

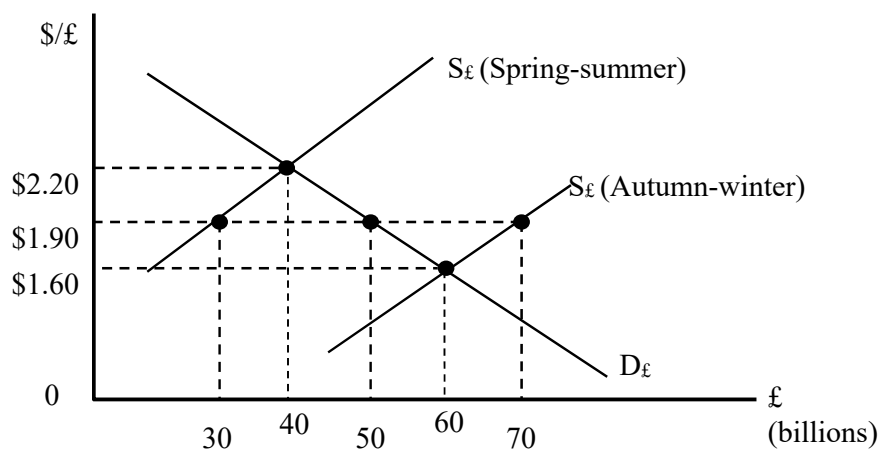
## Topic 4 Review Questions

### Multiple choices:

1. Which of the following statements is true?
  - a. The special drawing right (SDR) is a basket of currencies made up of U.S. dollars, euros, British pounds, and Japanese yen.
  - b. Today, only China and Switzerland have currencies fixed to gold.
  - c. Currencies whose prices are fixed to the same commodity would ensure that arbitrage will not work and exchange rates will be floating.
  - d. A country maintains a floating exchange rate value to weaken the international value of its currency.
  
2. Which of the following terms is used to describe an exchange rate regime in which the rate is fixed to a currency or basket of currencies?
  - a. Exchange controls
  - b. Pegged exchange rate
  - c. Managed float
  - d. Fully convertible
  
3. An exchange rate regime in which the government may change the fixed rate in the face of a significant disequilibrium in the country's international position is called a(n):
  - a. pegged exchange rate.
  - b. fixed exchange rate.
  - c. adjustable peg.
  - d. managed float.
  
4. If a country with a relatively high inflation rate maintains a pegged exchange rate against the currency of a relatively low inflation country:
  - a. its currency will depreciate.
  - b. its exports will become more competitive in international market.
  - c. its currency will sell at a discount.
  - d. its exports will become less competitive in the international market.
  
5. For a country which has a relatively high rate of inflation and wants some form of pegged exchange rate, which of the following exchange rate regimes is the best choice?
  - a. Fully fixed exchange rate
  - b. Adjustable peg
  - c. Crawling peg
  - d. Fully convertible
  
6. Which of the following mechanisms cannot be adopted by a country to defend a fixed exchange rate?
  - a. The government can buy or sell foreign currency in order to influence the actual exchange rate.
  - b. The government can allow the currency to self-adjust and the resulting market rate will be equal to the intended rate in the fixed exchange rate regime.
  - c. The government can impose a form of exchange control.
  - d. The government can alter domestic interest rates in order to influence short-term capital flows.

7. Consider that Britain is trying to maintain a fixed exchange rate with respect to the U.S. dollar. However, the present situation in the foreign exchange market is conducive for the British pound to depreciate with respect to the U.S. dollar. Which of the following interventions will stem the pressures for depreciation of the pound?
  - a. The government of Britain should sell pounds and buy dollars.
  - b. The government of Britain should do nothing as a fixed rate will not change.
  - c. The government of Britain should buy pounds and sell dollars.
  - d. The government of Britain should increase the country's money supply.
8. Consider that Britain is trying to maintain a fixed exchange rate with respect to the U.S. dollar. However, the present situation in the foreign exchange market is conducive for the British pound to depreciate with respect to the U.S. dollar. Pressures are there to make British pounds appreciate and not depreciate. Which of the following interventions is most likely in this situation?
  - a. The government of Britain should sell pounds and buy dollars.
  - b. The government of Britain should do nothing as a fixed rate will not change.
  - c. The government of Britain should buy pounds and sell dollars.
  - d. The government of Britain should decrease the country's money supply.
9. Consider that Britain is trying to maintain a fixed exchange rate with respect to the U.S. dollar. However, the present situation in the foreign exchange market is conducive for the British pound to depreciate with respect to the U.S. dollar. If the British government intervenes in the foreign exchange market, then it can be inferred that:
  - a. Britain is financing a surplus in its overall balance of payments.
  - b. the British money supply will rise.
  - c. Britain is financing a deficit in its overall balance of payments.
  - d. Britain is gaining official international reserves.
10. Consider that Britain is trying to maintain a fixed exchange rate with respect to the U.S. dollar. However, the present situation in the foreign exchange market is conducive for the British pound to depreciate with respect to the U.S. dollar. If the British government uses unsterilized intervention in the foreign exchange market, then it is expected that:
  - a. the British money supply will fall.
  - b. the British money supply will rise.
  - c. the British money supply will remain unchanged.
  - d. Britain is gaining official international reserves.
11. Consider that Britain is trying to maintain a fixed exchange rate with respect to the U.S. dollar. However, the present situation in the foreign exchange market is conducive for the British pound to depreciate with respect to the U.S. dollar. A fully sterilized intervention in the foreign exchange market by the British government is expected to cause:
  - a. the British money supply to fall.
  - b. the British money supply to rise.
  - c. the British money supply to remain unchanged.
  - d. Britain to gain official international reserves.
12. Consider that Britain is trying to maintain a fixed exchange rate with respect to the U.S. dollar. However, the present situation in the foreign exchange market is conducive for the British pound to depreciate with respect to the U.S. dollar. If the British government uses sterilized intervention in the foreign exchange market, then:
  - a. Britain is gaining official international reserves.
  - b. Britain will be running a surplus.
  - c. the British monetary authorities will be selling British government bonds.

- d. the British monetary authorities will be buying British government bonds.
13. Consider that Britain is trying to maintain a fixed exchange rate with respect to the U.S. dollar. However, the present situation in the foreign exchange market is conducive for the British pound to depreciate with respect to the U.S. dollar. The British government can only intervene in the foreign exchange market for a limited period of time because:
- the British government will eventually run out of pounds.
  - the British inflation rate will eventually rise so much that the government will give up their defense of the pegged rate.
  - the British government will end up with too many dollars in their central bank.
  - the British government will run out of official international reserves.
14. If a country's currency is \_\_\_\_\_, then the country can borrow from other countries almost without limit by issuing assets that will be held by the central banks of other countries.
- pegged
  - floating
  - a reserve currency
  - golden
15. The figure below shows the foreign exchange market.  $D_{\text{£}}$  is the demand curve for pounds.  $S_{\text{£}}$  (Spring-summer) and  $S_{\text{£}}$  (Autumn-winter) are the supply curves of pounds during the spring-summer and autumn-winter seasons, respectively. Assume that the British government is committed to maintain a fixed exchange rate at \$1.90 per pound. In the spring-summer period, what type of intervention must British monetary authorities engage in?



- Sell 20 billion pounds at \$1.90
- Buy 40 billion pounds at \$2.20
- Sell 10 billion pounds at \$2.20
- Buy 20 billion pounds at \$1.90

### Essays:

16. A country with a fixed exchange rate experiences upward pressure on the value of its currency. The central bank chooses to intervene in the market to maintain its fixed exchange rate. How would the central bank go about intervening? If the pressures for the currency to appreciate persist, would it be difficult to maintain the fixed exchange rate? Why or why not? Would your answers differ if the country carried out sterilized intervention? Why or why not. Give an example of a country that attempted to maintain

their exchange rate in the face of upward pressures on their currency value. What was the result?

17. Describe the Bretton Woods exchange rate system and explain how it fell apart.