Chapter 30 Exercises

Self-Check Questions

1. How will a stronger euro affect the following economic agents?
   a. A British exporter to Germany
   b. A Dutch tourist visiting Chile
   c. A Greek bank investing in a Canadian government bond
   d. A French exporter to Germany
2. Suppose that political unrest in Egypt leads financial markets to anticipate depreciation of the Egyptian pound. How will that affect the demand for pounds, supply of pounds, and exchange rate for pounds compared to U.S. dollars?
3. Suppose U.S. interest rates decline compared to the rest of the world. What would be the likely impact on the demand for dollars, supply of dollars, and exchange rate for dollars compared to euros?
4. Suppose Argentina gets inflation under control and the Argentine inflation rate decreases substantially. What would likely happen to the demand for Argentine pesos, the supply of Argentine pesos, and the peso/U.S. dollar exchange rate?
5. This chapter has explained that one of the most economically destructive effects of exchange rate fluctuations can happen through the banking system if banks borrow from abroad to lend domestically. Why is this less likely to be a problem for the U.S. banking system?
6. A booming economy can attract financial capital inflows, which promote further growth. But capital can just as easily flow out of the country, leading to an economic recession. Is a country whose economy is booming because it decided to stimulate consumer spending more or less likely to experience capital flight than an economy whose boom is caused by economic investment expenditure?
7. How would contractionary monetary policy affect the exchange rate, net exports, aggregate demand, and aggregate supply?
8. A central bank can allow its currency to fall indefinitely, but it cannot allow its currency to rise indefinitely. Why not?
9. Is a country for which imports and exports make up a large fraction of the GDP more likely to adopt a flexible exchange rate or a fixed (hard peg) exchange rate?

Review Questions

10. What is the foreign exchange market?
11. Describe some buyers and some sellers in the market for U.S. dollars.
12. What is the difference between foreign direct investment and portfolio investment?
13. What does it mean to hedge a financial transaction?
14. What does it mean to say that a currency appreciates? Depreciates? Becomes stronger? Becomes weaker?
15. Does an expectation of a stronger exchange rate in the future affect the exchange rate in the present? If so, how?
16. Does a higher rate of return in a nation's economy, all other things being equal, affect the exchange rate of its currency? If so, how?

17. Does a higher inflation rate in an economy, other things being equal, affect the exchange rate of its currency? If so, how?

18. What is the purchasing power parity exchange rate?

19. What are some of the reasons a central bank is likely to care, at least to some extent, about the exchange rate?

20. How can an unexpected fall in exchange rates injure the financial health of a nation's banks?

21. What is the difference between a floating exchange rate, a soft peg, a hard peg, and dollarization?

22. List some advantages and disadvantages of the different exchange rate policies.

Critical Thinking Questions

23. Why would a nation dollarize—that is, adopt another country's currency instead of having its own?

24. Can you think of any major disadvantages to dollarization? How would a central bank work in a country that has dollarized?

25. If a country's currency is expected to appreciate in value, what do you think will be the impact of expected exchange rates on yields (e.g., the interest rate paid on government bonds) in that country? (*Hint*: think about how expected exchange rate changes and interest rates affect demand and supply for a currency.)

26. Do you think that a country experiencing hyperinflation is more or less likely to have an exchange rate equal to its purchasing power parity value when compared to a country with a low inflation rate?

27. Suppose a country has an overall balance of trade so that exports of goods and services equal imports of goods and services. Does that imply that the country has balanced trade with each of its trading partners?

28. If a developing country needs foreign capital inflows, management expertise, and technology, how can it encourage foreign investors while at the same time protect itself against capital flight and banking system collapse, as happened during the Asian financial crisis?

29. Many developing countries, like Mexico, have moderate to high rates of inflation. At the same time, international trade plays an important role in their economies. What type of exchange rate approach would be best for such a country's currency compared to the U.S. dollar?

30. What would make a country decide to change from a common currency, like the euro, back to its own currency?

Problems

31. A British pound (GBP) cost 1.56 in U.S. dollars (USD) in 1996, but it cost USD 1.66 in 1998. Was the pound weaker or stronger against the dollar? Did the dollar appreciate or depreciate versus the pound?

32. Using the information from Question 31, calculate the cost of a U.S. dollar in terms of British pounds in 1996 and 1998.