , is equal to $I + (G - T)$. In an open economy, private saving, S^p , is equal to $I + CA + (G - T)$. An open economy helps in extending the opportunities for private saving or dis-saving, or borrowing.

5. Discuss the effects of government deficits on the current account.

Answer: See pages 306 – 307 A hard and difficult issue. During the Reagan administration, the creation of twin deficits, whereby slashing taxes, government deficits increased, which was accompanied with increased current account deficits.

Using the identity $CA = \text{Private Saving} - I - (G - T)$, one can see that if private savings and I are constants, an increase in the deficit, namely an increase in $(G - T)$, necessarily increases the CA deficits by the same magnitude.

However, government budget deficit may change both private savings and investment, thus avoiding a creation of the twin deficits. An example is the European countries reducing their budget deficits just prior to the introduction of the euro in January 1999. Now, under the “twin deficits: theory,” one would have expected the EU’s current account surpluses to increase. This has never happened. The main reason was sharp reduction in private saving rates.

A good answer should discuss Ricardian equivalence, which argues that when the government cut taxes and raises its deficit, consumers anticipate that they will face higher taxes later to pay for the resulting government debt. In anticipation, they raise their own private saving to

offset the fall in government saving. In addition, one should mention wealth effect in anticipation of one Europe, assets prices increased, lowering private saving rates.

4. What types of international transactions are recorded in the balance of payment accounts?

Answer: Three types: transactions that involve exports and imports of good and services; transactions that involve the purchase or sell of financial assets; and exports and imports of good and services; other activities resulting in transfer of wealth between countries that are recorded in the capital account.

7. “The balance of payments is always balanced.” Discuss.

Answer: True. Every international transaction automatically enters the balance of payments twice, once as a credit and once as a debit.

Current account + financial account + capital account = 0

8. “The balance of payments accounts seldom balance in practice.” Discuss.

Answer: True. The main reasons are due to the fact that data collected or received from different sources may differ in coverage, accuracy, and timing. In addition, data on services are not as reliable as data from the financial account. Moreover, accurate measurements of international interest and dividend receipts are particularly difficult.

9. What are the reasons for the world as a whole running a substantial current account deficit?

Answer: (See pages 314 – 315.) This deficit increased sharply in the early 1980s and has remained high. The main reasons are statistical discrepancies of national accounts, timing factors, while the main factor is the systematic misreporting of international interest income flows. Since the world interest rates rose sharply after 1980, the size of the world interest payment discrepancy increased with them. In addition, much of the world’s merchant shipping fleet is registered in countries that do not report maritime freight earnings to the IMF, which collects these data.

Quantitative/Graphing Problems

5. Assume
 $C = 40 + 0.8(Y - T)$
 $G = 10$
 $I = 20$
 $T = 0$, where T are taxes.

A. Calculate Y at equilibrium.

Answer: $Y = C + I + G$
 $Y = 350$

B. Calculate C , I , and G at equilibrium.

Answer: $C = 40 + 0.8 Y = 320$
 $I = 20$
 $G = 10$

C. Now assume,
 $EX = 5 + 4EP^*/P$
 $IM = 10 + 0.1(Y - T) - 3EP^*/P$
 $E = 3$
 $P^* = 1.5$
 $P = 2$
Find equilibrium Y

Answer:
 $Y = 269.1667$

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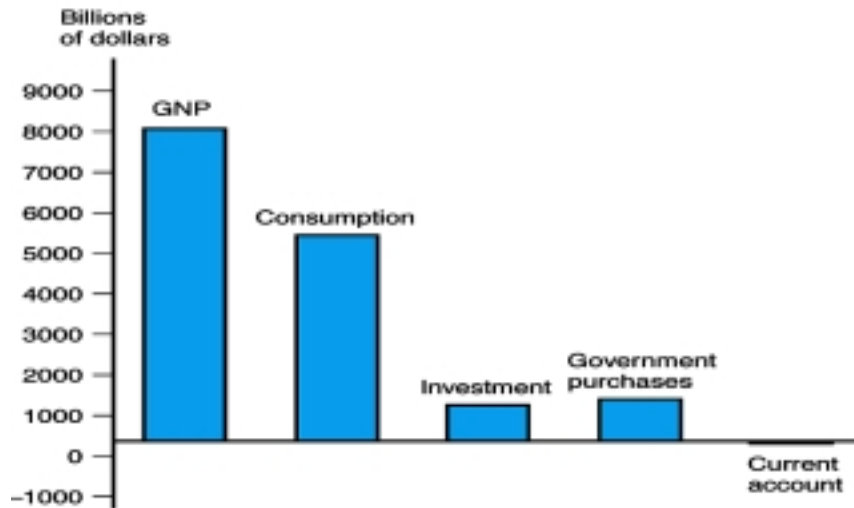
2. Fill in the following table:

GNP	Consumption	Investment	Government	Exports	Imports
	Investment		Purchases		
Total Output					
Consumption					
100		25	10	10	20
115	75		12	14	16
120	70	25		20	30
69	58	10	10		32
135	75	30	35	25	
	140	140	140	140	140
940		140	200	300	200
1150	600		300	200	150
1250	700	200		200	150

Answer

GNP	Consumption	Investment	Government	Exports	Imports
	Investment		Purchases		
Total Output					
Consumption					
100	75	25	10	10	20
115	75	30	12	14	16
120	70	25	35	20	30
69	58	10	10	23	32
135	75	30	35	25	30
420	140	140	140	140	140
940	500	140	200	300	200
1150	600	200	300	200	150
1250	700	200	300	200	150

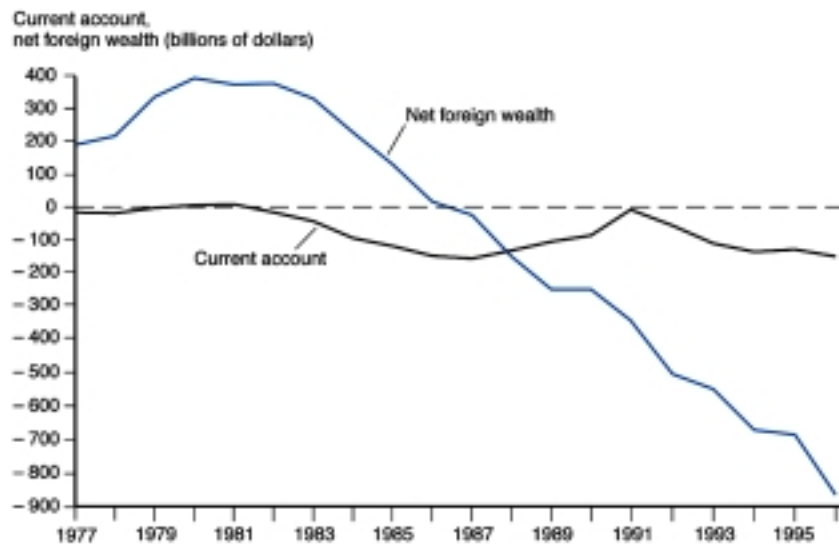
3. What can you learn from the figure below, which depicts the US GNP and its components for the year 1997?



Answer:

The figure shows the US GNP and its components for the year 1997. The U.S. GNP is about 8 trillion, consumption represents about 6 trillion, etc. The current account is in a small deficit, smaller than the one from 2000 that the students see in the Sixth Edition.

4. What can one learn from the following figure?



Answer:

The figure shows the U.S. current account and net foreign wealth from 1977 until 1996. It shows that a string of current account deficits in the 1980s reduced America's net foreign wealth until, by the end 1996, the country had accumulated a substantial net foreign debt. In 1987 the country became a net debtor to foreigners for the first time since World War I.

5. Consider how the United States' balance of payments accounts are affected when U.S. banks forgive two billion in debt owed to them by the government of Argentina.

Answer:

In this case, the United States makes a two billion dollars capital transfer to Argentina, which should appear as a negative two billion dollar entry in the capital account. The associated credit is in the financial account, in the form of a two billion dollar reduction in U.S. assets held abroad, i.e., a net asset “export,” and therefore a positive balance of payments entry.

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Chapter 13: Exchange Rates and the Foreign Exchange Market: An Asset Approach

Multiple Choice Questions

1. How many dollars would it cost to buy an Edinburgh Woolen Mill sweater costing 50 British pounds if the exchange rate is 1.25 dollars per one British pound?
- A. 50 dollars
 - B. 60 dollars
 - C. 70 dollars
 - D. 62.5 dollars
 - E. 40 British pounds

Answer: D

2. How many dollars would it cost to buy an Edinburgh Woolen Mill sweater costing 50 British pounds if the exchange rate is 1.50 dollars per one British pound?
- A. 50 dollars
 - B. 60 dollars
 - C. 70 dollars
 - D. 80 dollars
 - E. 75 dollars

Answer: E

3. How many dollars would it cost to buy an Edinburgh Woolen Mill sweater costing 50 British pounds if the exchange rate is 1.80 dollars per one British pound?
- A. 40 dollars
 - B. 90 dollars
 - C. 50 dollars
 - D. 100 dollars
 - E. 95 dollars

Answer: B

4. The German currency is called the
- A. Euro
 - B. DM
 - C. Yen
 - D. Dollar
 - E. Pound

Answer: A

5. How many British pounds would it cost to buy a pair of American designer jeans costing \$45 if the exchange rate is 1.50 dollars per British pound?
- A. 10 British pounds
 - B. 20 British pounds
 - C. 30 British pounds
 - D. 35 British pounds
 - E. 25 British pounds

Answer: C

6. 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. 10 British pounds
 - B. 25 British pounds
 - C. 20 British pounds
 - D. 30 British pounds
 - E. 40 British pounds

Answer: B

7. How many British pounds would it cost to buy a pair of American designer jeans costing \$45 if the exchange rate is 2.00 dollars per British pound?
- A. 22.5 British pounds
 - B. 32.5 British pounds
 - C. 12.5 British pounds
 - D. 40 British pounds
 - E. 30 British pounds

Answer: A

8. How many British pounds would it cost to buy a pair of American designer jeans costing \$45 if the exchange rate is 1.60 dollars per British pound?
- A. 38.125 British pounds
 - B. 28.125 British pounds
 - C. 48.125 British pounds
 - D. 58.125 British pounds
 - E. 18.125 British pounds

Answer: B

9. What is the exchange rate between the dollar and the British pound if a pair of American jeans costs 50 dollars in New York and 100 pounds in London?
- A. 1.5 dollars per British pound
 - B. 0.5 dollars per British pound
 - C. 2.5 dollars per British pound
 - D. 3.5 dollars per British pound
 - E. 2 dollars per British pound

Answer: B

10. What is the exchange rate between the dollar and the British pound if a pair of American jeans costs 60 dollars in New York and 30 pounds in London?
- A. 1.5 dollars per British pound
 - B. 0.5 dollars per British pound
 - C. 2.5 dollars per British pound
 - D. 3.5 dollars per British pound
 - E. 2 dollars per British pound

Answer: E

11. When a country's currency depreciates,
- A. foreigners find that its exports are more expensive, and domestic residents find that imports from abroad are more expensive.
 - B. foreigners find that its exports are more expensive, and domestic residents find that imports from abroad are cheaper.
 - C. foreigners find that its exports are cheaper; however, domestic residents are not affected.
 - D. foreigners are not affected, but domestic residents find that imports from abroad are more expensive.
 - E. None of the above.

Answer: E

12. An appreciation of a country's currency
- A. decreases the relative price of its exports and lowers the relative price of its imports.
 - B. raises the relative price of its exports and raises the relative price of its imports.
 - C. lowers the relative price of its exports and raises the relative price of its imports.
 - D. raises the relative price of its exports and lowers the relative price of its imports.
 - E. None of the above.

Answer: D

13. 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.
 - D. A depreciation of a country's currency makes its goods cheaper.
 - E. None of the above.

Answer: A

14. By early 2002,
- A. A Canadian dollar was worth only about 15 United States cents.
 - B. A Canadian dollar was worth only about 20 United States cents.
 - C. A Canadian dollar was worth only about 65 United States cents.
 - D. A Canadian dollar was worth only about 100 United States cents.
 - E. A Canadian dollar was worth only about 5 United States cents.

Answer: C

15. The largest trading of foreign exchange occurs in
- A. New York.
 - B. London.
 - C. Tokyo.
 - D. Frankfurt.
 - E. Singapore.

Answer: B

16. In 2001,
- A. 20 percent of foreign exchange transactions involved exchanges of foreign currencies for U.S. dollars.
 - B. 10 percent of foreign exchange transactions involved exchanges of foreign currencies for U.S. dollars.
 - C. 30 percent of foreign exchange transactions involved exchanges of foreign currencies for U.S. dollars.
 - D. 40 percent of foreign exchange transactions involved exchanges of foreign currencies for U.S. dollars.
 - E. 90 percent of foreign exchange transactions involved exchanges of foreign currencies for U.S. dollars.

Answer: E

17. Which one of the following statements is the most accurate? The term spot exchange rate is
- A. misleading because even spot exchanges usually become effective only three days after a deal is struck.
 - B. misleading because even spot exchanges usually become effective only four days after a deal is struck.
 - C. misleading because even spot exchanges usually become effective only five days after a deal is struck.
 - D. misleading because even spot exchanges usually become effective only six days after a deal is struck.
 - E. misleading because even spot exchanges usually become effective only two days after a deal is struck.

Answer: E

18. Which one of the following statements is the most accurate? Trades of U.S. dollars for Canadian dollars in New York are executed with
- A. a one-day lag.
 - B. a two-day lag.
 - C. a three-day lag.
 - D. a four-day lag.
 - E. a zero-day lag.

Answer: A

19. Forward and spot exchange rates
- A. are necessarily equal
 - B. do not move closely together
 - C. The forward exchange rate is always above the spot exchange rate.
 - D. while not necessarily equal, do move closely together.
 - E. None of the above.

Answer: D

20. A foreign exchange swap
- A. is a spot sale of a currency.
 - B. is a forward repurchase of the currency.
 - C. is a spot sale of a currency combined with a forward repurchase of the currency.
 - D. is a spot sale of a currency combined with a forward sale of the currency.
 - E. None of the above.

Answer: C

21. An American put option on foreign exchange
- A. gives the buyer the right to sell the foreign currency at a known exchange rate at any time during the period of the option.
 - B. gives the seller the right to sell the foreign currency at a known exchange rate at any time during the period of the option.
 - C. gives the buyer the right to sell the foreign currency at a known exchange rate at a specific time in the future.
 - D. obligates the buyer to sell the foreign currency at a known exchange rate at any time during the period of the option.
 - E. None of the above.

Answer: A

22. An American call option on foreign exchange
- A. obligates you to buy foreign currency at a known price at any time during the period of the option.
 - B. gives you the right to buy foreign currency at a known price at any time during the period of the option.
 - C. gives you the right to buy foreign currency at a known price at a specific day in the future.
 - D. gives you the right to sell foreign currency at a known price at any time during the period of the option.
 - E. None of the above.

Answer: B

23. The exchange rate between currencies depends on
- A. the interest rate that can be earned on deposits of those currencies.
 - B. the expected future exchange rate.
 - C. the interest rate that can be earned on deposits of those currencies and the expected future exchange rate.
 - D. national output.
 - E. None of the above.

Answer: B

24. Which one of the following statements is the most accurate? Countries in the euro zone include
- A. Austria, Australia, and Belgium.
 - B. Austria, Belgium, and Finland.
 - C. Austria and Finland.
 - D. Austria, Belgium, Finland, and France.
 - E. Austria, Belgium, Finland, France, and Germany.

Answer: E

25. Which one of the following statements is the most accurate?
- A. Because dollar and DM interest rates are measured in comparable terms, they can move quite differently over time.
 - B. Because dollar and DM interest rates are not measured in comparable terms, they can move quite differently over time.
 - C. Because dollar and DM interest rates are measured in comparable terms, they move quite the same over time.
 - D. Because dollar and DM interest rates are measured in comparable terms, they still move quite differently over time.
 - E. None of the above.

Answer: B

26. Which one of the following statements is the most accurate? Countries in the euro zone include
- A. Austria, Belgium, Finland, France, and Germany.
 - B. Austria, Belgium, Finland, France, Germany, and Greece.
 - C. Austria, Belgium, Finland, France, Germany, and Ireland.
 - D. Austria, Belgium, Finland, France, Germany, and Italy.
 - E. All of the above statements are correct.

Answer: E

27. Which one of the following statements is the most accurate? Countries in the euro zone include
- A. Austria, Belgium, Finland, France, Germany, and Greece.
 - B. Austria, Belgium, Finland, France, Germany, and Luxembourg.
 - C. Austria, Belgium, Finland, France, Germany, Portugal, and Ireland.
 - D. Austria, Belgium, Finland, France, Germany, Spain, and Italy.
 - E. All of the above statements are correct.

Answer: E

28. Which one of the following statements is the most accurate? Countries in the euro zone include
- A. Austria, Belgium, Finland, France, Germany, Greece, Luxemburg, and Ireland.
 - B. Austria, Belgium, Finland, France, Germany, Luxembourg, Portugal, and Poland.
 - C. Austria, Belgium, Finland, France, Germany, Portugal, Ireland, and the Czeck Republic.
 - D. Austria, Belgium, Finland, France, Germany, Spain, Italy, and Ukraine.
 - E. All of the above statements are correct.

Answer: A

29. Which one of the following statements is the most accurate?
- A. The dollar rate of return on euro deposits is the euro interest rate plus the rate of depreciation of the dollar against the euro.
 - B. 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.
 - C. The dollar rate of return on euro deposits is the euro interest rate minus the rate of depreciation 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 appreciation of the dollar against the euro.
 - E. 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.

Answer: E

30. 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 invest only in euros.
 - C. an investor should be indifferent between dollars and euros.
 - D. it is impossible to tell given the information.
 - E. All of the above.

Answer: D

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

Answer: A

32. If the dollar interest rate is 10 percent, the euro interest rate is 6 percent, and the expected return on dollar depreciation against the euro is 4 percent, then
- A. an investor should invest only in dollars.
 - B. an investor should invest only in euros.
 - C. an investor should be indifferent between dollars and euros.
 - D. It is impossible to tell given the information.
 - E. All of the above.

Answer: C

33. 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 8 percent, then
- A. an investor should invest only in dollars.
 - B. an investor should invest only in euros.
 - C. an investor should be indifferent between dollars and euros.
 - D. It is impossible to tell given the information.
 - E. All of the above.

Answer: B

34. If the dollar interest rate is 10 percent, the euro interest rate is 12 percent, and the expected return on dollar depreciation against the euro is negative 4 percent, then
- A. an investor should invest only in dollars.
 - B. an investor should invest only in euros.
 - C. an investor should be indifferent between dollars and euros.
 - D. It is impossible to tell given the information.
 - E. All of the above.

Answer: A

35. Which of the following statements is the most accurate?
- A. A rise in the interest rate offered by dollar deposits causes the dollar to appreciate.
 - B. A rise in the interest rate offered by dollar deposits causes the dollar to depreciate.
 - C. A rise in the interest rate offered by dollar deposits does not affect the U.S. dollar.
 - D. For a given euro interest rate and constant expected exchange rate, a rise in the interest rate offered by dollar deposits causes the dollar to appreciate.
 - E. None of the above.

Answer: D

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

Answer: A

37. Suppose that the one-year forward price of euros in terms of dollars is equal to \$1.113 per euro. Further, assume that the spot exchange rate is \$1.05 per euro, and the interest rate on dollar deposits is 10 percent and on euros it is 4 percent. What is the rate of return on a covered euro deposit?
- A. 0.10
 - B. 0.101
 - C. 0.102
 - D. 0.103
 - E. 0.104

Answer: D

38. Suppose that the one-year forward price of euros in terms of dollars is equal to \$1.113 per euro. Further, assume that the spot exchange rate is \$1.05 per euro, and the interest rate on dollar deposits is 10 percent and on euros it is 4 percent. Under these assumptions,
- A. covered interest parity does hold.
 - B. covered interest parity does not hold.
 - C. It is hard to tell whether covered interest parity does or does not hold.
 - D. Not enough information is given to answer the question.
 - E. None of the above.

Answer: B

Essay Questions

1. In the year 2000, Americans flocked to Paris. What economic forces made French goods appear so cheap to residents of the United States?

Answer: One major factor was a sharp fall in the dollar price of France's currency.

2. Who are the major participants in the foreign exchange market?

Answer:

1. Commercial banks
 2. Corporations
 3. Nonbank financial institutions
 4. Central banks
3. Based on the case study, "A Tale of Two Dollars," explain why errors in the currency market can be more costly to the Toronto Blue Jays baseball team than errors in the field.

Answer: See page 329. The Toronto team has 80 percent of its revenue paid in Canadian dollars and 80 percent of its expenses set in U.S. dollars. Since the Canadian dollar has depreciated substantially, it causes big losses for the team by raising its expenses relative to its receipts. To protect itself from the vagaries of the exchange rate, the team tries to predict its need for U.S. dollars ahead of time so that it can sell Canadian dollars and purchase the American currency in advance to lock in the exchange rate. Errors in the currency market can thus be more costly to the team than on the field.

4. Explain what a "vehicle currency" is. Why is the U.S. dollar considered a vehicle currency?

Answer: A vehicle currency is one that is widely used to denominate international contracts made by parties who do not reside in the country that issues the vehicle currency. Since 2001, ninety percent of foreign exchange transactions involve exchanges of foreign currencies for U.S. dollars; therefore, the dollar is considered a vehicle currency.

5. What are the factors affecting the demand for foreign currency?

Answer: Three factors affect the demand for foreign currency. They are expected return, risk, and liquidity.

6. What is the interest parity condition?

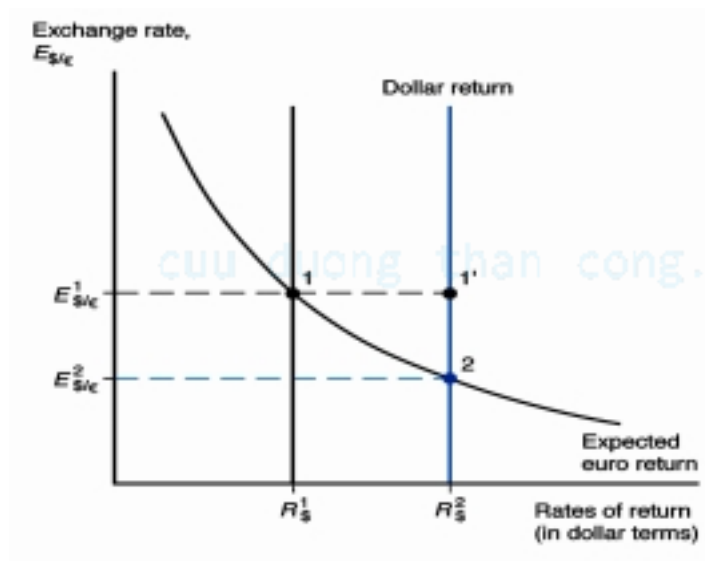
Answer: The condition that the expected returns on deposits of any two currencies are equal when measured in the same currency is called the interest parity condition. It implies that potential holders of foreign currency deposits view them as equally desirable assets, i.e. risk is assumed away.

In notational forms:

$$R_{\$} = R_E + (E_{\$/E}^e - E_{\$/E}) / E_{\$/E}.$$

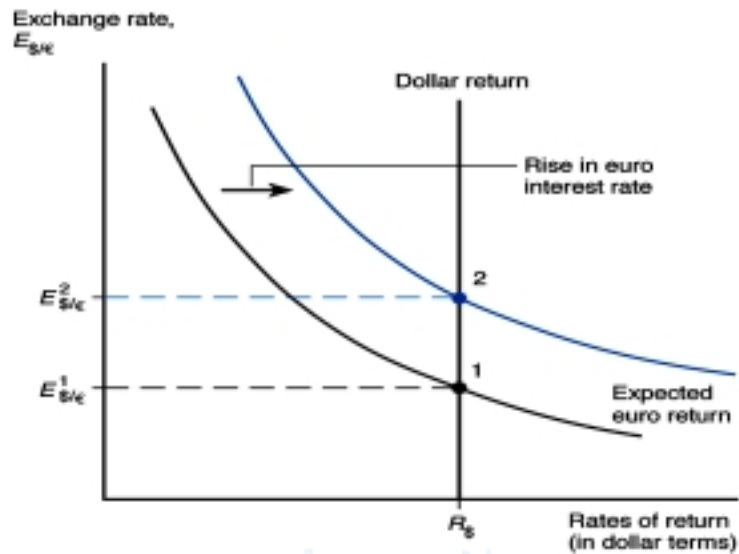
7. Discusses the effects of a rise in the dollar interest rate on the exchanger rate.

Answer: For a given euro interest rate and constant expected exchange rate, a rise in the interest rate offered by dollar deposits causes the dollar to appreciate.

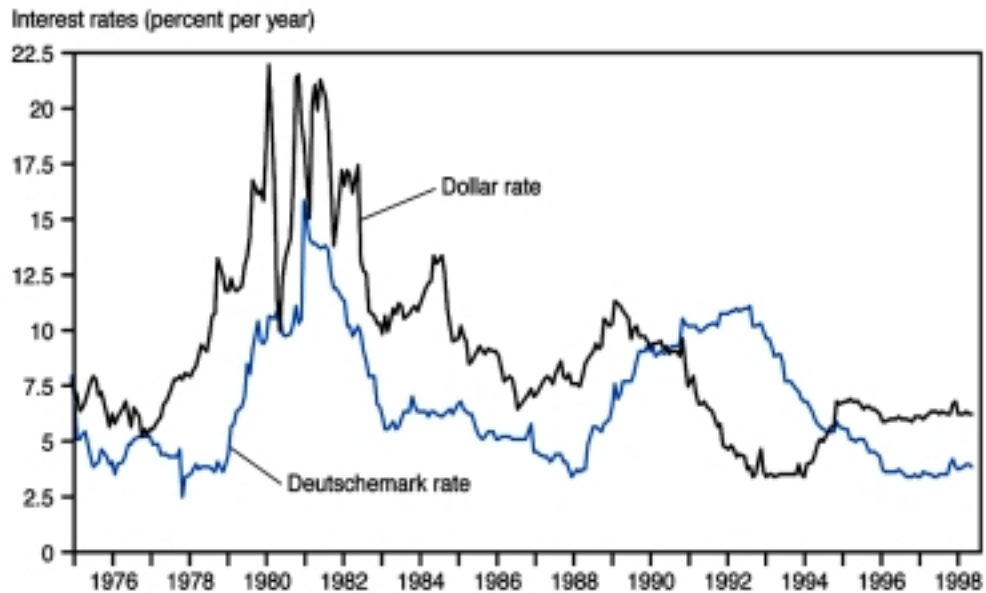


8. Discusses the effects of a rise in the interest rate paid by euro deposits on the exchanger rate.

Answer: For a given U.S. interest rate and a given expectation with regard to the future exchange rate, a rise in the interest rate paid by euro deposits causes the dollar to depreciate.

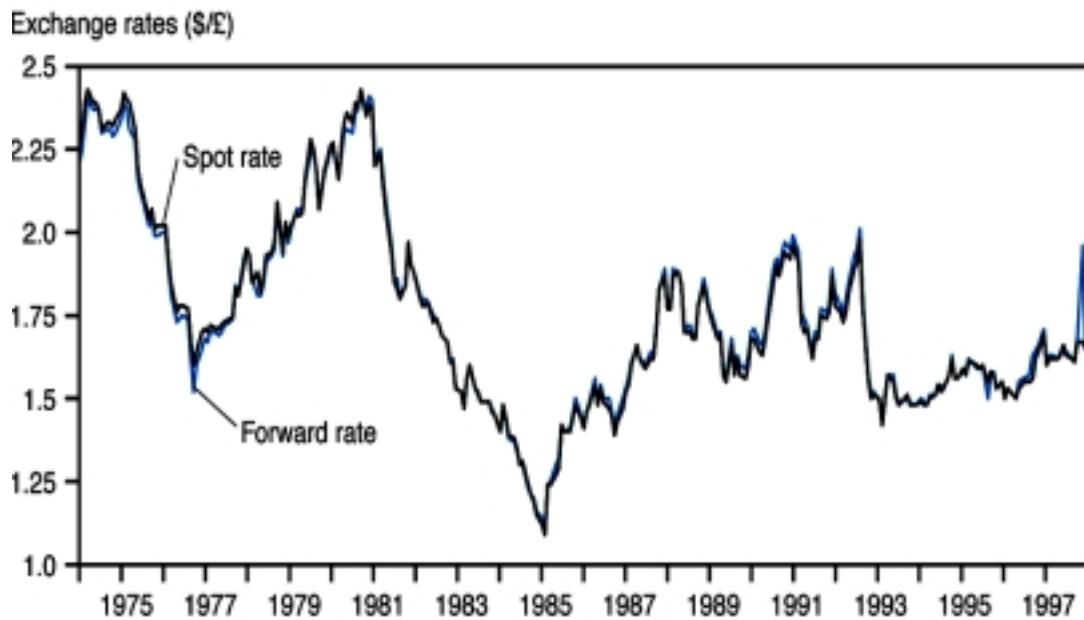


9. Explain the purpose of the following figure. Show the effects of German unification on Germany's interest rate.



Answer: The main purpose is to show that different interest rates exist for different assets since foreign currencies are different assets. From 1990 to 1995, the DM interest rate is higher than that of the United States. Excluding this period, the dollar rates are higher reflecting higher inflation in the United States and depreciating of the dollar versus the German currency.

10. Explain the purpose of the following figure.



Answer: To show that spot and forward exchange rates are in general close to each other.

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Quantitative/Graphing Problems

1. Compute how many dollars it would cost to buy an Edinburgh Woolen Mill sweater costing 50 British pounds for the following exchange rates:

Exchange Rate	Price of a sweater in British pounds	Price in dollars
Number of dollars per one British pound		
1	50	
1.1	50	
1.2	50	
1.25	50	
1.3	50	
1.4	50	
1.5	50	
1.6	50	
1.7	50	
1.75	50	
1.8	50	
1.9	50	
2	50	

Answer:

Exchange Rate	Price of a sweater in British pounds	Price in dollars
Number of dollars per one British pound		
1	50	\$ 50.00
1.1	50	\$ 55.00
1.2	50	\$ 60.00
1.25	50	\$ 62.50
1.3	50	\$ 65.00
1.4	50	\$ 70.00
1.5	50	\$ 75.00
1.6	50	\$ 80.00
1.7	50	\$ 85.00
1.75	50	\$ 87.50
1.8	50	\$ 90.00
1.9	50	\$ 95.00
2	50	\$ 100.00

2. Compute how many British pounds it would cost to buy a pair of American designer jeans costing \$45:

Exchange Rate	Price of a pair of American designer jeans	Price in British pounds
Number of dollars per one British pound		
1	45	
1.1	45	
1.2	45	
1.25	45	
1.3	45	
1.4	45	
1.5	45	
1.6	45	
1.7	45	
1.75	45	
1.8	45	
1.9	45	
2	45	

Answer:

Exchange Rate	Price of a pair of American designer jeans	Price in British pounds
Number of dollars per one British pound		
1	45	45
1.1	45	40.90909091
1.2	45	37.5
1.25	45	36
1.3	45	34.61538462
1.4	45	32.14285714
1.5	45	30
1.6	45	28.125
1.7	45	26.47058824
1.75	45	25.71428571
1.8	45	25
1.9	45	23.68421053
2	45	22.5

3. Find the exchange rate between the dollar and the British pound for the following cases:

Price of a pair of American designer jeans	Price in British pounds	Exchange Rate
		Number of dollars per one British pound
45	10	
45	20	
45	30	
45	40	
45	50	
45	60	
45	70	
45	80	
45	90	
45	100	
45	110	
45	120	
45	130	
45	140	

Answer:

Price of a pair of American designer jeans	Price in British pounds	Exchange Rate
		Number of dollars per one British pound
45	10	4.5
45	20	2.25
45	30	1.5
45	40	1.125
45	50	0.9
45	60	0.75
45	70	0.642857143
45	80	0.5625
45	90	0.5
45	100	0.45
45	110	0.409090909
45	120	0.375
45	130	0.346153846
45	140	0.321428571

4. For the following 15 cases, compare the dollar rates of return on dollar and euro deposits:

Case	Dollar Interest Rate, $R_{\$}$	Euro Interest Rate, $R_{\text{€}}$	Expected Rate of Dollar Depreciation against Euro	Rate of Return Difference between Dollar and Euro Deposits
1	0.1	0.06	0	
2	0.1	0.06	0.04	
3	0.1	0.06	0.08	
4	0.1	0.12	-0.04	
5	0.1	0.18	0	
6	0.15	0.06	0	
7	0.15	0.06	0.04	
8	0.15	0.06	0.08	
9	0.15	0.12	-0.04	
10	0.15	0.18	0	
11	0.2	0.06	0	
12	0.2	0.06	0.04	
13	0.2	0.06	0.08	
14	0.2	0.12	-0.04	
15	0.2	0.18	0	

Answer:

Case	Dollar Interest Rate, $R_{\$}$	Euro Interest Rate, $R_{\text{€}}$	Expected Rate of Dollar Depreciation against Euro	Rate of Return Difference between Dollar and Euro Deposits
1	0.1	0.06	0	0.04
2	0.1	0.06	0.04	0
3	0.1	0.06	0.08	-0.04
4	0.1	0.12	-0.04	0.02
5	0.1	0.18	0	-0.08
6	0.15	0.06	0	0.09
7	0.15	0.06	0.04	0.05
8	0.15	0.06	0.08	0.01
9	0.15	0.12	-0.04	0.07
10	0.15	0.18	0	-0.03
11	0.2	0.06	0	0.14
12	0.2	0.06	0.04	0.1
13	0.2	0.06	0.08	0.06
14	0.2	0.12	-0.04	0.12
15	0.2	0.18	0	0.02

5. For the table below, calculate the EXACT relationship.

Case	R\$	RE	Expected Rate of Dollar Depreciation against Euro E	Rate of Return Difference between Dollar and Euro Deposits	Exact formula
1	0.1	0.06	0	0.04	
2	0.1	0.06	0.04	0	
3	0.1	0.06	0.08	-0.04	
4	0.1	0.12	-0.04	0.02	
5	0.1	0.18	0	-0.08	
6	0.15	0.06	0	0.09	
7	0.15	0.06	0.04	0.05	
8	0.15	0.06	0.08	0.01	
9	0.15	0.12	-0.04	0.07	
10	0.15	0.18	0	-0.03	
11	0.2	0.06	0	0.14	
12	0.2	0.06	0.04	0.1	
13	0.2	0.06	0.08	0.06	
14	0.2	0.12	-0.04	0.12	
15	0.2	0.18	0	0.02	

Answer:

Case	R\$	RE	Expected Rate of Dollar Depreciation against Euro E	Rate of Return Difference between Dollar and Euro Deposits	Exact formula
1	0.1	0.06	0	0.04	0.04
2	0.1	0.06	0.04	0	-0.0024
3	0.1	0.06	0.08	-0.04	-0.0448
4	0.1	0.12	-0.04	0.02	0.0248
5	0.1	0.18	0	-0.08	-0.08
6	0.15	0.06	0	0.09	0.09
7	0.15	0.06	0.04	0.05	0.0476
8	0.15	0.06	0.08	0.01	0.0052
9	0.15	0.12	-0.04	0.07	0.0748
10	0.15	0.18	0	-0.03	-0.03
11	0.2	0.06	0	0.14	0.14
12	0.2	0.06	0.04	0.1	0.0976
13	0.2	0.06	0.08	0.06	0.0552
14	0.2	0.12	-0.04	0.12	0.1248
15	0.2	0.18	0	0.02	0.02

6. Calculate the interest rate in the United States, if interest parity condition holds, for the following 15 cases:

Case	RE	Expected Rate of Dollar Depreciation against Euro E	R\$
1	0.06	0	
2	0.06	0.04	
3	0.06	0.08	
4	0.12	-0.04	
5	0.18	0	
6	0.06	0	
7	0.06	0.04	
8	0.06	0.08	
9	0.12	-0.04	
10	0.18	0	
11	0.06	0	
12	0.06	0.04	
13	0.06	0.08	
14	0.12	-0.04	
15	0.18	0	

Answer:

Case	RE	Expected Rate of Dollar Depreciation against Euro E	R\$
1	0.06	0	0.06
2	0.06	0.04	0.1
3	0.06	0.08	0.14
4	0.12	-0.04	0.08
5	0.18	0	0.18
6	0.06	0	0.06
7	0.06	0.04	0.1
8	0.06	0.08	0.14
9	0.12	-0.04	0.08
10	0.18	0	0.18
11	0.06	0	0.06
12	0.06	0.04	0.1
13	0.06	0.08	0.14
14	0.12	-0.04	0.08
15	0.18	0	0.18

7. Calculate the interest rate in the euro zone if interest parity condition holds, for the following 15 cases:

Case	R_E	Expected Rate of Dollar Depreciation against Euro E	R\$
1		0	0.06
2		0.04	0.11
3		0.08	0.16
4		-0.04	0.05
5		0	0.1
6		0	0.11
7		0.04	0.16
8		0.08	0.21
9		-0.04	0.1
10		0	0.15
11		0	0.16
12		0.04	0.21
13		0.08	0.26
14		-0.04	0.15
15		0	0.2

Answer:

Case	R_E	E	R\$
1	0.06	0	0.06
2	0.07	0.04	0.11
3	0.08	0.08	0.16
4	0.09	-0.04	0.05
5	0.1	0	0.1
6	0.11	0	0.11
7	0.12	0.04	0.16
8	0.13	0.08	0.21
9	0.14	-0.04	0.1
10	0.15	0	0.15
11	0.16	0	0.16
12	0.17	0.04	0.21
13	0.18	0.08	0.26
14	0.19	-0.04	0.15
15	0.2	0	0.2

8. Assume that the euro interest rate is constant at 5 percent, and that the expected exchange rate is 1.05 dollars per one euro. Find the expected dollar return on euro deposits for the following cases:

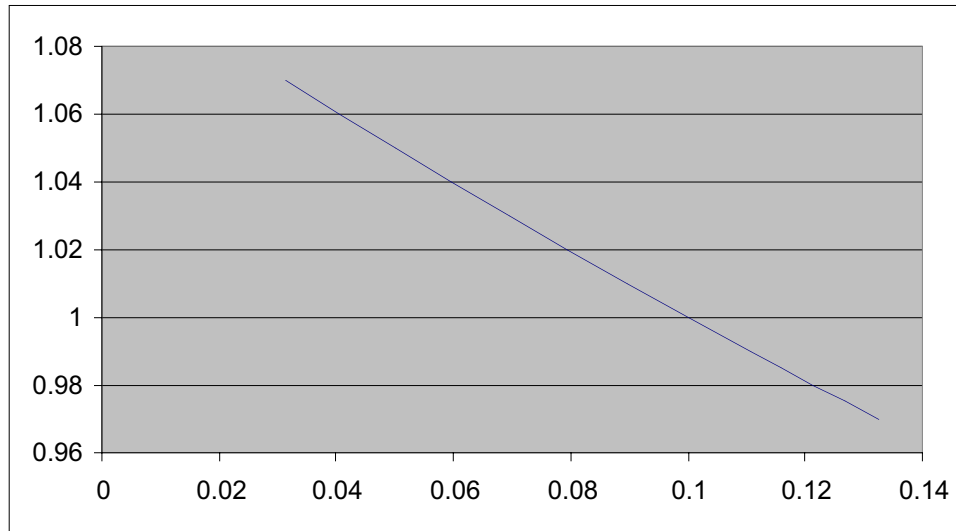
Case	Today's Dollar/Euro Exchange Rate	Interest Rate on Euro Deposits	Expected Dollar Depreciation Rate Against Euro $(1.05 - E)/E$	Expected Dollar Return on Euro Deposits $R_e + (1.05 - E)/E$
1	1.07			
2	1.06			
3	1.05			
4	1.04			
5	1.03			
6	1.02			
7	1.01			
8	1			
9	0.99			
10	0.98			

Answer:

Case	Today's Dollar/Euro Exchange Rate	Interest Rate on Euro Deposits	Expected Dollar Depreciation Rate Against Euro $(1.05 - E)/E$	Expected Dollar Return on Euro Deposits $R_e + (1.05 - E)/E$
1	1.07	0.05	-0.0186916	0.031308411
2	1.06	0.05	-0.009434	0.040566038
3	1.05	0.05	0	0.05
4	1.04	0.05	0.0096154	0.059615385
5	1.03	0.05	0.0194175	0.069417476
6	1.02	0.05	0.0294118	0.079411765
7	1.01	0.05	0.039604	0.08960396
8	1	0.05	0.05	0.1
9	0.99	0.05	0.0606061	0.110606061
10	0.98	0.05	0.0714286	0.121428571

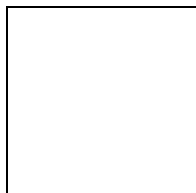
9. For the data in Question 8, plot today's dollar/euro exchange rate against the expected dollar return on euro deposits.

Answer:



10. Using the data from Question 8 and the plot in Question 9, show that if the interest rate in the United States is 10 percent, the exchange rate will be 1, and if the interest rate in the United States is 12 percent, the exchange rate will be 0.98 dollars per euro.

Answer: Points 1 and 2 in the figure below correspond to these two equilibrium points.



11. Assume the U.S. interest rate is 10 percent, and the interest rate on euro deposits is 5 percent. For the following exchange rates, find the forward exchange rates.

Today's Dollar/Euro Exchange Rate	Forward Exchange Rate
$E_{\$/\text{€}}$	$F_{\$/\text{€}}$
1	
1.05	

1.1	
1.2	
1.3	

Answer: Using the covered interest rate parity will yield the second column in the table:

$$F_{\$/\text{€}} = (R_{\$} - R_{\text{€}}) E_{\$/\text{€}} + E_{\$/\text{€}}$$

Today's Dollar/Euro Exchange Rate $E_{\$/\text{€}}$	Forward Exchange Rate $F_{\$/\text{€}}$
1	1.05
1.05	1.1025
1.1	1.155
1.2	1.26
1.3	1.365

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Chapter 14: Money, Interest Rates, and Exchange Rates

Multiple Choice Questions

1. The exchange rate between currencies depends on
- A. the interest rate that can be earned on deposits of those currencies.
 - B. the expected future exchange rate.
 - C. the interest rate that can be earned on deposits of those currencies and the expected future exchange rate.
 - D. national output.
 - E. None of the above.

Answer: B

2. Money serves as
- A. a medium of exchange.
 - B. a unit of account.
 - C. a store of value.
 - D. All of the above.
 - E. Only A and B

Answer: D

3. Money includes
- A. currency.
 - B. bank deposits on which check may be written.
 - C. both A and B.
 - D. travelers' checks.
 - E. A, B and D.

Answer: E

4. In the United States at the end of 2000, the total money supply, M1, amounted to approximately
- A. 10 percent of that year's GNP.
 - B. 20 percent of that year's GNP.
 - C. 30 percent of that year's GNP.
 - D. 40 percent of that year's GNP.
 - E. 50 percent of that year's GNP.

Answer: A

5. Individuals base their demand for an asset on
- A. the expected return the asset offers compared with the returns offered by other assets.
 - B. the riskiness of the asset's expected return.
 - C. the asset's liquidity.
 - D. All of the above.
 - E. Only A and B.

Answer: D

6. The family summer house on Cape Code pays a return in the form of
- A. interest rate.
 - B. capital gains.
 - C. the pleasure of vacations at the beach.
 - D. A, B and C.
 - E. B and C only.

Answer: E

7. In a world with money and bonds only,
- A. it is risky to hold money.
 - B. it is not risky to hold money.
 - C. risk does affect the demand for money.
 - D. there is no relationship between risk and holding money.
 - E. None of the above.

Answer: A

8. 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 money to rise.
 - D. A rise in the average value of transactions carried out by a household or a firm causes its demand for nominal money to rise.
 - E. A rise in the average value of transactions carried out by a household or a firm causes its demand for real money to rise.

Answer: E

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

Answer: D

10. The aggregate real money demand schedule $L(R,Y)$
- A. slopes upward because a fall in the interest rate raises the desired real money holdings of each household and firm in the economy.
 - B. slopes downward because a fall in the interest rate reduces the desired real money holdings of each household and firm in the economy.
 - C. 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.
 - D. slopes downward 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.

Answer: D

11. For a given level of [cuu duong than cong. com](https://fb.com/tailieudientucntt)
- A. nominal GNP, changes in interest rates cause movements along the $L(R,Y)$ schedule.
 - B. real GNP, changes in interest rates cause a decrease of the $L(R,Y)$ schedule.
 - C. real GNP, changes in interest rates cause an increase of the $L(R,Y)$ schedule.
 - D. nominal GNP, changes in interest rates cause an increase in the $L(R,Y)$ schedule.
 - E. real GNP, changes in interest rates cause movements along the $L(R,Y)$ schedule.

Answer: E

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12. A rise in
- A. real GNP decreases aggregate real money demand for a given interest rate, moving the $L(R,Y)$ schedule to the right.
 - B. real GNP raises aggregate real money demand for a given interest rate, moving the $L(R,Y)$ schedule to the left.
 - C. real GNP raises aggregate real money demand for a given interest rate, moving the $L(R,Y)$ schedule to the right.
 - D. nominal GNP raises aggregate real money demand for a given interest rate, moving the $L(R,Y)$ schedule to the right.
 - E. real GNP raises aggregate nominal money demand for a given interest rate, moving the $L(R,Y)$ schedule to the right.

Answer: C

13. The money supply schedule is
- A. horizontal because M^S is set by the central bank while P is taken as given.
 - B. vertical because M^S is set by the central bank.
 - C. vertical because M^S is set by the households and firms while P is taken as given.
 - D. vertical because M^S and P are set by the central bank.
 - E. vertical because M^S is set by the central bank while P is taken as given.

Answer: E

14. If there is initially
- A. excess demand for money, the interest rate falls, and if there is initially an excess supply, it rises.
 - B. excess supply of money, the interest rate falls, and if there is initially an excess demand, it rises.
 - C. excess supply of money, the interest rate increases, and if there is initially an excess demand, it falls.
 - D. excess supply of money, the interest rate falls, and if there is initially an excess demand, it further falls.
 - E. None of the above.

Answer: B

15. Which one of the following statements is the most accurate?
- A. A decrease in the money supply lowers the interest rate, while an increase in the money supply raises the interest rate, given the price level and output.
 - B. An increase in the money supply lowers the interest rate, while a fall in the money supply raises the interest rate, given the price level.
 - C. An increase in the money supply lowers the interest rate, while a fall in the money supply raises the interest rate, given the output level.
 - D. An increase in the money supply lowers the interest rate, while a fall in the money supply raises the interest rate, given the price level and output.
 - E. None of the above.

Answer: D

16. An increase in
- A. nominal output raises the interest rate, while a fall in real output lowers the interest rate, given the price level and the money supply.
 - B. real output decreases the interest rate, while a fall in real output increases the interest rate, given the price level.
 - C. real output raises the interest rate, while a fall in real output lowers the interest rate, given the money supply.
 - D. nominal output raises the interest rate, while a fall in real output lowers the interest rate, given the price level.
 - E. real output raises the interest rate, while a fall in real output lowers the interest rate, given the price level and the money supply.

Answer: E

17. An increase in a country's money supply causes
- A. its currency to appreciate in the foreign exchange market, while a reduction in the money supply causes its currency to depreciate.
 - B. its currency to depreciate in the foreign exchange market, while a reduction in the money supply causes its currency to appreciate.
 - C. no effect on the values of its currency in international markets.
 - D. its currency to depreciate in the foreign exchange market, while a reduction in the money supply causes its currency to further depreciate.
 - E. None of the above.

Answer: B

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

Answer: E

19. Given P_{US} and Y_{US} ,
- A. 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.
 - 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 depreciate against the dollar, and it creates excess demand for dollars in the U.S. money market.
 - 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.

Answer: D

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

Answer: C

21. Which one of the following statements is the most accurate?
- A. Only the long-run equilibrium price level is the value of P satisfying $P=M^S/L(R,Y)$.
 - B. Only the short-run equilibrium price level is the value of P satisfying $P=M^S/L(R,Y)$.
 - C. The short and long-run equilibrium price level is the value of P satisfying $P=M^S/L(R,Y)$.
 - D. The long-run equilibrium price level is the value of P satisfying $P=M^D/L(R,Y)$.
 - E. None of the above.

Answer: C

22. An increase in a country's money supply
- A. causes a more than proportional increase in its price level.
 - B. causes a less than proportional increase in its price level.
 - C. causes a proportional increase in its price level.
 - D. leaves its price level constant in long-run equilibrium.
 - E. None of the above.

Answer: C

23. A change in the level of the supply of money
- A. increases the long-run values of the interest rate and real output.
 - B. decreases the long-run values of the interest rate and real output.
 - C. has no effect on the long-run value of only the interest rate.
 - D. has no effect on the long-run value of only real output.
 - E. has no effect on the long-run values of the interest rate and real output.

Answer: E

24. Changes in the money supply growth rate
- A. are neutral in the short run.
 - B. need not be neutral in the short run.
 - C. are neutral both in the short and long run.
 - D. are neutral in the long run.
 - E. need not be neutral in the long run.

Answer: D

25. A sustained change in the monetary growth rate will
- A. immediately affect equilibrium real money balances by raising the money interest rate.
 - B. eventually affect equilibrium nominal money balances by raising the money interest rate.
 - C. eventually affect equilibrium real money balances by reducing 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 raising the money interest rate.

Answer: E

26. Money demand behavior may
- A. change as a result of demographic trends or financial innovations such as electronic cash-transfer facilities.
 - B. change only as a result of demographic trends.
 - C. change only as a result of financial innovations such as electronic cash-transfer facilities.
 - D. not change as a result of demographic trends or financial innovations such as electronic cash-transfer facilities.
 - E. change as a result of demographic trends but not as a result of financial innovations such as electronic cash-transfer facilities.

Answer: A

27. Which one of the following statements is the most accurate? In a
- A. cross-section of countries, long-term changes in money supplies and price levels show a clear negative correlation.
 - B. time series of countries, long-term changes in money supplies and price levels show a clear positive correlation.
 - C. cross-section of countries, short-term changes in money supplies and price levels show a clear negative correlation.
 - D. cross-section of countries, short-term changes in money supplies and price levels show a clear positive correlation.
 - E. cross-section of countries, long-term changes in money supplies and price levels show no clear correlation.

Answer: A

28. For Germany, long-term changes in money supplies and price levels
- A. do not show a clear positive correlation.
 - A. show a clear positive correlation.
 - B. do not show a clear negative correlation.
 - C. do show a high and significant positive correlation.
 - D. None of the above.

Answer: A

29. Year-by-year data from 1989 – 2000 show that
- A. there is a strong positive relationship between average Latin American money-supply growth and inflation.
 - B. there is a strong negative relationship between average Latin American money-supply growth and inflation.
 - C. there is a strong positive relationship between average Latin American money-supply growth and deflation.
 - D. it is difficult to find a strong positive relationship between average Latin American money-supply growth and inflation.
 - E. there is a weak positive relationship between average Latin American money-supply growth and inflation.

Answer: A

30. Which one of the following statements is the most accurate?
- A. A permanent increase in a country's money supply causes a proportional long-run depreciation of its currency against foreign currencies.
 - B. A temporary increase in a country's money supply causes a proportional long-run depreciation of its currency against foreign currencies.
 - C. A permanent increase in a country's money supply causes a proportional long-run appreciation of its currency against foreign currencies.
 - D. A permanent increase in a country's money supply causes a proportional short-run depreciation of its currency against foreign currencies.
 - E. A permanent increase in a country's money supply causes a proportional short-run appreciation of its currency against foreign currencies.

Answer: A

31. Wages
- A. enter indices of the price level directly.
 - B. do not enter indices of the price level directly, but they make up a small fraction of the cost of producing goods and services.
 - C. do not enter indices of the price level directly, but they make up a negligible fraction of the cost of producing goods and services.
 - D. do not enter indices of the price level directly, but they make up a large fraction of the cost of producing goods and services.
 - E. None of the above.

Answer: D

32. For all the main industrial countries in recent years,
- A. the exchange rate is much more variable than relative price levels.
 - B. the exchange rate is much less variable than relative price levels.
 - C. the exchange rate is as variable as the 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.

Answer: A

33. For all the main industrial countries in recent years,
- A. there is much less month-to-month variability of the exchange rate, suggesting that price levels are relatively sticky in the short run.
 - B. there is much more month-to-month variability of the exchange rate, suggesting that price levels are relatively sticky in the short run.
 - C. there is almost the same month-to-month variability of the exchange rate and price levels.
 - D. it is hard to tell whether month-to-month variability of the exchange rate is similar to changes in price levels.
 - E. there is much more month-to-month variability of the exchange rate, suggesting that price levels are relatively sticky in the long run.

Answer: B

34. Which one of the following statements is the most accurate?
- A. There is a lively academic debate over the possibility that seemingly sticky wages and prices are in reality quite fixed.
 - B. There is a lively academic debate over the possibility that seemingly sticky wages and prices are in reality much more sticky than theory assumes.
 - C. There is a lively academic debate over the possibility that seemingly sticky wages and prices are in reality quite flexible.
 - D. There is no debate over the possibility that wages and prices are sticky in the long run.
 - E. There is no debate over the possibility that wages and prices are sticky in the short run.

Answer: C

35. During hyperinflation, exploding inflation causes real money demand to
- A. fall over time, and this additional monetary change makes money prices rise even more quickly than the money supply itself rises.
 - B. increase over time, and this additional monetary change makes money prices rise even more quickly than the money supply itself rises.
 - C. fall over time, and this additional monetary change makes money prices decrease even more quickly than the money supply itself rises.
 - D. fall over time, and this additional monetary change makes money prices rise even more quickly than the money supply itself rises.
 - E. fall over time, and this additional monetary change makes money prices decrease even less quickly than the money supply itself rises.

Answer: A

36. In a classic paper, Columbia University economist Phillip Cagan drew the line between inflation and hyperinflation at an inflation rate of
- A. 50 percent per month.
 - B. 10 percent per month.
 - C. 20 percent per month.
 - D. 5 percent per month.
 - E. 25 percent per month.

Answer: A

37. In a classic paper, Columbia University economist Phillip Cagan drew the line between inflation and hyperinflation at an inflation rate of
- A. more than 120 percent per year.
 - B. more than 100 percent per year.
 - C. more than 200 percent per year.
 - D. more than 12,000 percent per year.
 - E. more than 1,000 percent per year.

Answer: D

38. In a world where the price level could adjust immediately to its new long-run level after a money supply increase,
- A. the dollar interest rate would increase because prices would adjust immediately and prevent the money supply from rising.
 - B. the dollar interest rate would fall because prices would adjust immediately and prevent the money supply from rising.
 - C. the dollar interest rate would fall because prices would adjust immediately and prevent the money supply from decreasing.
 - D. the dollar interest rate would decrease because prices would adjust immediately and prevent the money supply from decreasing.
 - E. None of the above.

Answer: B

39. After a permanent increase in the money supply,
- A. the exchange rate overshoots in the short run.
 - B. the exchange rate overshoots in the long run.
 - C. the exchange rate smoothly depreciates in the short run.
 - D. the exchange rate smoothly appreciates in the short run.
 - E. None of the above.

Answer: A

Essay Questions

1. What are the main functions of money?

Answer: Money serves in general three important functions: a medium of exchange; a unit of account; and a store of value.

As a medium of exchange, money avoids going back to a barter economy, with the enormous search costs connected with it. As a unit of account, the use of money economizes on the number of prices an individual faces. Consider an economy with N goods, then one needs only $(N - 1)$ prices. As a store of value, the use of money in general ensures that you can transfer wealth between periods.

2. What are the factors that determine the amount of money an individual desires to hold?

Answer: Three main factors: first, the expected return the asset offers compared with the returns offered by other assets; second, the riskiness of the asset's expected return; and third, the asset's liquidity.

3. What are the main factors determining the aggregate money demand?

Answer: Three main factors: interest rate, the price level, and real national income. A rise in the interest rate causes each individual in the economy to reduce her demand for money. If the price level rises, individual households and firms will spend more money than before. When real national income (GNP) rises, the demand for money will rise.

4. Explain why one can write the demand for money as follows:

$$M^d = P L(R, Y).$$

Answer: The aggregate money demand is proportional to the price level. Imagine that all prices in an economy doubled, but the interest rate and everyone's real incomes remained unchanged. Then, the money value of each individual's average daily transactions would then simply double, as would the amount of money each wishes to hold.

5. What will be the effects of an increase in the money supply on the interest rate?

Answer: An increase in the money supply will cause the interest rate to decrease. This should increase investment and possibly consumption of durable goods. The reduction in the interest rate will cause a depreciation of the dollar.

6. What will be the effects of an increase in real national income on the interest rate?

Answer: An increase in real national income will increase the interest rate. If investment depends only on interest rate, this will cause investment to go down. The increases interest rate will cause an appreciation of the dollar.

7. Analyze the effects of an increase in the European money supply on the dollar/euro exchange rate.

Answer: The main points are: An increase in the European money supply will reduce the interest rate on the euro, and thus causes the euro to depreciates against the dollar. The U.S. money demand and money supply are not going to be affected, and thus the interest rate in the U.S. will remain the same.

8. Explain how the money markets of two countries are linked through the foreign exchange market.

Answer: The monetary policy actions by the Fed affect the U.S. interest rate, changing the dollar/euro exchange rate that clears the foreign exchange market. The European System of Central Banks (ESCB) can affect the exchange rate by changing the European money supply and interest rate.

9. “Although the price levels appear to display short-run stickiness in many countries, a change in the money supply creates immediate demand and cost pressures that eventually lead to future increase in the price level.” Discuss.

Answer: (See pages 3479 – 380). The statement is true. The pressures come from three main sources: excess demand for output and labor; inflationary expectations; and raw material prices.

10. Explain the effects of a permanent increase in the U.S. money supply in the short run and in the long run. Assume that the U.S. real national income is constant.

An increase in the nominal money supply raises the real money supply, lowering the interest rate in the short run. The money supply increase is considered to continue in the future; thus, it will affect the exchange rate expectations. This will make the expected return on the euro more desirable and thus the dollar depreciates. In the case of a permanent increase in the U.S. money supply, the dollar depreciates more than under a temporary increase in the money supply.

Now, in the long run, prices will rise until the real money balances are the same as before the permanent increase in the money supply. Since the output level is given, the U.S. interest rate, which decreased before, will start to increase, until it will move back to its original level. The equilibrium interest rate must be the same as its original long -run value. This increase in the interest rate must cause the dollar to appreciate against the euro after its sharp depreciation as a result of the permanent increase in the money supply. So a large

depreciation is followed by an appreciation of the dollar. Eventually, the dollar depreciates in proportion to the increase in the price level, which in turn increases by the same proportion as the permanent increase in the money supply. Thus, money is neutral, in the sense that it cannot affect in the long run real variables, such as output, investment, etc.

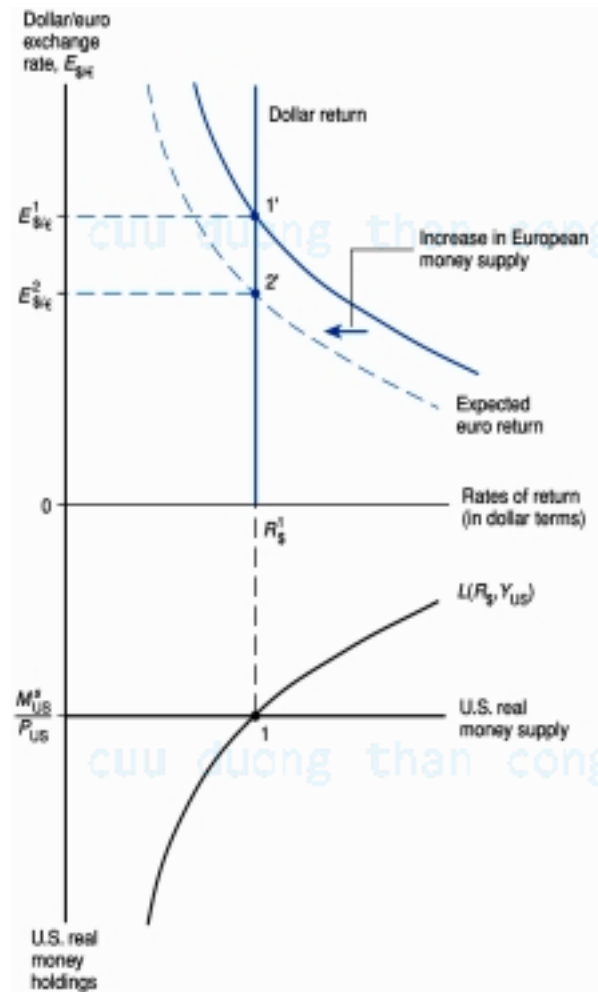
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Quantitative/Graphing Problems

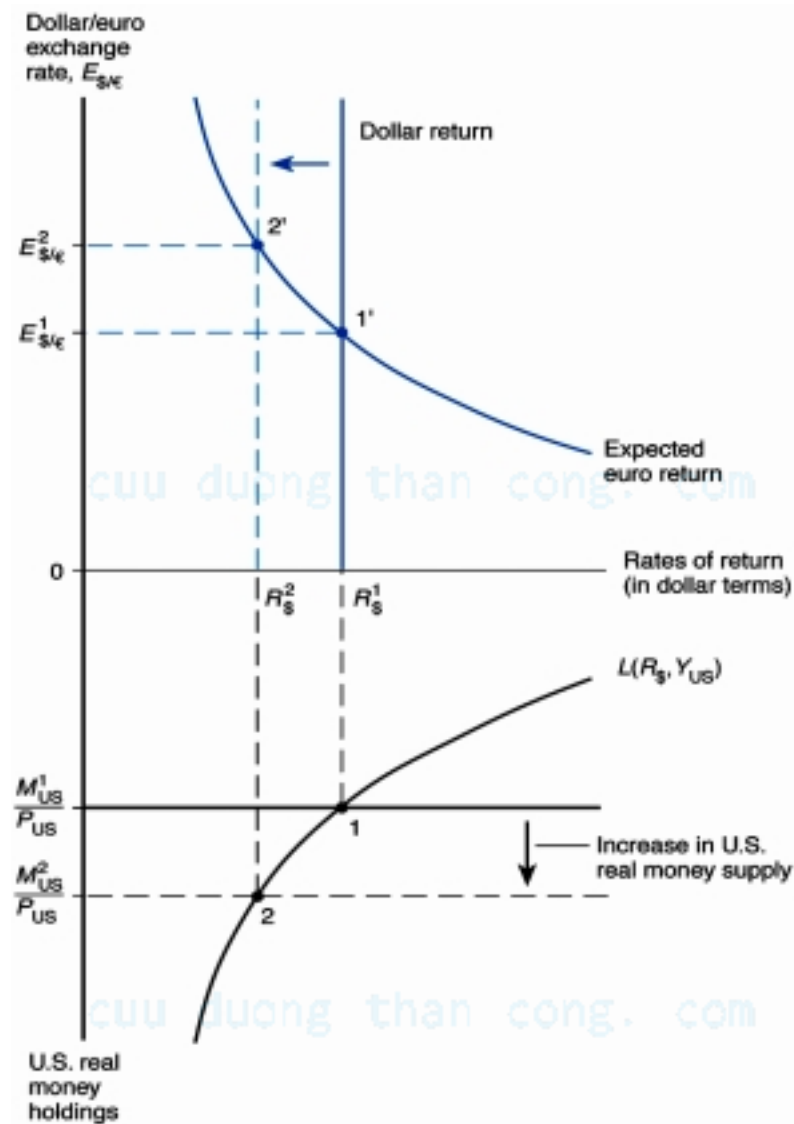
1. Using a figure describing both the U.S. money market and the foreign exchange market, analyze the effects of a temporary increase in the European money supply on the dollar/euro exchange rate.

Answer: An increase in the European money supply will reduce the interest rate on the euro and thus will cause the schedule of the expected euro return expressed in dollars to shift down, causing a reduction in the dollar/euro exchange rate, that is, an appreciation of the U.S. Dollar. The euro depreciates against the dollar. The U.S. money demand and money supply are not going to be affected, and thus the interest rate in the U.S. will remain the same.

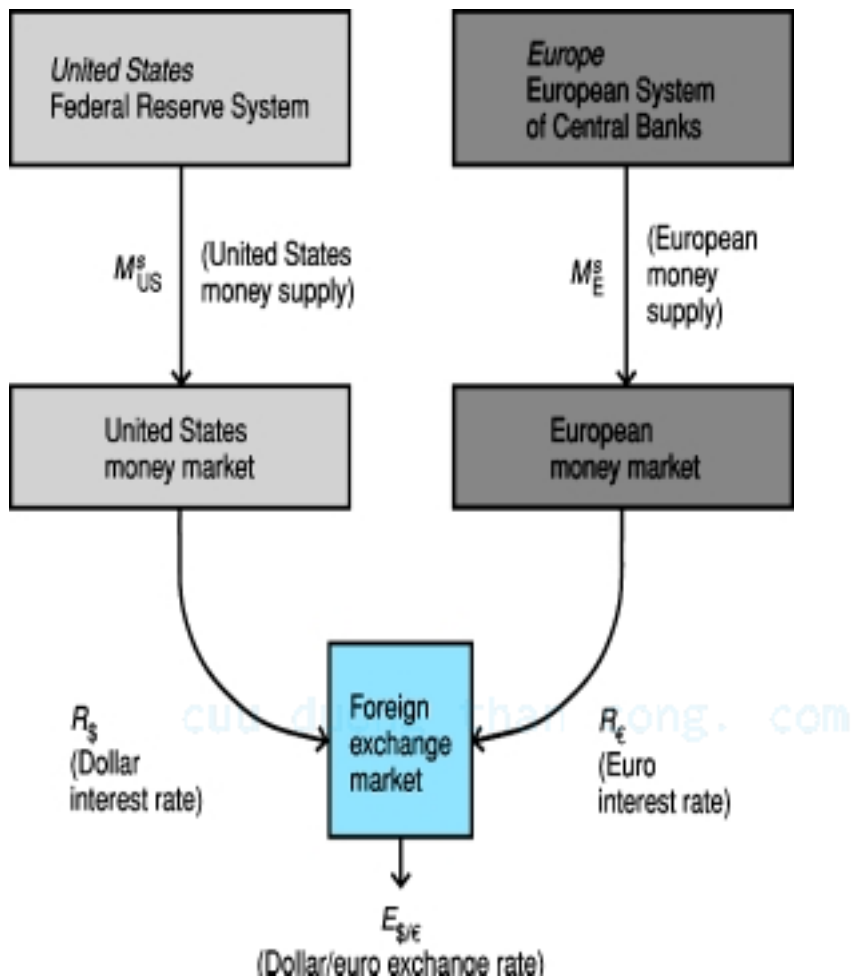


2. Using a figure describing both the U.S. money market and the foreign exchange market, analyze the effects of an increase in the U.S. money supply on the dollar/euro exchange rate.

Answer: An increase in the U.S. money supply will cause the interest rate to decrease. This should increase investment and possibly consumption of durable goods. The reduction in the interest rate will cause a movement to the left along the schedule depicting the expected euro return expressed in dollars. The result is an increase in E or a depreciation of the dollar.



3. Explain the following figure:

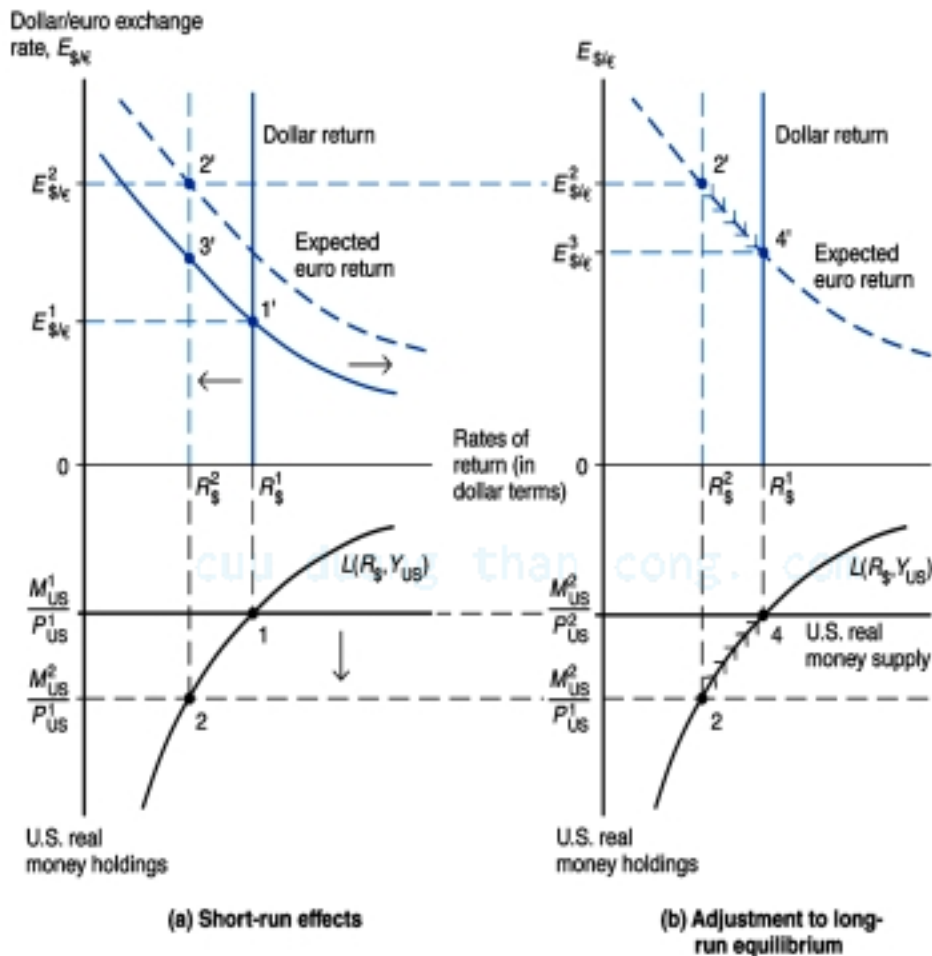


Answer:

The figure explains how the money markets of two countries are linked through the foreign exchange market. The monetary policy actions by the Fed affect the U.S. interest rate, changing the dollar/euro exchange rate that clears the foreign exchange market. The European System of Central Banks (ESCB) can affect the exchange rate by changing the European money supply and interest rate.

4. Using figures for both the short run and the long run, show the effects of a permanent increase in the U.S. money supply. Try to line up your figures to the short and long run equilibria side by side. Assume that the U.S. real national income is constant.

Answer:



An increase in the nominal money supply raises the real money supply, lowering the interest rate in the short run (the movement from 1 to 2 on the lower left figure). The money supply increase is considered to continue in the future, and thus it will affect the exchange rate expectations. This will make the expected return on the euro more desirable and thus the dollar depreciates. In the case of a permanent increase in the U.S. money supply, the dollar depreciates more than under a temporary increase in the money supply (from point 1' to point 2' in the upper left figure).

In the long run, (the right hand side figure), prices will rise until the real money balances are the same as before the permanent increase in the money supply (from point 2 to point 4, in the lower right figure). Since the output level is given, the U.S. interest rate, which decreased before, will start to increase, until it will move back to its original level (from

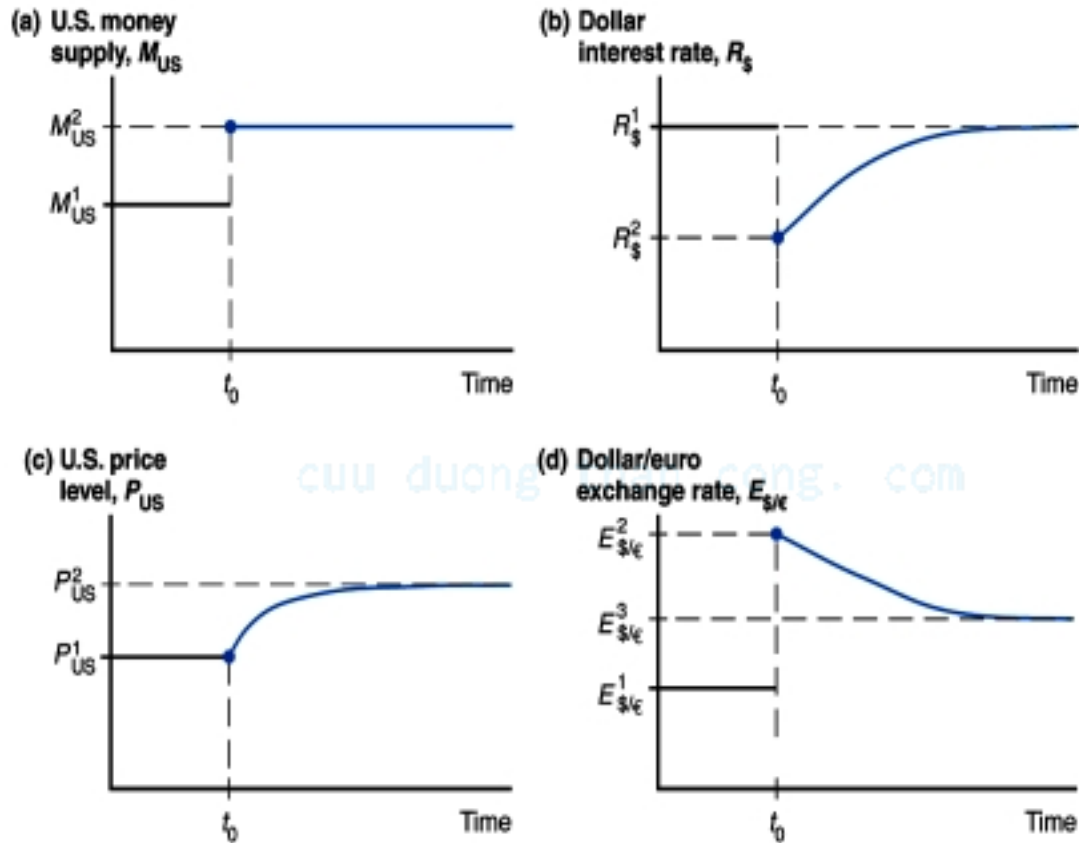
Point 2 to 4 in the lower left figure). The equilibrium interest rate must be the same as its original long-run value (at point 4 in the lower right figure). This increase in the interest rate must cause the dollar to appreciate against the euro after its sharp depreciation as a result of the permanent increase in the money supply (this process is depicted in the upper right figure from point 2' to 4'). So a large depreciation (from point 1' in the left upper figure to point 2' in both the left and right upper figures) is followed by an appreciation of the dollar (the movement from 2' to point 4' in the upper right hand side figure). Eventually, the dollar depreciates in proportion to the increase in the price level, which in turn increases by the same proportion as the permanent increase in the money supply. Thus, money is neutral, in the sense that it cannot affect in the long-run real variables, such as output, investment, etc. Note that points 3' and 4' represent the same exchange rate.

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5. Using 4 different figures, plot the time paths showing the effects of a permanent increase in the United States money supply on:
- U.S. money supply.
 - the dollar interest rate.
 - the U.S. price level.
 - the dollar/euro exchange rate.

Answer: See below.



Chapter 15: Price Levels and the Exchange Rate in the Long Run

Multiple Choice Questions

1. In order for the condition $E\$/HK\$ = P_{US}/P_{HK}$ to hold, what assumptions does the principle of purchasing power parity make?
- A. No transportation costs and restrictions on trade; commodity baskets that are a reliable indication of price level.
 - B. Markets are perfectly competitive, i.e., $P = MC$.
 - C. The factors of production are identical between countries.
 - D. No arbitrage exists.
 - E. All of the above.

Answer: E

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

Answer: A

3. Which of the following statements is the most accurate?
- A. In the long run, national price levels play a minor role in determining both interest rates and the relative prices at which countries' products are traded.
 - B. In the long run, national price levels play a key role only in determining interest rates.
 - C. In the long run, national price levels play a key role only in determining the relative prices at which countries' products are traded.
 - D. In the long run, national price levels play a key role in determining both interest rates and the relative prices at which countries' products are traded.
 - E. None of the above.

Answer: D

4. 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 barriers 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.
 - B. In competitive markets free of transportation costs and official barriers 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.
 - C. In competitive markets free of transportation costs and official barrier to trade, identical goods sold in different countries must sell for the same price.
 - D. Identical goods sold in different countries must sell for the same price when their prices are expressed in terms of the same currency.
 - E. None of the above.

Answer: A

5. Under Purchasing Power Parity,
- A. $E_{\$/\text{E}} = P_{\text{US}} / P_{\text{E}}$.
 - B. $E_{\$/\text{E}} = P_{\text{E}} / P_{\text{ES}}$.
 - C. $E_{\$/\text{E}} = P_{\text{US}} + P_{\text{E}}$.
 - D. $E_{\$/\text{E}} = P_{\text{US}} - P_{\text{E}}$.
 - E. None of the above.

Answer: A

6. Under Purchasing Power Parity,
- A. $E_{\$/\text{E}} = P_{\text{US}}^i / P_{\text{E}}^i$.
 - B. $E_{\$/\text{E}} = P_{\text{E}}^i / P_{\text{US}}^i$.
 - C. $E_{\$/\text{E}} = P_{\text{US}} / P_{\text{E}}$.
 - D. $E_{\$/\text{E}} = P_{\text{E}} / P_{\text{ES}}$.
 - E. None of the above.

Answer: C

7. Which of the following statements is the most accurate?
- A. The law of one price applies only to the general price level.
 - B. The law of one price applies to the general price level while PPP applies to individual commodities.
 - C. The law of one price applies to individual commodities while PPP applies to both the general price level and to individual commodities.
 - D. PPP applies only to individual commodities.
 - E. The law of one price applies to individual commodities while PPP applies to the general price level.

Answer: E

8. 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 reckon different countries' price levels are the same.
 - B. If the law of one price holds true for every commodity, PPP must hold automatically.
 - C. If the law of one price holds true for every commodity, PPP must automatically hold as long as the reference baskets used to reckon different countries' price levels are the same.
 - D. 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 reckon different countries' price levels are the same.
 - E. None of the above statements is true.

Answer: C

9. Which of the following statements is the most accurate?
- A. Absolute PPP does not imply relative PPP.
 - B. Relative PPP implies absolute PPP.
 - C. There is no causality relation between the two.
 - D. Absolute PPP implies relative PPP.
 - E. None of the above statements is true.

Answer: D

10. Which of the following statements is the most accurate?
- A. Relative PPP is valid even when absolute PPP is not, provided the factors causing deviations from absolute PPP are more or less stable over different commodities space.
 - B. Absolute PPP is valid even when relative PPP is not, provided the factors causing deviations from relative PPP are more or less stable over time.
 - C. Relative PPP is valid even when absolute PPP is not, provided the factors causing deviations from absolute PPP are more or less stable over time.
 - D. Relative PPP is not valid when absolute PPP is not.
 - E. None of the above statements is true.

Answer: C

11. Which of the following statements is the most accurate? In general,
- A. The monetary approach to the exchange rate is a long-run theory.
 - B. The monetary approach to the exchange rate is a short-run theory.
 - C. The monetary approach to the exchange rate is both a short- and long-run theory.
 - D. The monetary approach to the exchange rate neither long-run nor short-run theory.
 - E. None of the above statements is true.

Answer: A

12. The monetary approach makes the general prediction that
- A. The exchange rate, which is the relative price of American and European money, is fully determined in the long run by the relative supplies of those monies.
 - B. The exchange rate, which is the relative price of American and European money, is fully determined in the short run by the relative supplies of those monies and the relative demands for them
 - C. The exchange rate, which is the relative price of American and European money, is fully determined in the short- and long run by the relative supplies of those monies and the relative demands for them
 - D. The exchange rate, which is the relative price of American and European money, is fully determined in the long run by the relative supplies of those monies and the relative demands for them
 - E. None of the above statements is true.

Answer: A

13. Under the monetary approach to the exchange rate theory, money supply growth at a constant rate
- A. 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.
 - B. 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.
 - 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 or the long-run relative prices of goods and services.
 - D. 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.
 - E. None of the above statements is true.

Answer: C

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14. Which of the following statements is the most accurate? In general, under the monetary approach to the exchange rate,
- A. the interest rate is not independent of the money supply growth rate in the short run.
 - B. the interest rate is independent of the money supply growth rate in the long run.
 - C. the interest rate is not independent of the money supply growth rate in the long run, but independent in the short run.
 - D. the interest rate is not independent of the money supply growth rate in the long run.
 - E. None of the above statement is true.

Answer: D

15. Which of the following statements is the most accurate? In general, under the monetary approach to the exchange rate,
- A. while the short -run interest rate does not depend ion the absolute *level* of the money supply, continuing *growth* in the money supply eventually will affect the interest rate.
 - B. while the long-run interest rate does depend on the absolute *level* of the money supply, continuing *growth* in the money supply does not affect the interest rate.
 - C. while the long-run interest rate does not depend on the absolute *level* of the money supply, continuing *growth* in the money supply eventually will affect the interest rate.
 - D. the long-run interest rate does not depend on the absolute *level* of the money supply, and thus continuing *growth* in the money supply will not affect the interest rate.
 - E. None of the above statements is true.

Answer: C

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

Answer: A

17. Under PPP,
- A. a rise in a country's expected inflation rate will eventually cause a more-than proportional rise in the interest rate that depositors of its currency offer in order to accommodate for the higher inflation.
 - B. a fall in a country's expected inflation rate will eventually cause an equal rise in the interest rate that depositors of its currency offer.
 - C. a rise in a country's expected inflation rate will eventually cause an equal rise in the interest rate that depositors of its currency offer.
 - D. a rise in a country's expected inflation rate will eventually cause a less than proportional rise in the interest rate that depositors of its currency offer to accommodate the rise in expected inflation.
 - E. None of the above statements is true.

Answer: C

18. In the short run,
- A. the interest rate can rise when the domestic money supply falls.
 - B. the interest rate can decrease when the domestic money supply falls.
 - C. the interest rate stays constant when the domestic money supply falls.
 - D. the interest rate rises in the same proportion as the domestic money supply falls.
 - E. None of the above statements is true.

Answer: A

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

Answer: E

20. Under sticky prices,
- A. a fall in the money supply raises the interest rate to preserve money market equilibrium.
 - B. a fall in the money supply reduces the interest rate to preserve money market equilibrium.
 - C. a fall in the money supply keeps the interest rate intact to preserve money market equilibrium.
 - D. a fall in the money supply does not affect the interest rate in the short run, only in the long run.
 - E. None of the above statements is true.

Answer: A

21. Under sticky prices,
- A. an interest rate rise is associated with lower expected deflation and a long-run currency appreciation, so the currency appreciates immediately.
 - B. an interest rate rise is associated with higher expected inflation and a long-run currency appreciation, so the currency appreciates immediately.
 - C. an interest rate rise is associated with lower expected inflation and a long-run currency depreciation, so the currency appreciates immediately.
 - D. an interest rate rise is associated with lower expected inflation and a long-run currency depreciation, so the currency depreciates immediately.
 - E. an interest rate rise is associated with lower expected inflation and a long-run currency appreciation, so the currency appreciates immediately.

Answer: E

22. Under the monetary approach to the exchange rate,
- A. an interest rate decrease is associated with higher expected inflation and a currency that will be weaker on all future dates.
 - B. an interest rate increase is associated with higher expected deflation and a currency that will be weaker on all future dates.
 - C. an interest rate increase is associated with higher expected inflation and a currency that will be strengthened on all future dates.
 - D. an interest rate increase is associated with higher expected deflation and a currency that will be strengthened on all future dates.
 - E. an interest rate increase is associated with higher expected inflation and a currency that will be weaker on all future dates.

Answer: E

23. Under the monetary approach to the exchange rate,
- A. a reduction in the money supply will cause immediate currency depreciation.
 - B. a rise in the money supply will cause currency depreciation.
 - C. a rise in the money supply will cause immediate currency appreciation.
 - D. a rise in the money supply will cause depreciation.
 - E. a rise in the money supply will cause immediate currency depreciation.

Answer: E

24. In practice,
- A. changes in national price levels often tell us little or nothing about exchange rate movements.
 - B. changes in national price levels raise the exchange rate.
 - C. changes in national price levels lower the exchange rate.
 - D. changes in national price levels often tell us about exchange rate movements.
 - E. None of the above statements is true.

Answer: A

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

Answer: B

26. Which of the following statements is the most accurate?
- A. The law of one price does fare well in all recent studies.
 - B. The law of one price does fare well in many recent studies.
 - C. The law of one price sometimes fares well in recent studies.
 - D. The law of one price does not fare well in recent studies.
 - E. None of the above statements is true.

Answer: D

27. Which of the following statements is the most accurate?
- A. Relative PPP is not a reasonable approximation to the data.
 - B. Relative PPP is sometimes a reasonable approximation to the data but usually performs poorly.
 - C. Relative PPP is sometimes a reasonable approximation to the data.
 - D. PPP is sometimes a reasonable approximation to the data.
 - E. PPP is sometimes a reasonable approximation to the data but usually performs poorly.

Answer: B

28. Which of the following statements is the most accurate?
- A. PPP appears to be of limited use as a short-run explanation of exchange rate movements.
 - B. PPP appears to be of limited use even as a short-run explanation of exchange rate movements.
 - C. PPP appears to be of limited use even as a long-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.

Answer: C

29. Which of the following statements is the most accurate?
- A. Relative PPP has not held up well since the 1960s.
 - B. Relative PPP has not held up well since the early 1970s, but in the 1960s it was a more reliable guide to the relationship among exchange rates and national price levels.
 - C. Relative PPP has held up well since the early 1960s, but in the 1970s it was a more reliable guide to the relationship among exchange rates and national price levels.
 - D. Relative PPP has held up well since the early 1970s.
 - E. None of the above statements is true.

Answer: B

30. Which of the following statements is the most accurate?
- A. The price differences of Big Macs in Atlanta, Chicago, New York. and San Francisco are not larger than the international disparities.
 - B. The price differences of Big Macs in Atlanta, Chicago, New York. and San Francisco are close to zero.
 - C. The price differences of Big Macs in Atlanta, Chicago, New York. and San Francisco are less than 10 percent.
 - D. The price differences of Big Macs in Atlanta, Chicago, New York. and San Francisco are less than 15 percent.
 - E. The price differences of Big Macs in Atlanta, Chicago, New York. and San Francisco are in many cases larger than the international disparities.

Answer: E

31. In April 2001, the world's cheapest Big Macs were sold in
- A. The Philippines.
 - B. Russia.
 - C. Ukraine.
 - D. China.
 - E. the Czech Republic.

Answer: A

32. The PPP theory fails in reality because
- A. transport costs and restrictions on trade.
 - B. monopolistic or oligopolistic practices in goods markets.
 - C. the inflation data reported in different countries are based on different commodity baskets.
 - D. A, B, and C.
 - E. A and B only.

Answer: D

33. Which one of the following statements is the most accurate?
- A. The purchasing power of any given country will increase in countries where the prices of non-tradable goods rise.
 - B. The purchasing power of any given country will fall in countries where the prices of non-tradable goods increase.
 - C. The purchasing power of any given country will fall in countries where the prices of non-tradable goods rise.
 - D. The purchasing power of any given country will remain constant in countries where the prices of non-tradable goods rise.
 - E. The purchasing power of any given country will fall in countries where the prices of non-tradable goods remain constant.

Answer: C

34. Which one of the following statements is the most accurate? Since 1983,
- A. Hong Kong's price level has risen less rapidly than that of the United States despite a fixed exchange rate and no trade barriers.
 - B. Hong Kong's price level has risen much more rapidly than that of the United States despite a fixed exchange rate and because of no trade barriers.
 - C. Hong Kong's price level has risen much more rapidly than that of the United States despite trade barriers but because of a fixed exchange rate regime.
 - D. Hong Kong's price level has risen much more rapidly than that of the United States despite a fixed exchange rate and no trade barriers.
 - E. Hong Kong's price level has risen much less rapidly than that of the United States despite a flexible exchange rate and no trade barriers.

Answer: D

35. Which one of the following statements is the most accurate? In the early 1990s,
- A. buyers in Tokyo spent \$5,000 more for a UK-built Nissan than consumers in the UK.
 - B. buyers in Tokyo spent \$5,000 less for a UK-built Nissan than consumers in the UK.
 - C. buyers in Tokyo spent the same price for a UK-built Nissan as consumers in the UK.
 - D. buyers in Tokyo spent more than \$5,000 for a UK-built Nissan than consumers in the UK.
 - E. None of the above statements is true.

Answer: B

36. 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 could lead to PPP violations even if trade were free and costless.
 - E. None of the above statements is true.

Answer: C

37. Which one of the following statements is the most accurate?
- A. Departures from PPP are similar in both the short run and long run.
 - B. Departures from PPP are even greater in the long run than in the short run.
 - C. Departures from PPP are smaller in the long run than in the long run.
 - D. It is hard to tell whether departures from PPP are greater in the short run than in the long run.
 - E. Departures from PPP are even greater in the short run than in the long run.

Answer: E

38. Floating exchange rates
- A. systematically lead to larger and more frequent short-run deviations from the relative PPP.
 - B. systematically lead to much larger but less frequent short-run deviations from the relative PPP.
 - C. systematically lead to much larger and more frequent short-run deviations from the relative PPP.
 - D. systematically lead to much smaller and less frequent short-run deviations from the relative PPP.
 - E. systematically lead to much smaller but more frequent short-run deviations from the relative PPP.

Answer: C

Essay Questions

1. Explain the Law of One Price. Give an example.

Answer: The law of one price states that in competitive markets free of transportation costs and trade barriers, identical goods sold in different countries must sell for the same price when expressed in terms of the same currency.

$$P_{US}^i = (E_{\$/\text{£}}) \times (P_{\text{£}}^i) \text{ for good } i.$$
$$E_{\$/\text{£}} = P_{US}^i / P_{\text{£}}^i$$

If, for example, the price of the same sweater was cheaper in London than in New York, U.S. importers and British exporters would have an incentive to buy sweaters in London and ship them to New York, pushing the London price up and the New York price down, until both were equal.

2. Explain Purchasing Power Parity.

Answer: PPP states that the exchange rate between two countries' currencies equals the ratio of the countries' price levels.

A fall in a currency's domestic purchasing power (i.e. an increase in the domestic price level) will be associated with a proportional currency depreciation in the foreign exchange market and vice versa.

$E_{\$/\text{£}} = P_{US} / P_{\text{£}}$ where P is the price of a reference commodity basket.
Rearrange: $P_{US} = (E_{\$/\text{£}}) \times (P_{\text{£}})$

Thus, PPP asserts that all countries' price levels are equal when measured in terms of the same currency.

3. Discuss the relationship between PPP and the Law of One Price.

Answer: The law of one price applies to individual commodities while PPP applies to the general price level.

Proponents of PPP argue that its validity in the long run doesn't require the law of one price to hold exactly. When goods and services temporarily become more expensive in one country than in others, the demands for its currency and its products fall, pushing the exchange rate and domestic prices back in line with PPP and vice versa.

4. Discuss the differences between Absolute PPP and Relative PPP.

Answer: Absolute PPP states that the exchange rate between two currencies equals the ratio of their price levels. Relative PPP states that the percentage *change* in the exchange rate between two currencies over a given period equals the difference between the inflation rates of those two currencies.

5. Explain why Relative PPP is useful when comparing countries that base their price levels on different product baskets.

Answer: For Example: If the U.S. price level rises by 10% over a year while Europe's rises by only 5%, relative PPP predicts a 5% depreciation of the dollar against the euro. This just cancels the 5% by which U.S. inflation exceeds European, leaving the relative domestic and foreign purchasing powers of both currencies unchanged.

$$(E_{\$/\text{E},t} - E_{\$/\text{E},t-1})/E_{\$/\text{E},t-1} = \pi_{\text{US},t} - \pi_{\text{E},t} \text{ between dates } t \text{ and } t-1.$$

Relative PPP is useful when comparing countries that base their price levels on different product baskets. Relative PPP may be valid even when absolute PPP is not.

6. Explain why the exchange rate model based on PPP is a long-run theory.

Answer: PPP theory is a monetary approach to the exchange rate. It is a *long-run* theory because it does not allow for price rigidities. It assumes that prices can adjust right away to maintain full employment as well as PPP.

7. Present and explain the Fundamental Equation of the Monetary Approach.

Answer: Assume $E_{\$/\text{E}} = P_{\text{US}}/P_{\text{E}}$ and that domestic price levels depend on domestic money demands and supplies:

$$\begin{aligned} P_{\text{US}} &= M_{\text{US}}^S / L(R_{\$}, Y_{\text{US}}) \\ P_{\text{E}} &= M_{\text{E}}^S / L(R_{\text{E}}, Y_{\text{E}}) \end{aligned}$$

Therefore, the exchange rate is fully determined in the long run by the relative supplies of those monies and the relative real demands for them. Shifts in interest rates and output levels affect the exchange rate only through their influence on money demand.

8. What are the predictions for the long run of the Monetary Approach?

Answer:

Money supplies: Given the equations,

$$E_{\$/\text{E}} = P_{\text{US}}/P_{\text{E}}$$

$$P_{US} = M_{US}^S / L(R_{\$}, Y_{US})$$

$$P_E = M_E^S / L(R_E, Y_E)$$

one can show that an increase in the U.S. money supply, M_{US}^S , causes a proportional increase in the U.S. price level, P_{US} , which in turn causes a proportional increase in $E_{\$/\epsilon}$. Thus, an increase in U.S. money supply causes a proportional long-run depreciation of the dollar against the euro and vice versa.

Interest rates: A rise in the interest rate $R_{\$}$ lowers U.S. money demand $L(R_{\$}, Y_{US})$ thereby causing a rise in the U.S. price level and a proportional depreciation of the dollar against the euro.

Output levels: A rise in U.S. output Y_{US} raises real U.S. money demand leading to a fall in the long-run U.S. price level and an appreciation of the dollar against the euro.

9. Discuss the effects of ongoing inflation based on the PPP theory.

Answer: Other things equal, money supply growth at a constant rate eventually results in ongoing price level inflation at the same rate as the money supply growth, 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.

The interest rate, however, is affected by continuing growth in the money supply (inflation). This can be shown by combining PPP with the interest parity condition (refer to Ch. 13).

To show it analytically, recall that the condition of parity between dollar and euro assets is:

Interest rate in the United States is equal to interest rate in the euro countries plus expected depreciation of the dollar.

And according to relative PPP:

$$(E_{\$/\epsilon,t} - E_{\$/\epsilon,t-1}) / E_{\$/\epsilon,t-1} = \text{Inflation rate in the United States minus inflation rates in the euro countries.}$$

If people expect relative PPP to hold, the difference between interest rates offered by dollar and euro deposits will equal the difference between the expected inflation rates, over the relative horizon, in the U.S. and Europe.

10. Describe and explain the relationship between expected inflation rates in two countries and their interest rate differential according to the PPP theory.

Answer: Expected inflation is given by the following equation:

$$\pi^e = (P^e - P) / P, \text{ where } P^e \text{ is the expected price level in a country a year from today.}$$

If relative PPP is expected to hold, then:

$$(E_{\$/\text{E}}^e - E_{\$/\text{E}})/E_{\$/\text{E}} = \pi_{\text{US},t} - \pi_{\text{E},t}.$$

Combine the expected version of relative PPP with the interest parity condition:

$$R_{\$} = R_{\text{E}} + (E_{\$/\text{E}}^e - E_{\$/\text{E}})/E_{\$/\text{E}}$$

Rearrange:

$$R_{\$} - R_{\text{E}} = \pi_{\text{US},t} - \pi_{\text{E},t}$$

If, as PPP predicts, currency depreciation is expected to offset international inflation differences, the interest rate difference must equal the expected inflation difference.

11. What is the Fisher Effect? Provide an example.

Answer: All else equal, a rise in a country's expected inflation rate will eventually cause an equal rise in the interest rate that deposits of its currency offer. Similarly, a fall in the expected inflation rate will eventually cause a fall in the interest rate.

Ex: If the expected U.S. inflation were to rise permanently from π to $(\pi + \Delta\pi)$, current dollar interest rates $R_{\$}$ would eventually catch up to the higher inflation, rising by a value $\Delta R_{\$} = \Delta\pi$ in accordance with the Monetary Approach that in the long run purely monetary developments should have no effect on an economy's relative prices since the real rate of return on dollar assets would remain unchanged.

12. To answer the following question, please refer to the figure below. Concentrating only at the lower right quadrant, discuss the effects of a change in U.S. expected inflation.

Answer: The lower right quadrant shows the equilibrium in the U.S. Money Market, where

$$R1_{\$} = M1_{\text{US}}/P1_{\text{US}}.$$

A given interest rate $R1_{\$}$ corresponds with a given U.S. real money supply, $M1_{\text{US}}/P1_{\text{US}}$

Consider a rise of $\Delta\pi$ in the future rate of U.S. money supply growth (i.e. an increase in the expected rate of inflation).

The Key Point: The rise in expected future inflation generates expectations of more rapid currency depreciation in the future.

Under PPP the dollar now depreciates at a rate of $\Delta\pi + \Delta\pi$. Interest parity therefore requires the dollar interest rate to rise where

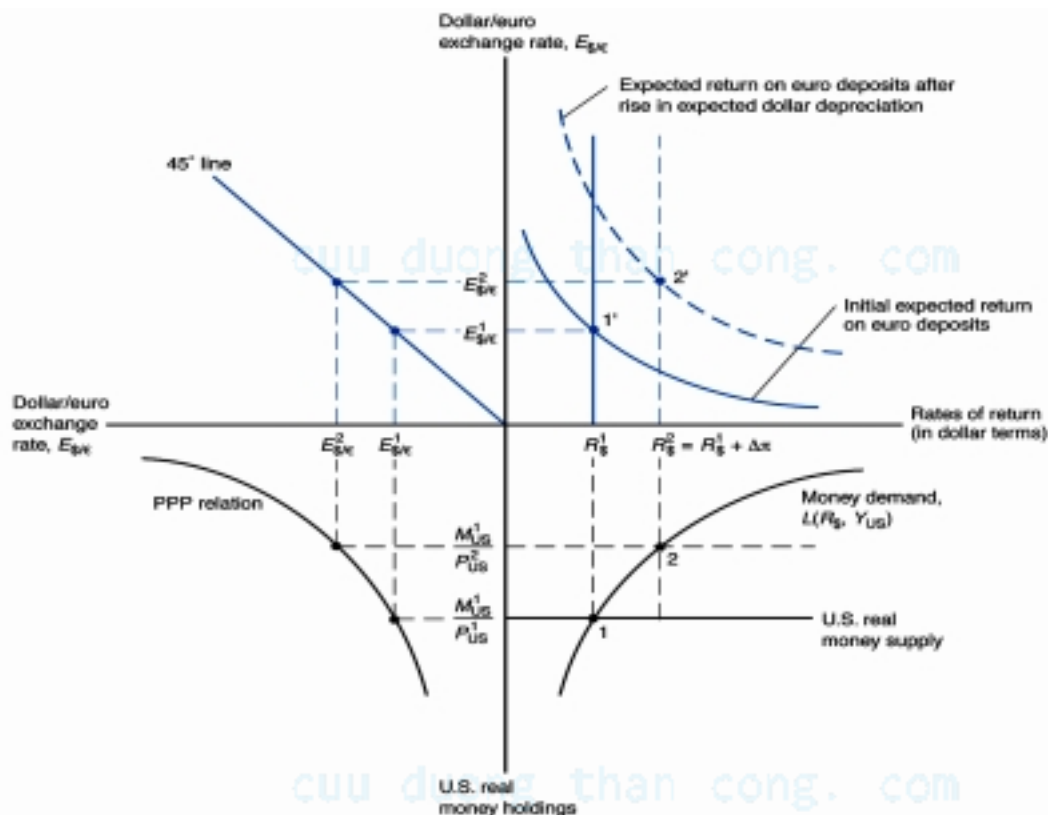
$$R_2\$ = R_1\$ + \frac{E^1_{\$/\text{€}} - E^2_{\$/\text{€}}}{E^1_{\$/\text{€}}}. \text{ (Point 2 in the figure.)}$$

$$\text{Note: } R_{\$} - R_{\text{€}} = \frac{E^c_{\text{US}}}{E^c_{\text{€}}} - \frac{E^c_{\text{€}}}{E^c_{\text{US}}}$$

This relation shows a change in the U.S. interest rate due to an increase in expected U.S. inflation has no effect on the euro interest rate.

The rise in the interest rate from $R_1\$$ to $R_2\$$ creates a momentary excess supply of real U.S. money balances at the prevailing price level P_1 . However, since under this

Monetary Approach, prices are assumed to be flexible, prices will immediately adjust from P_1 to P_2 , thus causing the following two effects: One: Reducing real money supply and, Two: Bringing the U.S. money market back into equilibrium.



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13. To answer the following question, please refer to the figure below. Concentrating only at the lower left quadrant, discuss the relationship between the U.S. real money supply and the dollar/euro exchange rate, $E_{\$/\text{€}}$.

Answer: The lower left quadrant in the figure described the Purchasing Power Parity (PPP) relationship. The relationship between the U.S. real money supply and the dollar/euro exchange rate, $E_{\$/\text{€}}$ is negative.

$E_{\$/\text{€}}$ is equal to the price level ratio, $P_{\text{US}}/P_{\text{€}}$.

In this derivation of the relationship, the following variables are assumed constants: $M1_{\text{US}}$, $R_{\text{€}}$, and $P_{\text{€}}$.

So, $E_{\$/\text{€}} = M1_{\text{US}}/P_{\text{US}}$

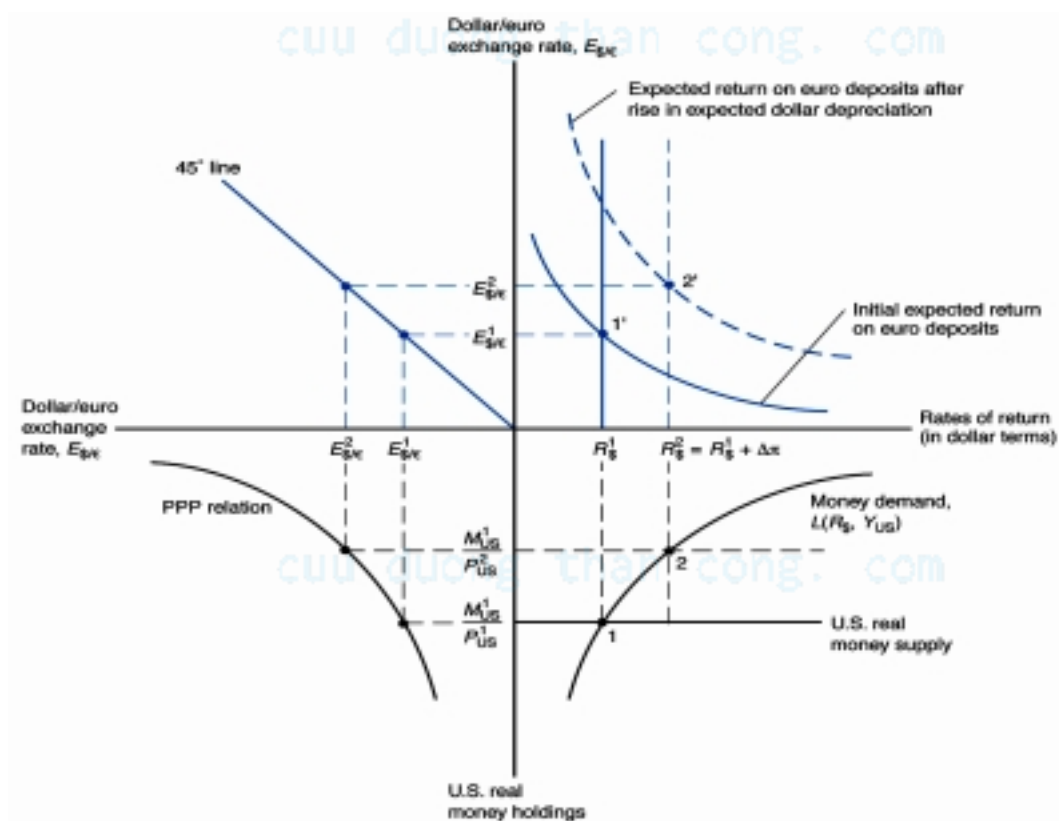
The increase in P_{US} leads to a positive increase in $E_{\$/\text{€}}$.

$P1_{\text{US}}$ will shift to $P2_{\text{US}}$

Thus, the purchasing power of the dollar decreases due to the increase in the price level.

$E1_{\$/\text{€}}$ will shift to $E2_{\$/\text{€}}$.

That is, the dollar depreciates due to PPP.



14. To answer the following question, please refer to the figure below. Concentrating only at the upper right quadrant, discuss the foreign exchange market equilibrium.

Answer: The upper right quadrant describes the equilibrium in the foreign exchange market.

We begin with the Interest Parity Condition:

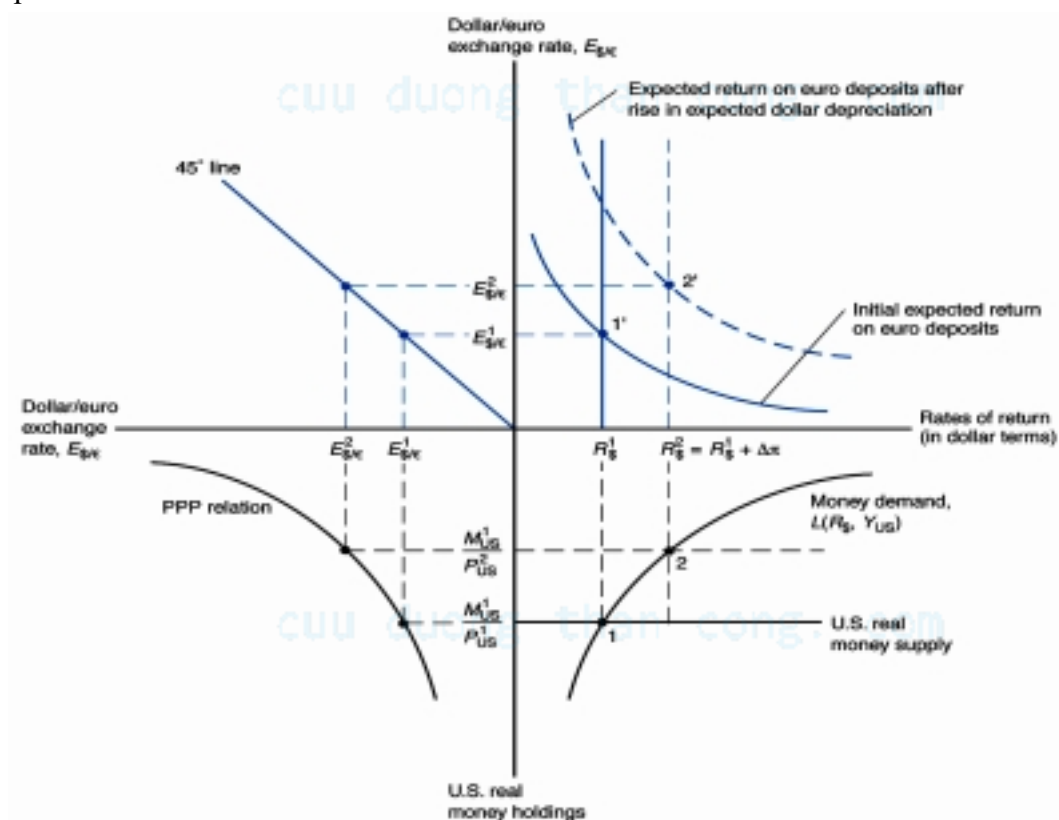
$$R_{\$} = R_E + (E_{\$/E}^c - E_{\$/E}) / E_{\$/E}.$$

In general, two effects are present:

$$R1_{\$} \text{ moves to } R2_{\$} \text{ and } E1_{\$/E} \text{ shifts to } E2_{\$/E}.$$

A rise in the interest rate normally creates an excess demand for dollar deposits and appreciation in the currency market.

However, in this case the increase is due to higher expected inflation or higher expected monetary growth in the U.S., which implies a faster **expected** depreciation of the dollar against the euro, E, thus, $E_{\$/E}^c$ goes up and therefore reduces the attractiveness of U.S. deposits.



15. Is a depreciation of the dollar/euro exchange rate correlated with a decrease in the dollar return on U.S. deposits?

Answer: No.

Assume that the Interest Parity is maintained. Holding the foreign interest rate constant, one would expect a depreciation of the dollar/euro exchange rate (i.e., an increase in E) to be correlated with a decrease in the U.S. interest rate, dollar returns on euro deposits. However, the higher expected inflation in the U.S. implies an increase in the expected future dollar to euro exchange rate. Thus, expected depreciation increases despite a depreciation in the current dollar to euro exchange rate.

16. Does the existence of non-tradable goods allow for deviations from Purchasing Power Parity?

Answer: Yes, the existence of non-tradable goods allows deviations from PPP. This is because the price of a non-tradable good is determined entirely by its domestic supply and demand curves, and in turn fluctuations in demand and supply for these goods will affect the price level. Examples include housing, haircuts, services, etc.

17. What effect do non-tradable goods have on PPP?

Answer: The effect is quite substantial. In 1997, the output of non-tradable goods accounted for about 55% of U.S. GNP. Along with haircuts, non-tradable goods include routine medical treatment, housing etc. For the most part, non-tradable goods are comprised of services and the output of the construction industry. Non-tradable helps explain much of the wide departure from PPP that is present in empirical data.

18. What can explain the failure of relative PPP to hold in reality?

Answer: Government measures of the price level differ from country to country.

One reason for these differences is that people living in different countries spend their income in different ways. Because of this inherent difference among countries, certain baskets will be affected more by price changes given their consumptions basket. For example, consumers in country X eat more fish relative to consumers in another country. More than likely, the government, upon determining a commodity basket to reflect preference, will have an overwhelming representation of fish in their basket. Any price level change in the fish market will be felt particularly by country X, and their overall price level will reflect this. Thus, changes in the relative prices of basket components can cause relative PPP to become distorted.

19. Explain why price levels are lower in poorer countries.

Answer: One theory explains the difference in prices on different endowments of capital and labor (Bhagwait, Kravis, and Lipsey). The explanation is as follows:

- Rich countries have high capital-labor ratios, while poor countries have much more labor relative to capital.
- Because rich countries have high capital-labor ratios, the MPL is greater and thus they have a higher wage.
- Higher wages lead to higher disposable income, and citizens' demand for goods will increase.
- Because labor is cheaper in poor countries and is used intensively in producing non-tradable goods; non-tradable goods will be cheaper in the poor countries than in the rich countries.
- The price of non-tradable goods will move with the increase in wages, thus increasing the price level of the goods.

Rich Countries: Expensive Non-tradable Goods vs. Poor Countries: Cheap Non-tradable Goods.

20. What are the predictions of the PPP theory with regard to the real exchange rates?

Answer: The real exchange rate between two countries is a broad summary measure of the prices of one country's goods and services relative to the other's. PPP predicts that the real exchange rate never permanently changes, which is different from nominal exchange rates that deal with the relative price of two *currencies*

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21. What is the real exchange rate between the dollar and the euro equal to?

Answer:

Let,

Real dollar/euro exchange rate	$q_{\$/\text{€}}$	Nominal exchange rate
$E_{\$/\text{€}}$	Price of an unchanging basket in US	P_{US}
Price of an unchanging basket in Europe	$P_{\text{€}}$	

Then,

$$q_{\$/\text{€}} = E_{\$/\text{€}} P_{\text{€}} / P_{\text{US}}.$$

A rise in the real dollar/euro exchange rate is called a **real depreciation** of the dollar against the euro, a fall in purchasing power of the dollar.

A fall in the real dollar/euro exchange rate is called a **real appreciation** of the dollar against the euro, a rise in purchasing power of the dollar.

22. How can long-run values in the real exchange rate change?

Answer: An *increase* in world relative **demand** for U.S. output causes a long-run real *appreciation* of the dollar against the euro (a *fall* in the real dollar/euro exchange rate).

A relative *expansion* of U.S. **output** causes a long-run real *depreciation* of the dollar against the euro (a *rise* in the real dollar/euro exchange rate).

23. Describe the chain of events leading to exchange rate determination for the following cases:

- a. An increase in the U.S. money supply
- b. An increase in the growth rate of the U.S. money supply
- c. An increase in world relative demand for U.S. products
- d. An increase in relative U.S. output supply

Answer: The chain of events leading to exchange rate determination:

The spot exchange rate is equal to the real exchange rate times the ratio of U.S. to European price levels.

Increase in U.S. money supply: The price level in the U.S. rises in proportion to the money supply; the real exchange rate remains the same. All dollar prices will rise (including the dollar price of the euro).

Increase in growth rate of U.S. money supply: The inflation rate, dollar interest rate, price level in the U.S., and spot exchange rate rise in proportion to the increase in the price level in the U.S.

Increase in world relative demand for U.S. products: E falls, and q does as well.

Increase in relative U.S. output supply: The dollar depreciates, lowering the relative price of U.S. output. The real exchange rate rises; the effect on E is not clear since the real exchange rate and the price level in the U.S. work in opposite directions.

24. Construct a table that will summarize the effects of money market and output market changes on the long-run nominal dollar/ euro exchange rate.

Answer:

Increase in...	Effect
US money supply	Proportional Increase
European money supply	Proportional Decrease
US money supply growth rate	Increase
European money supply growth	Decrease
Demand for US output	Decrease
Demand for European output	Increase
Output supply in US	Ambiguous
Output supply in Europe	Ambiguous

25. What is the real interest rate parity condition?

Answer: The nominal interest rates are rates of return measured in monetary terms.
The real interest rates are rates of return measured in real terms.

Real Interest Parity Condition: $(r_{US} - r_E) = (q_{\$/E} - q_{\$/E}) / q_{\$/E}$.

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Quantitative/Graphing Problems

1. Suppose Russia's inflation rate is 200% over one year, but the inflation rate in Switzerland is only 2%. According to relative PPP, what should happen over the year to the Swiss franc's exchange rate against the Russian ruble?

Answer: The exchange rate between the ruble and the franc at time t – The same exchange rate at time $t-1$ / the exchange rate between the ruble and the franc at time $t = 2 - 0.02 = 1.98$.

So there will be a 198% depreciation of the ruble against the franc or, conversely, a 198% appreciation of the franc against the ruble.

2. Assume that the dollar/pound exchange rate is \$1.50 per pound. A sweater that sells for \$45 in New York must sell for how many pounds in London?

Answer: 30 pounds

3. Fill in the following table, assuming the law of one price prevails.

Price in the United States of a sweater expressed in dollars	Price in Europe expressed in euro	Exchange rate between the dollar and the euro
20	30	
30	40	
40	50	
50	60	
60	70	
70	80	
80	90	
90	100	
100	110	

Answer:

Price in the United States of a sweater expressed in dollars, P_{US}^i	Price in Europe expressed in euro, P_E^i	Exchange rate between the dollar and the euro, $E_{\$/\text{€}}$
20	30	0.666667
30	40	0.75
40	50	0.8
50	60	0.833333
60	70	0.857143
70	80	0.875
80	90	0.888889
90	100	0.9
100	110	0.909091

4. Fill in the following table, assuming the law of one price prevails.

Price in the United States of a sweater expressed in dollars, P_{US}^i	Price in Europe expressed in euro, P_E^i	Exchange rate between the dollar and the euro, $E_{\$/\text{€}}$
25	32	0.78125
35		0.833333333
45	54	
	65	0.846153846
65		0.82278481
	85	0.882352941
85		0.787037037
95		0.871559633
115	139	

Answer:

Price in the United States of a sweater expressed in dollars, P_{US}^i	Price in Europe expressed in euro, P_E^i	Exchange rate between the dollar and the euro, $E_{\$/\text{€}}$
25	32	0.78125
35	42	0.833333333
45	54	0.833333333
55	65	0.846153846
65	79	0.82278481
75	85	0.882352941
85	108	0.787037037
95	109	0.871559633
115	139	0.827338129

5. Assuming relative PPP, fill in the table below:

$E_{\$/E,t}$	$E_{\$/E,t-1}$	$E_{\$/E,t-1}$	$_{US,t}$	$_{E,t}$
2			0.03	-0.08111
2.1	2	2	0.04	-0.01
2.2	2.1	2.1		0.002381
	2.2	2.2	0.06	0.014545
2.4			0.07	0.026522
2.5	2.4	2.4	0.08	
2.6	2.5	2.5		0.05
2.7	2.6	2.6	0.1	0.061538
	2.7	2.7	0.11	0.072963
2.9	2.8	2.8		0.084286
3	2.9	2.9	0.13	

Answer: Using $(E_{\$/E,t} - E_{\$/E,t-1})/E_{\$/E,t-1}$ = Inflation rate in the U.S. minus inflation rate in Europe, one gets:

$E_{\$/E,t}$	$E_{\$/E,t-1}$	$E_{\$/E,t-1}$	$_{US,t}$	$_{E,t}$
2	1.8	1.8	0.03	-0.08111
2.1	2	2	0.04	-0.01
2.2	2.1	2.1	0.05	0.002381
2.3	2.2	2.2	0.06	0.014545
2.4	2.3	2.3	0.07	0.026522
2.5	2.4	2.4	0.08	0.038333
2.6	2.5	2.5	0.09	0.05
2.7	2.6	2.6	0.1	0.061538
2.8	2.7	2.7	0.11	0.072963
2.9	2.8	2.8	0.12	0.084286
3	2.9	2.9	0.13	0.095517

Chapter 16: Output and the Exchange Rate in the Short Run

Multiple Choice Questions

1. How does an increase in the real exchange rate affect exports and imports?
- A. Exports increase; imports decrease
 - B. Exports decrease; imports increase.
 - C. Exports increase; imports change ambiguously.
 - D. Exports change ambiguously; imports decrease.
 - E. Exports increase; imports are constant.

Answer: C

2. How does a rise in real income affect aggregate demand?
- A. $Y \uparrow \rightarrow Y_d \uparrow \rightarrow Im \uparrow \rightarrow CA \downarrow \rightarrow AD \downarrow$, but $Y \uparrow \rightarrow Y_d \uparrow \rightarrow C \uparrow \rightarrow AD \uparrow$ by more.
 - B. $Y \uparrow \rightarrow Y_d \uparrow \rightarrow Im \downarrow \rightarrow CA \downarrow \rightarrow AD \downarrow$, but $Y \uparrow \rightarrow Y_d \uparrow \rightarrow C \uparrow \rightarrow AD \uparrow$ by more.
 - C. $Y \uparrow \rightarrow Y_d \uparrow \rightarrow Im \uparrow \rightarrow CA \uparrow \rightarrow AD \uparrow$, and $Y \uparrow \rightarrow Y_d \uparrow \rightarrow C \uparrow \rightarrow AD \uparrow$.
 - D. $Y \uparrow \rightarrow Y_d \uparrow \rightarrow Im \uparrow \rightarrow CA \downarrow \rightarrow AD \downarrow$, but $Y \uparrow \rightarrow Y_d \uparrow \rightarrow C \uparrow \rightarrow AD \uparrow$ by less.
 - E. $Y \uparrow \rightarrow Y_d \uparrow \rightarrow Im \downarrow \rightarrow CA \downarrow \rightarrow AD \downarrow$, but $Y \uparrow \rightarrow Y_d \uparrow \rightarrow C \uparrow \rightarrow AD \uparrow$ by less.

Answer: A

3. Assume the economy is initially consuming along the inter-temporal budget constraint at point A, where no saving occurs. How does a fall in the real interest rate, r , affect present consumption?
- A. Present consumption decreases.
 - B. Present consumption increases.
 - C. Present consumption is unaffected.
 - D. Present consumption's change is ambiguous.
 - E. Not enough information is provided.

Answer: B

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

Answer: D

5. The IS-LM Model presented in Appendix I of Chapter 16 implies which of the following?
- A. Fiscal policy is effective in the short run.
 - B. A permanent increase in the money supply is more effective than a temporary increase.
 - C. The relationship between the exchange rate and the domestic output is negative.
 - D. Fiscal policy may be effective only with a temporary increase in government spending.
 - E. The exchange rate adjustment to a change in the home interest rate is permanent.

Answer: D

6. The Marshall-Lerner Condition states that
- A. depreciation always has a favorable effect on the current account.
 - B. import dependency reinforces the effects of depreciation on the current account.
 - C. high elasticity of exports is sufficient for the favorable effects of depreciation on the current account to be observed.
 - D. depreciation has a favorable effect on the current account only if the sum of export and import elasticities is greater than one.
 - E. the sum of import and export elasticities must be equal to one in order for depreciation to occur.

Answer: D

7. If the economy starts in long-run equilibrium, a permanent fiscal expansion will cause
- A. an increase in exchange rate, E.
 - B. a decrease in exchange rate, E.
 - C. an increase in output, Y.
 - D. a decrease in output, Y.
 - E. shifting of the AA curve up and to the right.

Answer: B

8. In the long-run equilibrium, after a permanent money-supply increase there follows:
- A. an increase in exchange rate, E.
 - B. a decrease in exchange rate, E.
 - C. an increase in output, Y.
 - D. a decrease in output, Y.
 - E. Both B and D.

Answer: A

9. Which of the following are true in terms of the current account balance?
- A. Monetary expansion increases the current account balance.
 - B. Monetary expansion decreases the current account balance.
 - C. Fiscal expansion increases the current account balance.
 - D. Fiscal expansion decreases the current account balance.
 - E. Both A and D

Answer: E

10. In the short run, with prices fixed, how would an increase in government spending affect the DD-AA schedule?
- A. It will increase output and appreciate the currency.
 - B. It will increase output and depreciate the currency.
 - C. It will decrease output and appreciate the currency.
 - D. It will decrease output and depreciate the currency.
 - E. None of the above.

Answer: A

11. 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 a decrease in the domestic interest rate.
 - C. The AA schedule has a negative slope because an increase in output leads to an increase in the domestic interest rate.
 - D. The AA schedule has a positive slope because an increase in the money supply leads to an increase in the domestic interest rate.
 - E. None of the above.

Answer: C

12. Imagine that the economy is at a point on the DD-AA schedule that is above both AA and DD, where both the output and asset markets are out of equilibrium. Which first action is true?
- A. The economy will stay at this level in the short run.
 - B. The exchange rate will first drop to a point on the AA schedule.
 - C. The exchange rate will first move to a point on the DD schedule.
 - D. The AA-DD equilibrium will shift to the position of the economy.
 - E. None of the above.

Answer: B

13. Which one of the following statements is most accurate?
- A. In the long run, foreign output depends only on the available domestic supplies of factors of production.
 - B. In the short run, domestic output depends only on the available domestic supplies of factors of production.
 - C. In the long run, domestic output depends only on the available domestic supplies of factors of production.
 - D. In the long run and in the short run, domestic output depends only on the available domestic supplies of factors of production.
 - E. None of the above.

Answer: C

14. Which one of the following statements is most accurate?
- A. Factors of production can only be over-employed in the short run.
 - B. Factors of production can only be under-employed in the short run.
 - C. Factors of production can be over- or under- employed in the long run.
 - D. Factors of production can be over- or under- employed in the short run.
 - E. None of the above.

Answer: D

15. Which one of the following statements is most accurate?
- A. In general, consumption demand rises by less than income.
 - B. In general, consumption demand rises by less than disposable income.
 - C. In general, consumption demand rises by more than disposable income.
 - D. In general, consumption demand rises by more than income.
 - E. In general, consumption demand rises by the same amount as disposable income rises.

Answer: B

16. The current account balance is
- A. the supply of a country's exports less the country's own demand for imports.
 - B. the demand for a country's exports plus the country's own demand for imports.
 - C. the country's own demand for imports less the demand for a country's exports.
 - D. the demand for a country's exports less the country's own demand for imports.
 - E. None of the above.

Answer: D

17. The domestic currency price of a representative foreign expenditure basket is
- A. P , the domestic price level.
 - B. E , the nominal exchange rate.
 - C. P times E , the domestic price level times the domestic price level.
 - D. P^* , the foreign price level.
 - E. P^* times E , the foreign price level times the nominal exchange rate.

Answer: E

18. The domestic currency price of a representative domestic expenditure basket is
- A. P , the domestic price level.
 - B. E , the nominal exchange rate.
 - C. P times E , the domestic price level times the nominal exchange rate.
 - D. P^* , the foreign price level.
 - E. P^* times E , the foreign price level times the nominal exchange rate.

Answer: A

19. The real exchange rate, q , is defined as
- A. the price of the foreign basket in terms of the domestic one.
 - B. the price of the domestic basket in terms of the foreign one.
 - C. the price of the foreign basket.
 - D. the price of the domestic basket.
 - E. None of the above.

Answer: A

20. The real exchange rate, q , is defined as
- A. E .
 - B. E times P .
 - C. E times P^* .
 - D. $(E \text{ times } P^*) / P$.
 - E. $P / (E \text{ times } P^*)$.

Answer: D

21. 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 the U.S. basket is
- A. $[(0.9 \text{ \$/euro}) (40 \text{ euro per a European basket})] / [(50 \$ / \text{U.S. basket})]$.
 - B. $[(0.9 \text{ \$/euro}) (50 \$ / \text{U.S. basket})] / [(40 \text{ euro per a European basket})]$.
 - C. $[(40 \text{ euro per a European basket})] / [(50 \$ / \text{U.S. basket}) (0.9 \text{ \$/euro})]$.
 - D. $[(50 \$ / \text{U.S. basket})]$.
 - E. $[(0.9 \text{ \$/euro}) (40 \text{ euro per a European basket})] / [(50 \$ \text{ U.S. basket})]$.

Answer: A

22. When EP^*/P rises,
- A. IM will rise.
 - B. IM will fall.
 - C. IM may rise or fall.
 - D. IM is not affected.
 - E. None of the above.

Answer: C

23. When the real exchange rate rises,
- A. Imports measured in terms of domestic output will rise.
 - B. Imports measured in terms of domestic output will fall.
 - C. Imports measured in terms of domestic output will not be affected.
 - D. Imports measured in terms of domestic output will rise or fall.
 - E. None of the above.

Answer: B

24. Which one of the following statements is the most accurate?
- A. An increase in disposable income improves the current account.
 - B. An increase in disposable income does not affect the current account.
 - C. An increase in disposable income worsens the current account.
 - D. An increase in income worsens the current account.
 - E. An increase in income improves the current account.

Answer: C

25. Which one of the following statements is the most accurate?
- A. An increase in the real exchange rate and an increase in disposable income improve the current account.
 - B. A decrease in the real exchange rate and a decrease in disposable income improve the current account.
 - C. A decrease in the real exchange rate and a decrease in disposable income improve the current account.
 - D. An increase in the real exchange rate and a decrease in disposable income improve the current account.
 - E. None of the above.

Answer: D

26. Which one of the following statements is the most accurate?
- A. A rise in domestic real income raises aggregate demand for home output.
 - B. A rise in domestic real income decreases aggregate demand for home output because of the increased demand for import.
 - C. A rise in domestic real income keeps aggregate demand for home output at the same level.
 - D. It is difficult to tell whether a rise in domestic real income affects positively or negatively aggregate demand for home output.
 - E. None of the above.

Answer: A

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

Answer: A

28. In the short run, a reduction in the exchange rate, i.e. currency appreciation,
- A. raises aggregate demand and raises output.
 - B. raises aggregate demand and lowers output.
 - C. raises aggregate demand and does not affect output.
 - D. lowers aggregate demand and raises output.
 - E. lowers aggregate demand and lowers output.

Answer: D

29. In the short-run, any rise in the real exchange rate, EP^*/P , will cause
- A. an upward shift in the aggregate demand function and a reduction in output.
 - B. an upward shift in the aggregate demand function and an expansion of output.
 - C. a downward shift in the aggregate demand function and an expansion of output.
 - D. a downward shift in the aggregate demand function and a reduction in output.
 - E. an upward shift in the aggregate demand function, but it leaves output intact.

Answer: B

30. In the short-run, any rise in the nominal exchange rate, E , will cause
- A. an upward shift in the aggregate demand function and an expansion of output.
 - B. an upward shift in the aggregate demand function and a reduction in output.
 - C. a downward shift in the aggregate demand function and an expansion of output.
 - D. a downward shift in the aggregate demand function and a reduction in output.
 - E. an upward shift in the aggregate demand function but leaves output intact.

Answer: A

31. In the short run, any rise in the foreign price level, P^* , will cause
- A. an upward shift in the aggregate demand function and an expansion of output.
 - B. an upward shift in the aggregate demand function and a reduction in output.
 - C. a downward shift in the aggregate demand function and an expansion of output.
 - D. a downward shift in the aggregate demand function and a reduction in output.
 - E. an upward shift in the aggregate demand function but leaves output intact.

Answer: D

32. In the short run, any fall in EP^*/P , regardless of its causes, will cause
- A. an upward shift in the aggregate demand function and an expansion of output.
 - B. an upward shift in the aggregate demand function and a reduction in output.
 - C. a downward shift in the aggregate demand function and an expansion of output.
 - D. a downward shift in the aggregate demand function and a reduction in output.
 - E. an upward shift in the aggregate demand function, but it leaves output intact.

Answer: D

33. 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 depreciates the currency.
 - C. shifts the AA curve to the left, decreases output, and depreciates the currency.
 - D. shifts the AA curve to the left, increases output, and appreciates the currency.
 - E. shifts the AA curve to the right, increases output, and appreciates the currency.

Answer: A

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

Answer: E

35. In the short run, a temporary increase in fiscal policy causes
- A. a shift of the DD curve to the left, an increase in output, and currency appreciation.
 - B. a shift of the DD curve to the right, a decrease in output, and currency appreciation.
 - C. a shift of the DD curve to the right, an increase in output, and currency depreciation.
 - D. a shift of the DD curve to the left, a decrease in output, and currency depreciation.
 - E. a shift of the DD curve to the right, an increase in output, and currency appreciation.

Answer: E

36. Using the DD – AA framework, which one of the following statements is the most accurate?
- A. Only monetary policy can bring the economy to full employment.
 - B. Only fiscal policy can bring the economy to full employment.
 - C. Only both monetary and fiscal policies can bring the economy to full employment.
 - D. Neither policy is capable of bringing the economy to full employment.
 - E. Monetary policy by itself or fiscal policy by itself can bring the economy to full employment.

Answer: E

37. Which one of the following statements is the most accurate?
- A. A permanent increase in the money supply cannot have any short-run effects.
 - B. A permanent increase in taxes cannot have any short-run effects.
 - C. A permanent decrease in the money supply cannot have short-run effects.
 - D. A permanent decrease in taxes cannot have short-run effects.
 - E. None of the above.

Answer: E

38. A permanent increase in the domestic money supply
- A. must ultimately lead to a proportional decrease in E , and, therefore, the expected future exchange rate must rise proportionally.
 - B. must ultimately lead to a proportional decrease in E , and, therefore, the expected future exchange rate must decrease proportionally.
 - C. must ultimately lead to a proportional rise in E , and, therefore, the expected future exchange rate must rise proportionally.
 - D. must ultimately lead to a proportional rise in E , and, therefore, the expected future exchange rate must rise more than proportionally.
 - E. must ultimately lead to a proportional rise in E , and, therefore, the expected future exchange rate must rise less than proportionally.

Answer: C

39. In the short run, a permanent increase in the domestic money supply causes
- A. an upward shift in the DD curve, which is greater than that caused by an equal but transitory increase.
 - B. a downward shift in the AA curve, which is greater than that caused by an equal but transitory increase.
 - C. an upward shift in the AA curve, which is smaller than that caused by an equal but transitory increase.
 - D. a downward shift in the AA curve, which is smaller than that caused by an equal but transitory increase.
 - E. an upward shift in the AA curve, which is greater than that caused by an equal but transitory increase.

Answer: E

40. In the short run, a permanent increase in the domestic money supply
- A. has stronger effects on the exchange rate and output than an equal temporary increase.
 - B. has stronger effects only on the exchange rate but 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 output, but lower effect the exchange rate than an equal temporary increase.
 - E. None of the above.

Answer: A

41. A permanent fiscal expansion
- A. shifts the DD and the AA schedules to the right, increasing output.
 - B. shifts the DD and the AA schedules to the right, decreasing output.
 - C. shifts the DD to the right, increasing output.
 - D. shifts the DD to the left, decreasing output.
 - E. shifts the DD and the AA schedules to the right, leaving output the same .

Answer: E

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Essay Questions

1. Explain how an increase in government spending would affect the DD-AA schedule in the short run.

Answer: An increase in government spending will increase aggregate demand, which will shift the DD to the right. If AA remains unchanged, the new equilibrium will be at a higher Y and lower E . Since E is the nominal exchange rate, a lower E is an appreciation of the currency.

2. Explain how the AA schedule is derived.

Answer: For a fixed real money supply, an increase in output leads to an increase in the domestic interest rate. In the foreign exchange market, an increase in the domestic interest rate leads to a lower nominal exchange rate, thus appreciating the currency. Therefore, the relationship between nominal exchange rate and output is negative; this leads to a negative slope of the AA schedule, which has the nominal exchange rate and output on its axes.

3. Imagine that the economy is at a point on the DD-AA schedule that is above both AA and DD and where both the output and asset markets are out of equilibrium. Explain what will happen next.

Answer: Since the asset market adjusts very quickly, the exchange rate drops immediately to a point on the AA schedule. There will be excess demand for the domestic currency because the high expected future appreciation rate of the domestic currency implies that the expected domestic currency return on foreign deposits is below that on domestic deposits. This excess demand leads to an immediate fall in the exchange rate.

4. Explain how an increase in the real exchange rate affects exports and imports.

Answer: When the real exchange rate increases, domestic products are cheaper relative to foreign products. Due to this, exports increase as foreigners demand more domestic exports. The change in imports is ambiguous because fewer units of imports are purchased (the volume effect), but each foreign unit is now more expensive (the value effect). Remember: exports and imports are measured in terms of domestic output, *i.e.* dollar value, not volume of units. However, we often **assume** that the volume effect outweighs the value effect, so that imports decrease when the real exchange rate rises.

5. Explain how a rise in real income affects aggregate demand.

Answer: A rise in domestic real income, Y , leads to a rise in disposable income, Y_d . This raises the spending on imports, IM , thus lowering the current account, CA , and reducing aggregate demand, AD . However, the rise in Y_d also causes a rise in consumption, C , and raises aggregate demand, AD , by more than the corresponding decrease.

6. Assume the economy is initially consuming along the intertemporal budget constraint at point A, where no saving occurs. How does a fall in the real interest rate, r , affect present consumption?

Answer: A decrease in the real interest rate, r , causes the budget line to rotate counterclockwise about point A, decreasing the slope, and causing a rise in present consumption.

7. Discuss the main factors affecting the position of the DD schedule.

Answer: The level of government demand, taxes, and investment; the domestic and foreign price levels; variations in domestic consumption behavior; and the foreign demand for home output.

8. Discuss the main factors affecting the position of the AA schedule.

Answer: Changes in the domestic money supply; changes in the domestic price level; changes in the expected future exchange rate; changes in the foreign interest rate; and shifts in the aggregate real money demand schedule.

9. A naïve implication of the DD – AA framework is that either fiscal or monetary policy can lead to full employment. Discuss why this view is naïve.

Answer:

1. Inflation may arise without any gain in output if the government misuses its power to print money.
2. In practice, it is sometimes hard to be sure whether a disturbance to the economy originates in the output or assets markets.
3. Shifts in fiscal policy often can be made only after lengthy legislative deliberations. Governments are likely to respond to disturbances by changing the monetary policy even when a shift in fiscal policy would be more appropriate.
4. Fiscal policy impacts the government budget and may lead to a government budget deficit that must sooner or later be closed by a fiscal reversal. The state of the electoral cycle may be more important.
5. Policies operate in reality with lags of varying length.

Quantitative/Graphing Problems

- Find the real exchange rate for the following case: Assume that 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. What is the price of the European basket in terms of the U.S. basket?

Answer: $[(0.9 \text{ $/euro}) (40 \text{ euro per a European basket})] / [(50 \text{ $} / \text{U.S. basket})]$.

- Fill in the following table:

E	P	P*	EP*/P
	20	30	1.5
2		40	2.666667
3	40		3.75
4	50	60	
5	60		5.833333
6		80	6.857143
7	80		7.875
	90	100	8.888889
9		110	9.9
10	110		10.90909

Answer:

E	P	P*	EP*/P
1	20	30	1.5
2	30	40	2.666667
3	40	50	3.75
4	50	60	4.8
5	60	70	5.833333
6	70	80	6.857143
7	80	90	7.875
8	90	100	8.888889
9	100	110	9.9
10	110	120	10.90909

3. Fill in the following table

Nominal Exchange rate	Domestic price level	Foreign price level	Real exchange rate
	20	30	0.15
0.2		40	0.266666667
0.3	40		0.375
0.4	50	60	
0.5	60	70	
0.6	70		0.685714286
0.7		90	0.7875
	90	100	0.888888889
0.9		110	0.99
0.1	110	120	

Answer:

Nominal Exchange rate	Domestic price level	Foreign price level	real exchange rate
0.1	20	30	0.15
0.2	30	40	0.266666667
0.3	40	50	0.375
0.4	50	60	0.48
0.5	60	70	0.583333333
0.6	70	80	0.685714286
0.7	80	90	0.7875
0.8	90	100	0.888888889
0.9	100	110	0.99
0.1	110	120	0.109090909

4. Explain the difference between the following two expressions:

$$Y = C(Y^d) + I + G + CA(EP^*/P, Y^d) \text{ and}$$

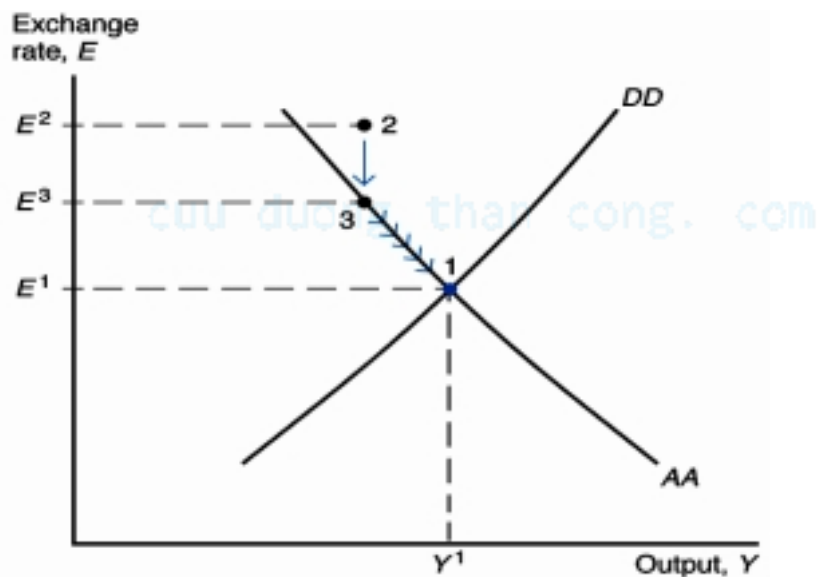
$$Y = C + I + G + CA$$

Answer: The first expression represents a behavioral equation and thus may express equilibrium conditions for the output market or the aggregate desired demand for output. The second equation is only an identity that is always true.

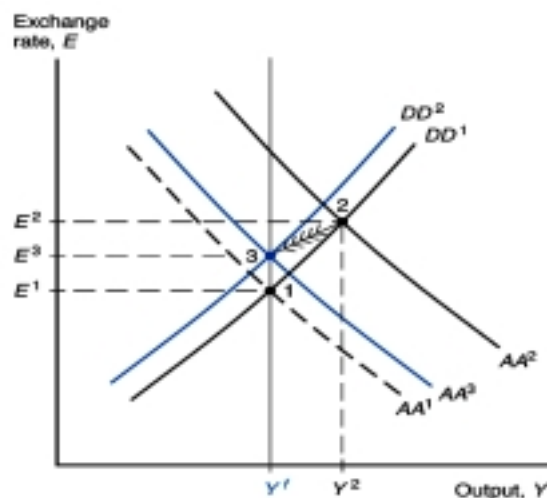
5. Use a figure to study the following question: Imagine that the economy is at a point on the DD-AA schedule that is above both AA and DD, where both the output and asset markets are out of equilibrium. Explain what will happen next.

Answer: Since the asset market adjusts very quickly, the exchange rate drops immediately to a point on the AA schedule. There will be excess demand for the domestic currency because the high expected future appreciation rate of the domestic currency implies that the expected domestic currency return on foreign deposits is below that on domestic deposits. This excess demand leads to an immediate fall in the exchange rate.

The figure:



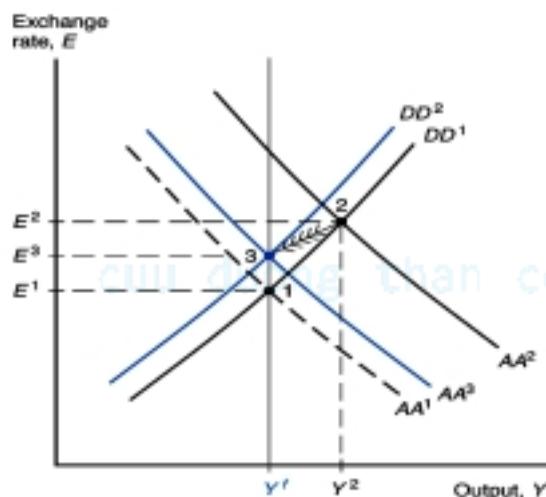
6. Explain the following figure:



Answer: The figure depicts the effect of a permanent increase in the money supply starting from full employment equilibrium. After the initial increase in the money supply and the move of the AA curve to the right from AA^1 to AA^2 , a steadily increasing price level shifts the AA and the DD schedules to the left until a new long-run equilibrium is reached. Note that point 3 is above point 1, because E^e is permanently higher after a permanent increase in the money supply. The expected exchange rate, E^e , has risen by the same percentage as M^s . Notice that along the adjustment path between the initial short-run equilibrium (point 2) and the long-run equilibrium (point 3) the domestic currency actually appreciates (from E^2 to E^3) following its initial sharp depreciation (from E^1 to E^2).

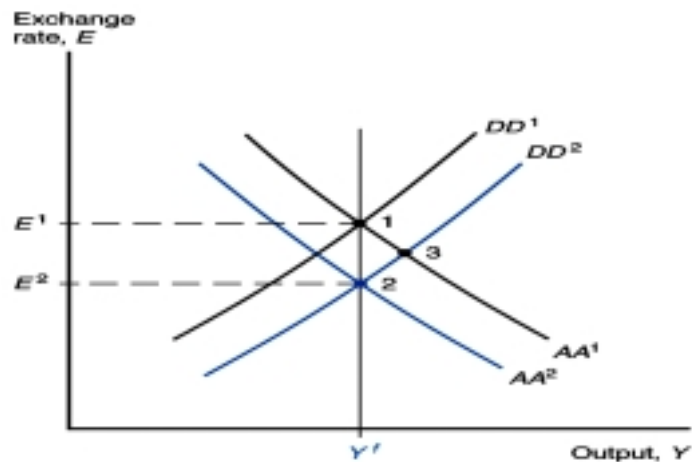
7. Using the DD – AA framework, show the phenomenon of overshooting. Use a figure to explain when it is taking place.

Answer: The figure below shows the phenomenon of overshooting. A permanent increase in the money supply starting from full employment equilibrium will shift the AA curve to the right from AA^1 to AA^2 . Now, a steadily increasing price level shifts the AA and the DD schedules to the left until a new long-run equilibrium is reached. Note that point 3 is above point 1, because E^e is permanently higher after a permanent increase in the money supply. The expected exchange rate, E^e , has risen by the same percentage as M^s . Notice that along the adjustment path between the initial short-run equilibrium (point 2) and the long-run equilibrium (point 3) the domestic currency actually appreciates (from E^2 to E^3) following its initial sharp depreciation (from E^1 to E^2). This exchange rate behavior is an example of overshooting, in which the exchange rate's initial response to some change is greater than its long-run response.



8. Using a figure, show that under full employment, a temporary fiscal expansion would increase output (over-employment) but cannot increase output in the long run.

Answer: A temporary fiscal expansion will move the economy from DD^1 to DD^2 , and output increases. A permanent fiscal expansion will also shift the AA curve to the left and down. The nominal exchange rate appreciates, i.e. E decreases.



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Chapter 17: Fixed Exchange Rates and Foreign Exchange Intervention

Multiple Choice Questions

1. Why is the reserve center in the reserve currency fixed rate system asymmetric?
- A. The reserve center fixes its exchange rate against the reserve currency, and all other countries are subject to that rate.
 - B. Other countries fix their exchange rate to the reserve currency, and there is no exchange rate left for the reserve center to fix.
 - C. The center country has to intervene all the time and regulate the balance of payments.
 - D. The center country never has to intervene and bears none of the burden of financing its balance of payments.
 - E. Both B and D.

Answer: E

2. Imperfect asset substitutability assumes that
- A. the returns on foreign and domestic currency bonds are the same.
 - B. the returns on foreign and domestic currency are different.
 - C. the returns on foreign and domestic currency are influenced by risk.
 - D. Both B and C
 - E. sterilized intervention proves to be unproductive.

Answer: D

3. Benefit(s) of the gold standard include
- A. asymmetry.
 - B. making real values of national monies more stable and predictable.
 - C. limiting money creation.
 - D. Both A and C.
 - E. Both B and C.

Answer: E

4. Which of the following are true, based on the Monetary Approach to the Balance of Payments?
- A. If the demand for money increases, a budget surplus will result, and the money supply will have to decrease to maintain equilibrium.
 - B. If the demand for money increases, a budget surplus will result, and the money supply will have to increase to maintain equilibrium.
 - C. If the demand for money increases, a budget deficit will result, and the money supply will have to decrease to maintain equilibrium.
 - D. If the demand for money increases, a budget deficit will result, and the money supply will have to increase to maintain equilibrium.
 - E. According to the Monetary Approach, money market equilibrium does not have to be maintained if the balance of payments is not in equilibrium.

Answer: B

5. By fixing the exchange rate, the central bank gives up its ability to
- A. adjust taxes.
 - B. increase government spending.
 - C. influence the economy through fiscal policy.
 - D. depreciate the domestic currency.
 - E. influence the economy through monetary policy.

Answer: E. By fixing the exchange rate, the central bank does not allow the foreign exchange market to determine the exchange rate. With the exchange rate fixed, the central bank cannot adjust the money supply using Monetary Policy.

6. Fiscal Expansion under a fixed exchange rate has what effect(s) on the economy?
- A. The money supply decreases.
 - B. Output decreases.
 - C. The exchange rate increases.
 - D. The exchange rate decreases initially but then returns to its original point.
 - E. Output is unchanged.

Answer: D. Fiscal expansion under a fixed exchange rate shifts the DD schedule outward, thereby causing an increase in output and a decrease in the exchange rate. However, with an accompanying outward shift of the AA schedule, output increases, and the exchange rate shifts outward. This shifts the exchange rate outward to its initial point.

7. When a country's currency is devalued,
- A. output decreases.
 - B. output increases.
 - C. the money supply decreases.
 - D. the money supply increases.
 - E. Both B and D.

Answer: E. When a currency is devalued, output and the money supply expand as the economy's equilibrium shifts outward.

3. A system of managed floating exchange rates is
- A. a system in which governments may attempt to moderate exchange rate movements without keeping exchange rates rigidly fixed.
 - B. a system in which governments use flexible exchange rates.
 - C. a system in which governments are forbidden from attempt to moderate exchange rate movements without keeping exchange rates rigidly fixed.
 - D. a system in which governments need to reach a prior agreement among them before they may attempt to moderate exchange rate movements without keeping exchange rates rigidly fixed.
 - E. None of the above statement is true.

Answer: A

4. Barbados
- A. pegs its exchange rate to the French franc.
 - B. pegs its exchange rate to the British pound.
 - C. pegs its exchange rate to the U.S. dollar.
 - D. pegs its exchange rate to the German DM.
 - E. Does not peg its currency.

Answer: C

5. Senegal
- A. pegs its exchange rate to the French franc.
 - B. pegs its exchange rate to the British pound.
 - C. pegs its exchange rate to the U.S. dollar.
 - D. pegs its exchange rate to the German DM.
 - E. Does not peg its currency.

Answer: A

6. Morocco
- A. pegs its exchange rate to the French franc.
 - B. pegs its exchange rate to the British pound.
 - C. pegs its exchange rate to the U.S. dollar.
 - D. pegs its exchange rate to a basket of currencies.
 - E. Does not peg its currency.

Answer: D

7. We study the system of fixed exchange rate because
- A. most exchange systems are not clean floats but dirty floats.
 - B. regional currency arrangements use fixed exchange rates.
 - C. many developing and countries in transition use fixed exchange rates.
 - D. they are lessons of the past for the future.
 - E. All of the above statements are true.

Answer: E

8. Argentina, Bulgaria, China, and Hong Kong managed their exchange rates
- A. under a fixed exchange rate regime.
 - B. under a flexible exchange rate regime.
 - C. under a managed floating exchange rate regime.
 - D. under a currency board exchange rate regime.
 - E. None of the above.

Answer: D

9. Australia and Poland managed their exchange rates
- A. under a fixed exchange rate regime.
 - B. under a flexible exchange rate regime.
 - C. under a managed floating exchange rate regime.
 - D. under a currency board exchange rate regime.
 - E. None of the above.

Answer: B

15. A central bank's international reserves include
- A. any gold that it owns.
 - B. any silver that it owns.
 - C. any gold that it owns and foreign and domestic assets.
 - D. any silver that it owns and foreign and domestic assets.
 - E. only foreign and domestic assets.

Answer: C

16. The liabilities side of a central bank include
- A. deposits held by the private banks.
 - B. currency in circulation.
 - C. deposits held by the private banks and currency in circulation.
 - D. deposits held by the private banks and currency in circulation.
 - E. deposits held by the private banks, foreign assets, and currency in circulation.

Answer: C

17. Which one of the following statements is most true?
- A. Any central bank purchase of assets *automatically* results in an increase in the domestic money supply, while any central bank sale of assets *automatically* causes the money supply to decline.
 - B. Any central bank purchase of assets results in an increase in the domestic money supply, while any central bank sale of assets causes the money supply to decline.
 - C. Any central bank purchase of assets *automatically* results in a decrease in the domestic money supply, while any central bank sale of assets *automatically* causes the money supply to decline.
 - D. Any central bank purchase of assets *automatically* results in a decrease in the domestic money supply, while any central bank sale of assets *automatically* causes the money supply to increase.
 - E. None of the above statement is true.

Answer: A

18. Which one of the following statements is the most true?
- A. If central banks are not sterilizing and the home country has a balance of payments surplus, any associated increase in the home central bank's foreign asset implies an increased home money supply.
 - B. If central banks are not sterilizing and the home country has a balance of payments surplus, any associated increase in the home central bank's foreign asset implies a decreased home money supply.
 - C. If central banks are not sterilizing and the home country has a balance of payments surplus, any associated increase in the home central bank's foreign asset implies an increased home money demand.
 - D. If central banks are not sterilizing and the home country has a balance of payments surplus, any associated decreased in the home central bank's foreign asset implies an increased home money supply.
 - E. None of the above statement is true.

Answer: A

19. Which one of the following statements is most true?
- A. If central banks are not sterilizing and the home country has a balance of payments surplus, any associated increase in a foreign central bank's claims on the home country implies a decreased foreign money supply.
 - B. If central banks are not sterilizing and the home country has a balance of payments surplus, any associated decrease in a foreign central bank's claims on the home country implies a decreased foreign money demand.
 - C. If central banks are not sterilizing and the home country has a balance of payments surplus, any associated decrease in a foreign central bank's claims on the home country implies a decreased foreign money supply.
 - D. There is not a clear connection between the two.
 - E. None of the above.

Answer: C

20. Under fixed exchange rate, in general,
- A. the domestic and foreign interest rates are equal, $R = R^*$.
 - B. $R = R^* + (E^e - E)/E$.
 - C. None of the above.
 - D. E is equal to one.
 - E. One of the above.

Answer: A

21. Under fixed exchange rate, in general which one of the following statements is the most accurate?
- A. The following condition should hold for domestic money market equilibrium: $M^s/P = L(R^*, Y)$.
 - B. The following condition should hold for domestic money market equilibrium: $M^s/P = L(R, Y)$.
 - C. The following condition should hold for domestic money market equilibrium: $M^d/P = L(R^*, Y)$.
 - D. The following condition should hold for domestic money market equilibrium: $M^s = L(R^*, Y)$.
 - E. The following condition should hold for domestic money market equilibrium: $P = L(R^*, Y)$.

Answer: A

22. Which one of the following statements is the most accurate?
- A. Under a fixed exchange rate, central bank monetary tools are powerless to affect the economy's money supply.
 - B. Under a flexible exchange rate, central bank monetary tools are powerless to affect the economy's money supply or its output.
 - C. Under a fixed exchange rate, fiscal policy tools are powerless to affect the economy's money supply or its output.
 - D. Under a fixed exchange rate, central bank monetary tools are powerless to affect the economy's money supply or its output.
 - E. Under a dirty float exchange rate, central bank monetary tools are powerless to affect the economy's money supply or its output.

Answer: D

23. Which one of the following statements is the most accurate?
- A. Under a fixed exchange rate, central bank monetary tools are powerless to affect the economy's money supply.
 - B. Under a flexible exchange rate, central bank monetary tools are powerless to affect the economy's money supply or its output.
 - C. Under a fixed exchange rate, fiscal policy tools are powerless to affect the economy's money supply or its output.
 - D. Under a flexible exchange rate, central bank monetary tools are powerful and do affect the economy's output.
 - E. Under a dirty float exchange rate, central bank monetary tools are powerless to affect the economy's money supply or its output.

Answer: D

24. Under fixed rates, which one of the following statements is the most accurate?
- A. Monetary policy can affect only output.
 - B. Monetary policy can affect only employment.
 - C. Monetary policy can affect only international reserves.
 - D. Monetary policy can not affect international reserves.
 - E. None of the above statements is true.

Answer: C

25. Under fixed rates, which one of the following statements is the most accurate?
- A. Fiscal policy can affect output, employment, and international reserves at the same time.
 - B. Fiscal policy can affect only employment.
 - C. Fiscal policy can affect only international reserves.
 - D. Fiscal policy can affect *only* output and employment.
 - E. None of the above statements is true.

Answer: A

26. Which one of the following statements is the most accurate?
- A. Fiscal policy has the same effect on employment under fixed and flexible exchange rate regimes.
 - B. Fiscal policy affects employment less under fixed than under flexible exchange rate regimes.
 - C. Fiscal policy affects employment more under fixed than under flexible exchange rate regimes.
 - D. Fiscal policy cannot affect employment under fixed exchange rate but does affect output under flexible exchange rate regimes.
 - E. None of the above statements is true.

Answer: C

27. Which one of the following statements is the most accurate?
- A. Fiscal policy has the same effect on output under fixed and flexible exchange rate regimes.
 - B. Fiscal policy affects output more under fixed than under flexible exchange rate regimes.
 - C. Fiscal policy affects output less under fixed than under flexible exchange rate regimes.
 - D. Fiscal policy cannot affect output under fixed exchange rate but does affect output under flexible exchange rate regimes.
 - E. None of the above statements is true.

Answer: B

28. Which one of the following statements is the most accurate?
- A. A *devaluation* occurs when the central bank lowers the domestic currency price of foreign currency, E, and a *revaluation* occurs when the central bank raises E.
 - B. A devaluation occurs when the central bank raises the domestic currency price of foreign currency, E, and a revaluation occurs when the central bank lowers E.
 - C. Devaluation occurs when the domestic currency price of foreign currency, E, is raised, and a revaluation occurs when E is lowered.
 - D. A devaluation occurs when the central bank of the foreign country raises the domestic currency price of foreign currency, E, and a revaluation occurs when the central bank of the foreign country lowers E.
 - E. None of the above statements is true.

Answer: B

29. Which one of the following statements is the most accurate?
- A. Depreciation is a rise in E when the exchange rate is fixed, and devaluation is a rise in E when the exchange rate floats.
 - B. Depreciation is a decrease in E when the exchange rate floats, and devaluation is a rise in E when the exchange rate is fixed.
 - C. Depreciation is a rise in E when the exchange rate floats, and devaluation is a rise in E when the exchange rate is fixed.
 - D. Depreciation is a rise in E when the exchange rate floats, and devaluation is a decrease in E when the exchange rate is fixed.
 - E. None of the above.

Answer: C

30. Which one of the following statements is the most accurate?
- A. Appreciation is a rise in E when the exchange rate floats, and revaluation is a fall in E when the exchange rate is fixed.
 - B. Appreciation is a fall in E when the exchange rate floats, and revaluation is a fall in E when the exchange rate is fixed.
 - C. Appreciation is a fall in E when the exchange rate is fixed, and revaluation is a fall in E when the exchange rate is flexible.
 - D. Appreciation is a fall in E when the exchange rate floats, and revaluation is a rise in E when the exchange rate is fixed.
 - E. None of the above.

Answer: B

31. Which one of the following statements is the most accurate?
- A. Devaluation reflects a deliberate government decision.
 - B. Depreciation reflects a deliberate government decision.
 - C. Devaluation reflects a deliberate government decision, and depreciation is an outcome of government actions and market forces acting together.
 - D. Depreciation reflects a deliberate government decision, and devaluation is an outcome of government actions and market forces acting together.
 - E. Devaluation and depreciation have the same meaning and the same causes.

Answer: C

32. Which one of the following statements is the most accurate?
- A. Revaluation reflects an outcome of government actions and market forces acting together, and appreciation reflects a deliberate government decision.
 - B. Revaluation reflects a deliberate government decision, and appreciation is an outcome of government actions and market forces acting together.
 - C. Revaluation reflects a deliberate government decision, and appreciation is an outcome of government actions.
 - D. Revaluation and appreciation have the same meaning and the same causes.
 - E. None of the above.

Answer: B

33. Under fixed exchange rate, which one of the following statements is the most accurate?
- A. Devaluation causes a decrease in output, a decrease in official reserves, and a contraction of the money supply.
 - B. Devaluation causes a rise in output, a rise in official reserves, and an expansion of the money supply.
 - C. Devaluation causes a rise in output and a rise in official reserves.
 - D. Devaluation causes a rise in output and an expansion of the money supply.
 - E. Devaluation causes a rise in official reserves and an expansion of the money supply.

Answer: B

34. Under fixed exchange rate, which one of the following statements is the most accurate?
- A. Devaluation causes a rise in output.
 - B. Devaluation causes a decrease in output.
 - C. Devaluation has no effect on output.
 - D. Devaluation causes a rise in output and a decrease in official reserves.
 - E. Devaluation causes a decrease in output and in official reserves.

Answer: A

35. Under fixed exchange rate, which one of the following statements is the most accurate?
- A. Devaluation causes a reduction of the money supply.
 - B. Devaluation has no effect on the stock of money.
 - C. Devaluation causes an expansion of the money supply.
 - D. Devaluation causes a reduction in output.
 - E. Devaluation causes a reduction in official reserves.

Answer: C

36. The main reason(s) why governments sometimes chose to devalue their currencies is (are):
- A. devaluation allows the government to fight domestic unemployment despite the lack of effective monetary policy.
 - B. devaluation improves in the current account.
 - C. devaluation increases foreign reserves held by the central bank.
 - D. All of the above.
 - E. None of the above.

Answer: D

37. During the Great Depression of the 1930s,
- A. the nominal interest rate hit zero in the United States.
 - B. the real interest rate hit zero in the United States.
 - C. the nominal interest rate hit 2 percent in the United States.
 - D. the real interest rate hit 2 percent in the United States.
 - E. the nominal interest rate hit one percent in the United States.

Answer: A

38. At negative nominal interest rates, which one of the following statements is the most accurate?
- A. People would find money strictly preferable to bonds.
 - B. People would find money strictly preferable to bonds and bonds therefore would be in excess supply.
 - C. People would find money strictly preferable to bonds and bonds therefore would be in excess demand.
 - D. People would find money strictly preferable to bonds and the bonds market would be in equilibrium.
 - E. None of the above statements is true.

Answer: B

39. Which one of the following statements is the most accurate?
- A. A government cannot escape from a liquidity trap by fixing its currency's exchange rate at a sufficiently depreciated level.
 - B. A government can escape from a liquidity trap by fixing its currency's exchange rate at a sufficiently appreciated level.
 - C. A government can escape from a liquidity trap by fixing its currency's exchange rate at a sufficiently depreciated level.
 - D. A government cannot escape from a liquidity trap by fixing its currency's exchange rate.
 - E. None of the above.

Answer: C

40. In November 2001, the Bank of Japan reported that
- A. the overnight interest rate was only -0.004 percent.
 - B. the overnight interest rate was only 1.004 percent.
 - C. the overnight interest rate was only 2.004 percent.
 - D. the overnight interest rate was only 3.004 percent.
 - E. the overnight interest rate was only 0.004 percent.

Answer: E

41. Which one of the following statements is the most accurate?
- A. Two assets are perfect substitutes when investors don't care how their portfolios are divided between them.
 - B. Two assets are perfect complements when investors don't care how their portfolios are divided between them provided both yield the same expected rate of return.
 - C. Two assets cannot be perfect substitutes even when investors don't care how their portfolios are divided between them provided both yield the same expected rate of return.
 - D. Two assets are perfect substitutes when investors do care how their portfolios are divided between them provided both yield the same expected rate of return.
 - E. None of the above statements is true.

Answer: A

Essay Questions

1. Why Study Fixed Exchange Rates?

Answer: Four main reasons:

- **Managed Floating** – Present monetary system is hybrid of pure fixed and floating rate systems; fixed exchange rates give insight to effects of foreign exchange intervention under floating rates.
- **Regional Currency Arrangements** – Exchange rate unions exist where member nations fix mutual exchange rates.
- **Developing Countries and Countries in Transition** – Nearly half the world engages in currency pegging.
- **Lessons of Past** – Fixed exchange rates were the norm in many historical periods; many economists propose resurrection of some fixed rate system.

2. How A Central Bank Fixes the Exchange Rate?

Answer:

The Central bank must always be willing to trade currencies at the fixed exchange rate with the private actors in the foreign exchange market to hold exchange rate constant.

Assume central bank fixes exchange rate at E^0 .

Foreign exchange market is in equilibrium when interest parity condition holds – when R , the domestic interest rate, equals R^* , the foreign interest rate, plus $(E^e - E)/E$, the expected rate of depreciation of the domestic currency against foreign currency.

E^0 is today's equilibrium exchange rate only if:

$$R = R^*$$

To hold the domestic interest at R^* , the central bank's foreign exchange intervention must adjust the money supply so that R^* equates aggregate real domestic money demand and the real money supply:

$$MS/P = L(R^*, Y)$$

When central bank intervenes to hold exchange rate fixed, it must automatically adjust the domestic money supply so that money market equilibrium is maintained with $R = R^*$.

3. Suppose E is fixed at E^0 and that the asset markets are in equilibrium. Suddenly output rises. What monetary measures keep the current exchange rate constant given unchanged expectations about the future rate?

Answer:

- Since output rises, demand for domestic money rises; this increase in money demand normally pushes the domestic interest rate upwards. To prevent appreciation of home currency (given E^0 is expected) the central bank buys foreign assets in foreign exchange market.
- This eliminates excess demand for domestic money because the central bank issues money to pay for the foreign assets it buys.
- The bank increases the money supply in this way until asset markets clear with $E = E^0$ and $R = R^*$.

4. What is the policy of sterilization? Give an example.

Answer:

- **Sterilized foreign exchange intervention** – policy by which central banks carry out equal foreign and domestic asset transactions in opposite directions to nullify the impact of foreign exchange operations on domestic money supply.
- Example: Bank of Pecunia sells \$100 in foreign assets, receives \$100 check from PecuniaCorp. Central foreign assets and liabilities decline simultaneously by \$100; fall in money supply.
- To negate effect on money supply, central bank buys \$100 of domestic assets. This increases its domestic assets and its liabilities by \$100, offsetting the money supply effect of sale of foreign assets.

5. Explain the phenomenon of capital flight.

Answer:

The reserve loss accompanying a devaluation scare is often labeled capital flight because the associated debt in the balance of payments accounts is a private capital outflow. Capital flight may force the central bank to devalue sooner and by a larger amount than planned because the central bank's reserves are low to begin with.

6. Explain how the timing of a balance of payment crisis is determined. Be careful to state all assumptions.

Answer: The assumptions of the model are:

- Prices are flexible.
- Output is at full employment levels.
- The central bank will allow domestic credits to expand forever.
- The exchange rate is currently at E^0 but will be allowed to float if foreign reserves ever fall to zero.
- Bank will defend E^0 by continuing to sell its reserves until they run out.
- Speculators, in an effort to float the exchange rate, will attempt to buy all the bank's reserves.

Now, according to Equation 17 AII-3 ($DF^* = (1/m)D[PL(R,Y)] - DA$).

As A_- , F^* , this is true because Y is fixed and with a fixed exchange rate, E , $R = R^*$. So eventually the central bank will run out of reserves and E will float. The lower panel of the graph shows how reserves behave over time when domestic credits, A , are growing.

At point T , as a result of the speculative attack, the rest of the reserves fall.

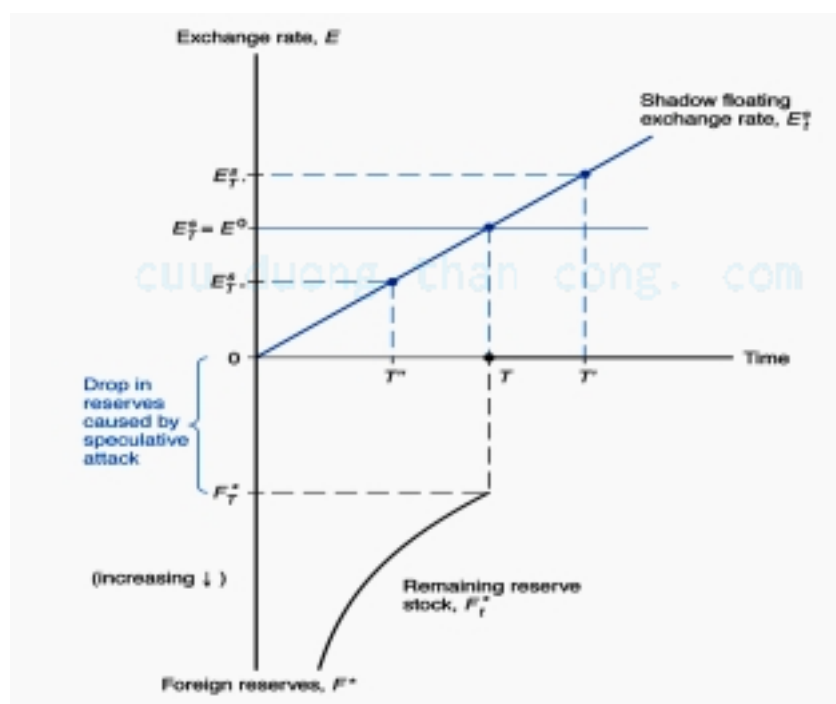
Reserves have to fall to zero at point T to keep asset markets in equilibrium

An attack can't occur at T'' because if reserves fell to zero the exchange rate would fall to $E_{T''}^s$ and everyone would then try to sell their reserves just before T'' because of the imminent appreciation of the home currency that will occur.

No speculator would want to buy the reserves at a price of E^0 because they know they are soon going to fall.

The exact date on which a Balance of Payments crisis will occur and force a country to float its exchange rates has thus been pinpointed as only being able to occur at T .

Likewise, an attack can't occur at T' because the opposite would happen.



7. Explain why in practice the extent to which a measured balance of payments disparity, either a surplus or a deficit, will affect home and foreign money supplies is quite uncertain?

Answer: A few reasons for that to be true: First, it is not clear how much financing of the payment gap is done through home official intervention and how much through foreign. This division depends on various factors, such as the economic goals of the central banks and institutional arrangements governing intervention. Second, central banks may be sterilizing to counter the monetary effects of reserve changes. Third, some central bank transactions indirectly help to finance a foreign country's balance of payments deficit, but they do not show up in the latter's published balance of payments figures (see also Chapter 12, for the third argument).

8. If the central bank does not purchase foreign assets when output increases but instead holds the money stock constant, can it still keep the exchange rate fixed at E^0 ?

Answer: No. This is because the domestic interest rate would begin to rise above R^* . Traders in the foreign exchange market would begin to bid up the price of domestic currency in terms of foreign currency. In the absence of central bank intervention, the exchange rate thus would fall below E^0 . In order to prevent this appreciation, the central bank must sell domestic currency and buy foreign assets, thereby increasing the money supply and preventing any excess money demand from pushing the home interest rate above R^* .

9. Explain why under fixed exchange rate, monetary policy is ineffective whereas under floating exchange rate it is effective in rising output.

Answer: Under floating, by purchasing domestic assets the central bank causes an initial excess supply of domestic money that simultaneously pushed the domestic interest rate downward and weakens the currency. However, under fixed exchange rate the central bank will resist any tendency of the currency to depreciate by selling foreign assets for domestic money and so removing the initial excess supply of money its policy move has caused.

10. Analyze the effects of devaluation on an economy.

Answer: Devaluation causes a rise in output, a rise in official reserves, and an expansion of the money supply. A private capital inflow matches the central bank's reserve gain (an official outflow) in the balance of payments accounts.

11. What are the three main reasons why governments sometimes chose to devalue their currencies?

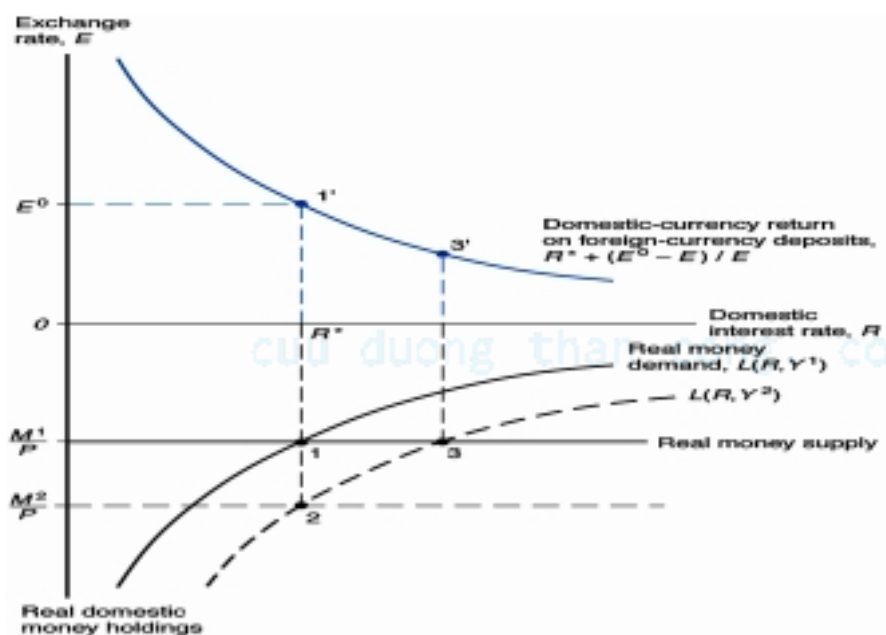
Answer:

1. Allow the government to fight domestic unemployment despite the lack of effective monetary policy.
2. Improve the current account.
3. Increase foreign reserves held by the central bank.

Quantitative/Graphing Problems

- Using a figure show the simultaneous equilibrium of the foreign exchange and domestic money markets when the exchange rate is fixed at E^0 and is expected to remain fixed at E^0 in the future. Assume both P and Y are constants. Now, study the effect of an increase in income, Y .

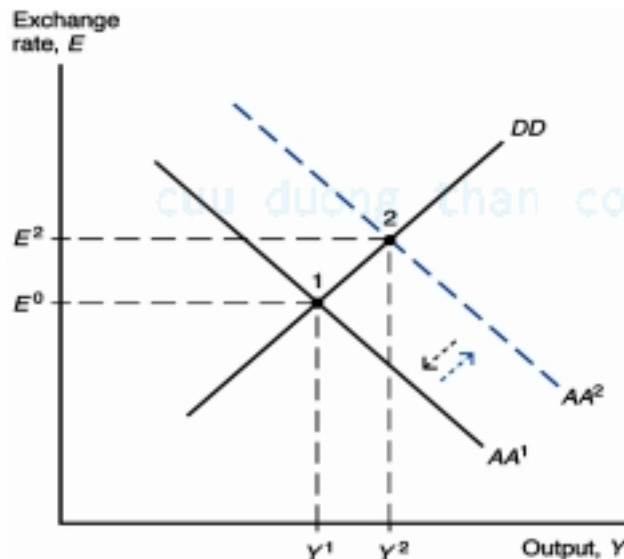
Answer: See figure, the $L(R^*, Y)$ will shift down and to the right, which will necessitate an increase in M to M^2 . This will require the domestic central bank to purchase foreign assets and thereby increase the money supply, leaving E at E^0 . Note that $R = R^*$ at the new equilibrium as before.



2. Use the fixed exchange rate DD – AA model to describe the economy's short-run equilibrium. Then, use the same figure to study an expansionary monetary policy. Show that the policy is ineffective.

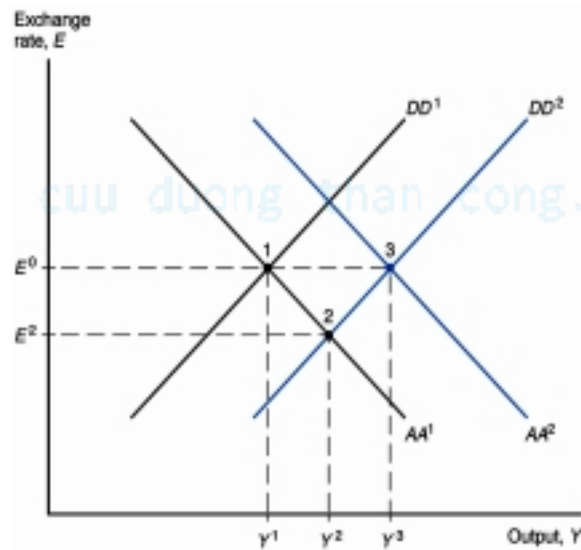
Answer: The fixed exchange rate DD – AA model requires the assumption that $E = E^0$. This shows that the economy's short-run equilibrium is at point 1 when the central bank fixes the exchange rate at the level C . Output equals Y^1 at point 1 and the money supply is at the level where a domestic interest rate equal to the foreign rate (R^*) clears the domestic market.

To Increase Output: Hoping to increase output to Y^2 , the central bank increases the money supply through the purchase of domestic assets and shifting AA^1 to AA^2 . Because the exchange rate is fixed, the central bank must maintain E^0 , it has to sell foreign assets for domestic currency, thereby decreasing the money supply immediately and returning AA^2 back to AA^1 . Output is unchanged as the initial equilibrium is maintained.



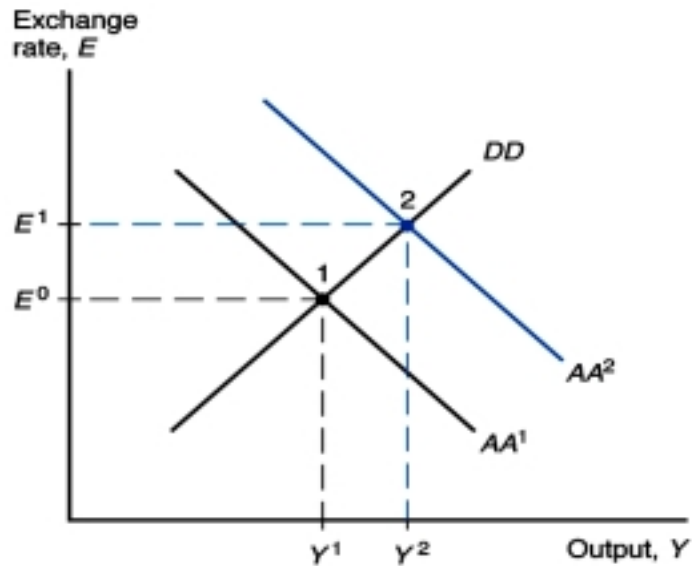
3. Under fixed exchange rate, show using a figure, the effects of an expansionary fiscal policy. Show the equilibrium under a flexible exchange rate. Discuss the difference in the two regimes.

Answer: An expansionary fiscal policy shifts the DD curve to the right. Under flexible exchange rate, point 2 in the figure is the equilibrium, e decreases (appreciates) and Y goes up. The picture is more complicated under fixed exchange rate, however, since E cannot change. Output is going up as a result of the fiscal expansion, and thus the demand for domestic money increases. To prevent the increased money demand from increase domestic interest rate above R^* , and with the appreciation of the currency, the central bank must buy foreign assets with domestic money and thereby increase the money supply. The AA shifts to the right until E is restored to the initial fixed exchange rate, E^0 , at point 3 in the figure. So under fixed exchanger rate, Y will increase by more than under a flexible exchange rate regime. Unlike monetary policy, fiscal policy can be used to affect output under a fixed exchange rate. A central bank is forced to expand the money supply through foreign exchange purchases.



4. Using a figure, show how devaluation affects an economy.

Answer: When a currency is devalued from E^0 to E^1 , the equilibrium shifts from point 1 to 2. Both output and money supply increase.



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5. Assume an economy is in a liquidity trap.

A. Write an equation expressing interest rate parity under a fixed exchange rate regime.

Answer: Liquidity trap implies $R = 0$. $R = 0 = R^* + (E^e - E)/E$.

B. Assume E^e is fixed. Suppose that the central bank raises the domestic money supply so as to depreciate the currency temporarily (that is, to raise E currently but return the rate to E^e later). Show that E cannot be raised.

Answer: Since $R = 0$, the equation in part A, the interest parity condition, implies: $E = E^e / (1 - R^*)$. Since E^e and R^* are fixed, E cannot change.

6. Write an expression for interest rate parity under the condition of imperfect asset substitutability.

Answer: $R = R^* + (E^e - E)/E + a$, where, a denotes the risk premium that reflects the difference between the risk of domestic and foreign bonds.

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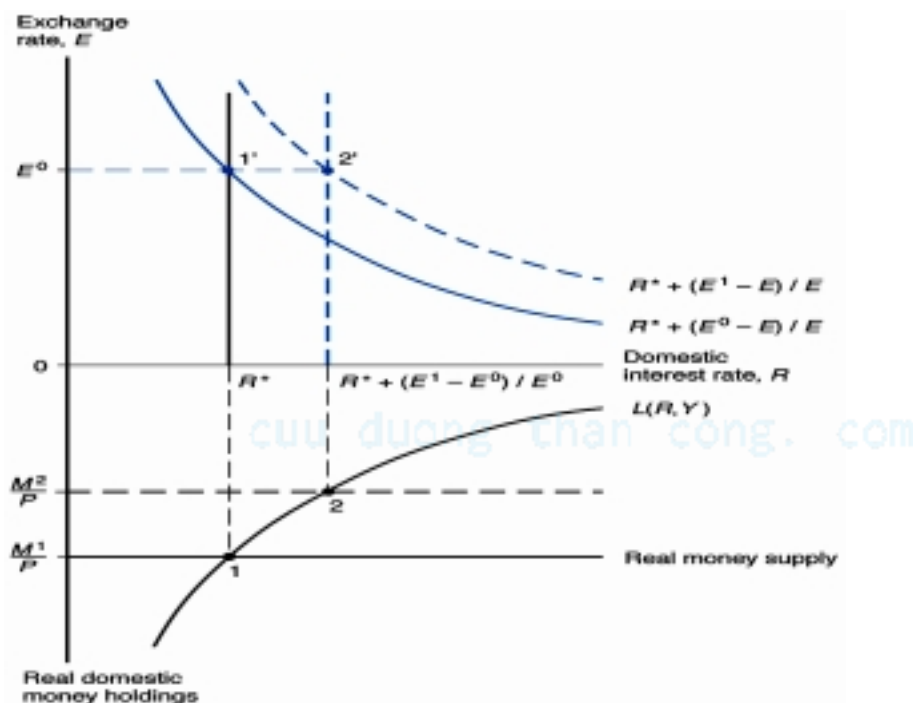
7. Use a figure to study the effects of a change in market belief with regard to the fixed exchange rate, in particular assume market participants expect the government to devalue.

Answer: This figure below shows the asset markets equilibrium at points 1 (the money market) and 1' (the foreign exchange market) with the exchange rate fixed at E^0 and expected to remain there indefinitely. M^1 is the money supply consistent with this initial equilibrium.

Deterioration in the current account to devalue in the future and adopt a new fixed exchange rate, E^1 , that is higher than the current rate, E^0 .

THE UPPER PART: a change in expectations as a rightward shift in the curve that measures the expected domestic currency return on foreign currency deposits. To hold the exchange rate fixed at E^0 after the market decides, it will be devalued to E^1 , the central bank must use its reserves to finance a private capital outflow that shrinks the money supply and raises the home interest rate. The expectation of a future devaluation causes a balance of payments crisis marked by a sharp fall in reserves and a rise in the home interest rate above the world interest rate. Similarly, an expected revaluation causes an abrupt rise in foreign reserves together with a fall in the home interest rate below the world rate.

The reserve loss accompanying a devaluation scare is often labeled capital flight because the associated debt in the balance of payments accounts is a private capital outflow. Capital flight may force the central bank to devalue sooner and by a larger amount than planned because the central bank's reserves are low to begin with.



Chapter 18: The International Monetary System, 1870 – 1973

Multiple Choice Questions

1. Under the price-specie-flow mechanism, what happens when Germany's current account surplus is greater than its non-reserve capital account deficits?
- A. German loans will finance all foreign net imports.
 - B. There will be an automatic drop in German domestic prices and a rise in foreign prices.
 - C. Gold reserves will flow into Germany.
 - D. Gold reserves will flow out of Germany.
 - E. None of the above.

Answer: C

2. The “rules of the game” under the gold standard can best be described as which of the following?
- A. Selling domestic assets in a deficit and buying assets in a surplus
 - B. Slowing down the automatic adjustments processes inherent in the gold standard
 - C. Selling domestic assets in order to accumulate gold
 - D. Selling foreign assets in a deficit and buying foreign assets in a surplus
 - E. None of the above.

Answer: A

3. 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 toward 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

4. By internal balance, most economists mean
- A. only full employment.
 - B. only price stability.
 - C. full employment and price stability.
 - D. full employment and moderate increase in prices.
 - E. None of the above.

Answer: C

5. By external balance, most economists mean
- A. avoiding excessive imbalances in international payments.
 - B. a balance between exports and imports.
 - C. a balance between trade account and service account.
 - D. a fixed exchange rate.
 - E. None of the above.

Answer: A

6. Which one of the following statements is true?
- A. Inflation but not deflation can occur even under conditions of full employment.
 - B. Deflation but not inflation can occur even under conditions of full employment.
 - C. Inflation or deflation can occur even under conditions of full employment.
 - D. Inflation can occur even under conditions of full employment only in the long run
 - E. None of the above.

Answer: C

7. Which one of the following statements is true?
- A. Inflation can occur even under conditions of full employment only if the central bank continues to inject money into the economy.
 - B. Inflation can occur even under conditions of full employment only if the central bank continues to withdraw money from the economy.
 - C. Deflation can occur even under conditions of full employment only if the central bank continues to inject money into the economy.
 - D. Inflation cannot occur even under conditions of full employment if the central bank continues to inject money into the economy.
 - E. None of the above.

Answer: A

8. A sudden increase in the U.S. price level
- A. makes those with dollar debts worse off.
 - B. makes those with dollar debts better off.
 - C. does not affect those with dollar debts.
 - D. makes those with DM debt better off.
 - E. None of the above.

Answer: B

9. A sudden increase in the U.S. price level

- A. makes creditors in dollars better off.
- B. makes creditors in dollars worse off.
- C. does not affect creditors in dollars.
- D. makes creditors in DM worse off.
- E. None of the above.

Answer: B

10. A sudden decrease in the U.S. price level
- A. makes those with dollar debts worse off.
 - B. makes those with dollar debts better off.
 - C. does not affect those with dollar debts.
 - D. makes those with DM worse off.
 - E. None of the above.

Answer: A

11. A sudden decrease in the U.S. price level
- A. makes creditors in dollars better off.
 - B. makes creditors in dollars worse off.
 - C. do not affect creditors in dollars.
 - D. makes creditors in DM better off.
 - E. None of the above.

Answer: A

12. The costs of inflation have been most apparent in the post-war period in countries such as
- A. Argentina.
 - B. Belgium.
 - C. The United States.
 - D. Canada.
 - E. Japan.

Answer: A

13. The costs of inflation have been most apparent in the post-war period in countries such as
- A. Brazil.
 - B. Belgium.
 - C. The United States.
 - D. Canada.
 - E. Japan.

Answer: A

14. The costs of inflation have been most apparent in the post-war period in countries such as
- A. Russia.
 - B. Belgium.
 - C. The United States.
 - D. Canada.
 - E. Japan.

Answer: A

15. External balance means
- A. balance in the country's current account.
 - B. balance in the country's service account.
 - C. balance in the country's capital account.
 - D. balance in the country's trade account.
 - E. None of the above.

Answer: E

16. A current account surplus
- A. poses a problem if domestic savings are being invested more profitably abroad than they would be at home.
 - B. may pose no problem if domestic savings are being invested more profitably abroad than they would be at home.
 - C. may pose no problem if domestic savings are being invested less profitably abroad than they would be at home.
 - D. there is no relation between current account surplus and between savings and investment.
 - E. None of the above.

Answer: B

17. A current account deficit
- A. poses a problem if domestic savings are being invested more profitably abroad than they would be at home.
 - B. may pose a problem if domestic savings are being invested more profitably abroad than they would be at home.
 - C. may pose no problem if domestic savings are being invested less profitably abroad than they would be at home.
 - D. There is no relation between the current account surplus and between savings and investment.
 - E. None of the above.

Answer: B

18. Which one of the following statements is true?

- A. Countries with strong investment opportunities should invest little at home and channel their savings into more productive investment activity abroad.
- B. Countries with weak investment opportunities should invest little at home and channel their savings into more productive investment activity abroad.
- C. Countries with weak investment opportunities should invest more at home.
- D. Countries with weak investment opportunities should invest little abroad.
- E. None of the above.

Answer: B

19. Countries with
- A. strong investment opportunities should invest little at home and channel their savings into more productive investment activity abroad.
 - B. strong investment opportunities should invest more at home and less abroad.
 - C. weak investment opportunities should invest more at home.
 - D. weak investment opportunities should invest little abroad.
 - E. None of the above.

Answer: B

20. Countries where investment is relatively
- A. productive should be net exporters of currently available output.
 - B. unproductive should be net importers of currently available output.
 - C. unproductive should be net exporters of currently available output.
 - D. unproductive should be net exporters of future available output.
 - E. None of the above.

Answer: C

21. Countries where investment is relatively
- A. productive should have current account deficits.
 - B. productive should have current account surpluses.
 - C. unproductive should have current account surpluses.
 - D. productive should balanced current account surpluses.
 - E. None of the above.

Answer: B

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22. Which one of the following statements is true?

- A. Countries where investment is relatively productive should be net importers of current output.
- B. Countries where investment is relatively unproductive should be net importers of current output.
- C. Countries where investment is relatively productive should be net exporters of current output.
- D. Countries where investment is relatively productive should not export or import current output.
- E. None of the above.

Answer: A

23. Countries where investment is
- A. relatively unproductive should have current account deficits.
 - B. relatively productive should have current account surpluses.
 - C. relatively productive should have current account deficits.
 - D. relatively productive should have balanced current accounts.
 - E. None of the above.

Answer: C

24. Governments prefer to avoid excessive current account surpluses because
- A. the returns to domestic savings may be easier to tax than those on assets abroad.
 - B. an addition to the home capital stock may reduce domestic unemployment and therefore lead to higher national income.
 - C. domestic investment by one firm may have beneficial technological spillover effects on other domestic producers that the investing firm does not capture.
 - D. All of the above.
 - E. None of the above.

Answer: D

25. Under the gold standard era of 1870 – 1914,
- A. Tokyo was the center of the international monetary system.
 - B. Paris was the center of the international monetary system.
 - C. Berlin the center of the international monetary system.
 - D. New York was the center of the international monetary system.
 - E. London was the center of the international monetary system.

Answer: E

26. Under the gold standard era of 1870 – 1914,

- A. central banks tried to have sharp fluctuations in the balance of payments.
- B. central banks tried to avoid sharp fluctuations in the current account of the balance of payments.
- C. central banks tried to avoid sharp fluctuations in the trade account of the balance of payments.
- D. central banks tried to avoid sharp fluctuations in the capital account of the balance of payments.
- E. central banks tried to avoid sharp fluctuations in the balance of payments.

Answer: E

27. A country is said to be in balance of payments equilibrium when the sum of its current and its
- A. non-reserved capital accounts equals zero.
 - B. reserved capital accounts equals zero.
 - C. non-reserved capital accounts equals to the surplus in the capital account.
 - D. non-reserved capital accounts equals to the deficit in the capital account.
 - E. None of the above.

Answer: A

28. Under the gold standard, a country is said to be in balance of payments equilibrium when the current account balance is
- A. financed entirely by international lending without reserve movements.
 - B. financed by international lending and with reserve movements.
 - C. equal to zero.
 - D. financed entirely by international lending and past gold reserves.
 - E. None of the above.

Answer: A

29. Mercantilism held that
- A. silver alone was the mainstay of national wealth.
 - B. gold alone was the mainstay of national wealth.
 - C. silver and gold were the mainstays of national wealth.
 - D. silver and gold are not important for the national wealth of a country.
 - E. None of the above.

Answer: C

30. The main policy goal for a country, according to the mercantilists, is

- A. to create a one-time deficit in the balance of payments.
- B. to create a continuing deficit in the balance of payments.
- C. to create a one-time surplus in the balance of payments.
- D. to create a continuing surplus in the balance of payments.
- E. None of the above.

Answer: D

31. The view of mercantilists can be summarized as follows:
- A. to sell less to strangers yearly than we consume of theirs in value.
 - B. to sell more to strangers yearly than we consume of theirs in value.
 - C. to consume more of theirs in value than we sell to strangers.
 - D. to consume the same amount as theirs in value as we sell to strangers.
 - E. None of the above.

Answer: B

32. Under the gold standard,
- A. a perpetual surplus is possible.
 - B. a perpetual deficit is possible.
 - C. a perpetual surplus is impossible, but a perpetual deficit is possible.
 - D. a perpetual deficit is impossible, but a perpetual surplus is possible.
 - E. a perpetual surplus is impossible.

Answer: E

33. Under the gold standard,
- A. a shortage of currency leads to low domestic prices and a foreign payments surplus.
 - B. a shortage of currency leads to high domestic prices and a foreign payments surplus.
 - C. a shortage of currency leads to low domestic prices and a foreign payments deficit.
 - D. a shortage of currency leads to low domestic prices but leaves the foreign balance of payments at equilibrium
 - E. None of the above.

Answer: A

34. Until the United States Civil War, The United States had a

- A. gold-based monetary standard.
- B. silver-based monetary standard.
- C. bimetallic monetary standard consisting of silver and gold.
- D. bimetallic monetary standard consisting of copper and silver.
- E. bimetallic monetary standard consisting of copper and gold.

Answer: C

35. Once the United States Civil War broke out, the United States moved to a
- A. gold standard.
 - B. silver standard.
 - C. bimetallic monetary standard consisting of silver and gold.
 - D. bimetallic monetary standard consisting of copper and gold.
 - E. paper currency, called the “greenback.”

Answer: E

36. L. Frank Baum’s classic 1900 children’s book, *The Wonderful Wizard of Oz*, is
- A. an allegorical rendition of the U.S. political struggle over silver.
 - B. an allegorical rendition of the U.S. political struggle over copper.
 - C. an allegorical rendition of the U.S. political struggle over both silver and gold.
 - D. None of the statements is true.
 - E. an allegorical rendition of the U.S. political struggle over gold.

Answer: E

37. In L. Frank Baum’s classic 1900 children’s book, *The Wonderful Wizard of Oz*, the name “Oz” is a reference to
- A. an ounce (oz.) of gold.
 - B. an ounce (oz.) of silver.
 - C. an ounce (oz.) of copper.
 - D. an ounce (oz.) of either gold or silver.
 - E. None of the above.

Answer: A

38. A policy of “beggar-thy-neighbor” is a policy that
- A. often benefits the home country in the long run.
 - B. often benefits the foreign country in the long run.
 - C. often benefits the foreign country in the short run.
 - D. does not often benefit any country in the long run.
 - E. None of the above.

Answer: D

39. The Great Depression that started in 1929 was

- A. confined only to the United States.
- B. confined only to the United States and Britain.
- C. confined only to the United States and Europe.
- D. a global phenomenon.
- E. None of the above.

Answer: D

40. Which one of the following statements is the most accurate? By the year 1932, the United States
- A. and Canada alone held more than 70 percent of the world's monetary gold.
 - B. and Germany alone held more than 70 percent of the world's monetary gold.
 - C. and Britain alone held more than 70 percent of the world's monetary gold.
 - D. Britain, and France alone held more than 70 percent of the world's monetary gold.
 - E. and France alone held more than 70 percent of the world's monetary gold.

Answer: E

41. Countries with the
- A. biggest deflations and output contractions are countries which were not on the gold standard until 1936.
 - B. biggest inflations and output contractions are countries which were on the gold standard until 1936.
 - C. lowest deflations and output contractions are countries which were on the gold standard until 1936.
 - D. biggest deflations and output increases are countries which were on the gold standard until 1936.
 - E. biggest deflations and output contractions are countries which stayed on the gold standard until 1936.

Answer: E

42. A convertible currency is a currency that may be freely exchanged for
- A. gold or silver.
 - B. only silver.
 - C. only copper.
 - D. national currency.
 - E. foreign currencies.

Answer: E

43. The IMF articles of 1944

- A. called for convertibility on current account transactions only.
- B. called for convertibility on capital account transactions only.
- C. called for convertibility on current and capital account transactions.
- D. did not call for convertibility on current account transactions.
- E. did not call for convertibility on current and capital account transactions.

Answer: A

44. The dollar of the United States became the postwar world's key currency because
- A. of the early convertibility of the U.S. dollar in 1945.
 - B. of the special position of the dollar under the Bretton Woods system.
 - C. of the strength of the American economy relative to the devastated economies of Europe and Japan.
 - D. Central banks naturally found it advantageous to hold their international reserves in the form of interest-bearing dollar assets..
 - E. All of the above.

Answer: E

45. The Marshall Plan was a program of
- A. dollar grants from the United States to European countries initiated in 1948.
 - B. dollar grants from the United States to European countries initiated in 1945.
 - C. British pound grants from the European countries to the United States initiated in 1948.
 - D. British pound grants from the European countries to the United States initiated in 1948.
 - E. dollar grants from the United States to Germany only initiated after World War II.

Answer: A

46. The current account surplus is
- A. an increasing function of disposable income and an increasing function of the real exchange rate.
 - B. a decreasing function of disposable income and a decreasing function of the real exchange rate.
 - C. a decreasing function of disposable income and an increasing function of the real exchange rate.
 - D. only a decreasing function of disposable income.
 - E. only an increasing function of the real exchange rate.

Answer: C

47. Under 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

48. Under fixed exchange rates, domestic asset transactions by the central bank
- A. can be used to alter the level of foreign reserves but not to affect the state of employment and output.
 - B. cannot be used to alter the level of foreign reserves or to affect the state of employment and output.
 - C. can be used to alter the level of foreign reserves and to affect the state of employment and output.
 - D. cannot be used.
 - E. None of the above.

Answer: A

49. The XX schedule shows how much
- A. fiscal expansion is needed to hold the current account surplus at X as the currency is devalued by a given amount.
 - B. monetary expansion is needed to hold the current account surplus at X as the currency is devalued by a given amount.
 - C. fiscal expansion is needed to hold the current account surplus at X as the currency is evaluated by a given amount.
 - D. fiscal and monetary expansions are needed to hold the current account surplus at X as the currency is devalued by a given amount.
 - E. None of the above.

Answer: A

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Essay Questions

1. How did the international monetary system influence macroeconomic policy-making and performance during the gold standard era (1870 – 1914)?

Answer: London was the center of the international monetary system. The primary responsibility of the central bank was to preserve the official parity between its currency and gold. To maintain this price, the central bank needed an adequate stock of gold reserves. Central banks tried to avoid sharp fluctuations in the balance of payments. Further details are in pages 537 – 543.

2. How did the international monetary system influence macroeconomic policy-making and performance during the interwar period (1918 – 1939)?

Answer: Governments effectively suspended the gold standard during World War I and financed part of their massive military expenditures by printing money. Further, labor forces and productivity capacity had been reduced sharply through war losses. As a result, price levels were higher everywhere at the conclusion of the war in 1918. Of special note is the German hyperinflation that occurred when prices in Germany increased by a factor of 481.5 billion!

The United States returned to gold in 1919. In 1922, at a conference in Genoa, Italy, a group of countries including Britain, France, Italy and Japan agreed on a program of a partial gold exchange standard in which smaller countries could hold as reserves the currencies of several large countries whose own international reserves would consist entirely of gold.

In 1925, Britain returned to the gold standard by pegging the pound to gold at the prewar price. Thus, the Bank of England was therefore forced to follow contractionary monetary policies that contributed to severe unemployment and to the decline of London as the leading financial center.

The world economy disintegrated into increasingly autarkic (self-sufficient) national units in the early 1930s.

See also pages 543 – 546.

3. How did the international monetary system influence macroeconomic policy-making and performance during the post-World War II years during which exchange rates were fixed under the Bretton Woods agreement (1946 – 1973)?

Answer: In July 1944, representatives of 44 countries met in Bretton Woods, New Hampshire, and drafted and signed the Articles of Agreement of the International Monetary Fund (IMF) and of the World Bank. The agreement established fixed exchange rates against the U.S. dollar and an unvarying dollar price of gold - \$35 an ounce.

The dollar of the United States became the postwar world's key currency because of a few factors:

1. The early convertibility of the U.S. dollar in 1945.
2. The special position of the dollar under the Bretton Woods system.
3. The strength of the American economy relative to the devastated economies of Europe and Japan.
4. Central banks naturally found it advantageous to hold their international reserves in the form of interest-bearing dollar assets.

The Marshall Plan, a program of dollar grants from the United States to European countries, was initiated in 1948.

Most countries in Europe did not restore convertibility until the end of 1958, with Japan following in 1964.

See also pages 546 – 561.

4. “The line distinguishing between external and internal goals can be fuzzy.” Discuss.

Answer: True. For example, employment target for export industries when export growth influences the ability of the economy to repay its foreign debts.

5. Why do governments prefer to avoid current account deficits that are too large?

Answer: A current account deficit may pose no problem if the borrowed funds are channeled into productive domestic investment projects that pay for themselves with the revenue they generate in the future. However, sometimes, large current account deficits represent temporarily high consumption resulting from misguided government policies or some other malfunctioning of the economy. Sometimes, the investment projects that draw on foreign funds may be badly planned, etc. In such cases, the government might wish to reduce the current account deficit immediately rather than face problems in repaying its foreign debt in the future.

6. Why do governments prefer to avoid excessive current account surpluses? Or, why are growing domestic claims to foreign wealth ever a problem?

Answer: For a given level of national saving, an increased current account surplus implies lower investment in domestic plant and equipment. A few reasons why: first, the returns to domestic savings may be easier to tax than those on assets abroad; second, an addition to the home capital stock may reduce domestic unemployment and therefore lead to higher national income; third, domestic investment by one firm may have beneficial technological spillover effects on other domestic producers that the investing firm does not capture. In addition, the

country may in the future find itself unable to collect the money it is owed. Furthermore, countries with large surpluses can become targets for discriminatory protectionist measures by trading partners with external deficits.

7. Refute the claim by mercantilists who claimed that without severe restrictions on international trade and payments, a country might find itself impoverished and without an adequate supply of circulating monetary gold as a result of balance of payments deficits.

Answer: The balance of payments would automatically regulate itself to ensure an adequate supply of money in every country.

8. Explain why under the gold standard a perpetual surplus or a perpetual deficit is impossible.

Answer: Since specie inflows drive up domestic prices and restore equilibrium in the balance of payments, any surplus eventually eliminates itself. A shortage of currency leads to low domestic prices and a foreign payments surplus, and any deficit eventually eliminates itself.

9. It is claimed that L. Frank Baum's classic 1900 children's book, *The Wonderful Wizard of Oz*, is an allegorical rendition of the U.S. political struggle over gold. Discuss.

Answer: True. In L. Frank Baum's classic 1900 children's book, *The Wonderful Wizard of Oz*, the name "oz" is a reference to an ounce (oz.) of gold, and the yellow brick road represents the false promise of gold. The story represents the struggle of farmers in the western United States who were heavily indebted.

10. Describe the effects of the Smoot-Hawley tariff imposed by the United States in 1930.

Answer: It had a damaging effect on employment abroad. The foreign response involved retaliatory trade restrictions and preferential trading arrangements among a group of countries. This is an example of a "beggar-thy-neighbor" policy, meaning a policy that benefits the home country only because it worsens economic conditions abroad.

11. What explains the nearly universal scope of the Great Depression?

Answer: The international gold standard played a central role in starting, deepening, and spreading the Great Depression.

12. What is a convertible currency?

Answer: A convertible currency is a currency that may be freely exchanged for foreign currencies.

13. Explain why the dollar of the United States became the postwar world's key currency.

Answer:

1. The early convertibility of the U.S. dollar in 1945.
2. The special position of the dollar under the Bretton Woods system.
3. The strength of the American economy relative to the devastated economies of Europe and Japan.
4. Central banks naturally found it advantageous to hold their international reserves in the form of interest-bearing dollar assets.

14. How did the international monetary system created at Bretton Woods in 1944 allow its members to reconcile their external commitments with their internal goals of full employment and price stability?

Answer: As the world economy evolved in the years after World War II, the meaning of “external balance” changed and conflicts between internal and external goals increasingly threatened the fixed exchange rate system. The United States, the issuer of the principal reserve currency, was a major concern, leading to proposals to reform the system.

15. “A monetary policy is not a policy tool under fixed exchange rates.” Discuss.

Answer: True. Under fixed exchange rates, domestic asset transactions by the central bank can be used to alter the level of foreign reserves but not to affect the state of employment and output.

16. What is an SDR?

Answer: An SDR is a Special Drawing Right at the IMF and holds a place as a world reserve currency (some countries, especially those that do not want to peg to the dollar for political reasons, peg to the SDR). An SDR's value is determined by a basket of currencies that make up a large portion of the world's GNP.

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Quantitative/Graphing Problems

1. Using an equation, explain why governments prefer to avoid excessive current account surpluses.

Answer: This follows from the national income identity, $S = CA + I$, which says that total domestic savings, S , is divided between foreign asset accumulation, CA , and domestic investment, I .

2. A. Assume that R denotes the domestic interest rate and R^* denotes the foreign interest rate. Under a fixed exchange rate, what is the relation between R and R^* ?

Answer: $R = R^*$.

- B. Assume E denotes the domestic currency price of the dollar for a country which is not the United States. If one wants to analyze only the short-run effects of a policy, what does one assume about the Home and Foreign price levels, P and P^* , respectively?

Answer: $P = P_0$ and $P^* = P^*_0$, where both P_0 and P^*_0 are constants.

- C. Assume that there is no ongoing balance of payment crisis. What does this assumption really assume?

Answer: That E^e , the expected exchange rate, is equal to the exchange rate today, E . In other words, $E = E^e$.

- D. Assume a fixed exchange rate system. What does this tell you about E ?

Answer: E is constant, i.e., $E = E_0$.

- E. Under the above assumptions, what are the conditions for internal balance?

Answer: Since P^* and E are fixed, the expected price is fixed; thus, no inflation is expected. Then, internal balance will require only full employment, aggregate demand equaling the full-employment level, Y^f .

- F. How would your answer to Part D above change if P^* is unstable due to foreign inflation?

Answer: In this case, full employment alone will not guarantee price stability under a fixed exchange rate.

G. Given the definitions above, how does one define the real exchange rate?

Answer: The real exchange rate is equal to EP^*/P .

H. Write the condition for internal balance.

Answer: $Y^f = C(Y^f - T) + I + G + CA(EP^*/P, Y^f - T)$

I. Define the variable not defined before in Part G.

Answer: C = consumption, I = Investment, $(Y^f - T)$ = disposable income, T = taxes.

J. Using the equation for internal balance derived above, and given our assumptions, analyze the effects of a fiscal expansion.

Answer: An increase in G or a reduction in T will increase aggregate demand and will cause output to rise in the short run.

K. What would happen if the government of that country, which is not the United States under Bretton Woods, decides to devalue its currency?

Answer: A rise in E makes domestic goods and services cheaper relative to those sold abroad, and thus increases demand for output.

L. What would happen if the government of that country, which is not the United States under Bretton Woods, decides to use monetary policy rather than fiscal policy?

Answer: A monetary policy is not a policy tool under fixed exchange rates. Under fixed exchange rates, domestic asset transactions by the central bank can be used to alter the level of foreign reserves but not to affect the state of employment and output.

M. Given all of the above, what is the relation between the exchange rate, E , and fiscal ease, i.e., an increase in G or a reduction in T ?

Answer: Negative relation.

N. Assume that the economy is at internal balance. What will happen if G goes up for a given level of E ?

Answer: Over-employment.

O. Assume that the economy is at internal balance. What will happen if G goes down for a given level of E ?

Answer: Underemployment.

3. Assume that the government has a target value, X , for the current account surplus.
- A. What is the goal of external balance?

Answer: The goal of external balance requires the government to manage fiscal policy and the exchange rate so that the following equation is satisfied: $CA(EP^*/P, Y - T) = X$.

- B. Assuming that we are dealing with only the short run, what are the values of P and P^* ?

Answer: $P = P_0$, $P^* = P^*_0$, both constants.

- C. Given fixed P and P^* , what would happen if E rises?

Answer: An increase in E makes domestic goods cheaper, thus improving the current account.

- D. Given P and P^* , what would happen if T decreases, i.e., an expansionary fiscal policy?

Answer: A fall in T raises output, Y . The resulting increase in output increases disposable income and thus leads to increased home spending on foreign goods, worsening the current account.

- E. Given P and P^* , what would happen if G increases, i.e., an expansionary fiscal policy?

Answer: Similar to the answer above. A rise in G causes CA to fall by increasing Y .

- F. Given all of the above, what is the relation between the exchange rate, E , and fiscal ease, i.e., an increase in G or a reduction in T ?

Answer: Positive relationship.

- G. Assume that the economy is in external balance. What will happen if the government maintains its current account at X , but devaluates the domestic currency?

Answer: The government raises E ; thus, either G should go up or T should go down to maintain the external balance.

- H. Assume that the economy is at external balance. What will happen if the government raises E ?

Answer: An increase in E raises net exports and thus leads to a surplus in the current account higher than the target level of X . This will represent a point above the XX schedule.

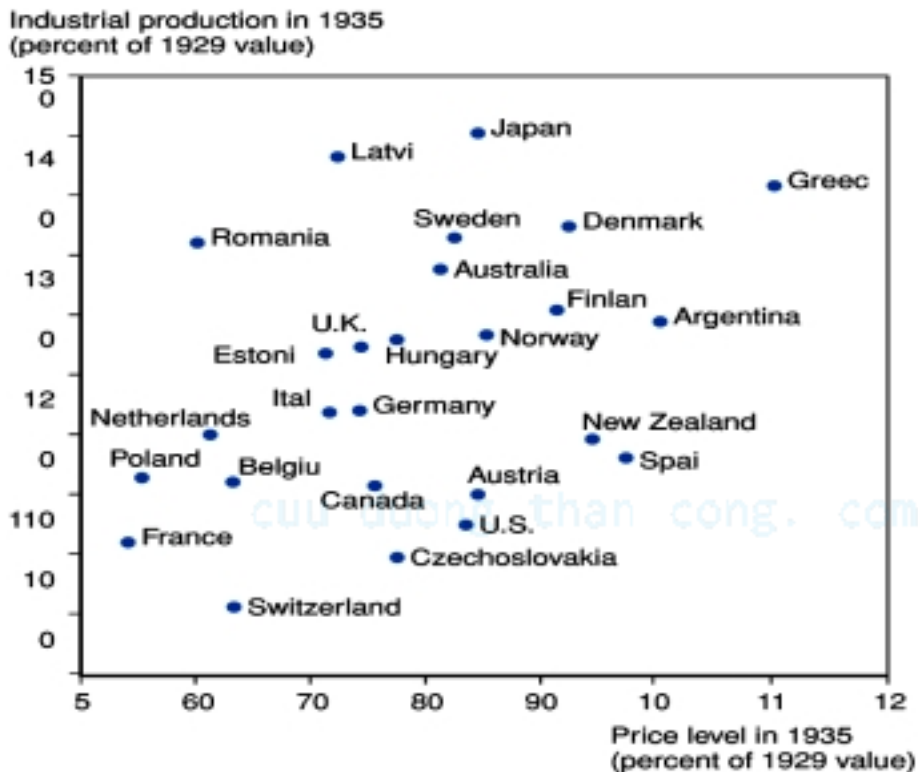
- I. Assume that the economy is at external balance. What will happen if the government lowers E ?

Answer: A decrease in E reduces net exports and thus leads to a deficit in the current account lower than the target level of X . This will represent a point below the XX schedule.

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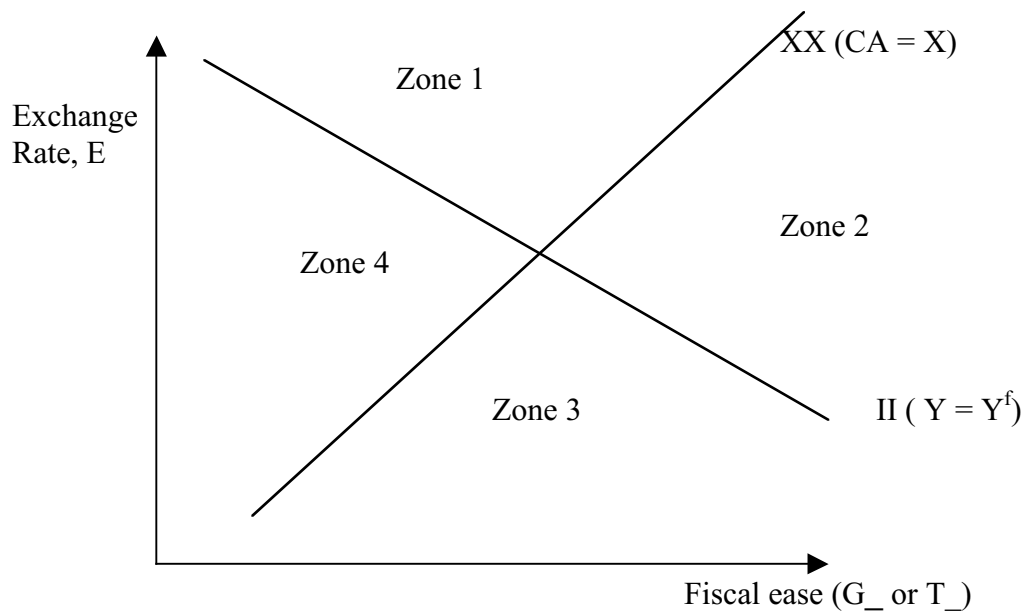
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4. The following table introduces the relationship between industrial production and wholesale price index changes between the years 1929 – 1935. What is the purpose of the following figure? Please note that the numbers should be starting from the origin with 50 and 50 and increase by ten units, each time. The numbers 10, 11, 12 etc. should read 100, 110, 120 etc. The numbers on the Y-axis best be ignored and just note that every dash represents a ten beginning from 50.



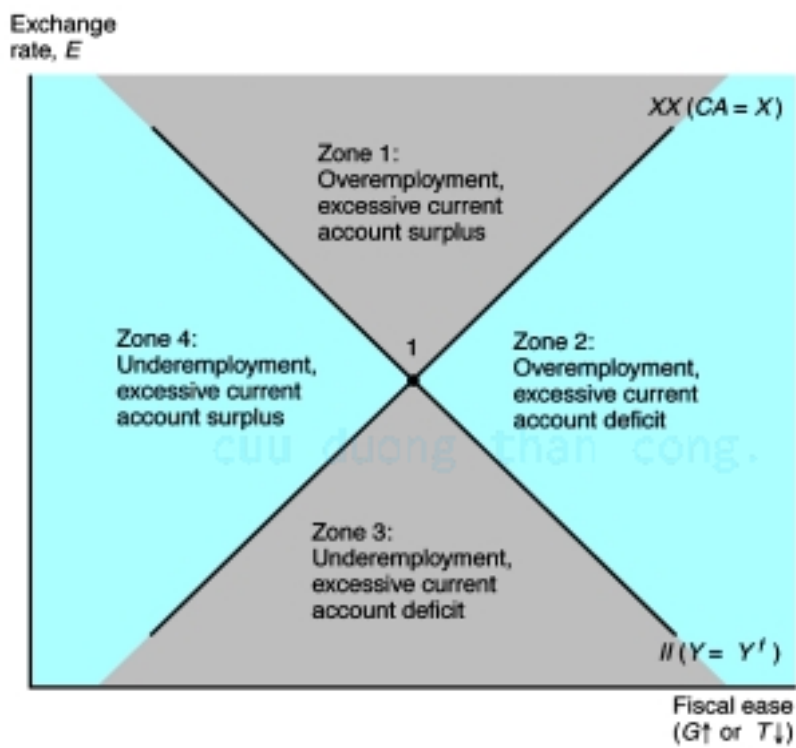
Answer: The purpose is to show that countries that left the gold standard early and adopted counter-deflationary monetary policies, such as Australia and the United Kingdom, experienced milder declines in output during the Great Depression. Countries such as France and Switzerland that stuck to the gold standard longer had greater decline in price level and output. A better figure is given on page 547 of the textbook.

5. Use the figure below to describe the four zones of economic discomfort.



Answer:

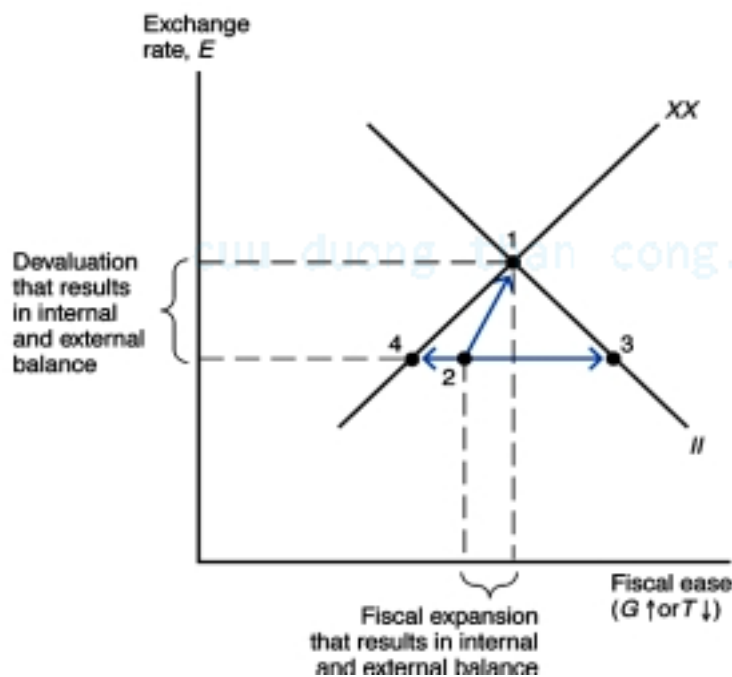
The answer is given in the following figure.



6. Using the II – XX framework, show using a figure that fiscal policies by themselves cannot bring the economy to both internal and external balances.

Answer:

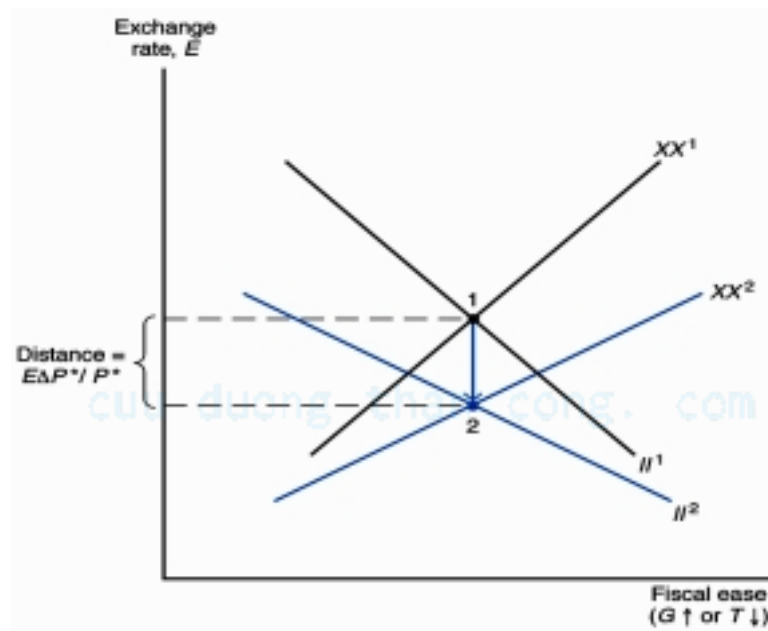
Starting at point 2, fiscal policy is shown as only horizontal movements. This means that the economy can reach either point 3 (internal balance) or point 4 (external balance) in the figure, but not both internal and external balances. Only a devaluation of the currency accompanied with an increase in fiscal ease, namely increasing government expenditures or decreasing taxes, will move the economy to both internal and external balances at point 1 in the figure.



7. Use the II – XX framework in order to show graphically how inflation can be imported from abroad unless exchange rates are adjusted.

Answer:

Suppose that the home economy is faced with foreign inflation, i.e., P^* is rising. For a given price level at home, i.e., P fixed, the increase in P^* will lower E , such that EP^*/P is unchanged. This implies that the II and XX curves will shift downward in such a way that the distance between the original E and the final E will be equal to $E \cdot P^*/P^*$, i.e., revaluation of the currency.



Chapter 19: Macroeconomic Policy and Coordination under Floating Exchange Rates

Multiple Choice Questions

1. Advocates of floating rate suggested it is favorable for economies for the following reasons EXCEPT that
- A. it discourages attack from foreign exchange speculators because of the fact that exchange rate adjustment is immediate.
 - B. it helps stabilize the shock effect on unemployment in case of economic changes such as fall in export demand.
 - C. it automatically matches the domestic inflation with ongoing foreign inflation.
 - D. it gives every country the opportunity to guide its own monetary conditions at home.
 - E. it brings the LR exchange rate to the level predicted by PPP without government policy decisions.

Answer: C

2. Which of the following is NOT a result of a *temporary* fall in foreign demand on one country's exports under *floating* exchange rate?
- A. The DD curve shifts to the left due to reduction of aggregate demand.
 - B. The AA curve shifts downwards due to reduction of money supply.
 - C. Aggregate output falls
 - D. The home country's currency depreciates.
 - E. None of the above.

Answer: B

3. Which of the following IS a result of a *permanent* fall in foreign demand on one country's exports under *floating* exchange rate?
- A. The DD curve shifts to the left due to reduction of aggregate demand.
 - B. The AA curve shifts upwards due to the increased expected long-run exchange rate.
 - C. Output is reduced by a smaller degree compared to temporary fall in demand.
 - D. The home country's currency depreciates.
 - E. ALL of the above.

Answer: E

4. Which of the following is/are INCORRECT (choose all that apply)? An argument against floating exchange rates is that
- A. a fixed rate automatically prevents instability in the domestic money market from affecting the economy if shocks come from the home domestic money market.
 - B. a fixed rate automatically prevents instability in the economy from output market shocks.
 - C. a rise in money demand under a fixed exchange rate would have no effect on the exchange rate and output.
 - D. a rise in money demand under a floating exchange rate would have no effect on the exchange rate and output.
 - E. All of the above.

Answer: B, D

5. The MAIN reason behind the claims that the "Greater Autonomy" resulting from floating rates is illusory is that
- A. there is no evidence backing the claim.
 - B. the exchange rate is an important macroeconomic variable and policy makers will still consider its effect on the exchange rate.
 - C. this claim is dependent on whom the government or policymakers are.
 - D. None of the above.
 - E. All of the above.

Answer: B

6. Why will the "discipline" imposed on governments by a fixed exchange rate disappear under a floating rate regime be a problem?
- A. Tempted to follow over expansionary fiscal policy
 - B. Tempted to follow over expansionary monetary policy
 - C. Economy may go into an inflation bias
 - D. May tempt governments to stimulate the economy to win an election
 - E. A and C only.

Answer: E

7. Many observers now think that the current exchange rate system is
- A. badly in need of reform.
 - B. in a need for some mild reform.
 - C. the right system.
 - D. adequate especially for developing countries.
 - E. None of the above.

Answer: A

8. Governments would be able to use monetary policy to reach
- A. internal balance.
 - B. external balance.
 - C. internal and external balance.
 - D. internal but not external balance.
 - E. external but not internal balance.

Answer: C

9. Advocates of flexible exchange rates claim that 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

10. Advocates of flexible exchange rates claim that under flexible exchange rates,
- A. The United States would now be able to set world monetary conditions all by itself.
 - B. Germany would no longer be able to set world monetary conditions all by itself.
 - C. The United Kingdom would no longer be able to set world monetary conditions all by itself.
 - D. The United States would no longer be able to set world monetary conditions all by itself.
 - E. Germany would now be able set world monetary conditions all by itself.

Answer: D

11. Advocates of flexible exchange rates claim that under flexible exchange rates,
- A. The United States would no longer have the same opportunity as other countries to influence its exchange rate against foreign currencies.
 - B. The United States would have the same opportunity as other countries to influence its exchange rate against foreign currencies.
 - C. The United Kingdom would not have the same opportunity as other countries to influence its exchange rate against foreign currencies.
 - D. Germany would not have the same opportunity as other countries to influence its exchange rate against foreign currencies.
 - E. None of the above.

Answer B

12. Some claim that the long and agonizing periods of speculation preceding exchange rate realignments would
- A. not occur under fixed-exchange-rate regime.
 - B. not occur under floating.
 - C. become more severe under currency board.
 - D. become less severe under floating.
 - E. None of the above.

Answer: D

13. Advocates of floating rates pointed out that
- A. removal of the obligation to peg currency values would restore monetary control to central banks.
 - B. imposing of the obligation to peg currency values would restore monetary control to central banks.
 - C. removal of the obligation to peg currency values would restore fiscal control.
 - D. imposing of the obligation to peg currency values would restore fiscal control.
 - E. None of the above.

Answer: A

14. Advocates of flexible exchange rates claim that under flexible exchange rates, if the central bank faced unemployment
- A. and thus wished to decrease its money supply, there would no longer be any legal barrier to the currency depreciation this would cause.
 - B. and thus wished to expand its money supply, there would no longer be any legal barrier to the currency depreciation this would cause.
 - C. and wished to expand its money supply, there would no longer be any legal barrier to the currency appreciation this would cause.
 - D. and wished to decrease its money supply, there now would be legal barriers to the currency depreciation this would cause.
 - E. None of the above.

Answer B

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15. Advocates of flexible exchange rates claim that under flexible exchange rates, a currency
- A. appreciation caused by increasing the money supply would reduce unemployment by lowering the relative price of domestic products.
 - B. depreciation caused by increasing the money supply would increase unemployment by lowering the relative price of domestic products.
 - C. depreciation caused by increasing the money supply would reduce unemployment by lowering the relative price of domestic products.
 - D. depreciation caused by increasing the money supply would reduce unemployment by increasing the relative price of domestic products.
 - E. None of the above.

Answer C

16. Advocates of flexible exchange rates claim that under flexible exchange rates, a currency
- A. depreciation caused by increasing the money supply would reduce unemployment by increasing world demand for them.
 - B. appreciation caused by increasing the money supply would reduce unemployment by increasing world demand for them.
 - C. appreciation caused by decreasing the money supply would reduce unemployment by increasing world demand for them.
 - D. appreciation caused by increasing the money supply would increase unemployment by increasing world demand for them.
 - E. appreciation caused by increasing the money supply would increase unemployment by decreasing world demand for them.

Answer A

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17. Advocates of flexible exchange rates claim that under flexible exchange rates, a currency
- A. depreciation caused by increasing the money supply would reduce unemployment by lowering the relative price of domestic products and increasing the world demand for them.
 - B. appreciation caused by increasing the money supply would reduce unemployment by lowering the relative price of domestic products and increasing world demand for them.
 - C. appreciation caused by decreasing the money supply would reduce unemployment by lowering the relative price of domestic products and increasing world demand for them.
 - D. appreciation caused by increasing the money supply would increase unemployment by lowering the relative price of domestic products and increasing world demand for them.
 - E. appreciation caused by increasing the money supply would increase unemployment by lowering the relative price of domestic products and by decreasing world demand for them.

Answer A

18. Advocates of flexible exchange rates claim that under flexible exchange rates, a currency
- A. depreciation caused by increasing the money supply would reduce unemployment by lowering the relative price of domestic products and increasing the world demand for them.
 - B. appreciation caused by increasing the money supply would reduce unemployment by lowering the relative price of domestic products and decreasing world demand for them.
 - C. appreciation caused by decreasing the money supply would reduce unemployment by lowering the relative price of domestic products and decreasing world demand for them.
 - D. appreciation caused by increasing the money supply would increase unemployment by increasing the relative price of domestic products and decreasing world demand for them.
 - E. appreciation caused by increasing the money supply would increase unemployment by lowering the relative price of domestic products and by decreasing world demand for them.

Answer A

19. Advocates of flexible exchange rates claim that under flexible exchange rates, the central bank of
- A. an *overheated* economy could cool down activity by *increasing* the money supply without worrying that undesired reserve *inflow* would undermine its stabilization effort.
 - B. a *cooled* economy could *cool down* activity by contracting the money supply without worrying that undesired reserve *inflow* would undermine its stabilization effort.
 - C. an *overheated* economy could cool down activity by contracting the money supply without worrying that undesired reserve *inflow* would undermine its stabilization effort.
 - D. an *overheated* economy could cool down activity by contracting the money supply without worrying that undesired reserve *outflow* would undermine its stabilization effort.
 - E. None of the above.

Answer: C

20. Advocates of flexible exchange rates claim that under flexible exchange rates,
- A. *enhanced* control over fiscal policy would allow countries to *dismantle* their distorting barriers to international payments.
 - B. *reduced* control over monetary policy would allow countries to *dismantle* their distorting barriers to international payments.
 - C. *enhanced* control over monetary policy would allow countries to *increase* their distorting barriers to international payments.
 - D. *enhanced* control over monetary policy would allow countries to *dismantle* their distorting barriers to international payments.
 - E. None of the above.

Answer: D

21. By the end of the 1960's, many countries felt that they were importing inflation from
- A. The United States.
 - B. Germany.
 - C. France.
 - D. Japan.
 - E. The United Kingdom.

Answer: A

22. 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

23. When all changes in the world are due to
- A. *fiscal policy*, purchasing power parity *holds* true in *the long run*.
 - B. *monetary policy*, purchasing power parity *does not hold* true in *the long run*.
 - C. *monetary policy*, purchasing power parity *holds* true in *the long run*.
 - D. *monetary policy*, purchasing power parity *holds* true even in *the short run*.
 - E. None of the above.

Answer: C

24. Under 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

25. Under purchasing power parity (PPP), if U.S. monetary growth leads to a long-run doubling of the U.S. price level, while Germany's price level remains constant, PPP predicts that the
- A. long-run DM price of the dollar will be doubled.
 - B. long-run DM price of the dollar will be halved.
 - C. long-run DM price of the dollar will remain the same.
 - D. short-run DM price of the dollar will be halved.
 - E. None of the above.

Answer: B

26. Under a flexible exchange rate regime, a money-induced
- A. *decrease* in U.S. prices causes an *immediate appreciation* of the foreign currencies against the dollar.
 - B. *increase* in U.S. prices causes an *immediate appreciation* of the foreign currencies against the dollar.
 - C. *increase* in U.S. prices causes an *eventual appreciation* of the foreign currencies against the dollar.
 - D. *increase* in U.S. prices causes an *eventual depreciation* of the foreign currencies against the dollar.
 - E. None of the above.

Answer: B

27. 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 United States could devalue its currency against the foreign currencies in conditions of "fundamental disequilibrium."
 - E. None of the above.

Answer: B

28. 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.

Answer: B

29. 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

30. Under flexible-exchange-rate regime, 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 depreciates, and output increases.
 - D. the currency depreciates, and output remains constant.
 - E. None of the above.

Answer: B

31. Under fixed-exchange-rate regime, 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

32. Comparing fixed to flexible exchange-rate regimes, the response of an economy to a temporary fall in foreign demand for its exports is
- A. output actually falls less under fixed rate than under floating rate.
 - B. output actually falls more under fixed rate than under floating rate.
 - C. output actually remains the same under fixed rate than under floating rate.
 - D. It is impossible to tell.
 - E. None of the above.

Answer: B

33. The case against floating exchange rates is because of
- A. discipline and destabilizing speculation and money market disturbances.
 - B. injury to international trade and investment.
 - C. uncoordinated economic policies.
 - D. the illusion of greater autonomy.
 - E. All of the above.

Answer: E

34. Under a fixed exchange rate regime, an increase in real money demand
- A. moves the AA curve to the right.
 - B. leaves the AA curve unchanged.
 - C. moves the AA curve to the left.
 - D. moves the DD curve to the right.
 - E. None of the above.

Answer: B

35. Under a flexible exchange rate regime, an increase in real money demand
- A. moves the AA curve to the right.
 - B. moves the AA curve to the left.
 - C. leaves the AA curve unchanged.
 - D. moves the DD curve to the right.
 - E. moves the DD curve to the left.

Answer: B

36. The effects of an increase in real money demand on an economy
- A. are a powerful argument in favor of fixed rates.
 - B. are a powerful argument in favor of flexible rates.
 - C. show the difficulties in determining which exchange rate is better.
 - D. are a powerful argument in favor of fixed rates only in the short run.
 - E. are a powerful argument in favor of fixed rates only in the long run.

Answer: A

37. If most of the shocks that buffet the economy come from the home money market, then
- A. a fixed-exchange-rate regime is better than a flexible exchange rate regime.
 - B. a flexible-exchange-rate regime is better than a fixed exchange rate regime.
 - C. which system is chosen is not important.
 - D. a fixed-exchange-rate regime is better than a flexible exchange rate regime only in the short run.
 - E. a flexible exchange rate regime is better than a fixed exchange rate regime only in the short run.

Answer: A

38. If most of the shocks that buffet the economy come from the home money market, then
- A. a fixed-exchange-rate regime is better than flexible exchange rates.
 - B. a flexible-exchange-rate regime is better than a fixed-exchange-rate regime.
 - C. which system is chosen is not important.
 - D. a fixed-exchange-rate is better than a flexible-exchange-rate regime only in the long run.
 - E. None of the above.

Answer: A

39. The effects of a decrease in export demand
- A. are a powerful argument in favor of fixed rates.
 - B. are a powerful argument in favor of flexible rates.
 - C. Show the difficulties in determining which exchange rate is better.
 - D. are a powerful argument in favor of fixed rates only in the short run.
 - E. are a powerful argument in favor of fixed rates only in the long run.

Answer: B

40. If most of the shocks that buffet the economy come from the output market shocks, then
- A. fixed exchange rates are better than flexible exchange rates.
 - B. flexible exchange rates are better than fixed exchange rates.
 - C. which system is chosen is not important.
 - D. fixed exchange rates are better than flexible exchange rates only in the short run.
 - E. flexible exchange rates are better than fixed exchange rates only in the short run.

Answer: B

41. If most of the shocks that buffet the economy come from the home money market, then
- A. fixed exchange rates are better than flexible exchange rates.
 - B. flexible exchange rates are better than fixed exchange rates.
 - C. which system is chosen is not important.
 - D. fixed exchange rates are better than flexible exchange rates only in the long run.
 - E. None of the above.

Answer: B

42. One should expect the forward exchange market
- A. to flourish under a fixed exchange rate regime.
 - B. to flourish under a flexible exchange rate regime.
 - C. to flourish the same under either a fixed or a flexible exchange rate regime.
 - D. to flourish under a fixed exchange rate regime in the short run.
 - E. None of the above.

Answer: B

43. Due to macroeconomic interdependence between large countries, the effect of a permanent monetary policy expansion by Home is as follows: Home output
- A. rises, Home's currency depreciates, and Foreign output may rise or fall.
 - B. falls, Home's currency depreciates, and Foreign output may rise or fall.
 - C. rises, Home's currency appreciates, and Foreign output may rise or fall.
 - D. rises, Home's currency depreciates, and Foreign output rises.
 - E. None of the above.

Answer: A

44. Due to macroeconomic interdependence between large countries, the effect of a permanent fiscal expansion by Home is as follows: Home output
- A. falls, Home's currency appreciates, Foreign output rises.
 - B. rises, Home's currency appreciates, Foreign output rises.
 - C. rises, Home's currency depreciates, Foreign output rises.
 - D. rises, Home's currency appreciates, Foreign output decreases.
 - E. None of the above.

Answer: B

45. The Group of Five (G-5) countries includes
- A. the United States, Britain, France, Germany and Japan.
 - B. the United States, Britain, France, Germany and Italy.
 - C. the United States, Britain, France, Germany and Russia.
 - D. the United States, Britain, France, Germany and Canada.
 - E. All of the above on a rotating basis.

Answer: A

46. The Plaza Accord of 1985 announces that the
- A. G-5 countries will intervene in the foreign exchange market to bring about a dollar appreciation.
 - B. G- 7 countries will intervene in the foreign exchange market to bring about a dollar depreciation.
 - C. G-5 countries will intervene in the foreign exchange market to bring about a dollar depreciation.
 - D. G-7 countries will intervene in the foreign exchange market to bring about a DM depreciation.
 - E. None of the above.

Answer: C

Essay Questions

1. Why would you suggest to a government to use a floating exchange-rate regime?

Answer:

- **Floating Exchange Rate**- an exchange rate in which central banks do not intervene in foreign exchange market to fix rates.
- **Reasons** for Floating Exchange Rates:
 - Monetary policy autonomy
 - Symmetry
 - Exchange rates as automatic stabilizers

2. Why would you suggest to a government NOT to use a floating exchange-rate policy?

Answer:

- There are some who **argue against floating exchange rates** for the following reasons:
 - Discipline
 - Destabilizing speculation & money market disturbances
 - Injury to international trade & investment
 - Uncoordinated economic policies
 - Illusion of greater autonomy

3. Present the case for floating exchange rates.

Answer:

1. Monetary policy autonomy
Governments would be able to use monetary policy to reach internal and external balance. No country would be forced to import inflation and deflation from abroad.
2. Symmetry
The United States would no longer be able to set world monetary conditions all by itself.
The United States would have the same opportunity as other countries to influence its exchange rate against foreign currencies.
3. Exchange rates as automatic stabilizers.
The long and agonizing periods of speculation preceding exchange rate realignments would not occur under floating.

4. Present the case against floating exchange rates.

Answer:

1. The discipline imposed on individual countries by a fixed rate would be lost.
2. Destabilizing speculation and money market disturbances.
3. Injury to international trade and investment.
4. Uncoordinated economic policies.
5. The illusion of greater autonomy.

5. “Under floating rates, the economy is more vulnerable to shocks coming from the domestic money market.” Discuss.

Answer: The statement is true. Under floating rates, a rise in real domestic money demand causes income to fall and domestic currency to appreciate. If the rise in real domestic money supply is permanent, it will lead eventually to a fall in the home price level.

Under a fixed exchange rate, the change in real money demand does not affect the economy at all. To prevent the home currency from appreciating, the central bank buys foreign reserves with domestic money until the real money supply rises by an amount equal to the rise in real money demand. This intervention has the effect of preventing any change in output or the price level.

6. How did countries use their policy tools to regain internal and external balance after the first oil shock of 1973?

Answer: As the recession deepened over 1974 and early 1975, most governments shifted to expansionary fiscal and monetary policies. The OPEC countries could not raise spending quickly enough to match their increased real income and were running a substantial current account surplus in 1975 and 1976.

7. “Even under flexible exchange rate regime, governments could not be indifferent to the behavior of exchange rates and inevitably surrendered some of their policy autonomy in other areas to prevent exchange rate movements they viewed as harmful to their economies.” Discuss.

Answer: True. One example is Volker in October 1979 decreasing the U.S. money supply to halt further weakening of the dollar.

8. Imagine a world with two large countries, Home and Foreign. Evaluate how Home's macroeconomic policies affect Foreign. Compare the small and the large country cases; consider both permanent monetary and fiscal policies.

Answer: Note that since the two countries are large, neither country can be thought of any longer as facing a fixed external interest rate or a fixed level of foreign export demand. Consider only permanent shifts.

A permanent monetary expansion by Home, in the small country's case, would lead to currency depreciation and increase in output, interest rates also falling. When the Home economy is large, the same would happen, but now the rest of the world is affected too. Because Home is facing real currency depreciation, Foreign must be experiencing a real currency appreciation. This makes foreign goods relatively expensive and thus reduces its output. However, this increases Home's output, since Home's imports will rise. Thus, it is not clear what will happen to Foreign output. Note that Foreign output can rise only if the Foreign nominal interest rate rises too, and it can fall only if Foreign nominal interest rate falls. This is because the foreign market equilibrium is:

$M^*/P^* = L(R^*, Y^*)$. (Because in this exercise M^* is not changing and P^* is sticky by assumption and thus fixed in the short run.)

Now consider a permanent expansionary fiscal policy in Home.

In the small country case, a permanent fiscal expansion would cause a real currency appreciation and a current account deterioration that would fully nullify any positive effect on aggregate demand. In effect, the expansionary impact of the Home fiscal ease would leak entirely abroad. This is because the counterpart of Home's lower current account balance must be a higher current account balance abroad.

In the large country case, Foreign output still rises because Foreign's exports become relatively cheaper when Home's currency appreciates. In addition, now some of Foreign's increased spending increases Home exports, so Home's output actually increases along with the output of Foreign. Home's nominal interest rate must rise and Foreign's interest rate rises at the same time as well.

9. What has been learned since 1973 with regard to the experience with floating exchange rate regime?

Answer:

1. Monetary policy autonomy: Yes, however, floating rate did not insulate countries completely from foreign policy shock. In addition, no central bank can be indifferent to its currency's value in the foreign exchange market, thus the name "dirty float" rather than "clean float."
 2. Symmetry: No, the dollar remains an important currency; the DM and the yen have gained importance; the British pound declines in importance.
 3. The exchange rate as an automatic stabilizer: Good performance of the flexible regimes; many believe that, otherwise, major realignments of exchange rates should have taken place. However, some sectors suffered, such as agriculture.
 4. Discipline: Did countries abuse the autonomy afforded by floating rates? Inflation rates did accelerate after 1973
 5. Destabilizing Speculation: Floating exchange rates have exhibited much more day-to-day volatility than the early advocates of floating would have predicted. However, exchange rates are assets prices and so considerable volatility is to be expected. Over the long run, they do not seem to support the notion of destabilizing speculation.
 6. International trade and investment: Critics of floating claimed that international trade and investment would suffer as a result of the increased uncertainty. This prediction was certainly wrong. The use of forward markets and other derivatives expanded dramatically. Still, some economists disagree about the benefit to international trade.
 7. Policy coordination: Floating exchange rates have not promoted policy coordination.
10. "Fixed exchange rates are not even an option for most countries." Discuss.

Answer: Durable fixed exchange rate arrangements may not even be possible unless countries are willing to maintain strict controls over capital movements (as China does), or, at the other extreme, move to a shared single currency with their monetary partners (as in Europe). Even a country following prudent monetary and fiscal policies is not safe from speculative attacks on its fixed exchange rate.

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Quantitative/Graphing Problems

- Use the following table to illustrate the importance of macroeconomic policy coordination. Show that the two governments would have been happier if the two of them had adopted looser monetary policies, but given the policies that the other government did adopt, it is not in the interest of any individual government to change its course. Assume that each country wishes to get the biggest reduction in inflation rate at the lowest cost in terms of unemployment. This means that each country maximizes the expression: minus the change in inflation divided by the change in unemployment, i.e., the inflation reduction per point of increased unemployment.

Foreign			
Home		Somewhat restrictive	Very restrictive
Somewhat restrictive		$\Delta\pi^* = -1\%$ $\Delta U^* = 1\%$	$\Delta\pi^* = -2\%$ $\Delta U^* = 1.75\%$
		$\Delta\pi = -1\%$ $\Delta U = 1\%$	$\Delta\pi = 0\%$ $\Delta U = 0.5\%$
Very restrictive		$\Delta\pi^* = 0\%$ $\Delta U^* = 0.5\%$	$\Delta\pi^* = -1.25\%$ $\Delta U^* = 1.5\%$
		$\Delta\pi = -2\%$ $\Delta U = 1.75\%$	$\Delta\pi = -1.25\%$ $\Delta U = 1.5\%$

Answer:

One needs to translate the outcomes of the table above into policy payoffs. Assume that each country wishes to get the biggest reduction in inflation rate at the lowest cost in terms of unemployment. This means that each country maximizes minus the change in inflation divided by the change in unemployment, the inflation reduction per point of increased unemployment. This leads to the following table. The outcome of this game is on the lower right hand side of the table, where the two countries use very restrictive monetary policies rather than cooperating and using the somewhat better restrictive policies for both of them.

Foreign Home		Somewhat restrictive	Very restrictive
Somewhat restrictive		1 1	$\frac{8}{7}$ 0
	Very restrictive	$\frac{8}{7}$ 0	$\frac{5}{6}$ $\frac{5}{6}$

2. Use the DD – AA model to examine and compare the response of an economy under fixed and floating exchange-rate regimes to a temporary fall in foreign demand for its exports.

Answer: The DD curve shifts to the left. When the exchange rate floats, because the demand shift is assumed to be temporary, it does not change the long-run expected exchange rate and so does not move the asset market equilibrium schedule AA. Thus, E rises, i.e. the currency depreciates and output falls.

Under a fixed exchange rate policy, the central bank must prevent the currency depreciation that occurs under a floating rate; thus, it buys domestic money with foreign currency, reducing the domestic money supply and shifting the AA to the left and down. E will remain constant and output will fall.

3. Use the DD – AA model to examine and compare the response of an economy under fixed and floating exchange-rates regimes to a permanent fall in foreign demand for its exports.

Answer: The DD curve shifts to the left. Under a flexible exchange-rate policy, the expected exchange rate E^e also rises and AA shifts upward and to the right. Thus, a permanent shock causes a greater depreciation than a temporary one.

Under a fixed exchange-rate policy, the central bank must prevent the currency depreciation that occurs under a floating-rate regime; thus, it buys domestic money with foreign currency, reducing the domestic money supply and shifting the AA to the left and down. E will remain constant and output will fall.

Under a fixed exchange-rate regime, a fall in export demand if permanent have led to a situation of “fundamental disequilibrium” calling for a devaluation of the currency or a long period of domestic unemployment as export prices fell. Uncertainty about the government’s intention would have encouraged speculative capital outflows, further worsening the situation by depleting central bank reserves and contracting the domestic money supply at a time of unemployment.

4. Using the AA – DD framework, compare the effects of a rise in real domestic money demand under flexible and under fixed exchange-rate regimes.

Answer: Under floating, a rise in real domestic money demand shifts the AA curve leftward and down, income falls and E decreases, i.e., the domestic currency appreciates. If the rise in real domestic money supply is permanent it will lead eventually to a fall in the home price level. Under a fixed exchange rate, the change in real money demand does not affect the economy at all. The AA curve does not move. To prevent the home currency from appreciating, the central bank buys foreign reserves with domestic money until the real money supply rises by an amount equal to the rise in real money demand. This intervention has the effect of keeping the AA in its original position, preventing any change in output. This is a powerful argument in favor of fixed rates if most of the shocks that buffet the economy come from the home money market.

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5. What are the outcomes of the following games, assuming the max-min criteria is used?

Let: the following expression denoted by X : minus the change in inflation divided by the change in unemployment, i.e., the inflation reduction per point of increased unemployment.

And let the corresponding expression for the foreign country denoted by X^* , i.e., minus the change in inflation in Foreign divided by the change in unemployment in Foreign, i.e., the inflation reduction per point of increased unemployment in the foreign country.

Upper left-hand side cell: $X^* = 5$
 $X = 5$

Upper right-hand side cell: $X^* = 8$
 $X = 5$

Lower left-hand side cell: $X^* = 6$
 $X = 8$

Lower right-hand side cell: $X^* = 4$
 $X = 4$

	Foreign – Somewhat Restrictive	Foreign Very Restrictive	
Home – Somewhat Restrictive			
Home – Very Restrictive			

Answer: In this case, the two countries will use the “somewhat restrictive” policies.

Chapter 20: Optimum Currency Areas and the European Experience

Multiple Choice Questions

1. What are the biggest advantages the U.S. has above the EU in terms of being an Optimum Currency Area?
 - A. Low mobility of labor, higher labor productivity, lower level of intra-regional trade
 - B. High unionization of U.S. Labor force
 - C. I don't know.
 - D. High mobility of labor force, more transfer payments between regions
 - E. Higher uniformity of population's taste in consumption

Answer: D

2. The European Monetary System
 - A. caused several countries to go into recession by causing interest rates to rise.
 - B. pegged different European currencies to each other, allowing for bands of variance.
 - C. was a product of the Werner Report.
 - D. fell apart in 1987.
 - E. None of the above.

Answer: A

3. The credibility theory of the EMS states that countries avoid
 - A. short-term interest rate changes to avoid long-term inflation.
 - B. depreciating their currencies to avoid political instability.
 - C. short-term gains from depreciation to avoid long-term costs from inflation.
 - D. short-term economic booms.

Answer: C

4. 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

5. The birth of the Euro
- A. resulted in fixed exchange rates between all EMU member countries.
 - B. resulted in flexible exchange rates between all EMU member countries.
 - C. resulted in crawling-peg exchange rates between all EMU member countries.
 - D. resulted in non-currency board exchange rates between all EMU member countries.
 - E. None of the above.

Answer: A

6. Which of the following is true?
- A. All European countries are part of the EMU.
 - B. All Western European countries are part of the EMU.
 - C. Originally, 11 countries joined the EMU in January 1999.
 - D. Not all Western European countries are part of the EMU.
 - E. None of the above.

Answer: C

7. The EMU created a currency area with more than
- A. 200 million consumers.
 - B. 250 million consumers.
 - C. about a billion customers.
 - D. 500 million consumers.
 - E. 300 million consumers.

Answer: E

8. The EU countries were prompted to seek closer coordination of monetary policies and greater exchange rate stability in the late 1960s in order
- A. to enhance Europe's role in the world monetary system.
 - B. to turn the European Union into a truly unified market.
 - C. both to enhance Europe's role in the world monetary system and to turn the European Union into a truly unified market.
 - D. None of the above.
 - E. both to turn the European Union into a truly unified market and to counter the rise of Japan in international financial markets.

Answer: C

9. Which of the following statements is true?
- A. The 1957 Treaty of Rome founded the EU and created a custom union.
 - B. The 1957 Treaty of Rome founded the EU.
 - C. The 1957 Treaty of Rome founded the euro.
 - D. The 1957 Treaty of Rome founded the European Central Bank.
 - E. The 1957 Treaty of Rome founded the Stability and Growth Pact.known as SGP.

Answer: A

10. The following countries consistently participated in the informal joint float against the dollar, known as the “snake,” in 1971-1973:
- A. Germany, France, the Netherlands, Belgium and Luxembourg.
 - B. Germany, Italy, the Netherlands, Belgium and Luxembourg.
 - C. Germany, the United Kingdom, France, the Netherlands, Belgium and Luxembourg.
 - D. Germany, the Netherlands, Belgium and Luxembourg.
 - E. Germany, France, Italy, the Netherlands, Belgium and Luxembourg.

Answer: D

11. The European Monetary System was founded on the initiative of
- A. France and Germany.
 - B. France, Germany, and Belgium.
 - C. France, Germany, Belgium, and Luxembourg.
 - D. France, Germany, Belgium, Luxemburg, and the Netherlands.
 - E. France, Germany, Belgium, Luxemburg, the Netherlands, and Austria.

Answer: A

12. The credibility theory of the EMS implies in effect that the political costs of violating international exchange rate agreements
- A. cannot restrain governments from depreciating their currency.
 - B. can restrain governments from depreciating their currency.
 - C. cannot restrain governments from depreciating their currency in the short run.
 - D. cannot restrain governments from depreciating their currency in the long run.
 - E. None of the above.

Answer: B

13. The credibility theory of the EMS implies in effect that the political costs of violating international exchange rate agreements
- A. cannot restrain governments from depreciating their currency to gain the short-term advantage of an economic boom at the long-term cost of higher inflation.
 - B. can restrain governments from depreciating their currency to gain the short-term advantage of an economic boom at the long-term cost of higher inflation.
 - C. cannot restrain governments from depreciating their currency in the short run.
 - D. cannot restrain governments from depreciating their currency in the long run.
 - E. None of the above.

Answer: B

14. The credibility theory of the EMS implies in effect that the political costs of violating international exchange rate agreements
- A. cannot restrain governments from depreciating their currency to gain the short-term advantage of an economic boom at the long-term cost of higher inflation..
 - B. can restrain governments from depreciating their currency to gain the long-term advantage of an economic boom at the short-term cost of higher inflation.
 - C. can restrain governments from depreciating their currency to gain the short-term advantage of an economic boom at the long-term cost of higher inflation.
 - D. cannot restrain governments from depreciating their currency in the short run.
 - E. None of the above.

Answer: C

15. Central bank independence appears to be associated with
- A. high inflation.
 - B. low unemployment.
 - C. low inflation.
 - D. high unemployment.
 - E. high government deficit.

Answer: C

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16. Which one of the following statements is true?
- A. To keep its reputation as a fighter against inflation, the German central bank has never intervened in EMS currency.
 - B. To keep its reputation as a fighter against inflation, the German central bank has often intervened in EMS currency.
 - C. The German central bank carried out some interventions in EMS currencies, thus reducing the supply of DM.
 - D. The German central bank carried out some interventions in EMS currencies, but it instantly sterilized any domestic effects.
 - E. None of the above.

Answer: D

17. The policies of the German central bank resulted in a system that functioned in the
- A. *asymmetric* way the Bretton Woods system did under U.S. dominance.
 - B. *symmetric* way the Bretton Woods system did under U.S. dominance.
 - C. *symmetric* way the Bretton Woods system did under U.K. dominance.
 - D. *asymmetric* way the Bretton Woods system did under U.K. dominance.
 - E. None of the above.

Answer: A

18. 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 pegged their currencies to the DM.
 - E. None of the above.

Answer: A

19. An inflation-prone country
- A. gains from vesting its monetary policy decisions with a “conservative” central bank.
 - B. loses from vesting its monetary policy decisions with a “conservative” central bank.
 - C. gains from vesting its fiscal policy decisions with a “conservative” central bank.
 - D. loses from vesting its fiscal policy decisions with a “conservative” central bank.
 - E. None of the above.

Answer: A

20. The most important feature of the Single European Act of 1986, which amended the founding Treaty of Rome, was dropping the requirement of
- A. unanimous consent for measures related to market completion and making it a decision that only Germany and France agreed about.
 - B. unanimous consent for measures related to market completion.
 - C. majority consent for measures related to market completion and making it a decision that only Germany and France agreed about.
 - D. unanimous consent for measures related to agricultural policies only.
 - E. unanimous consent for measures related only to fiscal policies.

Answer: B

21. To join the EMU, a country should have no more than a
- A. 1.5 percent inflation rate above the average of the three EU member states with the *highest* inflation.
 - B. 3 percent inflation rate above the average of the three EU member states with the *lowest* inflation.
 - C. 4 percent inflation rate above the average of the three EU member states with the *lowest* inflation.
 - D. 1.5 percent inflation rate above the average of the three EU member states with the *lowest* inflation.
 - E. None of the above.

Answer: D

22. To join the EMU, a country must have
- A. a public-sector deficit no higher than 3 percent of its GDP in general.
 - B. a public-sector deficit no higher than 2 percent of its GDP in general.
 - C. a public-sector deficit no higher than 1 percent of its GDP in general.
 - D. a zero public-sector deficit.
 - E. None of the above.

Answer: A

23. To join the EMU, a country must have a public debt below or approaching a reference level of
- A. 50 percent of its GDP.
 - B. 10 percent of its GDP.
 - C. 60 percent of its GDP.
 - D. 100 percent of its GDP.
 - E. 5 percent of its GDP.

Answer: C

24. A major economic
- A. benefit of fixed exchange rates it that they simplify economic calculations and provide a more predictable basis for decisions that involve international transactions than do floating rates..
 - B. benefit of floating exchange rates it that they simplify economic calculations and provide a more predictable basis for decisions that involve international transactions than do fixed rates.
 - C. cost of fixed exchange rates it that they simplify economic calculations and provide a more predictable basis for decisions that involve international transactions than do currency board rates.
 - D. benefit of flexible exchange rates it that they simplify economic calculations and provide a more predictable basis for decisions that involve international transactions than do crawling peg rates.
 - E. None of the above.

Answer: A

25. The efficiency
- A. gain from a fixed exchange rate with the euro is smaller when trade between say, Norway and the euro zone, is extensive than when it is small.
 - B. gain from a fixed exchange rate with euro is greater when trade between say, Norway and the euro zone, is extensive than when it is small.
 - C. loss from a fixed exchange rate with the euro is smaller when trade between say, Norway and the euro zone, is extensive than when it is small.
 - D. gain from a fixed exchange rate with euro is the same as when trade between say, Norway and the euro zone, is extensive than when it is small.
 - E. gain from a fixed exchange rate with euro is the same as when trade between say, Norway and the euro zone, is small than when it is small.

Answer: B

26. The monetary efficiency
- A. loss from pegging the Norwegian krone to the euro (for example) will be higher if factors of production can migrate freely between Norway and the euro area.
 - B. gain from pegging the Norwegian krone to the euro (for example) will be lower if factors of production can migrate freely between Norway and the euro area.
 - C. gain from pegging the Norwegian krone to the euro (for example) will be higher if factors of production cannot migrate freely between Norway and the euro area.
 - D. gain from pegging the Norwegian krone to the euro (for example) will be higher if factors of production can migrate freely between Norway and the euro area.
 - E. Hard to tell.

Answer: D

27. Which one of the following statements is true?
- A. The less extensive are cross-border trade and factor movements, the greater is the gain from a fixed cross-border exchange rate.
 - B. The more extensive are cross-border trade and factor movements, the greater is the loss from a fixed cross-border exchange rate.
 - C. The more extensive are cross-border trade and factor movements, the greater is the gain from a fixed cross-border exchange rate.
 - D. The more extensive are cross-border trade, the greater is the loss from a fixed cross-border exchange rate.
 - E. The more extensive are factor movements, the greater is the loss from a fixed cross-border exchange rate.

Answer: C

28. Which one of the following statements is true? Pick only one answer.
- A. The larger exchange rate area has a more stable and predictable price level than the country that joins in.
 - B. The smaller exchange rate area has a more stable and predictable price level than the country that joins in.
 - C. The larger exchange rate area has a more predictable price level than the country that joins in.
 - D. The smaller exchange rate area has a more stable and predictable price level than the country that joins in.
 - E. All of the above are possible alternatives.

Answer: E

29. Which one of the following statements is true? Pick only one answer.
- A. The larger exchange rate area has more commitment to fixed exchange rate than one country that tries to join in.
 - B. The larger exchange rate area has less commitment to fixed exchange rate than one country that tries to join in.
 - C. The larger exchange rate area has more commitment to fixed exchange rate than two countries that try to join in together.
 - D. The larger exchange rate area has less commitment to fixed exchange rate than two countries that try to join in together.
 - E. All of the above are possible alternatives.

Answer: E

30. A country that joins an exchange rate area
- A. 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* 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. gives up its ability to use only monetary policy for the purpose of stabilizing output *and* employment.

Answer: C

31. When the economy is disturbed by a change in the output market,
- A. a fixed exchange rate has an advantage over a flexible rate.
 - B. a floating exchange rate has an advantage over a fixed rate.
 - C. a crawling peg exchange rate has an advantage over a fixed rate.
 - D. a floating exchange rate has the same effect as a fixed rate.
 - E. None of the above.

Answer: B

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32. 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* 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

33. When the exchange rate is
- A. flexible, purposeful stabilization is more difficult because monetary policy has no power at all to affect domestic output and employment.
 - B. fixed, purposeful stabilization is less difficult because monetary policy has no power at all to affect domestic output and employment.
 - C. fixed, purposeful stabilization is more difficult because monetary policy has no power at all to affect domestic output and employment.
 - D. a crawling peg, rather than fixed, purposeful stabilization is more difficult because monetary policy has no power at all to affect domestic output and employment.
 - E. fixed rather than crawling peg, purposeful stabilization is more difficult because fiscal policy has no power at all to affect domestic output and employment.

Answer: C

34. When Norway unilaterally fixes its exchange rate against the euro but leaves the krone
- A. free to float against the non-euro currencies, it is *able* to keep *at least some* monetary independence.
 - B. free to float against the non-euro currencies, it is *unable* to keep *at least some* monetary independence.
 - C. free to float against the non-euro currencies, it is *able* to keep its monetary independence.
 - D. run by crawling peg against the non-euro currencies, it is *able* to keep at least some monetary independence.
 - E. None of the above.

Answer: B

35. After Norway unilaterally pegs the krone to the euro, domestic money market disturbances will
- A. *no longer affect* domestic output despite the continuation of float-rate regime against non-euro currencies.
 - B. *now have a major effect* on domestic output despite the continuation of float-rate regime against non-euro currencies.
 - C. *have some effect* on domestic output despite the continuation of float-rate regime against non-euro currencies.
 - D. *Have a major effect* on domestic employment despite the continuation of float-rate regime against non-euro currencies.
 - E. None of the above.

Answer: A

36. A krone/euro peg alone is
- A. not enough to provide automatic stability in the face of any monetary shocks that shift the AA schedule.
 - B. enough to provide automatic stability in the face of any monetary shocks that shift the AA schedule.
 - C. not enough to provide automatic stability in the face of any monetary shocks that shift the AA schedule, provided fiscal policy will be used as well.
 - D. enough to provide automatic stability in the face of any monetary shocks that shift the AA schedule, provided the government runs a budget deficit.
 - E. None of the above.

Answer: B

37. Since Norway has close trading links with the euro zone,
- A. a small reduction in its price will lead to an *increase* in euro zone demand for Norwegian goods that is *large* relative to Norway's output. Thus, full employment can be restored fairly quickly.
 - B. a *small* reduction in its price will lead to a *decrease* in euro zone demand for Norwegian goods that is *large* relative to Norway's output. Thus, full employment can be restored fairly quickly.
 - C. a *small* reduction in its price will lead to an *increase* in euro zone demand for Norwegian goods that is *small* relative to Norway's output. Thus, full employment can be restored fairly quickly.
 - D. a *big* reduction in its price will lead to an *increase* in euro zone demand for Norwegian goods that is *large* relative to Norway's output. Thus, full employment can be restored fairly quickly.
 - E. None of the above.

Answer: A

38. If Norway's labor and capital markets are highly correlated with those of its euro zone neighbors,
- A. unemployed workers can easily move abroad to find work, and domestic capital can be shifted to more profitable uses in other countries.
 - B. unemployed workers cannot easily move abroad to find work, and domestic capital cannot be shifted to more profitable uses in other countries.
 - C. while unemployed workers can easily move abroad to find work, domestic capital cannot be shifted to more profitable uses in other countries.
 - D. while capital can easily move abroad to be put to a more profitable use, unemployed workers cannot easily move abroad to find work.
 - E. None of the above.

Answer: A

39. 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

40. Which one of the following statements is true for Norway, a non-euro country?
- A. Of course, owners of capital that *cannot* be moved cannot avoid more of the economic stability loss due to fixed exchange rates when Norway's economy is *open* to capital flows.
 - B. Even owners of capital that *cannot* be moved can avoid more of the economic stability loss due to fixed exchange rates when Norway's economy is *open* to capital flows.
 - C. Owners of capital that *cannot* be moved can avoid more of the economic stability loss due to fixed exchange rates when Norway's economy is *closed* to capital flows.
 - D. Even owners of capital that *can* be moved can avoid more of the economic stability loss due to fixed exchange rates when Norway's economy is *closed* to capital flows.
 - E. None of the above.

Answer: B

41. The intersection of GG and LL determines
- A. the optimal level of integration desired by Norway.
 - B. the maximum integration level desired by Norway.
 - C. the minimum level of integration that will cause Norway to join the fixed exchange rate regime.
 - D. the maximum level of integration that will cause Norway to join the fixed exchange rare regime.
 - E. None of the above.

Answer: C

42. The European Central Bank has its headquarter in
- A. London.
 - B. Berlin.
 - C. Frankfurt.
 - D. Paris.
 - E. Brussels.

Answer: C

43. The level of fiscal federalism in the European Union is
- A. too big to cushion member countries from adverse economic events.
 - B. too small to cushion member countries from adverse economic events.
 - C. appropriate to cushion member countries from adverse economic events.
 - D. too big relative to the one in the U.S.
 - E. similar in its level to that of the U.S.

Answer: B

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Essay Questions

1. How and why did Europe set up its single currency?

Answer: The why part of the question is related to large fluctuations in the exchange rates among the European countries disturbed trade. Also, one of the main reasons was to design a way to prevent future world war. The how part of the question is related to the collapse of Breton woods and the European Currency reform of 1969-1978. The Werner Report of 1971 established a three-phase program to lead to the EMU.

2. How did the European single currency evolve?

Answer: The answer is related to the collapse of Bretton Woods and the European Currency reform of 1969-1978. The Werner Report of 1971 established a three-phase program to lead to the EMU.

3. What prompted the EU countries to seek closer coordination of monetary policies and greater exchange rate stability in the late 1960s?

Answer:

1. To enhance Europe's role in the world monetary system.
2. To turn the European Union into a truly unified market.

4. Discuss the effects of the reunification of eastern and western Germany in 1990 on both Germany and its neighboring European countries.

Answer: Germany: boom, high interest rates to fight inflation. Other European countries: France, Italy and UK in recession, trying to match the high German interest rates to hold their currencies fixed against Germany's, thereby pushing their economies into deep recession. Other European countries tried to continue the fixed exchange rate in order not to lose the credibility they had built up since 1985. The policy conflict between Germany and the other European countries led to a series of fierce speculative attacks on the EMS exchange parities starting in September 1992. By August 1993, the EMS was forced to retreat to very wide (+/- 10 percent) bands, which was kept in force until the introduction of the euro in 1993.

5. Explain why the EMS countries decided to fix their exchange rates against the German DM?

Answer: In this way, the other EMS countries in effect imported the credibility of the German central bank in fighting inflation, thus discouraging the development of inflationary pressures at home.

6. Explain the credibility theory of the EMS.

Answer: In this way, the other EMS countries in effect imported the credibility of the German central bank in fighting inflation, thus discouraging the development of inflationary pressures at home. This is known as the credibility theory of the EMS.

7. Explain how the German Bundesbank gained its low-inflation reputation.

Answer: Mainly, Germany's experience with hyperinflation in the 1920s and again after World War II left the German electorate with a deeply rooted fear of inflation. The law establishing the Bundesbank singled out the defense of the DM's real value as the primary goal of the German central bank.

8. Describe the main provisions of the Maastricht Treaty of 1991.

Answer: pages 612-613. It called for a single currency by January 1, 1999, harmonizing social security policy within the European Union, and centralizing foreign and defense policy decisions.

9. Why did the EU countries move away from the EMS toward the goal of a single shared currency?

Answer:

1. To produce a greater degree of European market integration by removing the threat of EMS currency realignments.
2. To reduce German dominance of the EMS monetary policy.
3. Given the move to complete freedom of capital movements within the EU, fixed but adjustable currency parities, may lead to ferociously speculative attacks, as in 1992 – 1993.
4. To guarantee the *political* stability of Europe.

10. How were the initial members of EMU chosen? How will new members be admitted? What is the structure of the complex of financial and political institutions that govern economic policy in the euro zone?

Answer: EU countries should satisfy:

1. Low inflation rate (no more than 1.5 percent above the average of the three EU member states with the *lowest* inflation).
2. A stable exchange rate within the ERM.
3. Public-sector deficit no higher than 3 percent of its GDP in general.
4. A public debt below or approaching a reference level of 60 percent of its GDP.

11. Explain the difficulties in naming the new European currency.

Answer: pages 616-617. Among the reasons: keeping the name ECU would be misleading; the ECU depreciated sharply against the DM; the Euro had bad connotations for Germans and Greeks; and names such as franken and shillings raise objections as well.

12. “The costs and benefits for a country from joining a fixed-exchange rate area such as the EMS depend on how well-integrated its economy is with those of its potential partners.” Discuss.

Answer: In general, true. This is the theory of optimum currency area. Mundell was awarded the Nobel Prize for developing the theory.

13. Discuss the benefits and costs of joining a fixed-exchange area.

Answer: Benefits: in general, gains from the stability of the area and reduced uncertainty. The efficiency gain from a fixed exchange rate with the euro is greater when trade between, say Norway and the euro zone, is extensive than when it is small. A major economic benefit of fixed exchange rates is that they simplify economic calculations and provide a more predictable basis for decisions that involve international transactions than do floating rates. The monetary efficiency gain from pegging, say the Norwegian krone to the euro, will be higher if factors of production can migrate freely between Norway and the euro area. The more extensive are cross-border trade and factor movements, the greater is the gain from a fixed cross-border exchange rate

Costs: A country that joins an exchange rate area gives up its ability to use the exchange rate *and* monetary policy for the purpose of stabilizing output *and* employment. When the economy is disturbed by a change in the output market, a floating exchange rate has an advantage over a fixed rate. 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. When the exchange rate is fixed, purposeful stabilization is more difficult because monetary policy has no power at all to affect domestic output and employment

14. Explain why when Norway unilaterally fixes its exchange rate against the euro but leaves the krone free to float against the non-euro currencies, it is *unable* to keep *at least some* monetary independence.

Answer: Any independent money supply change in Norway would put pressure on krone interest rates and thus on the krone/euro exchange rate. So by pegging the krone even to a single foreign currency, Norway completely surrenders its domestic monetary control.

15. Explain why after, say Norway unilaterally pegs the krone to the euro, domestic money market disturbances will *no longer affect* domestic output despite the continuation of float-rate regime against non-euro currencies.

Answer: Because Norway's interest rate must equal the euro interest rate, any pure shifts in the AA curve (see Chapter 19) will result in immediate reserve inflows or outflows that leave Norway's interest rate unchanged.

16. Explain why even owners of capital that *cannot* be moved can avoid more of the economic stability loss due to fixed exchange rates when Norway's economy is *open* to capital flows.

Answer: The main reason is through diversification. If Norway's capital market is integrated with those of the EMU neighbors, Norwegians will invest some of their wealth in other countries while at the same time part of Norway's capital stock will be owned by foreigners.

17. Explain why the oil price shocks after 1973 made countries unwilling to revive the Bretton Woods system of fixed exchange rates.

Answer: Using the GG – LL framework will help solve this question. The oil price shock of 1973 pushes the LL curve upward and to the right. Thus, the level of economic integration at which it becomes worthwhile to join the currency rises. In general, increased variability in the product markets makes countries less willing to enter fixed exchange rate areas. This prediction helps explain why the oil price shocks after 1973 made countries unwilling to revive the Bretton Woods system of fixed exchange rates.

18. Explain why it may make sense for the United States, Japan, and Europe to allow their mutual exchange rate to float?

Answer: Even though these regions trade with each other, the extent of that trade is modest compared with regional GNPs, and interregional labor mobility is low.

19. Is Europe an optimum currency area?

Answer: An open question. I think yes, the area's economy is closely integrated with its own: most EU members export from 10 to 20 percent of their output to other EU members. But still, the law of one price does not apply to many products such as the auto market. In 1998, prices for the BMW 520i varied by as much as 29.5 percent between the United Kingdom and the Netherlands. Prices for the Ford Fiesta varied as much as 43.5 percent between the United Kingdom and Portugal!

The text is more critical, claiming on page 625: "The extent of intra-European trade is not large enough, however, to give us an overwhelming reason for believing the European Union itself is an optimum currency area." Also, the text cites the fact that may be price convergence has more to do with Internet marketing than optimum currency area.

The book concludes that on balance, it seems doubtful that the 1992 measures have yet pushed Europe dramatically closer to being an optimum currency area.

See also pages 625 – 626, and even pages 625 - 630.

20. How mobile is Europe's labor force?

Answer: Differences in language and culture discourage labor movements between European countries. Differences in regional unemployment rates are smaller and less persistent in the United States than are differences between national unemployment rates in the European Union. Even *within* European countries, labor mobility appears limited, partly because of government regulations. For example, the requirement in some countries that workers establish residence before receiving unemployment benefits makes it harder for unemployed workers to seek jobs in regions that are far from their current homes.

21. How much trade do currency unions create?

Answer: The main result is that currency unions promote trade. One study found that on average, two countries that are members of the same currency union trade *three times* as much with each other as countries that do not share a currency. Even if the euro were to raise trade within the euro zone by 50 percent, the positive effect on people's welfare could be immense, as another study has shown. However, some challenge the conclusion. Some claim the results would not be duplicated when applied to large countries such as the members of the EU; another study found out that leaving a common currency area as Ireland did has not caused a reduction in UK - Ireland trade.

22. Explain why the European Union's current combination of rapid capital migration with limited labor migration may actually *raise* the cost of adjusting to product market shocks without exchange rate change.

Answer: If the Netherlands suffers an unfavorable shift in output demand, Dutch capital can flee abroad, leaving even more unemployed Dutch workers behind than in the case of government regulations that were to hinder the movement of capital outside the Netherlands. Severe and persistent regional depressions could result, worsened by the likelihood that the relatively few workers who did successfully emigrate would be precisely those who are most skilled, reliable, and enterprising. This is another example of the *theory of the second best*.

23. "Given that labor remains relatively immobile within Europe, the European Union's success in liberalizing its capital flows may have worked perversely to worsen the economic stability loss due to the process of monetary unification." Discuss.

Answer: Probably right. This is another example of the *theory of the second best*. If the Netherlands suffers an unfavorable shift in output demand, Dutch capital can flee abroad, leaving even more unemployed Dutch workers behind than in the case of government regulations that were to hinder the movement of capital outside the Netherlands. Severe and persistent regional depressions could result, worsened by the likelihood that the relatively

few workers who did successfully emigrate would be precisely those who are most skilled, reliable, and enterprising.

24. Discuss the problems that the EMU will face in the coming years.

Answer: pages 631-632. (1) Europe is not an optimum currency area; therefore asymmetric economic developments within different countries of the euro zone that call for different interest rates cannot be implemented. (2) The political part of the unification is much weaker and may limit the political legitimacy of the economic unification. (3) On the one hand, labor markets remain highly unionized and subject to high government unemployment taxes and other regulations impeding labor mobility. On the other hand, capital has high incentive to migrate to the EMU countries with the lowest wages. (4) Constraints on national fiscal policy are likely to be painful due to the absence of substantial fiscal federalism (fiscal transfer of resources from the rich to the less rich countries within the European Union). (5) The EU is considering a large-scale expansion of its membership into Eastern Europe and the Mediterranean. This will cause many coordination costs and also the issue of representation of small and big countries.

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Quantitative/Graphing Problems

1. Show the effects of the reunification of eastern and western Germany in 1990 on both Germany and its neighboring European countries using the AA – DD framework.

Answer: For Germany, this was a period of boom with high interest rates to fight inflation. Other European countries: France, Italy and UK were in recession, trying to match the high German interest rates to hold their currencies fixed against Germany's, thereby pushing their economies into deep recession. Other European countries tried to continue the fixed exchange rate in order not to lose the credibility they had build up since 1985. The policy conflict between Germany and the other European countries led to a series of fierce speculative attacks on the EMS exchange parities starting in September 1992. By August 1993, the EMS was forced to retreat to very wide (+/- 10 percent) bands, which was kept in force until the introduction of the euro in 1993.

2. Using the GG – LL framework, analyze the effect of an increase in the size and frequency of sudden shifts in the demand for a country's exports.

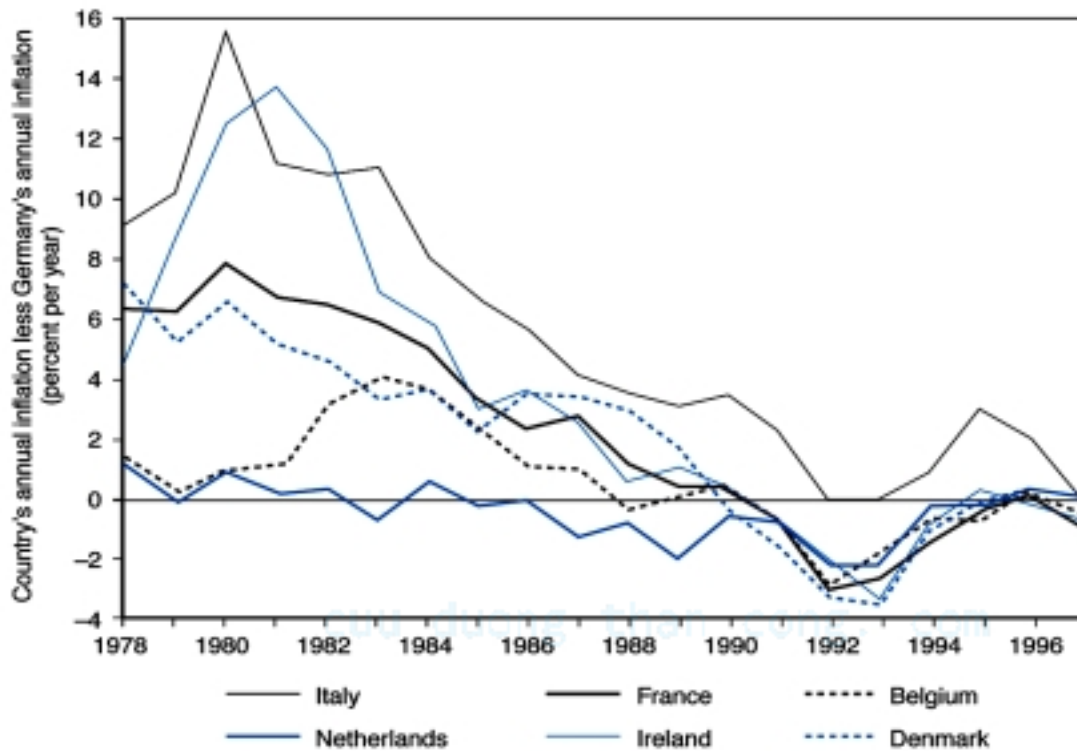
Answer: Such a change pushes LL upward and to the right. Thus, the level of economic integration at which it becomes worthwhile to join the currency rises. In general, increased variability in the product markets makes countries less willing to enter fixed exchange rate areas. This prediction helps explain why the oil price shocks after 1973 made countries unwilling to revive the Bretton Woods system of fixed exchange rates. See also Chapter 19.

3. Using the GG – LL framework, analyze the effect of Libya subsidizing the Pakistani Nuclear programs.

Answer: This will shift the GG curve upward and to the left causing the two countries to trade more, thus reducing the minimum value for the two countries to cooperate under a fixed exchange rate regime.

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4. What is the purpose of the following figure?



Answer:

The purpose of the figure is to show the inflation convergence within the six original EMS members. The figure shows the difference between domestic inflation and German inflation for six of the original EMS members. As of 1997, all national inflation rates were very close to the German levels. See Figure 20 in the textbook for a more updated figure.

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5. What do you know about the countries marked in blue in the following figure?



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Answer: They are members of the Euro zone as of January 1, 2001.

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Chapter 21: The Global Capital Market: Performance and Policy Problems

Multiple Choice Questions

1. What are three things to measure for in evaluating the performance of the capital markets?
 - A. Level of Intertemporal Trade, International Trade, Portfolio Diversification
 - B. Level of Portfolio Diversification, Balanced Capital Accounts, Global Inflation
 - C. Level of Portfolio Diversification, Intertemporal Trade, Efficiency of Foreign Exchange
 - D. Onshore-Offshore Interest Rate Parity, Level of Portfolio Diversification, Stability of Eurocurrency Market
 - E. Onshore-Offshore Interest Rate Parity, Interest Parity and Foreign Exchange, Balanced Capital Accounts

Answer: C

2. In the Interest Parity Condition, $R_t - R^*_t = (E^e_{t+1} - E_t)/E_t + x_t$, where $R_t - R^*_t$ is the interest rate differential and $(E^e_{t+1} - E_t)/E_t$ is the expected change in the exchange rate, what does x_t stand for if it potentially is a market efficient difference between the two?
 - A. Market inefficiency
 - B. Risk premium
 - C. Forecast error
 - D. Tracking error
 - E. Excessive volatility

Answer: B

3. 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. It would get larger.
 - B. It would get smaller.
 - C. It would stay the same.
 - D. None of the above.
 - E. Not enough information.

Answer: B

4. If you are offered a gamble in which you win 500 dollars $\frac{3}{8}$ of the time and you lose 500 dollars $\frac{5}{8}$ of the time, what is your expected payoff and your behavior given that you are a risk-lover?
- A. \$500, take the gamble
 - B. -\$125, take the gamble
 - C. -\$12, you are indifferent
 - D. \$500, decline the gamble
 - E. -\$125, decline the gamble

Answer: B

5. The two types of trade, intertemporal and pure asset swap _____ perfect substitutes, because
- A. are; they both offer considerable payoff and are equal in the long run.
 - B. are; they both involve the smoothing out of current and future consumption.
 - C. are not; asset swapping is immediate and involves only assets, while intertemporal trade takes two time periods and involves both assets and goods/services.
 - D. Both B and C.
 - E. could possibly be, as different economic states occur at different points in time.

Answer: E

6. A shadow price is
- A. a time-lagged variable that is only apparent after the current period.
 - B. something that has to do with trees out the window.
 - C. a price neither in nor determined by a market.
 - D. the discounted price of a foreign asset in the home country.
 - E. the marginal utility of future consumption.

Answer: C

7. For the following question assume the following facts:
- 1: Balance of Payments = 0 prior to the transactions.
 - 2: Person A (who lives in the United States) purchases an airplane from British Airways for \$150,000.
 - 3: Person A pays with a check from his account at First Union Bank in the United States.
 - 4: British Airways, since it will need dollars in 1 month, deposits the check at the Bank of England.
 - 5: Bank of England deposits the \$150,000 at Commonwealth Bank, which is located in the United States.

Due to the transactions above, what are the effects on the balance of payments?

- A. -\$150,000 due to import of good (current account debit)
- B. +\$150,000 due to import of good (current account credit)
- C. -\$150,000 due to deposit of Bank of England (capital account debit)
- D. +\$150,000 due to deposit of Bank of England (capital account credit)
- E. No effect (150,000 current account debit and 150,000 capital account credit).

Answer: E

8. For the following questions ,assume the following facts:
- 1: Balance of Payments = 0 prior to the transactions.
 - 2: Person A (who lives in the United States) purchases an airplane from British Airways for \$150,000.
 - 3: Person A pays with a check from his account at First Union Bank in the United States.
 - 4: British Airways, because it will need dollars in 1 month, deposits the check at the Bank of England.
 - 5: Bank of England deposits the \$150,000 at Commonwealth Bank, which is located in the United States.

Due to the transactions above, what are the effects on the reserve at the Fed?

- A. No effects at all.
- B. Fact 3 is a decrease of \$150,000, Fact 5 is an increase of \$150,000, a net effect of 0
- C. Fact 3 is an increase of \$150,000, Fact 5 is a decrease of \$150,000, a net effect of 0
- D. Both Fact 3 and Fact 5 result in increases of \$150,000, a net effect of +\$300,000
- E. Both Fact 3 and Fact 5 result in decrease of \$150,000, a net effect of -\$300,000

Answer: B

9. For the following question, assume the following facts:
- 1: Chase (which is located in the United States) has a 20% reserve requirement imposed by the government.
 - 2: Bank of Germany has no reserve requirements.
 - 3: Both banks may invest at an 8% interest rate.
 - 4: Both banks have fixed costs of \$3 per deposit made.

What is the difference between the minimum interest rates each bank can offer and still make a profit if the deposit is \$500 for 1 year?

- A. 0 – both banks can offer the same rate
- B. 1%
- C. 1.6%
- D. .4%
- E. 20%

Answer: C

Explanation for the answer:

Minimum Chase rate: Revenue from deposit: $(500 \times .08) - 3 = 29$

Minimum rate it can offer = $29/500 = 5.8\%$

Minimum Bank of Germany rate: Revenue from deposit: $(500) \times .08 - 3 = 37$

Minimum rate it can offer = $37/500 = 7.4\%$

Difference in rates: 1.6%

10. Suppose you are offered a gamble in which you win \$1,000 half the time but lose \$1,000 half the time. Since in this case you are as likely to win as to lose the \$1,000, the average payoff on this gamble – its expected value- is:

$$0.5 \times \$1,000 + 0.5 \times (-\$1,000) = 0.$$

Under such circumstances:

- A. No one will take the gamble.
- B. Risk averse individuals will take the gamble.
- C. Risk lovers will take the gamble.
- D. Risk neutral individuals will take the gamble.
- E. Not enough information.

Answer: C

11. Suppose you are offered a gamble in which you win \$100,000 half the time but lose \$100,000 half the time. Since in this case you are as likely to win as to lose the \$100,000, the average payoff on this gamble – its expected value- is:
- $$0.5 * \$100,000 + 0.5 * (-\$100,000) = 0.$$
- Under such circumstances:
- A. No one will take the gamble.
 - B. Risk averse individuals will take the gamble.
 - C. Risk lovers will take the gamble.
 - D. Risk neutral individuals will take the gamble.
 - E. Not enough information to answer.

Answer: C

12. For most practical matters, economists assume that
- A. individuals are risk neutral.
 - B. individuals are risk lovers.
 - C. individuals are risk averse.
 - D. most individuals are risk lovers.
 - E. most individuals are risk neutral.

Answer: A

13. People who are risk averse
- A. value a collection of assets only on the basis of their expected returns.
 - B. value a collection of assets only on the basis of the risk of that return.
 - C. value a collection of assets not only on the basis of its expected returns, but also on the basis of the risk of that return.
 - D. No clear cut criteria exist.
 - E. None of the above.

Answer: C

14. The idea of risk aversion
- A. is at odds with the idea of insurance.
 - B. help explain the profitability of insurance companies.
 - C. has nothing to do with insurance companies.
 - D. helps explain the losses suffers by the insurance industry.
 - E. helps explain why insurance companies in the long run are zero profit companies.

Answer: B

15. Risk averse people
- A. will never hold bonds denominated in several different currencies because of transaction costs.
 - B. will always hold bonds denominated in several different currencies because of transaction costs.
 - C. may hold bonds denominated in several different currencies.
 - D. may hold bonds denominated in several different currencies only if satisfying the well known interest parity condition .
 - E. will hold only domestic bonds because of the home bias effect.

Answer: C

16. In general, for a risk averse individual
- A. a portfolio whose return fluctuates widely from year to year is more desirable than one that offers the same average return with only mild year-to-year fluctuations.
 - B. a portfolio whose return fluctuates widely from year to year is less desirable than one that offers the same average return with only mild year-to-year fluctuations.
 - C. a portfolio whose return fluctuates widely from year to year is more desirable.
 - D. a portfolio whose return fluctuates less from year to year is more desirable.
 - E. None of the above.

Answer: B

17. Generally, for a risk-loving individual,
- A. a portfolio whose return fluctuates widely from year to year is more desirable than one that offers the same average return with only mild year-to-year fluctuations.
 - B. a portfolio whose return fluctuates widely from year to year is less desirable than one that offers the same average return with only mild year-to-year fluctuations.
 - C. a portfolio whose return fluctuates widely from year to year is more desirable.
 - D. a portfolio whose return fluctuates less from year to year is more desirable.
 - E. None of the above.

Answer: A

18. Generally, for a risk neutral individual,
- A. a portfolio whose return fluctuates widely from year to year is more desirable than one that offers the same average return with only mild year-to-year fluctuations.
 - B. a portfolio whose return fluctuates widely from year to year is less desirable than one that offers the same average return with only mild year-to-year fluctuations.
 - C. a portfolio whose return fluctuates widely from year to year is more desirable.
 - D. a portfolio whose return fluctuates less from year to year is more desirable.
 - E. Not enough information.

Answer: E

19. Generally,
- A. a portfolio whose return fluctuates widely from year to year is more desirable than one that offers the same average return with only mild year-to-year fluctuations.
 - B. a portfolio whose return fluctuates widely from year to year is less desirable than one that offers the same average return with only mild year-to-year fluctuations.
 - C. a portfolio whose return fluctuates widely from year to year is more desirable.
 - D. a portfolio whose return fluctuates less from year to year is more desirable.
 - E. Not enough information

Answer: E

20. Investment banks in the United States are
- A. regular banks specializing in investment projects.
 - B. not banks at all but institutions which specialize in underwriting sales of stocks and bonds.
 - C. special arms of the U.S. government for U.S. banks operating outside the U.S.
 - D. regular banks specializing in investment projects, but allowed to offer limited domestic transactions.
 - E. None of the above.

Answer: B

21. First Boston Corporation, Goldman Sachs, and Lazard Freres are examples of
- A. commercial banks.
 - B. corporations.
 - C. non-bank financial institutions, such as insurance companies, pension funds, and mutual funds. This includes investment banks, which specialize in underwriting sales of stocks and bonds by corporations and in some cases governments.
 - D. central banks and other government agencies
 - E. None of the above.

Answer: C

22. Citicorp, Morgan Guaranty, and Bankers Trust are examples of
- A. commercial banks.
 - B. corporations.
 - C. non-bank financial institutions, such as insurance companies, pension funds, and mutual funds. This includes investment banks, which specialize in underwriting sales of stocks and bonds by corporations and in some cases governments.
 - D. central banks and other government agencies.
 - E. None of the above.

Answer: A

23. A country can control
- A. fixed exchange rates only.
 - B. monetary policy oriented toward domestic goals.
 - C. freedom of international capital movements.
 - D. Any two of the above three.
 - E. Only A and B.

Answer: D

24. Under a gold standard, countries control
- A. fixed exchange rates only.
 - B. monetary policy oriented toward domestic goals.
 - C. freedom of international capital movements.
 - D. Only A and C.
 - E. Only A and B.

Answer: D

25. After the Bretton Woods period, countries chose to control
- A. fixed exchange rates only
 - B. monetary policy oriented toward domestic goals.
 - C. freedom of international capital movements.
 - D. Only B and C.
 - E. Only A and B.

Answer: D

26. Under the unified Euro regime, the European countries control
- A. fixed exchange rates only.
 - B. monetary policy oriented toward domestic goals.
 - C. freedom of international capital movements.
 - D. Only B and C.
 - E. Only A and C.

Answer: E

27. Which one of the following possibilities is true?
- A. Much of eurocurrency trading occurs in Europe.
 - B. Much of eurocurrency trading occurs in the United States.
 - C. Eurocurrency trading occurs everywhere except the United States.
 - D. Eurocurrency trading occurs everywhere except Europe.
 - E. None of the above.

Answer: C

28. Eurodollars are
- A. dollar deposits located in the United States.
 - B. dollar deposits located in Europe.
 - C. dollar deposits located outside Europe.
 - D. dollar deposits located outside the United States.
 - E. dollar deposits located outside both Europe and the United States.

Answer: D

29. Eurobanks are
- A. all European Banks.
 - B. all non-American banks.
 - C. banks that accept deposits denominated in Eurocurrencies excluding Eurodollars.
 - D. banks that accept deposits denominated in Eurocurrencies including Eurodollars.
 - E. None of the above.

Answer: D

30. The leading center of Eurocurrency trading is
- A. New York City.
 - B. Chicago.
 - C. London.
 - D. Paris.
 - E. Frankfurt.

Answer: C

31. The Fed's Regulation Q
- A. placed a ceiling on the interest rates U.S. banks could pay on time deposits to foreigners.
 - B. placed a ceiling on the interest rates U.S. banks could pay on time deposits.
 - C. placed a ceiling on the amount U.S. residents can deposits in Euro banks.
 - D. placed a ceiling on the amount foreign residents can deposits in domestic American banks.
 - E. None of the above.

Answer: B

32. Which of the following statements is true?
- A. Bank failure is limited to banks that have mismanaged their assets.
 - B. Bank failure is limited to banks that have invested in real estate.
 - C. Bank failure is limited to banks that have invested in government bonds.
 - D. Bank failure is limited to a few banks.
 - E. Bank failure is not limited to banks that have mismanaged their assets.

Answer: E

33. Which of the following statements is true?
- A. Bank failures inflict serious financial harm on individual depositors.
 - B. Bank failures do not inflict serious financial harm on individual depositors.
 - C. Bank failures inflict not only serious financial harm on individual depositors, but also harm the macroeconomic stability of the economy.
 - D. Bank failures inflict serious financial harm on individual depositors, but fortunately do not harm the macroeconomic stability of the economy.
 - E. None of the above.

Answer: C

34. Which of the following statements is true?
- A. Banks with cautious investment strategies never fail if unconfirmed rumors of financial trouble begin circulating.
 - B. Banks with cautious investment strategies never fail if rumors of financial trouble begin circulating.
 - C. Banks with cautious investment strategies may fail if unconfirmed rumors of financial trouble begin circulating.
 - D. Banks with cautious investment strategies may fail if rumors of financial trouble begin circulating.
 - E. None of the above.

Answer: C

35. Which of the following statements is true for the United States?
- A. The Federal Deposit Insurance Corporation (FDIC) insures bank deposits against losses up to \$100,000.
 - B. The Federal Deposit Insurance Corporation (FDIC) insures bank deposits against floods up to \$100,000.
 - C. The Federal Deposit Insurance Corporation (FDIC) insures bank deposits against losses up to \$10,000.
 - D. The Federal Deposit Insurance Corporation (FDIC) insures bank deposits against natural disaster up to \$100,000.
 - E. None of the above.

Answer: A

36. Which of the following statements is true for the United States?
- A. Banks are required to make contributions to the FDIC to cover the cost of bank deposits insurance.
 - B. Banks are not required to make contributions to the FDIC to cover the cost of bank deposits insurance.
 - C. The states are not required to make contributions to the FDIC to cover the cost of bank deposits insurance for banks with their main branch in that state.
 - D. The states are required to make contributions to the FDIC to cover the cost of bank deposits insurance for banks with their main branch in that state.
 - E. The specific municipality where the main branch of the bank is located is required to make contributions to the FDIC to cover the cost of bank deposit insurance.

Answer: A

37. Which of the following statements is true for the United States?
- A. The FDIC does not provide insurance for deposits for Savings and Loans (S&L) associations.
 - B. The FDIC does provide insurance for deposits for Savings and Loans (S&L) associations, but only up to \$50,000.
 - C. The FDIC does provide insurance for deposits for Savings and Loans (S&L) associations up to \$100,000.
 - D. The FDIC does provide insurance for deposits for Savings and Loans (S&L) associations up to \$150,000.
 - E. None of the above.

Answer: C

38. Banks in the United States
- A. face rules against lending too large a fraction of their assets to a single private customer only.
 - B. face rules against lending too large a fraction of their assets to a single private customer or to a single foreign government borrower.
 - C. face rules against lending too large a fraction of their assets to a single foreign government borrower only.
 - D. Although a good idea, banks are not restricted at all as far as whom they lend money to as long as other safeguards exist.
 - E. Because this is a bad idea, banks are not restricted at all as far as whom they lend money to as long as other safeguards exist.

Answer: B

39. Banks in the United States
- A. cannot hold common stocks.
 - B. can hold common stocks.
 - C. cannot hold common stocks of companies they do business with.
 - D. cannot hold common stocks of companies that have their headquarters in the same state.
 - E. None of the above.

Answer: A

40. Banks in the United States
- A. are prevented from holding assets that are “too risky.”
 - B. are not prevented from holding assets that are “too risky.”
 - C. are encouraged not to hold assets that are “too risky.”
 - D. are not encouraged not to hold assets that are “too risky.”
 - E. None of the above.

Answer: A

41. In the United States, the following agencies have the right to examine the bank's books:
- A. Fed and the FDIC.
 - B. FDIC and the Office of the Comptroller of the Currency.
 - C. Fed and the office of the Comptroller of the Currency.
 - D. Both B and C.
 - E. Only the Fed.

Answer: D

43. In the United States, banks
- A. cannot be forced to sell assets that the bank examiner deems too risky.
 - B. can be forced to sell assets that the bank examiner deems too risky.
 - C. can be forced to sell assets that the bank examiner deems too risky only after a court order.
 - D. can be forced to sell assets that the bank examiner deems too risky only after both examiners from the Fed and from the FDIC agree.
 - E. None of the above.

Answer: B

44. In the United States, banks
- A. may not be forced by bank examiner to adjust their balance sheets by writing off loans the examiner thinks will not be repaid.
 - B. may be forced by the bank examiner to adjust their balance sheets by writing off loans the examiner thinks will not be repaid.
 - C. may be forced by the bank examiner to adjust their balance sheets by writing off loans the examiner thinks will not be repaid only if the Fed and the FDIC examiners agree.
 - D. may be forced by the bank examiner to adjust their balance sheets by writing off loans the examiner thinks will not be repaid only if the Fed and the Office of the Comptroller of the Currency examiners agree.
 - E. Both C and D.

Answer: B

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Essay Questions

1. What are the three types of transactions between the residents of different countries?

Answer:

1. Trades of goods and services for goods or services.
2. Trades of goods and services for assets.
3. Trades of assets for assets.

2. What are the three types of gains from international transactions between the residents of different countries?

Answer:

1. Gains due to comparative advantage and economies of scale.
2. Gains due to inter-temporal trade, which is the exchange of goods and services for claims to future goods and services, which is for assets.
3. Gains due to trades of assets for assets, such as the exchange of real estate located in London for U.S. Treasury bonds.

3. How can international trade in assets make both countries better off?

Answer: By allowing them to reduce the riskiness of the return on their wealth and by allowing the two parties to diversify their portfolios, i.e., to divide their wealth among a wider spectrum of assets, and thus reduce the amount of money placed on one specific asset.

4. Explain Tobin's idea of "Don't put all your eggs in one basket."

Answer: The idea of diversification advanced by Tobin in his Attitude Towards Risk and Portfolio Diversification's paper.

5. Why is it useful to make a distinction between debt and equity instruments?

Answer: See page 640 and Chapter 22. Debt instruments such as bonds and bank deposits are repaid regardless of economic circumstances. Equity instruments, such as a share of stock, have a payoff that is linked to economic performances. However, remember the possibility of bankruptcy and the real return, which is subject to domestic currency fluctuations.

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6. Who are the main actors in the international capital market?

Answer:

1. Commercial banks.
2. Corporations.
3. Non-bank financial institutions, such as insurance companies, pension funds, and mutual funds. This includes investment banks, which specialize in underwriting sales of stocks and bonds by corporations and in some cases governments.
4. Central banks and other government agencies.

7. Describe the role of offshore banking and of offshore currency (eurocurrencies) trading.

Answer: See pages 643-647. Both have mushroomed due to increased international trade, increased multinational corporations, and globalization. Students should also emphasize banks' desire to escape domestic government regulations and taxes on financial activities and political concerns from holding deposits in the country that issued them, which increases default concerns on the part of the foreign investors, etc.

8. What do you expect would be the effects of 9/11 on the size of the Eurocurrency markets?

Answer: Will increase due to fear that foreign deposits in the United States will be frozen unless coordinated efforts by all countries.

9. Explain why a London Eurobank has a competitive advantage over a bank in New York in attracting dollar deposits.

Answer: It can pay more because the London bank is not subject to any reserve requirements (neither American nor British), whereas the New York bank is subject to U.S. reserve requirements.

10. Many observers believe that the largely unregulated nature of global banking activity leaves the world financial system vulnerable to bank failure on a massive scale. Is this a real threat? If so, what measures have governments taken to reduce it?

Answer: See pages 647 – 654.

11. “Bank failure may not be limited to banks that have mismanaged their assets.” Explain why.

Answer: A sound bank faced with the wholesale loss of deposits is likely to close its door even if the asset side of its balance sheet is fundamentally sound because many bank assets are illiquid and cannot be sold quickly to meet deposit obligations without substantial loss to the bank. Students should stress the atmosphere of financial panic, which will lead to self-fulfilling expectations.

12. “It is in the interest of each depositor to withdraw her money from a bank if all other depositors are doing the same, even when the bank’s assets are sound.” Discuss. As part of your answer clearly state whether the statement is true or false.

Answer: True. Students should elaborate on bank run and stress the atmosphere of financial panic, which will lead to self-fulfilling expectations.

13. “There is evidence that the string of U.S. bank closings in the early 1930s helped start and worsen the Great Depression.” Discuss.

Answer: True. See the reference to Bernanke in the textbook and earlier account by Anna Schwartz and Milton Friedman.

14. Describe the extensive “safety net” that has been set up in the United States in order to reduce the risk of bank failure.

Answer:

1.	Deposit insurance
2.	Reserve requirements
3.	Capital requirements and asset restrictions
4.	Bank examination
5.	Lender of last resort facilities

15. Explain why the FDIC is following a “too-big-to-fail” policy of fully protecting all depositors at the largest banks.

Answer: A tricky question. The FDIC does that although, officially, it still applies only to the \$100,000 limit. Probably, the idea is that the cost to one depositor is unbearable relative to the small cost we all need to pay as a collective. Also, there are the issues of political pressure and avoiding blaming the government for mismanaging the safeguards.

16. Explain the issues involved with the Fed acting as a lender of Last Resort (LLR).

Answer: On the one hand, LLR enables the Fed to avoid panic and disturbance to proper functioning of financial markets. On the other hand, using the policy may cause problems of moral hazard.

17. Explain the causes of the U.S. Savings and Loans crisis of the early 1980s.

Answer: On the one hand, allowing S&L to make much riskier loans, for example, loans on commercial real estate. On the other hand, inadequate examination for the new situation and depositors, together with increase in interest rates due to increased inflation rate.

18. Explain the difficulties in regulating international banking.

Answer:

1. No deposit insurance, in particular, inter-bank deposits are unprotected
2. Absence of reserve requirements
3. Bank examination more difficult to enforce
4. Not clear which group of regulators has responsibility for monitoring a given bank's assets
5. Not clear which central bank, if any, is responsible for providing Lender of Last Resort assistance

19. "The internationalization of banking has weakened national safeguards against banking collapse, but at the same time it has made the need for effective safeguards more urgent." Discuss.

Answer: True. Students should elaborate on:

1. No deposit insurance, in particular, inter-bank deposits are unprotected
2. Absence of reserve requirements
3. Bank examination more difficult to enforce
4. Not clear which group of regulators has responsibility for monitoring a given bank's assets
5. Not clear which central bank, if any, is responsible for providing Lender of Last Resort assistance.

20. What is the connection between the 1991 film *The Godfather, Part III* and international banking?

Answer: See page 651.

21. Why did the Fed step in to organize a rescue for Long Term Capital Management (LTCM) in September 1998, rather than simply letting the trouble fund fail? Was the Fed's action necessary or advisable?

Answer: See pages 653-654. To avoid what the Fed perceived as a possible meltdown of international banking caused by the crisis in Russia and when Asia and Latin American economies were already facing a steep economic slowdown. The problem is moral hazard again.

22. How well has the international capital market performed?

Answer: International portfolio diversification has increased. See also page 655.

23. Explain why, according to Feldstein and Horioka, one should expect that domestic investment rates diverge widely from saving rates.

Answer: The decisions of corporations to invest and for households to save are different. Thus globalization means more and different ways to save and invest and increasing the differences between the two ratios.

24. Explain why large interest rate differences would be strong evidence of unrealized gains from trade.

Answer: The difference between onshore and offshore interest rates on similar assets denominated in the same currency should be small if information about global investment opportunities is transmitted efficiently. Data show that this is the case for the United States, Germany, Japan and the Netherlands.

25. Discuss studies based on the interest parity conditions.

Answer: pages 659-660. In general, the formula does not hold and is not a good predictor of future devaluations. Even worse, it failed to predict correctly even the *direction* in which the spot exchange rate would change.

26. What is securitization?

Answer: The term refers to financial instruments in which bank assets are repackaged in readily marketable forms. These kind of “derivatives,” although useful for the international investors and the banks that underwrite them, causes huge problems in government abilities to monitor bank assets and independently assess their risk to the soundness of the international banking system.

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Quantitative/Graphing Problems

1. Suppose you are offered a gamble in which you win \$1,000 half the time but lose \$1,000 half the time. If you are a risk averter, will you take the gamble?

Answer: Because you are as likely to win as to lose the \$1,000, the average payoff on this gamble—its expected value—is:

$0.5 * \$1,000 + 0.5 * (-\$1,000) = 0$. If you are risk averse, you will not take the gamble because, for you, the possibility of losing \$1000 outweighs the possibility that you will win, although both outcomes are equally likely.

2. Calculate the expected payoff for the following cases, where q_1 and q_2 are the probabilities of state 1 and 2, respectively.

q_1	q_2	payoff if state 1	Payoff if state 2	Expected payoff
0.5	0.5	1,000	-1000	
0.5	0.5	200	-200	
0.5	0.5	300	-100	
0.6	0.4	1,000	-1000	

Answer:

q_1	q_2	payoff if state 1	payoff if state 2	Expected payoff
0.5	0.5	1,000	-1000	0
0.5	0.5	200	-200	0
0.5	0.5	300	-100	100
0.6	0.4	1,000	-1000	200

3. Complete the following table

q1	q2	payoff if state 1	Payoff is state 2	Expected payoff
0.5	0.5	1,000		0
0.5	0.5	200		0
0.5	0.5		-100	100
0.6	0.4		-1000	200
0.7		1100	1000	1070
0.3		1200	-100	290
	0.9	1300	-100	40
0.4		1400	-100	500

Answer:

q1	q2	payoff if state 1	Payoff is state 2	Expected payoff
0.5	0.5	1,000	-1000	0
0.5	0.5	200	-200	0
0.5	0.5	300	-100	100
0.6	0.4	1,000	-1000	200
0.7	0.3	1100	1000	1070
0.3	0.7	1200	-100	290
0.1	0.9	1300	-100	40
0.4	0.6	1400	-100	500

4. The following simple two-country question illustrates how countries are made better off by trade in assets. Imagine that there are two countries, Home and Foreign, and that residents of each own only one asset, domestic land yielding an annual harvest of kiwi fruit. Assume that the yield on the land is uncertain. Half the time, Home's land yields a harvest of 100 tons of kiwi fruit at the same time that Foreign's land yields a harvest of 50 tons. The other half of the time the outcomes are reversed. Foreign's harvest is 100 tons, but the Home harvest is only 50.

A. Calculate the average, for each country, of kiwi harvest.

Answer: The average for each country of kiwi harvest is: $0.5 \cdot 100 + 0.5 \cdot 50 = 75$ tons of kiwi fruit. However, note that the inhabitants of the two countries never know in advance whether the next year will bring feast or famine.

- B. Now suppose the two countries can trade shares in the ownership of their prospective assets. Further, assume that a Home citizen owns a 10 percent share in Foreign land. He will receive a 10 percent share in Foreign land, and thus receives 10 percent of the annual Foreign kiwi fruit harvest. Further assume that a Foreign owner of a 10 percent share in Home land is permitted. In this case, a Foreigner is entitled to 10 percent of the Home harvest.

Calculate the expected value of kiwi fruit for each investor. Is the investor better off?

Answer: Good year at Home: the farmer will get 90 tons of kiwi from home and 5 tons of kiwi from Foreign. Bad years at home: he will get 45 tons of kiwi from his Home and 10 tons from the Foreign country, namely 55 tons. The probability for a good or a bad year is 0.5. Thus the expected returns will now be:

$$0.5 \cdot 95 + 0.5 \cdot 55 = 75$$

It is not clear whether the investor is better off or not. If he likes to smooth his consumption, he may be better off. Otherwise, it is impossible to tell without a particular utility function.

- C. Now suppose the two countries can trade shares in the ownership of their prospective assets. Further assume that a Home citizen owns a 25 percent share in Foreign land. He will receive a 25 percent share in Foreign land and thus receives 25 percent of the annual Foreign kiwi fruit harvest. Further assume that a Foreign ownership of a 25 percent share in Home land is permitted also. In this case, a Foreigner is entitled to 25 percent of the Home harvest. Calculate the expected value of kiwi fruit for each investor.

Good year at Home: $75 + 12.5 = 87.5$ tons with probability 0.5

Bad year at Home: 37.5 from Home and 25 from Foreign = 62.5 with probability 0.5.

The expected return is: $0.5 \cdot 87.5 + 0.5 \cdot 62.5 = 75$. Again, this case shows smoother consumption relative to parts A or B.

- D. Now suppose the two countries can trade shares in the ownership of their prospective assets without any restrictions. Assume that the consumers in both countries would like to totally smooth their consumption. Describe the outcomes.

Answer: In this case, Home residents will buy a 50 percent share of the land in Foreign, and they will pay for it by giving Foreign residents a 50 percent share in Home land. To understand why, think about the returns to the Home and Foreign portfolios when both are equally divided between titles to Home and Foreign land. When times are good at Home (and therefore bad in Foreign), each country earns the same return harvest, which is 75 every year with certainty.

Half of the Home harvest (100 ton of kiwi fruit) plus half of the Foreign harvest (50 tons of kiwi fruit) or 75 tons of fruit.

$$0.5 \cdot 100 + 0.5 \cdot 500 = 75.$$

In the opposite case, bad times in Home, good time in Foreign, each country still earns 75 tons of fruit.

Thus, we have shown that if the countries hold portfolios equally divided between the two assets, each country earns a *certain* return of 75 tons of kiwi fruit. This certain return is exactly the same as the average harvest each faced before international asset trading was allowed. This trade completely eliminates the risk faced by both countries without changing average returns. Assuming risk-averse individuals in both countries, the two countries are better off as a result of asset trading.

- E. Now suppose that trade in assets is not allowed but the two countries sign a treaty that guarantee the sending of 25 tons of kiwi in good time by the high output country in that season. What will be the outcome of such a treaty? Explain why.

Answer: The outcomes will be exactly the same as in Case D above. In other words, rather than signing a treaty, just leaving the financial markets to function will lead us to the desirable results.

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5. Does the interest rate parity hold in each of the following cases? In case it does not hold, calculate the risk premium.
- $R_t = 5, R_t^* = 3, E_t = 5, E_{t+1}^e = 7$
 - $R_t = 6, R_t^* = 3, E_t = 5, E_{t+1}^e = 7$
 - $R_t = 7, R_t^* = 3, E_t = 5, E_{t+1}^e = 7$
 - $R_t = 8, R_t^* = 3, E_t = 5, E_{t+1}^e = 7$
 - $R_t = 5, R_t^* = 4, E_t = 5, E_{t+1}^e = 7$
 - $R_t = 5, R_t^* = 5, E_t = 5, E_{t+1}^e = 7$
 - $R_t = 5, R_t^* = 6, E_t = 5, E_{t+1}^e = 7$
 - $R_t = 5, R_t^* = 3, E_t = 6, E_{t+1}^e = 7$
 - $R_t = 5, R_t^* = 3, E_t = 7, E_{t+1}^e = 7$
 - $R_t = 5, R_t^* = 3, E_t = 8, E_{t+1}^e = 7$
 - $R_t = 5, R_t^* = 3, E_t = 5, E_{t+1}^e = 8$
 - $R_t = 5, R_t^* = 3, E_t = 5, E_{t+1}^e = 9$
 - $R_t = 5, R_t^* = 3, E_t = 5, E_{t+1}^e = 10$

Answer:

Case	R_t	R_t^*	E_t	E_{t+1}^e	Risk Premium
A	5	3	5	7	1.6
B	6	3	5	7	2.6
C	7	3	5	7	3.6
D	8	3	5	7	4.6
E	5	4	5	7	0.6
F	5	5	5	7	-0.4
G	5	6	5	7	-1.4
H	5	3	6	7	1.833333333
I	5	3	7	7	2
J	5	3	8	7	2.125
K	5	3	5	8	1.4
L	5	3	5	9	1.2
M	5	3	5	10	1

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6. Assume interest parity holds. Calculate E_{t+1}^e for each of the following cases.

Case	R_t	R_t^*	E_t	E_{t+1}^e
A	5	3	5	
B	6	3	5	
C	7	3	5	
D	8	3	5	
E	5	4	5	
F	5	5	5	

Answer:

Case	R_t	R_t^*	E_t	E_{t+1}
A	5	3	5	15
B	6	3	5	20
C	7	3	5	25
D	8	3	5	30
E	5	4	5	10
F	5	5	5	5

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Chapter 22

Developing Countries: Growth, Crisis, and Reform

Multiple Choice Questions

1. The world's economies can be divided into four main categories according to their annual per-capita income levels: low-income, lower middle-income, upper middle-income and high-income economies. What category would Pakistan and India fall under?
- A. Low-income
 - B. Upper middle-income
 - C. High-income
 - D. Lower middle-income
 - E. Pakistan and India fall between lower-middle and upper-middle

Answer: A

2. While many developing countries have reformed their economies in order to imitate the success of the successful industrial economies, the process remains incomplete and most developing countries tend to be characterized by all of the following except:
- A. Seigniorage
 - B. Control of capital movements by limiting foreign exchange transactions connected with trade in assets.
 - C. Use of natural resources or agricultural commodities as an important share of exports.
 - D. A worse job of directing savings toward their most efficient investment uses.
 - E. Reduced corruption and poverty due to limited underground markets.

Answer: E

3. Average per-capita GNP in the richest, most prosperous economies is ____ times that of the average in the ____ economies.
- A. 95 and low (poorest) income
 - B. 95 and lower-middle income
 - C. 73 and lower-middle income
 - D. 55 and low (poorest) income
 - E. 63 and low (poorest) income

Answer: E

4. Compared with industrialized economies, most developing countries are poor in the factors of production essential to modern industry: These factors are
- A. capital and skilled labor
 - B. capital and unskilled labor
 - C. fertile land and unskilled labor
 - D. fertile land and skilled labor
 - E. water and capital

Answer: A

5. The main factors that discourage investment in capital and skills in developing countries are:
- A. political instability, insecure property rights
 - B. political instability, insecure property rights, misguided economic policies
 - C. political instability, misguided economic policies
 - D. political instability
 - E. insecure property rights, misguided economic policies

Answer: B

6. The world's economies can be divided into four main categories according to their annual per-capita income levels: low-income, lower middle-income, upper middle- income and high-income economies. What category would sub-Saharan Africa fall under?
- A. Low-income
 - B. Upper middle- income
 - C. High-income
 - D. Lower middle-income
 - E. Sub-Saharan Africa falls between lower-middle and upper-middle

Answer: A

7. The world's economies can be divided into four main categories according to their annual per-capita income levels: low-income, lower middle-income, upper middle- income and high-income economies. What category would mainland China fall under?
- A. Low-income
 - B. Upper middle- income
 - C. High-income
 - D. Lower middle-income

Answer: B

8. The world's economies can be divided into four main categories according to their annual per-capita income levels: low-income, lower middle-income, upper middle- income and high-income economies. What category would the smaller Latin American and Caribbean countries fall under?
- A. Low-income
 - B. Upper middle- income
 - C. High-income
 - D. Lower middle-income
 - E. Smaller Latin American and Caribbean countries fall between low income and lower middle income

Answer: D

9. The world's economies can be divided into four main categories according to their annual per-capita income levels: low-income, lower middle-income, upper middle- income and high-income economies. What category would the Saudi Arabia falls under?
- A. Low-income
 - B. Upper middle- income
 - C. High-income
 - D. Lower middle-income
 - E. Saudi Arabia falls between low income and lower middle income economies

Answer: B

10. The world's economies can be divided into four main categories according to their annual per-capita income levels: low-income, lower middle-income, upper middle- income and high-income economies. What category would the Turkey falls under?
- A. Low-income
 - B. Upper middle- income
 - C. High-income
 - D. Lower middle-income
 - E. Turkey falls between low income and lower middle income economies

Answer: B

11. The world's economies can be divided into four main categories according to their annual per-capita income levels: low-income, lower middle-income, upper middle- income and high-income economies. What category would the Poland, Hungary, and the Czech and Slovak Republics fall under?
- A. Low-income
 - B. Upper middle- income
 - C. High-income
 - D. Lower middle-income
 - E. Poland, Hungary, and the Czech and Slovak Republics fall between low income and lower middle income economies

Answer: B

12. The world's economies can be divided into four main categories according to their annual per-capita income levels: low-income, lower middle-income, upper middle- income and high-income economies. What category would Malaysia falls under?
- A. Low-income
 - B. Upper middle- income
 - C. High-income
 - D. Lower middle-income
 - E. Malaysia falls between low income and lower middle income economies

Answer: B

13. The world's economies can be divided into four main categories according to their annual per-capita income levels: low-income, lower middle-income, upper middle- income and high-income economies. What category would Israel falls under?
- A. Low-income
 - B. Upper middle- income
 - C. High-income
 - D. Lower middle-income
 - E. Israel falls between low income and lower middle income economies

Answer: C

14. The world's economies can be divided into four main categories according to their annual per-capita income levels: low-income, lower middle-income, upper middle-income and high-income economies. What category would Kuwait falls under?
- A. Low-income
 - B. Upper middle-income
 - C. High-income
 - D. Lower middle-income
 - E. Kuwait falls between low income and lower middle income economies

Answer: C

15. The world's economies can be divided into four main categories according to their annual per-capita income levels: low-income, lower middle-income, upper middle-income and high-income economies. What category would Singapore falls under?
- A. Low-income
 - B. Upper middle-income
 - C. High-income
 - D. Lower middle-income
 - E. Singapore falls between low income and lower middle income economies

Answer: C cuuduongthancong.com

16. The upper middle-income countries enjoy only about ____ of the per-capita GNP of the industrial group.
- A. 20 percent
 - B. 15 percent
 - C. 10 percent
 - D. 5 percent
 - E. 30 percent

Answer: A

17. In general, one expects that life expectancy reflect international differences in income levels. Do the data support such a claim?
- A. Average life span falls as relative poverty increases
 - B. Average life span increases as relative poverty increases
 - C. There is no statistically significant relationship between the two
 - D. The relation is not very strong
 - E. The relationship looks more like a U-shape.

Answer: B

18. When one compares per-capital output *growth rates* among countries,
- A. One needs to correct the data to account for departures from purchasing power parity
 - B. Such corrections are often not necessary
 - C. Such corrections are sometimes necessary
 - D. The evidence whether such corrections are necessary are vague
 - E. Such corrections are not necessary

Answer: A

19. Over the period 1960 – 1992, the United States economy grew at roughly
- A. 2 percent
 - B. 3 percent
 - C. 4 percent
 - D. one percent
 - E. 3.5 percent

Answer: A

20. Over the period 1960 – 1992, Canada grew relative to the United States economy
- A. more
 - B. less
 - C. the same
 - D. The Canadian economy grew by one percent
 - E. The Canadian economy grew by 2 percent

Answer: A

21. Over the post-war era, the tendency for gaps between *industrial* countries' living standards
- A. disappeared
 - B. stayed the same
 - C. increased
 - D. decreased
 - E. hard to tell from the data

Answer: A

22. Over the post-war era, the tendency for gaps between all countries' living standards
- A. disappeared
 - B. stayed the same
 - C. increased
 - D. decreased
 - E. hard to tell from the data

Answer: E

22. Over the post-war era, poorer countries grew
- A. faster
 - B. slower
 - C. stayed the same
 - D. no general tendency can be found
 - E. Grew faster, then grew slower

Answer: D

23. Countries in Africa have grown at rates far _____ those of the main industrial countries.
- A. below
 - B. above
 - C. the same
 - D. above at the beginning of the period and below at the end of the period
 - E. below at the beginning of the period and Above at the end of the period

Answer: A

23. Since 1960, Botswana in Southern Africa enjoyed an average per-capita growth rate well _____ the average African countries
- A. above
 - B. below
 - C. the same
 - D. above at the beginning of the period and below at the end of the period
 - E. below at the beginning of the period and above at the end of the period

Answer: A

24. Since 1960, South Korea and Singapore enjoyed an average per-capita growth rate well _____ the average industrialized world
- A. above
 - B. below
 - C. the same
 - D. above at the beginning of the period and below at the end of the period
 - E. below at the beginning of the period and above at the end of the period

Answer: A

25. Until recently, per-capita income increased in East Asian countries such as Hong Kong, Singapore, South Korea, and Taiwan by ____ fold every generation
- A. 2
 - B. 3
 - C. 4
 - D. 5
 - E. 1

Answer: D

26. Since 1960, South Korea and Singapore enjoyed an average per-capita growth rate well _____ the average industrialized world
- A. above
 - B. below
 - C. the same
 - D. above at the beginning of the period and below at the end of the period
 - E. below at the beginning of the period and above at the end of the period

Answer: A

27. Between 1960 and 1992, the annual growth rate in percent per year was the highest in
- A. Canada
 - B. United States
 - C. Brazil
 - D. Honk Kong
 - E. South Korea

Answer: E

28. Seigniorage refers to
- A. real resources a government earns when it prints money to use for spending on goods and services
 - B. nominal resources a government earns when it prints money to use for spending on goods and services
 - C. real resources a government earns when it prints money
 - D. nominal resources a government earns when it prints money
 - E. real resources a government earns when it issues bonds to use for spending on goods and services

Answer: A

29. In developing countries, exchange rates tend to be
- A. floating with some government intervention
 - B. pegged
 - C. hard to tell from the data
 - D. run by currency boards
 - E. flexible

Answer: B

30. Most developing countries have tried to
- A. liberalize capital movement
 - B. control capital movements
 - C. hard to tell from the data
 - D. in the 1960's and 1970s control, now to liberalize
 - E. in the 1960's and 1970s liberalize, now to control

Answer: B

31. For many developing countries, natural resources or agricultural commodities make up _____ share of exports
- A. close to zero
 - B. not important
 - C. hard to tell
 - D. an important
 - E. close to 5 percent

Answer: D

32. In general, the development of underground economic activity ____ economic efficiency
- A. hinders
 - B. has no effect
 - C. aides
 - D. hard to tell, sometime hinders, sometimes aides
 - E. None of the above.

Answer: A

33. One should expect _____ relationship between annual per-capita GDP and an inverse index of corruption
- A. weak and negative
 - B. weak and positive
 - C. strong and negative
 - D. strong and positive
 - E. no relationship

Answer: D

34. According to Transparency International's 2000 rankings, the cleanest (least corrupt) country in the world was
- A. USA
 - B. France
 - C. Britain
 - D. Canada
 - E. Finland

Answer: E

35. According to Transparency International's 2000 rankings, the most corrupt country in the world was
- A. South Africa
 - B. Malaysia
 - C. Singapore
 - D. Nigeria
 - E. Argentina

Answer: D

36. In developing economies, national saving is often ____ relative to developed economies
- A. high
 - B. the same
 - C. hard to tell
 - D. low
 - E. low for the very poor countries and high for the more developed

Answer: D

37. Industrial countries _____
- A. have defaulted on their foreign obligations
 - B. have never defaulted on their external debts
 - C. rarely defaulted on their foreign obligations
 - D. defaulted on their foreign obligations only in the nineteen century
 - E. defaulted on their foreign obligations only in the twenties century

Answer: A

38. The word *tablita* refers to
- A. Spanish food
 - B. devaluation in Chile
 - C. devaluation in Argentina
 - D. devaluation in Uruguay
 - E. crawling peg regime in the Southern Cone countries

Answer: E

39. The Convertibility Law of April 1991 in Argentina
- A. pegged the Argentinean currency to the US dollar at a ratio of one to one.
 - B. pegged the Argentinean currency to the US dollar at a ratio of one to two.
 - C. pegged the Argentinean currency to the US dollar at a ratio of one to 0.5.
 - D. represents an era of floating exchange rate in Argentina
 - E. pegged the Argentinean currency to the British pound at a ratio of one to one

Answer: A

40. The \$50 billion emergency loan orchestrated by the U.S. Treasury and the IMF to Mexico in 1994
- A. was a disastrous policy for Mexico
 - B. avoided a disaster to the Mexican economy
 - C. did not affect Mexico in the short run
 - D. did not affect Mexico in the long run
 - E. was ineffective both in the short and long runs

Answer: B

41. Based on 1988 data, the trade share in Singapore is approximately
- A. 1
 - B. 2
 - C. 3
 - D. 3.5
 - E. 0.5

Answer: D

42. Based on 1988 data, the trade share in Hong Kong is approximately
- A. 1
 - B. 2
 - C. 3
 - D. 3.5
 - E. 0.5

Answer: C

43. Based on 1988 data, the trade share in Malaysia is approximately
- A. 1
 - B. 2
 - C. 3
 - D. 3.5
 - E. 0.5

Answer: A

44. Based on 1988 data, the trade share in Latin American countries is approximately
- A. 1
 - B. 2
 - C. 0.5
 - D. 0.25
 - E. 0.0

Answer: D

45. Brazil's 1999 crisis was relatively short lived because
- A. Brazil's financial institutions had avoided borrowing all together
 - B. Brazil's financial institutions had avoided heavy borrowing in local currency
 - C. Brazil's financial institutions had avoided heavy borrowing in dollars
 - D. Brazil's financial institutions had extended low-interest loans
 - E. Brazil's financial institutions had extended high-interest loans

Answer: C

46. 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

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Essay Questions

1. What explains the sharply divergent long-run growth patterns?

The answer lies in the economic and political features of developing countries and the way these have changed over time in response to both world events and internal pressures.

2. Describe some of the features hindering developing countries from growing faster.

Answer: pages 669-670

One of the features that can hold developing countries from growing faster is corruption. The way governments control the economy by developing restrictions that would not allow international trade among other countries; knowing that by having the doors open for international trading the country can be better off. Moreover, governments also owning or controlling the largest industries, that produce more in the countries, and controlling international transactions, they do not lead new opportunities to come into their society.

These governments also do tax evasion, which must of the time in some countries it's been out of control. Basically, developing countries have been managed by corrupt and inexperienced peoples that just want to be disturbed instead of encouraging new opportunities for a better future.

3. What factors lie behind capital inflows to the developing world?

Answer: page 672

Many developing countries have received a lot of capital inflows that lead them to a huge debt to foreigners. These debts are produced because the economy of the developing world is very small compared to the economy of the industrial world. Since developing countries face a lot of poverty and poor financial institutions, national savings is often low and because of that, they are always facing current account deficit. Even though, these countries are very poor in capital, there are opportunities for profitable introduction or expansion of firms and equipments, and these opportunities give good reason for a high level of investment. However, because these countries always have deficits in their current account, a country can obtain resources from abroad to invest even if its domestic savings level is low. This means that the country is going to have to borrow money from a foreign country. These ways of production are the one that lie behind capital inflows because by helping these countries to grow and expand, the price to be paid is a big debt which they know based on their circumstances it's going to be hard to repaid.

4. Describe alternative forms of capital inflow to finance external deficits and explain why these methods were used in different times?

Answer: pages 675-676

The capital inflows that finance developing countries' deficits are: Bond finance in which developing countries sell bonds to private foreign citizens to finance their deficits. At that time bond finance is a key to get money to solve the deficit of the country. Bank finance, which help developing countries to borrow widely from commercial banks. At that time banks provide more or less a quarter of developing country external finance. Official lending, this is use because developing countries sometimes borrow from official foreign agencies such as the World Bank or Inter American Development Bank. They like to take advantage of these banks because they to lend at interest rates below market level or on a market basis that allows the lender to earn the market rate of return. Direct foreign investment, which allows a foreign largest firm owned by foreigner's residents, acquires or expands a subsidiary firm or factory domestically. Since WWII, direct investment has been a consistently important source of developing country's capital.

5. Explain why the distinction between debt and equity finance is useful in analyzing the response of developing countries to unforeseen events such as recession or terms of trade change?

Answer: page 676. When a country's liabilities are in the form of debt, its fixed scheduled payments to creditors do not fall when its real income falls. This makes it difficult to honor the developing country's foreign obligations and may lead to default.

6. Explain why despite enormous natural resources, much of Latin America's population remains in poverty and the region has been repeatedly experiencing financial crises.

Answer: pages 676 – 677

Most Latin America population remains in poverty because bad advise and inefficient proliferated about investment decisions having taken. At the same time, the revenues available to those able to exploit limited domestic markets inspired lobbying for imports licenses and expanding the market as well as corruption. Discrimination in the import that alternates financial system and poverty at the lowest income levels grew over time. Government corruption and bad administration of money have been one of the factors that enable Latin America population from growing. Sine in 1950s and 1960s many of the Latin America countries in the region were able to attain amazing growth rates by exploiting the initially high returns from moving resources in to industrial uses from inefficient agricultural activities. Instead of using the growth to get rid of debts and decrease the deficit of the country, governments along with corrupt people wasted for getting about the debt that the country was facing.

7. Explain why in exchange rate-based stabilization plan may result in a real appreciation?

Answer: page 679. Footnote 8 gives three reasons: first, persistent inflation due to say lagged wage indexation; second, lack of credibility of the policy; and third, productivity shifts due to inflation reduction or efficient reforms. See also Figure 22-3 for illustration in the case of Argentina, Chile, Brazil and Mexico. See also Chapter 15.

8. Write an essay on the importance of a sound banking system in developing countries.

Answer: see for example the vivid example of Chile in 1981-1982 experience described in pages 681. Students should explain the phenomena of moral hazard as a part of their answer. See also page 683: the debt crisis of the 1980s. See also the case of Mexico in page 687. See pages 687 – 688 and page 690 for the East Asia case.

9. Explain why Argentina, one of the world's richest countries at the start of the twentieth century, has become progressively poorer relative to the industrial countries. [An alternative question: What explain Argentina's regress from riches to rags?]

Answer: Case Study in pages 681-683. As usual, the answer is complex, but the country's inward orientation and macroeconomic instability appear to be the major culprits.

10. Evaluate the economic policies of Juan Peron, the husband of the famous Evita?

Answer: pages 682-683.

As soon as Peron got the power in 1946, in Argentina, the economy that at that time was not so open to became even less open. Looking for the support of urban workers, Peron went beyond the policies of the 1930s in favoring import replacement over traditional agricultural exports such as wheat and bee. Its influence made it difficult for successive in Argentine governments to take apart trade barriers, reduce government involvement in industry, or impose control over public spending and inflation. Macroeconomic instability and low growth was the result. Only after the economy experienced true hyperinflation at the end of the 1980s was when a reform minded government able, starting in 1991, to remove long-standing barriers to economic growth. The economy has generally performed well since 1991, growing at an average annual rate of 6% and moving back into the ranks of upper middle-income developing countries.

11. The 1980s are considered as the "lost decade" of Latin American growth. Explain why?

Answer: page 683 and also students may get data from the IMF web site for extra credit.

Just as the Great Depression made it hard for developing countries to make payments on their foreign loans, the great recession of the 1980s also sparked a crisis over developing country debt. The fall in the industrial countries' aggregate demand had a direct negative impact on the developing countries. The problem was made worse by the dollar's sharp appreciation in the foreign exchange market, which raised the real value of the dollar debt burden substantially. The crisis began in August 1982 when Mexico announced that its central bank had run out of foreign reserves and that it could no longer meet payments on its \$80 billion in foreign debt. Seeing potential similarities between Mexico and other large Latin American debtors such as Argentina, Brazil, and Chile, banks in the industrial countries, the largest private lenders to Latin America scrambled to reduce their risks by cutting off new credits and demanding repayment on earlier loans. The result was a widespread inability of developing countries to meet prior debt obligations, and a rapid move to the edge of a generalized default. Latin America was perhaps hardest hit, but so were soviet bloc countries like Poland that had borrowed from the European banks. Nonetheless, by the end of 1986 more than 40 countries had encountered severe financing problems. Growth had slowed sharply in much of the developing countries because they have to stop producing in order to pay the debtors.

12. Explain why East Asian countries have done so well relative to South American countries.

Answer: Page 684. Mainly, the reasons are: less moral hazard, less government debt to foreigners and smaller budget deficits in East Asian countries.

13. Evaluate the Argentinean Convertibility Law of April, 1991.

Answer: pages 684-685. Good idea in the short run, catastrophic idea in the long run. The law was abandoned only in January 2002.

14. Explain how Brazil was able to reduce the rate of inflation from 2,669 percent in 1994 to less than 10 percent in 1997?

Answer: By introducing a new currency and initially pegging it to the dollar. At the cost of widespread bank failures, high interest rates in 1995 and the shift to a fixed upwardly crawling peg and a substantial real appreciation of the local currency.

15. Some economists claim that the Chilean experience during the 1990s was much more successful than its Latin American neighbors. Evaluate the Chilean policies during that decade.

Answer: page 686. Students should refer to the democratic nature of the regime, and the fact that the policies specifically targeted corruption.

16. Based on this chapter and Chapter 10, explain the reasons for the economic “miracle” of the East Asian countries between 1960 and 1997. Is it only because of the common Asian practice of industrial policy and business-government cooperation?

Answer: pages 687 – 691. Students should emphasize high rates of savings and investment, rapidly improving educational levels among the work force, and a high degree of openness to and integration with world markets.

17. Based on the 1997 Crisis and your own experience, what are the main weaknesses of the East Asian economies?

Answer: pages 689 – 692. The textbook raised mainly three issues. The first weakness is little productivity increase, most of the growth due to capital and labor inputs increase, eventually leading to diminishing returns. The second weakness is the poor state of banking regulation in most of the Asian economies. The third reason is inadequate legal framework for dealing with companies in trouble.

18. Describe the Asian financial crisis as it unfolds beginning with the devaluation of the Thai currency in July 1997, followed by the Malaysian, Indonesian and South Korean crises. As part of your answer, elaborate on the Malaysian response to the crisis versus its troubled neighbors responses.

Answer: Pages 691-692. Students should emphasize the relation to the slowdown in their largest industrial neighbor, Japan, and the reliability on large debts denominated in dollars. Malaysia did not turn to the IMF with its austerity plans. Malaysia imposed extensive foreign exchange controls on capital movements.

19. Describe the crisis in Russia starting from 1989. Explain why?

Answer: pages 692 – 694. Students should emphasize lack of legal system, tax collection, corruption, organized crime, inflation, seigniorage financing, inability to reduce spending, reduction in oil prices, gold prices, world’s recession etc. high and unsustainable interest rates, and continued support from the IMF for fear of collapse of the regime, including a possible nuclear threat if Russia decided to sell off its arsenal.

20. Contrast the crisis in Poland and Russia. Explain why the Polish economy has done better?

Answer: page 693, including table 22-6.

By the end of the 1990s, a handful of East European economies including Poland, Hungary, and the Czech Republic had made successful transitions to the entrepreneur order. Not surprisingly each of these countries was geographically close to the European Union (EU) and had a recent tradition, of industrial capitalism, including a body of contract and property law. In regards to Russia, by 1990 the Russia’s government was

unable to collect taxes or even to enforce basic laws; the country was riddled with corruption and organized crime. That is why the measured output got smaller progressively and the inflation was hard to control, so at the end of the 1990s most Russians were substantially worse off than under the old Soviet regime. As we can see, Poland's economy started producing more money to growth and decrease inflation because they were having business with potential firms.

21. The main reason for the crisis in Argentina in 2001 and 2002, as to do with exchange rate policy, i.e., the continued peg of the exchange rate to the dollar. Discuss.

Answer: pages 694-695. Student should emphasize that the quote is mainly true. Students should compare Argentina in those years with the better experience of Chile and Mexico with flexible exchange rates and emphasize the appreciation of the dollar.

22. Based on the case study, answer the following question: Can currency boards make fixed exchange rates credible?

Answer: pages 695- 697.

No, because is prohibited by law from acquiring any domestic assets, so all the currency it issues automatically is fully backed by foreign reserves. Also countries that adopt currency board, do it because one of the mayor advantage aside from the constrain it places on fiscal policy, central bank can never run out of foreign exchange reserves in the face of a speculative attack on the exchange rate. So the currency board cannot fix exchange rates.

23. Based on the case study, answer the following question: Can currency boards make low-inflation policies credible?

Answer: pages 695- 697.

Currency boards have the power to bring in anti-inflation credibility from the country to which the domestic currency is hook. Currency boards typically may not acquire government debt, but it can discourage fiscal deficits leading to reduce a major cause of inflation and devaluation. In order for a currency board to be successful is by increasing the banking sector and that can get the government under pressure to abandon the currency board. Moreover if the markets anticipate that the government is leaving the currency board, the country may not benefit from the potential of a currency board.

24. Compare currency board to conventional fixed exchange rate

Answer: pages 695-696. Currency board may not acquire domestic assets and thus cannot lend currency freely to domestic banks in time of financial crisis. Also, limit government ability to "surprise" the market and have real devaluation.

25. What do you think about dollarization?

Answer: This is an open question. The answer is probably a bad idea unless in the very short run. Students should talk about the loss of seigniorage and the gain in credibility against devaluation, which should lead to lower domestic interest rates. Students should mention the importance of political will to repair the fundamental economic weaknesses of the country.

26. What are the main lessons economists learned from the developing country crisis?

Answer:

1. Choosing the right exchange rate regime.
2. The central importance of sound banking system.
3. The proper sequence of reform measures.
4. The importance of contagion.

27. What is the theory of *Second Best*?

Answer: page 698 and Chapter 9. The principal of the *second best* tells us that when an economy suffers from multiple distortions, the removal of only a few may make matters worse, not better.

28. “Developing countries should delay opening the capital account until the domestic financial system is strong enough to withstand the sometimes violent ebb and flow of world capital.” Discuss.

Answer: page 698. Probably true. The issue is related to the theory of second best and the proper sequence of reform measures. Of course, students may argue against such step-by-step measures.

29. “Trade liberalization should precede capital account liberalization.” Discuss.

Answer: page 698. The answer is probably true. The issue is related to the theory of second best and the proper sequence of reform measures. Of course, students may argue against such step-by-step measures.

30. What is the domino effect or contagion?

Answer: page 698. The definition is the vulnerability of even seemingly healthy economies to crisis of confidence generated by events elsewhere in the world. Students should provide examples like the Thai crisis, which provoked another crisis in South Korea, a much larger economy some 7,000 miles away. Or the Russian crisis sparking massive speculation against the Brazil's real.

31. Explain the basic macroeconomic policy *trilemma* for open economies.

Answer: pages 699-701 and Chapter 21. Of three goals most countries share – *independence in monetary policy, stability in the exchange rate, and the free movement of capital* – only two can be reached simultaneously.

32. Discuss the role of more “transparency” in reducing the risk of financial crisis.

Answer: page 701. Students should discuss the Asian crisis where foreign banks lent money to Asian enterprises without any clear idea of what the risks were, and then pulled their money out equally blindly when it became clear those risks were larger than they anticipated.

33. Should the IMF be abolished? Discuss.

Answer: An open answer. Arguments for abolishing the IMF should mention moral hazard, insistence on high interest rates, hasty structural reforms, etc. Arguments against abolishing will stress more coordination, more credit lines, transparency, etc.

34. What do you think about international “Chapter 11”?

Answer: A formal procedure whereby a country can seek international legal authorization to temporarily stop paying its debt and then negotiate a settlement that gives it more time to repay, or in extreme cases, actually writes off part of its obligations. The answer is that such an idea is probably a good idea, but again more moral hazard.

35. Compare the macroeconomic performances in the 1990s of the following countries under the following exchange-rate regimes: floating exchange rates, Mexico and Brazil; capital control, China and Malaysia; and currency boards, Estonia and Hong Kong; dollarization, Argentina.

Answer: An open question. Students should use the IMF web site to discuss the issue, and to obtain data.

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Numerical Questions

1. Explain the following simple algebra of moral hazard. Suppose a real estate deal, which requires 100 million as investment today will yield 120 million with probability of 10 percent and will lose 20 million with probability of 90 percent. Suppose that the interest rate is 5 percent per annum.
 - A. Without government intervention, would anyone invest in this deal?
 - B. Suppose that now the deal is backed by full government guarantee. What will be the outcome? Does your answer depend on the attitude of the investor toward risk?
 - C. Suppose that now government guarantying only 80 percent of the initial investment. What will be the outcome? Does your answer depend on the attitude of the investor toward risk?

Answer:

Answer to question 1A, B, C.

Q#1A

No, because the expected return is less than the 100 million, which is the amount the investor has to come upfront. Based on the probability of losing so much, the investment would not take place.

Q#1B

If the government gets involve guaranteeing that he will protect the lenders or investors, yes people will invest in this type of deals. Yes, the answer depends on the attitude of the investor towards risk. When people know that someone is taking responsibility for the risk, it makes things easier.

Q#1C

The investors would not play the game if they know in advance that they will lose about 20 million, even though the government guarantees 80% of the initial investment. The deal would not take place.

2. A. Based on the Table in the case study in page 682, calculate the annual growth rate for each country for each period.
- B. Repeat A but now do it for any other time period.
- C. Repeat A but now calculates the rate of growth from 1900 to 1987.

The following table may be useful for you in order to summarize your results.

Country	1900	1913	1929	1950	1973	1987
Argentina	1284	1770	2036	2324	3713	3302
Q:A						
Q:B						
Q:C						
Australia	2923	3390	3146	4389	7696	9533
Q:A						
Q:B						
Q:C						
Canada	1808	2773	3286	4822	9350	12702
Q:A						
Q:B						
Q:C						
OECD	1817	2224	2727	3553	7852	10205
Q:A						
Q:B						
Q:C						

Answer: Student should use the formula $A(1+R)^n = B$, where for example, A is Argentina's output per capita in 1900 (=1,284), n is the number of years between, say 1900 and 1913 (n=13), and B is the Argentinean output in 1913.

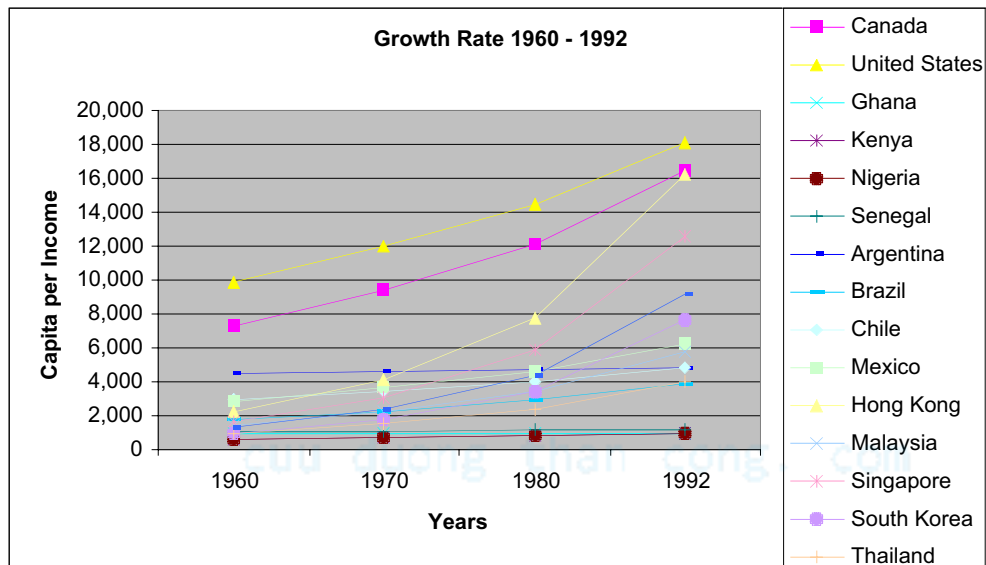
Country	1900	1913	1929	1950	1973	1987
Argentina	1284	1770	2036	2324	3713	3302
Q:A		2.50%	0.88%	0.63%	2.06%	-0.83%
Q:B				1.19%		0.95%
Q:C						1.09%
Australia	2923	3390	3146	4389	7696	9533
Q:A		1.15%	-0.47%	1.60%	2.47%	1.54%
Q:B				0.82%		
Q:C						1.37%
Canada	1808	2773	3286	4822	9350	12702
Q:A		3.34%	1.07%	1.84%	2.92%	2.21%
Q:B				1.98%		
Q:C						2.27%
OECD	1817	2224	2727	3553	7852	10205
Q:A		1.57%	1.28%	1.27%	3.51%	1.89%
Q:B				1.35%		
Q:C						2.00%

3. (Incorrectly) assume that the average annual growth rate between 1960 and 1992 were the same for each year within the period. Add two columns to Table 22-2, one for the year 1970 and one for the year 1980. Using EXCEL, plot your results in one figure, where each country has a different color.

Answer:

Country	1960	1970	1980	1992	Annual Growth Rate
Canada	7,240	9,359	12,097	16,461	2.6
United States	9,908	11,960	14,437	18,095	1.9
Ghana	886	904	922	944	0.2
Kenya	646	721	804	917	1.1
Nigeria	560	669	800	991	1.8
Senegal	1,062	1,094	1,128	1,169	0.3
Argentina	4,481	4,571	4,664	4,777	0.2
Brazil	1,780	2,279	2,917	3,923	2.5
Chile	2,897	3,395	3,979	4,814	1.6
Mexico	2,825	3,616	4,629	6,226	2.5
Hong Kong	2,231	4,149	7,715	16,242	6.4
Malaysia	1,409	2,188	3,398	5,763	4.5
Singapore	1,626	3,081	5,838	12,570	6.6
South Korea	898	1,750	3,411	7,596	6.9
Thailand	940	1,474	2,311	3,964	4.6
Taiwan	1,255	2,334	4,340	9,136	6.4

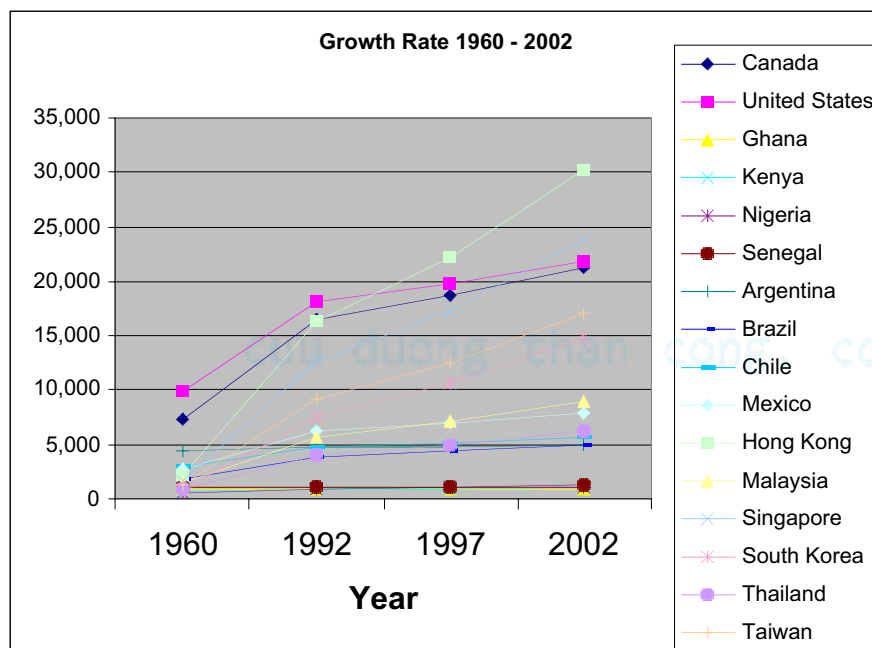
See figure



4. (Incorrectly) assume that the average annual growth rate between 1960 and 1992 continues until 2002. Add two columns to Table 22-2, one for the year 1997 and one for the year 2002. Using EXCEL, plot your results in one figure, where each country has a different color. Find which country, if any, will be the first one to overpass the US per capita income.

Answer:

Country	1960	1992	1997	2002	Annual Growth Rate
Canada	7,240	16,461	18,715	21,278	2.6
United States	9,908	18,095	19,881	21,842	1.9
Ghana	886	944	954	964	0.2
Kenya	646	917	968	1,023	1.1
Nigeria	560	991	1,084	1,185	1.8
Senegal	1,062	1,169	1,186	1,204	0.3
Argentina	4,481	4,777	4,825	4,873	0.2
Brazil	1,780	3,923	4,438	5,021	2.5
Chile	2,897	4,814	5,212	5,643	1.6
Mexico	2,825	6,226	7,044	7,969	2.5
Hong Kong	2,231	16,242	22,148	30,203	6.4
Malaysia	1,409	5,763	7,181	8,949	4.5
Singapore	1,626	12,570	17,304	23,819	6.6
South Korea	898	7,596	10,604	14,803	6.9
Thailand	940	3,964	4,964	6,215	4.6
Taiwan	1,255	9,136	12,459	16,990	6.4

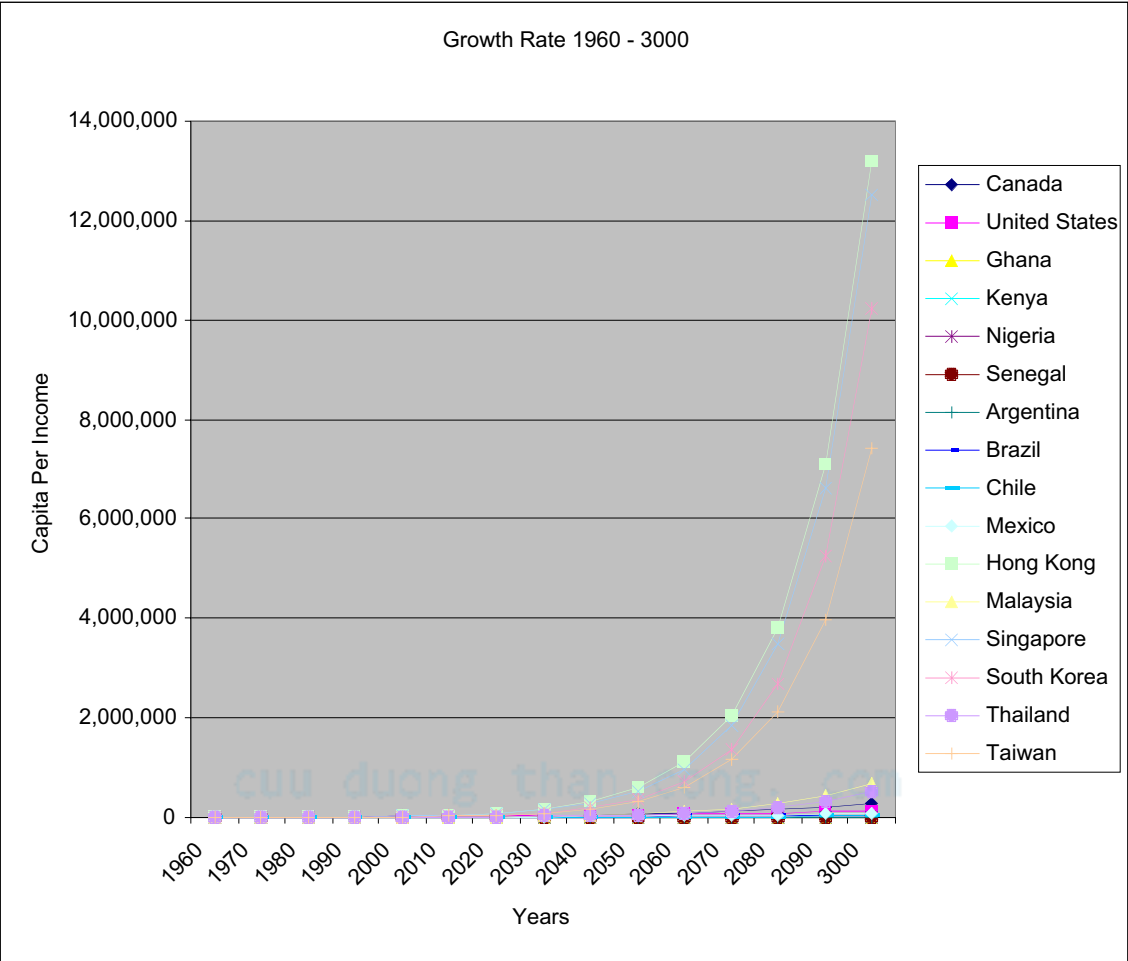


5. (Incorrectly) assume that the average annual growth rate between 1960 and 1992 were the same for each year until the end of the third millennium. Add columns to Table 22-2, one for each decade, starting from 1970, 1980, etc. until the year 3000. Using EXCEL, plot your results in one figure, where each country has a different color. Find which country will be the first one to overpass the US per capita income.

Answer:

		10	20	30	40	50	60	70
Country	1960	1970	1980	1990	2000	2010	2020	2030
Canada	7,240	9,359	12,097	15,637	20,213	26,128	33,774	43,657
United States	9,908	11,960	14,437	17,427	21,036	25,392	30,650	36,998
Ghana	886	904	922	941	960	979	999	1,019
Kenya	646	721	804	897	1,001	1,116	1,245	1,389
Nigeria	560	669	800	956	1,143	1,366	1,633	1,952
Senegal	1,062	1,094	1,128	1,162	1,197	1,234	1,271	1,310
Argentina	4,481	4,571	4,664	4,758	4,854	4,952	5,052	5,154
Brazil	1,780	2,279	2,917	3,734	4,779	6,118	7,832	10,025
Chile	2,897	3,395	3,979	4,664	5,466	6,407	7,509	8,801
Mexico	2,825	3,616	4,629	5,926	7,585	9,710	12,429	15,911
Hong Kong	2,231	4,149	7,715	14,347	26,679	49,611	92,257	171,559
Malaysia	1,409	2,188	3,398	5,277	8,195	12,727	19,765	30,694
Singapore	1,626	3,081	5,838	11,062	20,961	39,717	75,258	142,602
South Korea	898	1,750	3,411	6,647	12,953	25,244	49,197	95,877
Thailand	940	1,474	2,311	3,623	5,681	8,907	13,965	21,895
Taiwan	1,255	2,334	4,340	8,070	15,008	27,908	51,897	96,507

	80	90	100	110	120	130	140	
Country	2040	2050	2060	2070	2080	2090	3000	Annual Growth Rate
Canada	56432.26	72945.93	94291.96	121884.4	157551.3	203655.2	263250.4	2.6
United States	44660.21	53909.16	65073.53	78550.01	94817.41	114453.7	138156.6	1.9
Ghana	1039.565	1060.544	1081.947	1103.781	1126.057	1148.782	1171.965	0.2
Kenya	1549.976	1729.165	1929.07	2152.086	2400.884	2678.445	2988.094	1.1
Nigeria	2333.513	2789.254	3334.002	3985.14	4763.448	5693.76	6805.765	1.8
Senegal	1349.582	1390.62	1432.906	1476.479	1521.376	1567.638	1615.307	0.3
Argentina	5257.662	5363.767	5472.013	5582.443	5695.102	5810.035	5927.287	0.2
Brazil	12833.03	16427.36	21028.42	26918.15	34457.51	44108.52	56462.64	2.5
Chile	10314.43	12088.77	14168.35	16605.67	19462.27	22810.28	26734.23	1.6
Mexico	20367.03	26071.52	33373.75	42721.22	54686.77	70003.69	89610.65	2.5
Hong Kong	319028.7	593261.4	1103221	2051534	3815003	7094327	13192512	6.4
Malaysia	47666.61	74024.78	114958.2	178526.6	277246.4	430555.1	668638.9	4.5
Singapore	270207.2	511998.8	970154.7	1838286	3483254	6600201	12506310	6.6
South Korea	186849.8	364141.2	709654.3	1383006	2695262	5252645	10236584	6.9
Thailand	34329.12	53824.43	84391.03	132316.2	207457.9	325272.1	509992.4	4.6
Taiwan	179462.6	333726.2	620592.5	1154045	2146046	3990758	7421157	6.4



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