Chapter 18
The International Financial System

18.1 Intervention in the Foreign Exchange Market

1) A central bank _______ of domestic currency and corresponding _______ of foreign assets in the foreign exchange market leads to an equal decline in its international reserves and the monetary base, everything else held constant.
   A) sale; purchase
   B) sale; sale
   C) purchase; sale
   D) purchase; purchase

Answer: C
Ques Status: Revised

2) A central bank _______ of domestic currency and corresponding _______ of foreign assets in the foreign exchange market leads to an equal increase in its international reserves and the monetary base, everything else held constant.
   A) sale; purchase
   B) sale; sale
   C) purchase; sale
   D) purchase; purchase

Answer: A
Ques Status: Revised

3) Suppose that the Bank of Japan buys U.S. dollar assets with yen-denominated assets. Everything else held constant, this transaction will cause _______ in the foreign assets held by the Federal Reserve and _______ in the U.S. monetary base.
   A) an increase; an increase
   B) an increase; a decrease
   C) a decrease; an increase
   D) a decrease; a decrease

Answer: A
Ques Status: New
4) Suppose that the Bank of Japan buys yen–denominated assets with U.S. dollar assets. Everything else held constant, this transaction will cause ______ in the foreign assets held by the Federal Reserve and ______ in the U.S. monetary base.

   A) an increase; an increase
   B) an increase; a decrease
   C) a decrease; an increase
   D) a decrease; a decrease

Answer: D

5) When the central bank allows the purchase or sale of domestic currency to have an effect on the monetary base, it is called

   A) an unsterilized foreign exchange intervention.
   B) a sterilized foreign exchange intervention.
   C) an exchange rate feedback rule.
   D) a money neutral foreign exchange intervention.

Answer: A

6) A foreign exchange intervention with an offsetting open market operation that leaves the monetary base unchanged is called

   A) an unsterilized foreign exchange intervention.
   B) a sterilized foreign exchange intervention.
   C) an exchange rate feedback rule.
   D) a money neutral foreign exchange intervention.

Answer: B

7) Everything else held constant, if a central bank makes an unsterilized purchase of foreign assets, then the domestic money supply will ______ and the domestic currency will ______.

   A) increase; appreciate
   B) increase; depreciate
   C) decrease; appreciate
   D) decrease; depreciate

Answer: B
8) Everything else held constant, if a central bank makes an unsterilized _______ of foreign assets, then the domestic money supply will increase and the domestic currency will _______.
   A) purchase; appreciate
   B) purchase; depreciate
   C) sale; appreciate
   D) sale; depreciate
   Answer: B
   Ques Status: New

9) Everything else held constant, if a central bank makes an unsterilized _______ of foreign assets, then the domestic money supply will _______ and the domestic currency will appreciate.
   A) purchase; increase
   B) purchase; decrease
   C) sale; increase
   D) sale; decrease
   Answer: D
   Ques Status: New

10) Everything else held constant, if a central bank makes an unsterilized sale of foreign assets, then the domestic money supply will _______ and the domestic currency will _______.
    A) increase; appreciate
    B) increase; depreciate
    C) decrease; appreciate
    D) decrease; depreciate
    Answer: C
    Ques Status: New

11) Everything else held constant, if a central bank makes an unsterilized _______ of foreign assets, then the domestic money supply will decrease and the domestic currency will _______.
    A) purchase; appreciate
    B) purchase; depreciate
    C) sale; appreciate
    D) sale; depreciate
    Answer: C
    Ques Status: New
12) Everything else held constant, if a central bank makes an unsterilized ________ of foreign assets, then the domestic money supply will ________ and the domestic currency will depreciate.

A) purchase; increase  
B) purchase; decrease  
C) sale; increase  
D) sale; decrease

Answer: A  
Ques Status: New

13) Everything else held constant, if a central bank makes a sterilized purchase of foreign assets, then the domestic currency will ________.

A) appreciate  
B) depreciate  
C) either appreciate, depreciate, or remain constant  
D) not be affected

Answer: D  
Ques Status: New

14) Because sterilized interventions mean offsetting open market operations, there is no impact on the monetary base and the money supply, and therefore a sterilized intervention

A) causes the exchange rate to overshoot in the short run.  
B) causes the exchange rate to undershoot in the short run.  
C) causes the exchange rate to depreciate in the short run, but has no effect on the exchange rate in the long run.  
D) has no effect on the exchange rate.

Answer: D  
Ques Status: Previous Edition

15) Everything else held constant, if a central bank makes a sterilized sale of foreign assets, then the domestic currency will ________.

A) appreciate  
B) depreciate  
C) either appreciate, depreciate, or remain constant  
D) not be affected

Answer: D  
Ques Status: New
16) If the United States has a current account deficit with England of $1 million, and the Bank of England sells $1 million worth of pounds in the foreign exchange market, then England _______ $1 million of international reserves and its monetary base _______ by $1 million.

A) gains; rises
B) gains; falls
C) loses; rises
D) loses; falls

Answer: A
Ques Status: Revised

17) Explain and demonstrate graphically how an unsterilized purchase of foreign assets leads to overshooting of the exchange rate, and describe the long-run behavior of the exchange rate, everything else held constant.

Answer: See figure below.

A purchase of foreign assets increases the monetary base and money supply, increasing the price level and decreasing the expected appreciation of the domestic currency. In the short run, this decreased expected appreciation of the domestic currency along with the lower domestic interest rate will decrease the relative expected return on domestic assets causing the domestic currency to depreciate. Over the long run, as the domestic interest rate starts to increase, the domestic currency will start to appreciate, but (assuming money neutrality) will still be at a lower value compared to the starting value.

Ques Status: Revised
18.2 Balance of Payments

1) The difference between merchandise exports and imports is called the ________ balance.
   A) current account
   B) capital account
   C) official reserve transactions
   D) trade

Answer: D
Ques Status: Revised

2) The account that shows international transactions involving currently produced goods and services is called the
   A) trade balance.
   B) current account.
   C) balance of payments.
   D) capital account.

Answer: B
Ques Status: Previous Edition

3) The account that shows international transactions involving financial transactions (stocks, bonds, bank loans, etc.) is called the
   A) trade balance.
   B) current account.
   C) balance of payments.
   D) capital account.

Answer: D
Ques Status: New

4) Which of the following does not appear in the current account part of the balance of payments?
   A) A loan of $1 million from Chase Manhattan bank to Brazil.
   B) Foreign aid to El Salvador.
   C) An Air France ticket bought by an American.
   D) Income earned by General Motors from its plants abroad.

Answer: A
Ques Status: Revised
5) Of the following, the one that appears in the current account of the balance of payments is
   A) an Italian investor's purchase of IBM stock.
   B) income earned by U.S. subsidiaries of Barclay’s Bank of London.
   C) a loan by a Swiss bank to an American corporation.
   D) a purchase of a British Treasury bond by the Fed.

   Answer: B
   Ques Status: Revised

6) Capital ______ are American purchases of foreign assets, and capital ______ are foreign
   purchases of American assets.
   A) inflows; outflows
   B) inflows; inflows
   C) outflows; outflows
   D) outflows; inflows

   Answer: D
   Ques Status: Previous Edition

7) Which of the following appears in the capital account part of the balance of payments?
   A) A gift to an American from his English aunt.
   B) A purchase by the Honda corporation of a U.S. Treasury bill.
   D) Income earned by the Honda corporation on its automobile plant in Ohio.

   Answer: B
   Ques Status: Revised

8) The net amount of international reserves that move between governments to finance
   international transactions is called the ______ balance.
   A) capital account
   B) current account
   C) trade
   D) official reserve transactions

   Answer: D
   Ques Status: New
9) If the current account balance shows a surplus, and the capital account also shows a surplus, then the official reserve transactions balance

A) must be positive.
B) must be negative.
C) must best be zero.
D) can either be positive, negative, or zero.

Answer: A

Ques Status: Revised

10) A current account surplus indicates that America is ______ its claims on foreign wealth, while a deficit indicates that this country is ______ its claims on foreign wealth.

A) reducing; reducing
B) reducing; increasing
C) increasing; reducing
D) increasing; increasing

Answer: C

Ques Status: Previous Edition

11) Because it provides some indication of what is happening to U.S. claims on foreign wealth and the demand for imports and exports, the ______ is closely followed by economists wanting information on the future movement of exchange rates.

A) trade balance
B) capital account
C) current account balance
D) statistical discrepancy

Answer: C

Ques Status: Previous Edition

12) Economists closely follow the current account balance because they believe it can provide information on the future movement of

A) interest rates.
B) gold flows.
C) exchange rates.
D) special drawing rights.

Answer: C

Ques Status: Previous Edition
18.3 Exchange Rate Regimes in the International Financial System

1) Under a gold standard in which one dollar could be turned in to the U.S. Treasury and exchanged for 1/20th of an ounce of gold and one German mark could be exchanged for 1/100th of an ounce of gold, an exchange rate of ______ marks to the dollar would stimulate a flow of gold from the United States to Germany.

   A) 7
   B) 6
   C) 5
   D) 4

   Answer: D
   Ques Status: Previous Edition

2) When gold production was low in the 1870s and 1880s, the money supply grew _______ causing _______.

   A) rapidly; inflation
   B) rapidly; disinflation
   C) slowly; deflation
   D) slowly; disinflation

   Answer: C
   Ques Status: Previous Edition

3) The fixed exchange rate regime established at a meeting in New Hampshire in 1944 has been known as the

   A) General Agreement on Tariffs and Trade.
   B) Bretton Woods system.
   C) International Settlement Fund.
   D) Balance of Payments Compliance Accord.

   Answer: B
   Ques Status: Previous Edition

4) Under the Bretton Woods system, the organization assigned the task of making loans to countries that were experiencing balance of payments difficulties is known as the

   A) World Bank.
   B) International Development Association.
   C) International Monetary Fund.
   D) Federal Reserve System.

   Answer: C
   Ques Status: Previous Edition
5) The Bretton Woods agreement created the ________, which was given the task of promoting the growth of world trade by setting rules for the maintenance of fixed exchange rates and by making loans to countries that were experiencing balance of payments difficulties.
   A) IMF
   B) World Bank
   C) Central Settlements Bank
   D) Bank of International Settlements
   Answer: A
   Ques Status: Revised

6) The World Bank is an international organization that:
   A) promotes the growth of trade by setting rules for how tariffs and quotas are set by countries.
   B) makes loans to countries to finance projects such as dams and roads.
   C) makes loans to countries with balance of payment difficulties.
   D) helps developing countries that have been having difficulties in repaying their loans to come to terms with lenders in the West.
   Answer: B
   Ques Status: Previous Edition

7) Under the Bretton Woods system, the United States was designated as the
   A) reserve-currency country.
   B) fixed-rate country.
   C) par-standard country.
   D) dollar-standard country.
   Answer: A
   Ques Status: Previous Edition

8) Under a fixed exchange rate regime, if the domestic currency is initially ________, that is, ________ par, the central bank must intervene to sell the domestic currency by purchasing foreign assets.
   A) overvalued; below
   B) overvalued; above
   C) undervalued; below
   D) undervalued; above
   Answer: D
   Ques Status: Previous Edition
9) Under a fixed exchange rate regime, if the domestic currency is initially undervalued, that is, above par, the central bank must intervene to sell the ________ currency by purchasing ________ assets.
   A) domestic; foreign
   B) domestic; domestic
   C) foreign; foreign
   D) foreign; domestic
   Answer: A
   Ques Status: Revised

10) Under a fixed exchange rate regime, if the domestic currency is initially ________, that is, ________ par, the central bank must intervene to purchase the domestic currency by selling foreign assets.
    A) overvalued; below
    B) overvalued; above
    C) undervalued; below
    D) undervalued; above
    Answer: A
    Ques Status: Previous Edition

11) Under a fixed exchange rate regime, if the domestic currency is initially overvalued, that is, below par, the central bank must intervene to purchase the ________ currency by selling ________ assets.
    A) domestic; foreign
    B) domestic; domestic
    C) foreign; foreign
    D) foreign; domestic
    Answer: A
    Ques Status: Previous Edition

12) Under a fixed exchange rate regime, if a central bank must intervene to purchase the ________ currency by selling ________ assets, then, like an open market sale, this action reduces the monetary base and the money supply, causing the interest rate on domestic assets to rise.
    A) domestic; foreign
    B) domestic; domestic
    C) foreign; foreign
    D) foreign; domestic
    Answer: A
    Ques Status: Previous Edition
13) Under a fixed exchange rate regime, if a central bank must intervene to purchase the domestic currency by selling foreign assets, then, like an open market sale, this action _______ the monetary base and the money supply, causing the interest rate on domestic assets to _______.

A) increases; rise
B) increases; fall
C) reduces; rise
D) reduces; fall

Answer: C

Ques Status: Previous Edition

14) When the domestic currency is initially overvalued in a fixed exchange rate regime, the central bank must intervene in the foreign exchange market to _______ the domestic currency, thereby allowing the money supply to _______.

A) purchase; decline
B) sell; decline
C) purchase; increase
D) sell; increase

Answer: A

Ques Status: Revised

15) When the domestic currency is initially undervalued in a fixed exchange rate regime, the central bank must intervene in the foreign exchange market to _______ the domestic currency, thereby allowing the money supply to _______.

A) purchase; decline
B) sell; decline
C) purchase; increase
D) sell; increase

Answer: D

Ques Status: Revised

16) Under a fixed exchange rate regime, if a country has an overvalued exchange rate, then its central bank’s attempt to keep its currency from _______ will result in a _______ of international reserves.

A) depreciating; gain
B) depreciating; loss
C) appreciating; gain
D) appreciating; loss

Answer: B

Ques Status: Previous Edition
17) Under a fixed exchange rate regime, if a country has an _______ exchange rate, then its central bank’s attempt to keep its currency from depreciating will result in a _______ of international reserves.
   A) undervalued; gain
   B) undervalued; loss
   C) overvalued; gain
   D) overvalued; loss

   Answer: D
   Ques Status: Previous Edition

18) Under a fixed exchange rate regime, if a country has an undervalued exchange rate, then its central bank’s attempt to keep its currency from _______ will result in a _______ of international reserves.
   A) depreciating; gain
   B) depreciating; loss
   C) appreciating; gain
   D) appreciating; loss

   Answer: C
   Ques Status: Revised

19) Under a fixed exchange rate regime, if a country has an _______ exchange rate, then its central bank’s attempt to keep its currency from appreciating will result in a _______ of international reserves.
   A) undervalued; gain
   B) undervalued; loss
   C) overvalued; gain
   D) overvalued; loss

   Answer: A
   Ques Status: Revised

20) Under a fixed exchange rate regime, if a country’s central bank runs out of international reserves, it cannot keep its currency from
   A) depreciating.
   B) appreciating.
   C) deflating.
   D) inflating.

   Answer: A
   Ques Status: Previous Edition
21) Under a fixed exchange rate regime, a country that depletes its international reserves in an attempt to keep its currency from ________ will be forced to ________ its currency.

A) depreciating; revalue
B) depreciating; devalue
C) appreciating; revalue
D) appreciating; devalue

Answer: B
Ques Status: Revised

22) Under a fixed exchange rate regime, a central bank that does not want to acquire international reserves to keep its currency from ________ will decide to ________ its currency.

A) depreciating; revalue
B) depreciating; devalue
C) appreciating; revalue
D) appreciating; devalue

Answer: C
Ques Status: Revised

23) Under a fixed exchange rate system, countries that ran large, persistent balance of payments deficits would ________ international reserves, thereby pressuring them into ________ their exchange rate.

A) gain; devaluing
B) gain; revaluing
C) lose; devaluing
D) lose; revaluing

Answer: C
Ques Status: Previous Edition

24) Under a fixed exchange rate system, countries that ran large, persistent balance of payments surpluses would ________ international reserves, thereby pressuring them into ________ their exchange rate.

A) gain; devaluing
B) gain; revaluing
C) lose; devaluing
D) lose; revaluing

Answer: B
Ques Status: Revised
25) A balance of payments _______ is associated with a loss of international reserves, while a balance of payments _______ is associated with a gain.
   A) surplus; surplus
   B) surplus; deficit
   C) deficit; surplus
   D) deficit; deficit
   Answer: C
   Ques Status: Previous Edition

26) A balance of payments deficit is associated with a _______ of international reserves, while a balance of payments surplus is associated with a _______.
   A) loss; loss
   B) loss; gain
   C) gain; loss
   D) gain; gain
   Answer: B
   Ques Status: Previous Edition

27) To keep from running out of international reserves under the Bretton Woods system, a country had to implement _______ monetary policy to _______ its currency.
   A) expansionary; strengthen
   B) expansionary; weaken
   C) contractionary; strengthen
   D) contractionary; weaken
   Answer: C
   Ques Status: Previous Edition

28) Under the Bretton Woods system, when a country adopted an expansionary monetary policy, thereby causing a balance of payments _______, the country would eventually be forced to implement _______ monetary policy.
   A) deficit; expansionary
   B) deficit; contractionary
   C) surplus; expansionary
   D) surplus; contractionary
   Answer: B
   Ques Status: Previous Edition
29) Because the United States was the reserve-currency country under the Bretton Woods system, it could run large balance of payments _______ without _______ significant amounts of international reserves.

A) deficits; losing
B) deficits; gaining
C) surpluses; losing
D) surpluses; gaining

Answer: A

Ques Status: Previous Edition

30) The Bretton Woods system was one in which central banks

A) bought and sold their own currencies to keep their exchange rates fixed.
B) agreed not to intervene in the foreign exchange market to maintain a fixed exchange rate regime that had existed prior to World War I.
C) agreed to limit domestic money growth to the average of the five largest industrial nations.
D) agreed to limit domestic money growth to the average of the seven largest industrial nations.

Answer: A

Ques Status: Previous Edition

31) The Bretton Woods system broke down in the early 1970s for all but one of the following reasons:

A) deficit countries losing international reserves were not willing to devalue their currencies.
B) surplus countries were not willing to revalue their currencies upwards.
C) surplus countries were not willing to pursue more expansionary policies.
D) the United States had been pursuing an inflationary monetary policy to reduce domestic unemployment.

Answer: A

Ques Status: Revised

32) To maintain fixed exchange rates when countries had balance of payments deficits and were losing international reserves, the _______ would loan _______ countries international reserves contributed by other members.

A) IMF; deficit
B) IMF; surplus
C) World Bank; deficit
D) World Bank; surplus

Answer: A

Ques Status: Revised
33) Under the Bretton Woods system, the IMF could encourage _______ countries to pursue _______ monetary policies that would strengthen their currency or eliminate their balance of payment deficits.
   A) surplus; expansionary
   B) surplus; contractionary
   C) deficit; expansionary
   D) deficit; contractionary

Answer: D
Ques Status: Previous Edition

34) Under the Bretton Woods system, the IMF could encourage deficit countries to pursue contractionary monetary policies that would _______ their currency or eliminate their balance of payment _______.
   A) strengthen; surpluses
   B) strengthen; deficits
   C) weaken; surpluses
   D) weaken; deficits

Answer: B
Ques Status: Previous Edition

35) A weakness of the Bretton Woods system was that the _______ had no way to force surplus countries to either revalue their exchange rates upwards or pursue more expansionary policies.
   A) IMF
   B) World Bank
   C) European Exchange Rate Mechanism (ERM)
   D) Bank of International Settlements

Answer: A
Ques Status: Revised

36) Under the Bretton Woods system, a country running a balance of payments deficit _______ international reserves, and had to implement _______ monetary policy to strengthen its currency.
   A) lost; expansionary
   B) lost; contractionary
   C) gained; expansionary
   D) gained; contractionary

Answer: B
Ques Status: Previous Edition
37) Under the Bretton Woods system, a country running a balance of payments _______ lost international reserves, and had to implement _______ monetary policy to strengthen its currency.

   A) surplus; expansionary
   B) surplus; contractionary
   C) deficit; expansionary
   D) deficit; contractionary

   Answer: D

   Ques Status: Previous Edition

38) Under the Bretton Woods system, a country running a balance of payments surplus _______ international reserves, and had to implement _______ monetary policy to weaken its currency.

   A) lost; expansionary
   B) lost; contractionary
   C) gained; expansionary
   D) gained; contractionary

   Answer: C

   Ques Status: Previous Edition

39) Under the Bretton Woods system, if IMF loans were insufficient to prevent _______ of a currency, then the country was allowed to devalue its currency by setting a new, _______ exchange rate.

   A) depreciation; lower
   B) depreciation; higher
   C) appreciation; lower
   D) appreciation; higher

   Answer: A

   Ques Status: Previous Edition

40) As a result of its power to dictate loan terms to borrowing countries (under the Bretton Woods system), the IMF could encourage _______ countries to pursue _______ monetary policies that would strengthen their currency or eliminate their balance of payments deficits.

   A) surplus; contractionary
   B) surplus; expansionary
   C) deficit; contractionary
   D) deficit; expansionary

   Answer: C

   Ques Status: Previous Edition
41) Because central banks have not been willing to give up their option of intervening in the foreign exchange market, the current international financial system can best be described as a
   A) variable-pegged exchange rate system.
   B) moving-pegged exchange rate system.
   C) hybrid of a fixed exchange rate and flexible exchange rate system.
   D) flexible-exchange, dollar-pegged exchange rate system.
   Answer: C
   *Ques Status: Previous Edition*

42) The current international financial system is a managed float exchange rate system because
   A) exchange rates fluctuate in response to, but are not determined solely by, market forces.
   B) some countries keep their currencies pegged to the dollar, which is not allowed to fluctuate.
   C) all countries allow their exchange rates to fluctuate in response to market forces.
   D) all countries peg their currencies to the dollar which is allowed to fluctuate in response to market forces.
   Answer: A
   *Ques Status: Previous Edition*

43) Policymakers in a country with a balance of payments surplus may not want to see their country’s currency appreciate because this would
   A) hurt consumers in their country by making foreign goods more expensive.
   B) hurt domestic businesses by making foreign goods cheaper in their country.
   C) increase inflation in their country.
   D) decrease the wealth of the country.
   Answer: B
   *Ques Status: Revised*

44) Under the current managed float exchange rate regime, countries with balance of payments deficits frequently do not want to see their currencies depreciate because it makes _______ goods more expensive for _______ consumers and can stimulate inflation.
   A) foreign; foreign
   B) foreign; domestic
   C) domestic; foreign
   D) domestic; domestic
   Answer: B
   *Ques Status: Previous Edition*
45) Countries with surpluses in their balance of payments frequently do not want to see their currencies _______ because it makes their goods _______ expensive abroad.
   A) appreciated; less
   B) appreciate; more
   C) depreciated; less
   D) depreciate; more
Answer: B

46) Countries with balance of payments deficits do not want to see their currencies _______ because it makes foreign goods _______ expensive for domestic consumers.
   A) appreciate; less
   B) appreciate; more
   C) depreciate; less
   D) depreciate; more
Answer: D

47) Under the current managed float exchange rate regime, countries with _______ in their balance of payments frequently do not want to see their currencies _______ because it makes their goods more expensive abroad and foreign goods cheaper in their countries.
   A) surpluses; depreciate
   B) deficits; depreciate
   C) surpluses; appreciate
   D) deficits; appreciate
Answer: C

48) Under the current managed float exchange rate regime; countries with surpluses in their balance of payments frequently do not want to see their currencies appreciate because it makes their goods _______ expensive abroad and foreign goods _______ in their countries.
   A) more; cheaper
   B) more; costlier
   C) less; cheaper
   D) less; costlier
Answer: A
49) Under the current managed float exchange rate regime, countries with balance of payments _______ frequently do not want to see their currencies _______ because it makes foreign goods more expensive for domestic consumers and can stimulate inflation.
   A) surpluses; depreciate
   B) deficits; depreciate
   C) surpluses; appreciate
   D) deficits; appreciate

   Answer: B

50) Which of the following is true?
   A) Special drawing rights are loans to countries made by the IMF.
   B) Changes in the quantity of special drawing rights are tied to changes in the quantity of gold.
   C) Special drawing rights are a paper substitute for gold.
   D) Special drawing rights are not held as international reserves.

   Answer: C

51) An ECU was
   A) a paper substitute for gold issued by the IMF.
   B) a loan by European countries to the IMF.
   C) a paper currency issued by the European Common Market.
   D) a monetary unit created by the European Monetary System.

   Answer: D

52) Under the Exchange Rate Mechanism of the European Monetary System, when the British pound depreciated below its lower limit against the German mark, the Bank of England was required to buy _______ and sell _______, thereby _______ international reserves.
   A) pounds; marks; losing
   B) pounds; marks; gaining
   C) marks; pounds; gaining
   D) marks; pounds; losing

   Answer: A
53) Under the Exchange Rate Mechanism of the European Monetary System, when the British pound depreciated below its lower limit against the German mark, the German central bank was required to buy ______ and sell _______, thereby ______ international reserves.
   A) pounds; marks; losing
   B) pounds; marks; gaining
   C) marks; pounds; gaining
   D) marks; pounds; losing

   Answer: B

   Ques Status: Previous Edition

54) Under the Exchange Rate Mechanism of the European Monetary System, when the German mark depreciated below its lower limit against the British pound, the Bank of England was required to buy ______ and sell _______, thereby ______ international reserves.
   A) pounds; marks; losing
   B) pounds; marks; gaining
   C) marks; pounds; gaining
   D) marks; pounds; losing

   Answer: C

   Ques Status: Previous Edition

55) Under the Exchange Rate Mechanism of the European Monetary System, when the German mark depreciated below its lower limit against the British pound, the German central bank was required to buy _____ and sell ____, thereby ____ international reserves.
   A) pounds; marks; losing
   B) pounds; marks; gaining
   C) marks; pounds; gaining
   D) marks; pounds; losing

   Answer: D

   Ques Status: Revised

56) In September 1992, the Bundesbank attempted to keep the mark from appreciating relative to the British pound, but it failed because participants in the foreign exchange market came to expect the
   A) appreciation of the mark.
   B) depreciation of the mark.
   C) revaluation of the dollar.
   D) end of the Exchange Rate Mechanism.

   Answer: A

   Ques Status: Revised
57) The East Asia currency crisis in 1997 started in
   A) Japan.
   B) Thailand.
   C) South Korea.
   D) Philippines.

   Answer: B
   Ques Status: Previous Edition

58) Between May and July 1997, concerns about the large current account deficit in Thailand and
   the weakness in the Thai financial system caused speculators to suspect that Thailand might be
   forced to
   A) devalue its currency.
   B) sell baht to prop up its value.
   C) buy dollars to prop up the baht.
   D) impose capital controls.

   Answer: A
   Ques Status: Previous Edition

59) Explain and demonstrate graphically the situation of an overvalued exchange rate in a fixed
   exchange rate system. What alternative policies are available to eliminate the overvaluation of
   the exchange rate?

   Answer: See the figure below.

   ![Exchange Rate Diagram]

   The par value is above the equilibrium value, resulting in overvaluation of the exchange
   rate. One approach is to pursue contractionary monetary policies, raising interest rates
   and increasing the demand for domestic assets. This process continues until equilibrium
   at par value is restored. Another alternative is for the central bank to purchase domestic
   currency by selling foreign assets.

   Ques Status: Revised
60) Assume that a fixed exchange rate is overvalued. Describe the situation of a speculative crisis against this currency. What can the central bank do to defend the currency? Why might the alternative of devaluation be preferable?

Answer: When the speculative attack begins, the expected depreciation of the domestic currency increases substantially, decreasing the demand for domestic assets. Contractionary monetary policy is needed to increase domestic interest rates enough to defend the currency. The cost to the central bank in terms of the costs of intervention and the contractionary effect on the economy may make devaluation preferable.

Ques Status: Revised

18.4 Capital Controls

1) A capital ______ can promote financial instability in an emerging-market country because it is what forces a country to ______ its currency.

A) inflow; devalue
B) inflow; revalue
C) outflow; devalue
D) outflow; revalue

Answer: C
Ques Status: Previous Edition

2) A capital ______ can promote financial instability in an emerging-market country because it can lead to a lending boom and excessive risk-taking on the part of banks, which helps trigger a ______.

A) inflow; financial crisis
B) inflow; currency devaluation
C) outflow; financial crisis
D) outflow; currency devaluation

Answer: A
Ques Status: Previous Edition

3) A case for capital inflow controls can be made because capital inflows

A) can cause a lending boom and lead to excessive risk taking.
B) never finance productive investments.
C) always finance productive investments.
D) are less likely to cause financial crises than regulation of banking activities.

Answer: A
Ques Status: Revised
4) Which of the following is not a disadvantage of controls on capital outflows?

A) The controls may lead to excessive risk taking by the domestic banks.
B) They are seldom effective during a crisis.
C) Capital flight may increase after they are put in place.
D) Controls often lead to an increase in government corruption.

Answer: A

Ques Status: New

18.5 The Role of the IMF

1) In the 1990s this agency has acted like an international lender of last resort to cope with financial instability.

A) World Bank
B) European Central Bank
C) IMF
D) International Bank for Reconstruction and Development

Answer: C

Ques Status: Previous Edition

2) An international lender of last resort creates a serious _______ problem because depositors and other creditors of banking institutions expect that they will be protected if a crisis occurs.

A) moral hazard
B) adverse selection
C) public choice
D) strategic choice

Answer: A

Ques Status: Previous Edition

3) An international lender of last resort creates a serious moral hazard problem because _______ and other _______ of banking institutions expect that they will be protected if a crisis occurs.

A) depositors; debtors
B) depositors; creditors
C) borrowers; debtors
D) borrowers; creditors

Answer: B

Ques Status: Previous Edition
4) Critics of the IMF contend that its lending in the Mexican crisis, which was used to bail out foreign _______, set the stage for the ________ crisis because these _______ expected to be bailed out if things went wrong.

A) lenders; East Asian; borrowers
B) lenders; East Asian; lenders
C) borrowers; Russian; borrowers
D) borrowers; Russian; lenders

Answer: B

Ques Status: Previous Edition

5) Critics of the IMF contend that its lending in the ________ crisis, which was used to bail out foreign lenders, set the stage for the ________ crisis because these lenders expected to be bailed out if things went wrong and thus provided funds that were used to fuel excessive risk taking.

A) Russian; Mexican
B) Russian; East Asian
C) Mexican; Russian
D) Mexican; East Asian

Answer: D

Ques Status: Previous Edition

6) An advantage of an international lender of last resort is its ability to prevent ________, in which a successful speculative attack on one currency leads to attacks on others; its disadvantage is the problem of ________ if creditors expect to be protected if a crisis occurs.

A) contagion; moral hazard
B) contagion; adverse selection
C) currency virus; moral hazard
D) currency virus; adverse selection

Answer: A

Ques Status: Previous Edition

18.6 International Considerations and Monetary Policy

1) In the early 1970s, the U.S. ran large balance of payments _______, causing an _______ dollar and an _______ German mark.

A) deficits; undervalued; overvalued
B) deficits; overvalued; undervalued
C) surpluses; undervalued; overvalued
D) surpluses; overvalued; undervalued

Answer: B

Ques Status: Previous Edition
2) In response to the overvalued dollar in the early 1970s, the German Bundesbank bought _______ and sold _______ to keep the exchange rate fixed, gaining international reserves.

A) marks; dollars  
B) marks; pounds  
C) dollars; marks  
D) dollars; pounds

Answer: C
Ques Status: Revised

3) In response to the overvalued dollar in the early 1970s, the German Bundesbank bought dollars and sold marks to keep the exchange rate fixed, gaining international reserves. The huge purchase of international reserves meant that the German monetary base began to _______, leading to _______ growth in the German money supply.

A) decline; sluggish  
B) decline; rapid  
C) grow; sluggish  
D) grow; rapid

Answer: D
Ques Status: Revised

4) The German central bank gained international reserves in the early 1970s because it sold _______ to prevent mark _______.

A) marks; appreciation  
B) dollars; appreciation  
C) marks; depreciation  
D) dollars; depreciation

Answer: A
Ques Status: Revised

5) Since the abandonment of the Bretton Woods system, balance of payments considerations have become _______ important, and exchange rate considerations _______ important in the conduct of monetary policy.

A) more; less  
B) more; more  
C) less; less  
D) less; more

Answer: D
Ques Status: Previous Edition
6) If a central bank does not want to see its currency fall in value, it may pursue _______ monetary policy to _______ the domestic interest rate, thereby strengthening its currency.
   A) expansionary; raise
   B) contractionary; raise
   C) expansionary; lower
   D) contractionary; lower
   Answer: B
   Ques Status: Previous Edition

7) If a central bank does not want to see its currency _______ in value, it may pursue contractionary monetary policy to raise the domestic interest rate, thereby _______ its currency.
   A) fall; strengthening
   B) fall; weakening
   C) rise; strengthening
   D) rise; weakening
   Answer: A
   Ques Status: Previous Edition

8) If a central bank does not want to see its currency rise in value, it may pursue _______ monetary policy to _______ the domestic interest rate, thereby weakening its currency.
   A) expansionary; raise
   B) contractionary; raise
   C) expansionary; lower
   D) contractionary; lower
   Answer: C
   Ques Status: Previous Edition

9) If a central bank does not want to see its currency _______ in value, it may pursue expansionary monetary policy to lower the domestic interest rate, thereby _______ its currency.
   A) fall; strengthening
   B) fall; weakening
   C) rise; strengthening
   D) rise; weakening
   Answer: D
   Ques Status: Previous Edition
10) If a central bank does not want to allow the domestic currency to appreciate, it will _______ international reserves by selling its currency, thereby _______ the monetary base and increasing the risk of higher inflation.

A) lose; decreasing
B) lose; increasing
C) acquire; decreasing
D) acquire; increasing

Answer: D

11) If a central bank does not want to allow the domestic currency to depreciate, it will _______ international reserves by purchasing its currency, thereby _______ the monetary base and increasing the risk of higher unemployment.

A) lose; decreasing
B) lose; increasing
C) acquire; decreasing
D) acquire; increasing

Answer: A

12) A central bank's attempt to prevent an appreciation of its currency can stimulate domestic inflation if the _______ of its currency leads to _______ international reserves which _______ the monetary base.

A) purchase; higher; increases
B) purchase; lower; decreases
C) sale; lower; decreases
D) sale; higher; increases

Answer: D

13) A central bank's attempt to prevent an appreciation of its currency can stimulate domestic inflation if the _______ of foreign currencies leads to _______ international reserves which _______ the monetary base.

A) purchase; higher; increases
B) purchase; lower; decreases
C) sale; lower; decreases
D) sale; higher; increases

Answer: A
18.7 To Peg or not to Peg: Exchange-Rate Targeting as an Alternative Monetary Policy Strategy

1) A monetary policy strategy that uses a fixed exchange rate regime that ties the value of a currency to the currency of a large, low inflation country is called _______ targeting.

   A) exchange-rate  
   B) currency  
   C) monetary  
   D) inflation

   Answer: A

   Ques Status: New

2) Under an exchange-rate targeting rule for monetary policy, a crawling peg

   A) fixes the value of the domestic currency to a commodity such as gold.  
   B) fixes the value of the domestic currency to that of a large, low-inflation country.  
   C) allows the domestic currency to depreciate at a steady rate so that inflation in the pegging country can be higher than that of the anchor country.  
   D) allows the domestic currency to depreciate at a steady rate so that inflation in the pegging country can be lower than that of the anchor country.

   Answer: C

   Ques Status: Revised

3) An advantage to exchange-rate targeting is it helps keep inflation under control by tying the inflation rate for _______ traded goods to what is found in the _______ country.

   A) domestically; anchor  
   B) domestically, domestic  
   C) internationally; anchor  
   D) internationally; domestic

   Answer: C

   Ques Status: New

4) Exchange-rate targeting allows a central bank to _______, thus this will _______ the probability of policy developing a time-inconsistency problem.

   A) be governed by a policy rule; decrease  
   B) follow discretionary policy; decrease  
   C) be governed by a policy rule; increase  
   D) follow discretionary policy; increase

   Answer: A

   Ques Status: New
5) Which of the following is not an advantage to exchange-rate targeting?
   A) It provides a strong nominal anchor to keep inflation under control.
   B) It provides an automatic rule for policy to help avoid the time-inconsistency problem.
   C) It is simple and clear so that the public can easily understand it.
   D) It increases the accountability of policymakers.

   Answer: D
   Ques Status: New

6) Under exchange-rate targeting, the central bank in the targeting country _______ lose the ability to pursue its own independent monetary policy and any shocks to the anchor country is _______ transmitted to the targeting country.
   A) does; directly
   B) does not; directly
   C) does; not directly
   D) does not; not directly

   Answer: A
   Ques Status: New

7) Both France and the United Kingdom successfully used exchange-rate targeting to lower inflation in the late 1980s and early 1990s by tying the value of their currencies to the
   A) U.S. dollar.
   B) German mark.
   C) Swiss franc.
   D) Euro.

   Answer: B
   Ques Status: Previous Edition

8) Which of the following is not a disadvantage of exchange-rate targeting?
   A) It relies on a stable money-inflation relationship.
   B) The targeting country gives up an independent monetary policy.
   C) The targeting country is left open for a speculative attack.
   D) It can weaken the accountability of policymakers.

   Answer: A
   Ques Status: New
9) Two reasons for industrialized countries to adopt an exchange-rate targeting regime are if the country ________ conduct successful monetary policy on their own, and if the country wants to ________ integration of the domestic economy with its neighbors.

   A) cannot; encourage
   B) cannot; discourage
   C) can; encourage
   D) can; discourage

   Answer: A
   Ques Status: New

10) An emerging market country that successfully used exchange-rate targeting to lower its inflation from above 100 percent in 1988 to below 10 percent in 1994 (before devaluation) was

   A) Thailand.
   B) Mexico.
   C) Philippines.
   D) Indonesia.

   Answer: B
   Ques Status: Previous Edition

11) Because many emerging market countries have not developed the political or monetary institutions that allow the successful use of discretionary monetary policy,

   A) they have little to gain from pegging their exchange rate to an anchor country like the U.S. or Germany.
   B) they have little to gain from using a nominal anchor, because it would mean a monetary policy that is overly expansionary.
   C) they have very little to gain from an independent monetary policy, but a lot to lose.
   D) they would be better off giving their central bankers the independence to use discretion, rather than take their discretion away through any nominal anchor.

   Answer: C
   Ques Status: Previous Edition
12) Emerging market countries are in effect between a rock and a hard place because
   A) they would be wise to adopt the monetary policy of the United States by pegging their
   currencies to the dollar, but this policy leaves them open to speculative attacks.
   B) to avoid speculative attacks on their currencies they must peg their exchange rates to an
   anchor country, but this means giving central bankers in these countries too much
   discretion.
   C) to avoid speculative attacks on their currencies they must peg their exchange rates to an
   anchor country, but this means giving central bankers in these countries too little
   discretion.
   D) by adopting the monetary policy of the anchor country through an exchange rate peg,
   these countries allow for too little monetary expansion and thereby sacrifice economic
   growth for price stability.

   Answer: A
   Ques Status: Previous Edition

13) When a domestic currency is completely backed by a foreign currency and the note-issuing
    authority establishes a fixed exchange rate to this foreign currency, then the country is said to
    have
       A) created a currency board.
       B) undergone dollarization.
       C) adopted a managed exchange system.
       D) adopted an exchange rate monetary system.

   Answer: A
   Ques Status: New

14) When a country forgoes its own currency and starts using another country’s currency as its
    own, we say that this country has
       A) created a currency board.
       B) undergone dollarization.
       C) adopted a managed exchange system.
       D) adopted an exchange rate monetary system.

   Answer: A
   Ques Status: New
15) The revenue a government gains from issuing money is
   A) interest.
   B) rent.
   C) seignorage.
   D) the national dividend.
   E) the inflation tax.
   Answer: C
   Ques Status: Previous Edition

16) A country that dollarizes
   A) maximizes its seignorage.
   B) earns the same amount of seignorage as it would with a currency board.
   C) earns the same amount of seignorage as it would with exchange-rate targeting.
   D) eliminates its seignorage.
   E) must pay seignorage to other governments to use their currency.
   Answer: D
   Ques Status: Previous Edition

17) The seignorage for a government is greater for _______ than for _______.
   A) dollarization; a currency board
   B) dollarization; exchange-rate targeting
   C) dollarization; monetary targeting
   D) dollarization; inflation targeting
   E) exchange-rate targeting; dollarization
   Answer: E
   Ques Status: Previous Edition

18) Exchange-rate targeting is not an option for the United States because
   A) the United States is already dollarized.
   B) the United States is too large.
   C) the Fed has adopted a monetary targeting strategy.
   D) the Fed has adopted an inflation targeting strategy.
   Answer: B
   Ques Status: Revised
19) The monetary policy strategy that provides an automatic rule for the conduct of monetary policy is

A) exchange-rate targeting.
B) monetary targeting.
C) inflation targeting.
D) the implicit nominal anchor.

Answer: A

20) The monetary policy strategy that does not allow the policy to focus on domestic considerations is

A) exchange-rate targeting.
B) monetary targeting.
C) inflation targeting.
D) the implicit nominal anchor.

Answer: A

21) The monetary policy strategy that results in the loss of an independent monetary policy is

A) exchange-rate targeting.
B) monetary targeting.
C) inflation targeting.
D) the implicit nominal anchor.

Answer: A

22) The monetary policy strategy that directly ties down the price of internationally traded goods is

A) exchange-rate targeting.
B) monetary targeting.
C) inflation targeting.
D) the implicit nominal anchor.

Answer: A

23) Explain an additional disadvantage for a country undergoing dollarization compared to a currency board or other exchange-rate targeting regimes.

Answer: The additional disadvantage to dollarization is that the government loses seignorage. Seignorage is the income that a government earns by issuing its own currency.
24) Explain the 1992 crisis that led to the breakdown of the European Union’s Exchange Rate Mechanism. What disadvantages of exchange-rate targeting were exhibited during this crisis?

Answer: The 1992 crisis began with Germany raising interest rates in 1990 to stem inflationary pressures from reunification. This demand shock was immediately transmitted to the other nations in the exchange-rate mechanism. Thus, these countries did not have independent monetary policies and were subject to shocks from the anchor country. This gave rise to the second problem. Speculators bet that these other countries would not want the increased unemployment resulting from the tight monetary policy. Betting that their commitment was weak, speculators bet against these currencies, and a number were forced to devalue or drop out of the ERM. The disadvantages illustrated by this are the lack of independent policy subjecting member nations to shocks from the anchor nation, and the possibility of speculative attacks when commitment is felt to be weak.

Ques Status: Previous Edition