

CHAPTER 15

EXCHANGE-RATE ADJUSTMENTS AND THE BALANCE OF PAYMENTS

MULTIPLE-CHOICE QUESTIONS

1. According to the absorption approach, the economic circumstances that *best* warrant a currency *devaluation* is where the domestic economy faces:
 - a. Unemployment coupled with a payments deficit
 - b. Unemployment coupled with a payments surplus
 - c. Full employment coupled with a payments deficit
 - d. Full employment coupled with a payments surplus
2. According to the J-curve effect, when the exchange value of a country's currency *appreciates*, the country's trade balance:
 - a. First moves toward deficit, then later toward surplus
 - b. First moves toward surplus, then later toward deficit
 - c. Moves into deficit and stays there
 - d. Moves into surplus and stays there
3. Assume that Brazil has a constant money supply and that it *devalues* its currency. The monetary approach to devaluation reasons that one of the following tends to occur for Brazil:
 - a. Domestic prices rise—purchasing power of money falls—consumption falls
 - b. Domestic prices rise—purchasing power of money rises—consumption rises
 - c. Domestic prices fall—purchasing power of money rises—consumption falls
 - d. Domestic prices fall—purchasing power of money rises—consumption rises
4. According to the Marshall-Lerner approach, a currency *depreciation* will best lead to an *improvement* on the home country's trade balance when the:
 - a. Home demand for imports is inelastic—foreign export demand is inelastic
 - b. Home demand for imports is inelastic—foreign export demand is elastic
 - c. Home demand for imports is elastic—foreign export demand is inelastic
 - d. Home demand for imports is elastic—foreign export demand is elastic

5. Assume an economy operates at *full employment* and faces a *trade deficit*. According to the absorption approach, currency devaluation will improve the trade balance if domestic:
 - a. Interest rates rise, thus encouraging investment spending
 - b. Income rises, thus stimulating consumption
 - c. Output falls to a lower level
 - d. Spending is cut, thus freeing resources to produce exports

6. An appreciation of the U.S. dollar tends to:
 - a. Discourage foreigners from making investments in the United States
 - b. Discourage Americans from purchasing foreign goods and services
 - c. Increase the number of dollars that could be bought with foreign currencies
 - d. Discourage Americans from traveling overseas

7. The Marshall-Lerner condition deals with the impact of currency depreciation on:
 - a. Domestic income
 - b. Domestic absorption
 - c. Purchasing power of money balances
 - d. Relative prices

8. According to the J-curve concept, which of the following is *false*? That the effects of a currency depreciation on the balance of payments are:
 - a. Transmitted primarily via the income adjusted mechanism
 - b. Likely to be adverse or negative in the short run
 - c. In the long run positive, given favorable elasticity conditions
 - d. Influenced by offsetting devaluations made by other countries

9. Which of the following is *true* for the J-curve effect? It:
 - a. Applies to the interest rate effects of currency depreciation
 - b. Applies to the income effects of currency depreciation
 - c. Suggests that demand tends to be most elastic over the long run
 - d. Suggests that demand tends to be least elastic over the long run

10. American citizens planning a vacation abroad would welcome:
 - a. Appreciation of the dollar
 - b. Depreciation of the dollar
 - c. Higher wages extended to foreign workers
 - d. Lower wages extended to foreign workers

11. Assume the Canadian demand elasticity for imports equals 0.2, while the foreign demand elasticity for Canadian exports equals 0.3. Responding to a trade deficit, suppose the Canadian dollar depreciates by 20 percent. For Canada, the depreciation would lead to a (an):
 - a. Worsening trade balance—a larger deficit
 - b. Improved trade balance—a smaller deficit
 - c. Unchanged trade balance
 - d. None of the above

12. Assume the Canadian demand elasticity for imports equals 1.2, while the foreign demand elasticity for Canadian exports equals 1.8. Responding to a trade deficit, suppose the Canadian dollar depreciates by 10 percent. For Canada, the depreciation would lead to a(n):
 - a. Worsening trade balance—a larger deficit
 - b. Improving trade balance—a smaller deficit
 - c. Unchanged trade balance
 - d. None of the above
13. From 1985 to 1988 the U.S. dollar depreciated over 50 percent against the yen, yet Japanese export prices to Americans did not come down the full extent of the dollar depreciation. This is best explained by:
 - a. Partial currency pass-through
 - b. Complete currency pass-through
 - c. Partial J-curve effect
 - d. Complete J-curve effect
14. Because of the J-curve effect and partial currency pass-through, a depreciation of the domestic currency tends to increase the size of a:
 - a. Trade surplus in the short run
 - b. Trade surplus in the long run
 - c. Trade deficit in the short run
 - d. Trade deficit in the long run
15. According to the Marshall-Lerner condition, a currency depreciation is *least* likely to lead to an improvement in the home country's trade balance when:
 - a. Home demand for imports is inelastic and foreign export demand is inelastic
 - b. Home demand for imports is elastic and foreign export demand is inelastic
 - c. Home demand for imports is inelastic and foreign export demand is elastic
 - d. Home demand for imports is elastic and foreign export demand is elastic
16. If foreign manufacturers cut manufacturing costs and profit margins in response to a depreciation in the U.S. dollar, the effect of these actions is to:
 - a. Shorten the amount of time in which the depreciation leads to a smaller trade deficit
 - b. Shorten the amount of time in which the depreciation leads to a smaller trade surplus
 - c. Lengthen the amount of time in which the depreciation leads to a smaller trade deficit
 - d. Lengthen the amount of time in which the depreciation leads to a smaller trade surplus
17. The shift in focus toward imperfectly competitive markets in domestic and international trade questions the concept of:
 - a. Official exchange rates
 - b. Complete currency pass-through
 - c. Exchange arbitrage
 - d. Trade-adjustment assistance
18. The extent to which a change in the exchange rate leads to changes in import and export prices is known as:
 - a. The J-curve effect
 - b. The Marshall-Lerner effect
 - c. The absorption effect
 - d. Pass-through effect

19. Complete currency pass-through arises when a 10 percent *depreciation* in the value of the dollar causes U.S.:
 - a. Import prices to fall by 10 percent
 - b. Import prices to rise by 10 percent
 - c. Export prices to rise by 10 percent
 - d. Export prices to rise by 20 percent

20. Which approach predicts that if an economy operates at full employment and faces a trade deficit, currency devaluation (depreciation) will improve the trade balance only if domestic spending is cut, thus freeing resources to produce exports?
 - a. Absorption approach
 - b. Marshall-Lerner approach
 - c. Monetary approach
 - d. Elasticities approach

21. Which approach analyzes a nation's balance of payments in terms of money demand and money supply?
 - a. Expenditures approach
 - b. Absorption approach
 - c. Elasticities approach
 - d. Monetary approach

22. The _____ effect suggests that following a currency depreciation a country's trade balance worsens for a period before it improves.
 - a. Marshall-Lerner
 - b. J-curve
 - c. Absorption
 - d. Pass-through

23. The J-curve effect implies that following a currency appreciation, a country's trade balance:
 - a. Worsens before it improves
 - b. Continually worsens
 - c. Improves before it worsens
 - d. Continually improves

24. Which analysis considers the extent by which foreign and domestic prices adjust to a change in the exchange rate in the short run:
 - a. Monetary analysis
 - b. Absorption analysis
 - c. Expenditures analysis
 - d. Pass-through analysis

25. The longer the currency pass-through period, the _____ required for currency depreciation to have the intended effect on the trade balance.
 - a. Shorter the time period
 - b. Longer the time period
 - c. Larger the spending cut
 - d. Smaller the spending cut

26. The shorter the currency pass-through period, the _____ required for currency depreciation to have the intended effect on the trade balance.
- Shorter the time period
 - Longer the time period
 - Larger the spending cut
 - Smaller the spending cut
27. Assume that Ford Motor Company obtains all of its inputs in the United States and all of its costs are denominated in dollars. A depreciation of the dollar's exchange value:
- Enhances its international competitiveness
 - Worsens its international competitiveness
 - Does not affect its international competitiveness
 - None of the above
28. Assume that Ford Motor Company obtains all of its inputs in the United States and all of its costs are denominated in dollars. An appreciation of the dollar's exchange value:
- Enhances its international competitiveness
 - Worsens its international competitiveness
 - Does not affect its international competitiveness
 - None of the above
29. Assume that Ford Motor Company obtains some of its inputs in Mexico (foreign sourcing). As the peso becomes a larger portion of Ford's total costs, a dollar *appreciation* leads to a _____ in the peso cost of a Ford vehicle and a _____ in the dollar cost of a Ford compared to the cost changes that occur when all input costs are dollar denominated.
- Smaller increase, larger decrease
 - Smaller increase, smaller decrease
 - Larger increase, smaller decrease
 - Larger increase, larger decrease
30. Assume that Ford Motor Company obtains some of its inputs in Mexico (foreign sourcing). As the peso becomes a larger portion of Ford's total costs, a dollar *depreciation* leads to a (an) _____ in the peso cost of a Ford vehicle and a (an) _____ in the dollar cost of a Ford compared to the cost changes that occur when all input costs are dollar denominated.
- Decrease, increase
 - Increase, decrease
 - Decrease, decrease
 - Increase, increase
31. Given favorable elasticity conditions, an appreciation of the yen results in:
- A smaller Japanese trade deficit
 - A larger Japanese trade surplus
 - Decreased prices for imported products for Japan
 - Increased prices for imported products for Japan

32. Given favorable elasticity conditions, a depreciation of the lira tends to result in:
 - a. Lower prices of imported products for Italy
 - b. Higher prices of imported products for Italy
 - c. A larger trade deficit for Italy
 - d. A smaller trade surplus for Italy

33. According to the J-curve effect, a depreciation of the pound's exchange value has:
 - a. No impact on a U.K. balance-of-trade deficit in the short run
 - b. No impact on a U.K. balance-of-trade deficit in the long run
 - c. An immediate negative effect on the U.K. balance of trade
 - d. An immediate positive effect on the U.K. balance of trade

34. According to the J-curve effect, an appreciation of the yens exchange value has:
 - a. No impact on the Japanese trade balance in the short run
 - b. No impact on the Japanese trade balance in the long run
 - c. An immediate negative effect on the Japanese trade balance
 - d. An immediate positive effect on the Japanese trade balance

35. According to the Marshall-Lerner condition, currency depreciation has no effect on a country's trade balance if the elasticity of demand for its exports plus the elasticity of demand for its imports equals:
 - a. 0.1
 - b. 0.5
 - c. 1.0
 - d. 2.0

36. According to the Marshall-Lerner condition, currency depreciation would have a positive effect on a country's trade balance if the elasticity of demand for its exports plus the elasticity of demand for its imports equals:
 - a. 0.2
 - b. 0.5
 - c. 1.0
 - d. 2.0

37. According to the Marshall-Lerner condition, currency depreciation would have a negative effect on a country's trade balance if the elasticity of demand for its exports plus the elasticity of demand for its imports equals:
 - a. 0.5
 - b. 1.0
 - c. 1.5
 - d. 2.0

38. The absorption approach suggests that which of the following causes a trade deficit to decrease following currency depreciation?
 - a. A decline in domestic interest rates
 - b. A rise in domestic imports
 - c. A rise in government spending
 - d. A decline in domestic absorption

39. The absorption approach to currency depreciation is represented by which of the following equations?
- $B = Y - A$
 - $Y = C + I + G + (X - M)$
 - $I + X = S + M$
 - $S - I = X - M$
40. The time period that it takes for companies to form new business connections and place new orders in response to currency depreciation is known as the:
- Recognition lag
 - Replacement lag
 - Decision lag
 - Production lag
41. The time period that it takes for companies to increase output of commodities for which demand has increased due to currency depreciation is known as the:
- Recognition lag
 - Decision lag
 - Replacement lag
 - Production lag
42. According to the J-curve effect, currency appreciation:
- Decreases a trade surplus
 - Increases a trade surplus
 - Decreases a trade surplus before increasing a trade surplus
 - Increases a trade surplus before decreasing a trade surplus
43. According to the J-curve effect, currency depreciation:
- Decreases a trade deficit
 - Increases a trade deficit
 - Decreases a trade deficit before increasing a trade deficit
 - Increases a trade deficit before decreasing a trade deficit
44. The analysis of the effects of currency depreciation include all of the following except the:
- Absorption approach
 - Elasticity approach
 - Fiscal approach
 - Monetary approach
45. According to the absorption approach ($B = Y - A$), currency devaluation improves a nation's trade balance if:
- Y increases and A increases
 - Y decreases and A decreases
 - Y increases and/or A decreases
 - Y decreases and/or A increases

46. The effect of currency depreciation on the purchasing power of money balances and the resulting impact on domestic expenditures is emphasized by the:
- Absorption approach
 - Monetary approach
 - Fiscal approach
 - Elasticity approach
47. The Marshall-Lerner condition suggests that depreciation of the franc leads to a worsening of France's trade account if the:
- Elasticity of demand for French exports is 0.4 while the French elasticity of demand for imports is 0.2
 - Elasticity of demand for French exports is 0.6 while the French elasticity of demand for imports is 0.4
 - Elasticity of demand for French exports is 0.5 while the French elasticity of demand for imports is 0.7
 - Elasticity of demand for French exports is 0.6 while the French elasticity of demand for imports is 0.7

Table 15.1. *Hypothetical Costs of Producing an Automobile for Toyota Inc. of Japan*

<u>Cost Component</u>	<u>Yen Cost</u>	<u>Dollar-Equivalent Cost</u>
Labor	1,200,000	
Materials		
Steel	800,000	
Other materials	1,600,000	
Total material costs	2,400,000	
Other costs	400,000	
Total costs	4,000,000	

48. Refer to Table 15.1. Assuming that Toyota obtains all inputs from Japanese suppliers and that the yen/dollar exchange rate is 200 yen per dollar. The dollar-equivalent cost of a Toyota automobile equals:
- \$5,000
 - \$10,000
 - \$15,000
 - \$20,000
49. Refer to Table 15.1. Assume that Toyota Inc. obtains all of its automobile inputs from Japanese suppliers. If the yen's exchange value appreciates from 200 yen = \$1 to 100 yen = \$1, the yen cost of a Toyota automobile equals:
- 4,000,000 yen
 - 6,000,000 yen
 - 8,000,000 yen
 - 10,000,000 yen

50. Refer to Table 15.1. Assume that Toyota Inc. obtains all of its automobile inputs from Japanese suppliers. If the yen's exchange value appreciates from 200 yen = \$1 to 100 yen = \$1, the dollar-equivalent cost of a Toyota automobile equals:
- \$10,000
 - \$20,000
 - \$30,000
 - \$40,000
51. Refer to Table 15.1. Assume that Toyota Inc. imports steel from U.S. suppliers, whose costs are denominated in dollars, while all other inputs are obtained from Japanese suppliers whose costs are denominated in yen. If the yen's exchange value appreciates from 200 yen = \$1 to 100 yen = \$1, the yen cost of a Toyota automobile equals:
- 2,400,000 yen
 - 3,000,000 yen
 - 3,600,000 yen
 - 4,200,000 yen
52. Refer to Table 15.1. Assume that Toyota Inc. imports steel from U.S. suppliers, whose costs are denominated in dollars, while all other inputs are obtained from Japanese suppliers whose costs are denominated in yen. If the yen's exchange value appreciates from 200 yen = \$1 to 100 yen = \$1, the dollar-equivalent cost of a Toyota automobile equals:
- \$24,000
 - \$30,000
 - \$36,000
 - \$42,000

TRUE-FALSE QUESTIONS

- T F 1. Currency devaluation is initiated by governmental policy rather than the free-market forces of supply and demand.
- T F 2. If a currency's exchange rate is overvalued, a government would likely initiate actions to revalue the currency.
- T F 3. If a currency's exchange rate is undervalued, a government would likely initiate actions to devalue the currency.
- T F 4. The purpose of currency devaluation is to cause a depreciation in a currency's exchange value.
- T F 5. The purpose of currency revaluation is to cause an appreciation in a currency's exchange value.
- T F 6. Assume that General Motors employs labor and materials, whose costs are denominated in dollars, in the production of automobiles. If the dollar's exchange value depreciates by 10 percent against the yen, the yen-denominated cost of a GM vehicle rises by 10 percent.

- T F 7. Assume that General Motors employs labor and materials, whose costs are denominated in dollars, in the production of automobiles. If the dollar's exchange value appreciates by 10 percent against the yen, the yen-denominated cost of a GM vehicle falls by 10 percent.
- T F 8. Appreciation of the dollar's exchange value worsens the international competitiveness of Boeing Inc., whereas a dollar depreciation improves its international competitiveness.
- T F 9. When manufacturing automobiles, suppose that General Motors uses labor and materials whose costs are denominated in dollars and pounds respectively. If the dollar's exchange value appreciates by 15 percent against the pound, the pound-denominated cost of a GM vehicle rises by 15 percent.
- T F 10. According to the absorption approach, currency devaluation best improves a country's trade balance when its economy is at maximum capacity.
- T F 11. When manufacturing computer software, suppose that Microsoft Inc. uses labor and materials whose costs are denominated in dollars and francs respectively. If the dollar's exchange value depreciates 10 percent against the franc, the franc-denominated cost of the firm's software falls by 10 percent.
- T F 12. When producing jetliners, suppose that Boeing employs labor and materials whose costs are denominated in dollars and marks respectively. If the dollar's exchange value depreciates 20 percent against the mark, the mark-denominated cost of a Boeing jetliner falls by an amount less than 20 percent.
- T F 13. As yen-denominated costs become a larger portion of Ford's total costs, a dollar appreciation results in a smaller increase in the yen-denominated cost of a Ford auto than occurs when all input costs are dollar denominated.
- T F 14. A depreciation of the dollar results in Whirlpool dishwashers becoming less competitive in Europe.
- T F 15. By decreasing the relative production costs of U.S. companies, a dollar appreciation tends to lower U.S. export prices in foreign-currency terms, which induces an increase in the amount of U.S. goods exported abroad.
- T F 16. By increasing relative U.S. production costs, a dollar depreciation tends to increase U.S. export prices in foreign-currency terms, which results in an increase in the quantity of U.S. goods exported abroad.
- T F 17. Suppose the exchange value of the franc rises against the currencies of Switzerland's major trading partners. To protect themselves from decreases in foreign sales caused by the mark's appreciation, Swiss companies could shift production to countries whose currencies had depreciated against the mark.
- T F 18. In the early 1990s, the yen sharply appreciated against the dollar. To protect themselves from export reductions caused by the yen's appreciation, Japanese auto companies transferred increasing amounts of auto production from the United States to Japan.

- T F 19. The elasticity approach to currency depreciation emphasizes the income effects of depreciation.
- T F 20. The elasticity approach to currency depreciation emphasizes the relative price effects of depreciation and suggests that depreciation best improves a country's trade balance when the elasticities of demand for the country's imports and exports are high.
- T F 21. The absorption approach to currency devaluation deals with the income effects of devaluation while the elasticity approach to devaluation deals with the price effects of devaluation.
- T F 22. According to the absorption approach, an increase in domestic expenditures must occur for currency devaluation to promote balance of trade equilibrium.
- T F 23. The monetary approach emphasizes the effects of currency depreciation on the purchasing power of money, and the resulting impact on domestic expenditure levels.
- T F 24. According to the Marshall-Lerner condition, currency depreciation will worsen a country's balance of trade if the country's elasticity of demand for imports plus the foreign demand elasticity for the country's exports exceeds 1.0.
- T F 25. The Marshall-Lerner condition asserts that if the sum of a country's elasticity of demand for imports and the foreign elasticity of demand for the country's exports equals 1.0, a depreciation of the country's currency will not affect its balance of trade.
- T F 26. Suppose the U.S. price elasticity of demand for imports equals 0.4 and the foreign demand elasticity for the U.S. exports equals 0.2. According to the Marshall-Lerner condition, a depreciation of the dollar's exchange value will improve the U.S. balance of trade.
- T F 27. The Marshall-Lerner condition suggests that if the sum of a country's elasticity of demand for imports and the foreign elasticity of demand for the country's exports exceeds 1.0, an appreciation of the country's exchange rate will worsen its balance of trade.
- T F 28. Suppose the U.S. price elasticity of demand for imports equals 1.2 and the foreign elasticity of demand for U.S. exports equals 1.5. According to the Marshall-Lerner condition, an appreciation of the dollar's exchange value would worsen the U.S. balance of trade.
- T F 29. Empirical research suggests that most countries' price elasticities of demand for imports and exports are very inelastic, suggesting that currency depreciation would result in a worsening of a country's balance of trade.
- T F 30. The J-curve effect implies that in the short run a currency depreciation will result in a balance of trade surplus for the home country. As time passes, however, the home country's balance of trade will move toward deficit.
- T F 31. Suppose the dollar appreciates 10 percent against the Swiss franc. According to the J-curve effect, the U.S. balance of trade will initially worsen, but then improve as time passes.
- T F 32. The J-curve effect implies that the price elasticity of demand for imports and exports is more elastic in the short run than in the long run.

- T F 33. The extent to which changing currency values result in changing prices of imports and exports is known as the J-curve effect.
- T F 34. Complete currency pass through suggests that if the dollar's exchange value depreciates by 10 percent, imports will become 10 percent more expensive to Americans while U.S. exports will become 10 percent cheaper to foreigners.
- T F 35. Partial currency pass-through implies that if the dollar's exchange value appreciates by 10 percent, imports would become, say, 6 percent more expensive to Americans while U.S. exports would become, say, 8 percent cheaper to foreigners.
- T F 36. Suppose the U.S. economy is operating at full capacity and the dollar's exchange value depreciates. According to the absorption approach, the United States would have to accept reductions in domestic spending if the U.S. trade balance is to improve as a result of the depreciation.

ANSWERS

Answers to Multiple-Choice Questions

- | | | | | |
|-------|-------|-------|-------|-------|
| 1. a | 12. b | 23. c | 34. d | 45. c |
| 2. b | 13. a | 24. d | 35. c | 46. b |
| 3. a | 14. c | 25. b | 36. d | 47. a |
| 4. d | 15. a | 26. a | 37. a | 48. d |
| 5. d | 16. c | 27. a | 38. d | 49. d |
| 6. a | 17. b | 28. b | 39. a | 50. d |
| 7. d | 18. d | 29. a | 40. c | 51. c |
| 8. a | 19. b | 30. a | 41. d | 52. c |
| 9. c | 20. a | 31. c | 42. d | |
| 10. a | 21. d | 32. b | 43. d | |
| 11. a | 22. b | 33. c | 44. c | |

Answers to True-False Questions

- | | | | | |
|------|-------|-------|-------|-------|
| 1. T | 9. F | 17. T | 25. F | 33. F |
| 2. F | 10. F | 18. F | 26. T | 34. T |
| 3. F | 11. F | 19. T | 27. T | 35. F |
| 4. T | 12. T | 20. T | 28. T | 36. T |
| 5. T | 13. T | 21. T | 29. F | |
| 6. T | 14. F | 22. F | 30. F | |
| 7. T | 15. F | 23. T | 31. T | |
| 8. T | 16. F | 24. F | 32. F | |