CHAPTER OVERVIEW

This chapter seeks to explain the factors that underlie currency movements. These factors include market fundamentals and market expectations.

The chapter notes that the determinants of exchange rate fluctuations are different in the short run, medium run, and long run.

Although exchange rate overshooting can persist for significant periods, fundamental forces tend to push the currency back to its long-run equilibrium path.

The chapter considers how changes in real income affect exchange rates. With floating exchange rates, a nation that experiences faster economic growth than the rest of the world tends to find its currency’s exchange value depreciating.

Short-term real interest rates are another determinant of exchange rates. With floating exchange rates, a nation that has relatively high real interest rates finds its currency appreciating.

According to the purchasing power parity approach, changes in national price levels determine changes in exchange rates over the long run. A currency maintains its purchasing power parity if it depreciates by an amount equal to the excess of domestic inflation over foreign inflation.

Another exchange rate theory emphasized in the chapter is the asset-markets theory which suggests that stock adjustments among financial assets are a key determinant of short-run movements in exchange rates.

The chapter then addresses the phenomenon of exchange-rate overshooting. An exchange rate is said to overshoot when its short-run response to a change in market fundamentals is greater than its long-run response.

Finally, the chapter considers the methods that currency forecasters use to predict exchange-rate movements: (1) judgmental forecasts, (2) technical analysis, and (3) fundamental analysis.

After completing this chapter, students should be able to:

• Identify the market fundamentals which underlie movements in exchange rates.
• Explain how market expectations affect currency values.
• Discuss how market fundamentals and market expectations interact to influence exchange rates.
• Explain how the volatility of exchange rates is influenced by the phenomenon of overshooting.
BRIEF ANSWERS TO STUDY QUESTIONS

1. Market fundamentals and market expectations. Long run exchange rates are best explained by factors including real income differentials, inflation rate differentials, productivity changes, and the like. In the short run, exchange rates respond to real interest rate differentials, news about market fundamentals, and speculative opinion about future exchange rates.

2. The nominal interest rate refers to the interest rate, unadjusted for inflation. The real interest rate equals the nominal interest rate minus the inflation rate. International investors are especially concerned about the real interest rate.

3. The purchasing-power-parity theory predicts that a country’s currency will depreciate by an amount equal to the excess of domestic inflation over foreign inflation. The theory also predicts that a country’s exchange rate will appreciate by an amount equal to the excess of foreign inflation over domestic inflation. The theory does not consider the impact of international capital movements, and it suffers from the choice of an appropriate price index used in price calculations.

4. An overvalued currency tends to lead to a balance-of-payments deficit for the home country, while an undervalued currency leads to a balance-of-payments surplus.

5. The monetary approach to exchange-rate determination views exchange rates as determined by changes in the supplies and demands of national currencies. The monetary approach suggests that an increase in the domestic money supply causes the home currency’s exchange rate to depreciate, and vice versa. It also maintains that an increase in the domestic demand for money leads to an appreciation in the home country’s exchange rate.

6. The asset-markets approach contends that stock adjustments among financial assets are a key determinant of exchange-rate movements. This approach is thus a broader or more comprehensive approach than the monetary approach, which emphasizes national currencies.

7. The dollar’s exchange rate will:
   a. Depreciate
   b. Appreciate
   c. Appreciate, depreciate
   d. Appreciate
   e. Depreciate
   f. Depreciate
   g. Appreciate

8. An exchange rate is said to overshoot when its short-run response (depreciation/appreciation) to a change in market fundamentals is greater than its long-run response. Exchange rate overshooting occurs because exchange rates tend to be more flexible than other prices; exchange rates often depreciate/appreciate more in the short run than in the long run so as to compensate for other prices that are slower to adjust to their long-run equilibrium levels.
9. Currency forecasters generally use one of three methods to predict future exchange rates: (1) judgmental analysis, (2) technical analysis, or (3) fundamental analysis.

10. | Supply of pounds | Demand for pounds | Exchange rate ($ per pound) |
    |------------------|--------------------|-----------------------------|
    | decrease         | decrease           | decrease                    |
    | decrease         | increase           | increase                    |
    | increase         | decrease           | decrease                    |
    | decrease         | decrease           | decrease                    |
    | increase         | increase           | increase                    |
    | increase         | decrease           | decrease                    |
    | increase         | decrease           | decrease                    |
    | increase         | decrease           | decrease                    |
    | increase         | increase           | increase                    |

11. a. False
    b. True
    c. True
    d. True

12. More expensive, less expensive, increased, decreased

13. a. Dollar depreciates by 10 percent, to approximately $0.55 per mark.
    b. Dollar appreciates by 10 percent, to approximately $0.45 per mark.
    c. Dollar appreciates by 15 percent, to approximately $0.43 per mark.
    d. Dollar depreciates by 5 percent, to approximately $0.53 per mark.

14. a. –2 percent in the United States, 2 percent in the United Kingdom.
    b. Investment would flow from the United States to the United Kingdom.
    c. The dollar would depreciate against the pound.

MULTIPLE-CHOICE QUESTIONS

1. The relationship between the exchange rate and the prices of tradable goods is known as the:
   a. Purchasing-power-parity theory
   b. Asset-markets theory
   c. Monetary theory
   d. Balance-of-payments theory

2. If the exchange rate between French francs and British pounds is 5 francs per pound, then the number of pounds that can be obtained for 200 francs equals:
   a. 20 pounds
   b. 40 pounds
3. Low real interest rates in the United States tend to:
   a. Decrease the demand for dollars, causing the dollar to depreciate
   b. Decrease the demand for dollars, causing the dollar to appreciate
   c. Increase the demand for dollars, causing the dollar to depreciate
   d. Increase the demand for dollars, causing the dollar to appreciate

4. High real interest rates in the United States tend to:
   a. Decrease the demand for dollars, causing the dollar to depreciate
   b. Decrease the demand for dollars, causing the dollar to appreciate
   c. Increase the demand for dollars, causing the dollar to depreciate
   d. Increase the demand for dollars, causing the dollar to appreciate

5. Assume that the United States faces an 8 percent inflation rate while no (zero) inflation exists in Japan. According to the purchasing-power parity theory, the dollar would be expected to:
   a. Appreciate by 8 percent against the yen
   b. Depreciate by 8 percent against the yen
   c. Remain at its existing exchange rate
   d. None of the above

6. In the presence of purchasing-power parity, if one dollar exchanges for 2 British pounds and if a VCR costs $400 in the United States, then in Great Britain the VCR should cost:
   a. 200 pounds
   b. 400 pounds
   c. 600 pounds
   d. 800 pounds

7. If wheat costs $4 per bushel in the United States and 2 pounds per bushel in Great Britain, then in the presence of purchasing-power parity the exchange rate should be:
   a. $.50 per pound
   b. $1.00 per pound
   c. $2.00 per pound
   d. $8.00 per pound

8. A primary reason that explains the appreciation in the value of the U.S. dollar in the 1980s is:
   a. Large trade surpluses for the United States
   b. High inflation rates in the United States
   c. Lack of investor confidence in the U.S. monetary policy
   d. High interest rates in the United States

9. The high foreign exchange value of the U.S. dollar in the early 1980s can best be explained by:
   a. Additional investment funds made available from overseas
   b. Lack of investor confidence in U.S. fiscal policy
   c. Market expectations of rising inflation in the United States
   d. American tourists overseas finding costs increasing
10. When the price of foreign currency (i.e., the exchange rate) is below the equilibrium level:
   a. An excess demand for that currency exists in the foreign exchange market
   b. An excess supply of that currency exists in the foreign exchange market
   c. The demand for foreign exchange shifts outward to the right
   d. The demand for foreign exchange shifts backward to the left

11. When the price of foreign currency (i.e., the exchange rate) is above the equilibrium level:
   a. An excess supply of that currency exists in the foreign exchange market
   b. An excess demand for that currency exists in the foreign exchange market
   c. The supply of foreign exchange shifts outward to the right
   d. The supply of foreign exchange shifts backward to the left

12. The appreciation in the value of the dollar in the early 1980s is explained by all of the following except:
   a. The United States being considered a safe haven by foreign investors
   b. Relatively high real interest rates in the United States
   c. Confidence of foreign investors in the U.S. economy
   d. Relatively high inflation rates in the United States

13. Suppose Germany and France were the only two countries in the world. There exists an excess supply of French francs on the foreign exchange market. This suggests that:
   a. The French balance of payments is in surplus
   b. The French balance of payments is in deficit
   c. The German balance of payments is in deficit
   d. There is an excess supply of German marks

14. If Canada runs a balance-of-trade surplus and exchange rates are floating:
   a. The value of other currencies will rise relative to the dollar
   b. The dollar will depreciate relative to other currencies
   c. The price of foreign goods will become cheaper for Canadians
   d. The price of foreign goods will rise for Canadians

15. If Germany runs a foreign trade deficit and exchange rates are floating:
   a. German exports become more expensive to foreign buyers
   b. German exports become less expensive to foreign buyers
   c. German imports become less expensive for German buyers
   d. German imports become more prestigious to German buyers

16. The international exchange value of the U.S. dollar is determined by:
   a. The rate of inflation in the United States
   b. The number of dollars printed by the U.S. government
   c. The international demand and supply for dollars
   d. The monetary value of gold held at Fort Knox, Kentucky
17. For the United States, suppose the annual interest rate on government securities equals 8 percent while the annual inflation rate equals 4 percent. For France, suppose the annual interest rate on government securities equals 10 percent while the annual inflation rate equals 7 percent. These variables would cause investment funds to flow from:
   a. The United States to France, causing the dollar to depreciate
   b. The United States to France, causing the dollar to appreciate
   c. France to the United States, causing the franc to depreciate
   d. France to the United States, causing the franc to appreciate

18. For the United States, suppose the annual interest rate on government securities equals 12 percent while the annual inflation rate equals 8 percent. For Germany, suppose the annual interest rate equals 5 percent. These variables would cause investment funds to flow from:
   a. The United States to Germany, causing the dollar to depreciate
   b. The United States to Germany, causing the dollar to appreciate
   c. Germany to the United States, causing the mark to depreciate
   d. Germany to the United States, causing the mark to appreciate

19. Given a system of floating exchange rates, rising income in the United States would trigger a(n):
   a. Increase in the demand for imports and an increase in the demand for foreign currency
   b. Increase in the demand for imports and a decrease in the demand for foreign currency
   c. Decrease in the demand for imports and an increase in the demand for foreign currency
   d. Decrease in the demand for imports and a decrease in the demand for foreign currency

20. Given a system of floating exchange rates, falling income in the United States would trigger a(n):
   a. Increase in the demand for imports and an increase in the demand for foreign currency
   b. Increase in the demand for imports and a decrease in the demand for foreign currency
   c. Decrease in the demand for imports and an increase in the demand for foreign currency
   d. Decrease in the demand for imports and a decrease in the demand for foreign currency

21. Under a system of floating exchange rates, relatively low productivity and high inflation rates in the United States result in a(n):
   a. Increase in the demand for foreign currency, a decrease in the supply of foreign currency, and a depreciation in the dollar
   b. Increase in the demand for foreign currency, an increase in the supply of foreign currency, and an appreciation in the dollar
   c. Decrease in the demand for foreign currency, a decrease in the supply of foreign currency, and a depreciation in the dollar
   d. Decrease in the demand for foreign currency, an increase in the supply of foreign currency, and an appreciation in the dollar

22. Under a system of floating exchange rates, relatively high productivity and low inflation rates in the United States result in:
   a. An increase in the demand for foreign currency, a decrease in the supply of foreign currency, and a depreciation in the dollar
   b. An increase in the demand for foreign currency, an increase in the supply of foreign currency, and an appreciation in the dollar
   c. A decrease in the demand for foreign currency, a decrease in the supply of foreign currency, and a depreciation in the dollar
d. A decrease in the demand for foreign currency, an increase in the supply of foreign currency, and an appreciation in the dollar

23. Which example of market expectations causes the dollar to \textit{appreciate} against the yen; expectations that the U.S. economy will have:
   a. Faster economic growth than Japan
   b. Higher future interest rates than Japan
   c. More rapid money supply growth than Japan
   d. Higher inflation rates than Japan

24. Which example of market expectations causes the dollar to \textit{depreciate} against the yen; expectations that the U.S. economy will have:
   a. Faster economic growth than Japan
   b. Higher future interest rates than Japan
   c. Less rapid money supply growth than Japan
   d. Lower inflation rates than Japan

25. Starting at the point of equilibrium between the money supply and the money demand, an \textit{increase} in the domestic money supply causes the value of the home currency to:
   a. Depreciate relative to other currencies
   b. Appreciate relative to other currencies
   c. Not change relative to other currencies
   d. None of the above

26. Starting at the point of equilibrium between the money supply and the money demand, a \textit{decrease} in the domestic money supply causes the value of the home currency to:
   a. Depreciate relative to other currencies
   b. Appreciate relative to other currencies
   c. Not change relative to other currencies
   d. None of the above

27. Starting at the point of equilibrium between the money supply and the money demand, an \textit{increase} in the demand for money in the home country causes the value of the home currency to:
   a. Depreciate relative to other currencies
   b. Appreciate relative to other currencies
   c. Not change relative to other currencies
   d. None of the above

28. Starting at the point of equilibrium between the money supply and the money demand, a \textit{decrease} in the demand for money in the home country causes the value of the home currency to:
   a. Depreciate relative to other currencies
   b. Appreciate relative to other currencies
   c. Not change relative to other currencies
   d. None of the above

29. Which theory of exchange-rate determination best views the foreign exchange market as being similar to a stock exchange where future expectations are important and prices are volatile?
   a. Balance-of-payments approach
b. Purchasing-power-parity approach  
c. Asset-markets approach  
d. Monetary approach  

30. According to the purchasing-power-parity theory, the U.S. dollar maintains its purchasing-power parity if it 
*depreciates* by an amount equal to the excess of:
   a. U.S. interest rates over foreign interest rates  
   b. Foreign interest rates over U.S. interest rates  
   c. U.S. inflation over foreign inflation  
   d. Foreign inflation over U.S. inflation  

31. An exchange rate is said to __________ when its short-run response to a change in market fundamentals is greater than its long-run response.  
   a. Overshoot  
   b. Undershoot  
   c. Depreciate  
   d. Appreciate  

32. Concerning exchange rate forecasting, ____________ is a common sense approach based on a wide array of political and economic data.  
   a. Econometric analysis  
   b. Technical analysis  
   c. Judgmental analysis  
   d. Sunspot analysis  

33. Concerning exchange rate forecasting, ____________ involves the use of historical exchange rate data to estimate future values, while ignoring the economic determinants of exchange rate movements.  
   a. Econometric analysis  
   b. Judgmental analysis  
   c. Technical analysis  
   d. Sunspot analysis  

34. Concerning exchange rate forecasting, ____________ relies on econometric models which are based on macroeconomic variables likely to affect currency values.  
   a. Fundamental analysis  
   b. Technical analysis  
   c. Judgmental analysis  
   d. Sunspot analysis  

35. Concerning exchange-rate determination, “market fundamentals” include all of the following *except*:  
   a. Monetary policy and fiscal policy  
   b. Profitability and riskiness of investments  
   c. Speculative opinion about future exchange rates  
   d. Productivity changes affecting production costs  

36. In the short run, exchange rates respond to market forces such as:  
   a. Inflation rates  
   b. Expectations of future exchange rates
37. Long-run exchange rate movements are governed by all of the following except:
   a. National productivity levels
   b. Consumer tastes and preferences
   c. Rates of inflation
   d. Interest rate levels

38. In a world of market-determined exchange rates, a country experiencing ____________ economic growth than the rest of the world tends to find its currency’s exchange value ____________.
   a. Faster, depreciating
   b. Faster, appreciating
   c. Slower, appreciating
   d. Slower, remaining constant

39. That identical goods should cost the same in all nations, assuming it is costless to ship goods between nations and there are no barriers to trade, is a reflection of the:
   a. Monetary approach to exchange-rate determination
   b. Law of one price
   c. Fundamentalist approach to exchange-rate determination
   d. Exchange-rate-overshooting principle

40. The Canadian dollar would depreciate on the foreign exchange market if:
   a. Canadian consumer tastes change in favor of goods produced domestically
   b. The profitability of assets in Canada rises relative to the profitability of assets abroad
   c. Canada experiences a disastrous wheat crop failure, leading to imports of more wheat
   d. Canada realizes technological improvements in the production of manufactured goods, leading to relatively low costs for Canada

41. The demand in the United States for yen will increase if, other things remaining equal:
   a. Labor costs rise in Japan
   b. Income rises in Japan
   c. Prices rise in Japan
   d. Interest rates rise in Japan

42. The quantity of marks supplied to the foreign exchange market would increase if, other things remaining equal:
   a. Income rises in Germany
   b. Manufacturing productivity increases in Germany
   c. Prices decrease in Germany
   d. Import tariffs rise in Germany

43. The U.S. demand for pesos would shift to the right if there occurred a(n):
   a. Change in preferences toward U.S. manufactured goods
   b. Increase in the dollar/peso exchange rate
c. Decrease in the U.S. population

d. Increase in the U.S. price level

44. The supply of francs would shift to the right for all of the following reasons except:
   a. An increase in French real income
   b. An increase in French prices
   c. An increase in the French population
   d. An increase in French interest rates
The next six questions pertain to the figure below which illustrates the supply and demand schedules of French francs in a market of freely-floating exchange rates.

**Figure 13.1**
*The Market for Francs*

45. Refer to Figure 13.1. Should real income grow in the United States and fall in France, there would occur a(n):
   a. Increase in the demand for francs—decrease in the supply of francs—depreciation of the dollar
   b. Increase in the demand for francs—decrease in the supply of francs—appreciation of the dollar
   c. Decrease in the demand for francs—decrease in the supply of francs—appreciation of the dollar
   d. Decrease in the demand for francs—increase in the supply of francs—depreciation of the dollar

46. Refer to Figure 13.1. Should real interest rates in the United States rise relative to real interest rates in France, there would occur a(n):
   a. Increase in the demand for francs—decrease in the supply of francs—depreciation of the dollar
   b. Increase in the demand for francs—decrease in the supply of francs—appreciation of the dollar
   c. Decrease in the demand for francs—increase in the supply of francs—appreciation of the dollar
   d. Decrease in the demand for francs—decrease in the supply of francs—depreciation of the dollar

47. Refer to Figure 13.1. Should the U.S. price level rise relative to the French price level, there would occur a(n):
   a. Increase in the demand for francs—increase in the supply of francs—appreciation of the dollar
   b. Decrease in the demand for francs—decrease in the supply of francs—depreciation of the dollar
   c. Increase in the supply of francs—decrease in the demand for francs—appreciation of the dollar
   d. Decrease in the supply of francs—increase in the demand for francs—depreciation of the dollar

48. Refer to Figure 13.1. Should the United States impose tariffs on imports from France, there would occur a(n):
   a. Increase in the demand for francs and a depreciation of the dollar
   b. Decrease in the demand for francs and an appreciation of the dollar
   c. Decrease in the supply of francs and an appreciation of the dollar
   d. Increase in the supply of francs and a depreciation of the dollar
49. Refer to Figure 13.1. Should French labor productivity rise, leading to a decrease in French manufacturing costs, there would occur a(n):
   a. Increase in the supply of francs and a depreciation of the dollar
   b. Increase in the supply of francs and an appreciation of the dollar
   c. Decrease in the demand for francs and an appreciation of the dollar
   d. Increase in the demand for francs and a depreciation of the dollar

50. Refer to Figure 13.1. If France experienced a disastrous wheat crop failure, leading to additional wheat imports from the United States, there would occur an:
   a. Increase in the supply of francs and an appreciation of the dollar
   b. Increase in the supply of francs and a depreciation of the dollar
   c. Increase in the demand for francs and a depreciation of the dollar
   d. Increase in the demand for francs and an appreciation of the dollar

51. Given floating exchange rates, if Japan increases its demand for German goods at the same time that Germany increases its demand for Japanese goods, then we would expect the yen’s exchange value to:
   a. Appreciate against the mark
   b. Depreciate against the mark
   c. Remain constant against the mark
   d. Appreciate, depreciate, or remain constant against the mark

52. Given floating exchange rates, assume that the French decrease their import purchases from Italy while at the same time the Italians increase their purchases of French government securities. The first action by itself would lead to a(n) ____________ of the franc against the lira while the second action by itself would lead to a(n) ____________ of the franc against the lira.
   a. Appreciation, appreciation
   b. Depreciation, depreciation
   c. Appreciation, depreciation
   d. Depreciation, appreciation

53. Given floating exchange rates, a simultaneous decrease in the Canadian demand for British products and increase in the British desire to invest in Canadian government securities would cause a(n):
   a. Appreciation of the pound against the dollar
   b. Depreciation of the pound against the dollar
   c. Unchanged pound/dollar exchange rate
   d. None of the above

54. Assume a system of floating exchange rates. Due to a high savings rate, suppose the level of savings in Japan is in excess of domestic investment needs. If Japanese residents invest abroad, the yen’s exchange value will ____________ and the Japanese trade balance will move toward ____________.
   a. Appreciate, deficit
   b. Appreciate, surplus
   c. Depreciate, deficit
   d. Depreciate, surplus
55. Given a system of floating exchange rates, assume that Boeing Inc. of the United States places a large order, payable in marks, with a German contractor for jet engine parts. The immediate effect of this transaction will be a shift in the:
   a. Supply curve of marks to the left which causes the dollar to appreciate against the mark
   b. Supply curve of marks to the right which causes the dollar to depreciate against the mark
   c. Demand curve for marks to the left which causes the dollar to appreciate against the mark
   d. Demand curve for marks to the right which causes the dollar to depreciate against the mark

56. For purchasing-power parity to exist:
   a. Flows of currency in the trade account must be offset by flows of currency in the capital account
   b. The nominal interest rate must be equal to the real interest rate in all countries
   c. Converting a sum of funds from one currency to another does not alter its purchasing power
   d. A country’s trade account must always be in balance

57. Assume that interest rates in the United States and France are the same. If a U.S. resident anticipates that the exchange value of the dollar is going to appreciate against the franc, she should:
   a. Borrow needed funds from French banks rather than U.S. banks
   b. Borrow needed funds from U.S. banks rather than French banks
   c. Convert U.S. dollars into French francs
   d. Any of the above

58. Given a system of floating exchange rates, if Canada’s rate of economic growth rises relative to the growth rates of its trading partners:
   a. Canadian imports will fall and the dollar will appreciate
   b. Canadian imports will fall and the dollar will depreciate
   c. Canadian imports will rise and the dollar will appreciate
   d. Canadian imports will rise and the dollar will depreciate

59. Assume that economic growth is slower in the United States than in its trading partners. Given a system of floating exchange rates, the impact of this growth differential for the United States will be:
   a. Increased exports and an appreciation of the dollar
   b. Increased exports and a depreciation of the dollar
   c. Increased imports and an appreciation of the dollar
   d. Increased imports and a depreciation of the dollar

60. Suppose the exchange rate between the U.S. dollar and the Japanese yen is initially 90 yen per dollar. According to purchasing-power parity, if the price of traded goods rises by 10 percent in the United States and remains constant in Japan, the exchange rate will become:
   a. 72 yen per dollar
   b. 81 yen per dollar
   c. 99 yen per dollar
   d. 108 yen per dollar
61. Suppose the exchange rate between the U.S. dollar and the Japanese yen is initially 90 yen per dollar. According to purchasing-power parity, if the price of traded goods rises by 5 percent in the United States and 15 percent in Japan, the exchange rate will become:
   a. 72 yen per dollar
   b. 81 yen per dollar
   c. 99 yen per dollar
   d. 108 yen per dollar

62. Suppose the exchange rate between the U.S. dollar and the Japanese yen is initially 90 yen per dollar. According to purchasing power parity, if the price of traded goods falls by 5 percent in the United States and rises by 5 percent in Japan, the exchange rate will become:
   a. 72 yen per dollar
   b. 81 yen per dollar
   c. 99 yen per dollar
   d. 108 yen per dollar

63. Suppose that the yen-dollar exchange rate changes from 85 yen per dollar to 80 yen per dollar. One can say that:
   a. The yen has appreciated against the dollar and the dollar has depreciated against the yen
   b. The yen has depreciated against the dollar and the dollar has appreciated against the yen
   c. The yen has appreciated against the dollar and the dollar has appreciated against the yen
   d. The yen has depreciated against the dollar and the dollar has depreciated against the yen

64. Given a floating exchange rate system an increase in __________ would cause the dollar to appreciate against the mark.
   a. U.S. labor costs
   b. The U.S. money supply
   c. U.S. real income
   d. U.S. real interest rates

65. Under a system of floating exchange rates, a Japanese trade surplus against Canada would result in a(n):
   a. Rise in the dollar price of the yen
   b. Fall in the dollar price of the yen
   c. Rise in the yen price of the dollar
   d. Unchanged dollar/yen exchange rate

**TRUE-FALSE QUESTIONS**

T  F  1. In a free market, exchange rates are determined by market fundamentals and market expectations.

T  F  2. Concerning exchange-rate determination, market fundamentals include real income, real interest rates, inflation rates, investment profitability, and speculative opinion about future exchange rates.
T F 3. Market expectations include news about market fundamentals, speculative opinion about future exchange rates, and profitability and riskiness of investments.

T F 4. In a free market, the equilibrium exchange rate occurs at the point where the quantity demanded of a foreign currency equals the quantity of that currency supplied.

T F 5. Exchange rates are determined by the unregulated forces of supply and demand for foreign currencies as long as central banks do not intervene in the foreign exchange markets.

T F 6. Over the long run, foreign exchange rates are determined by transfers of bank deposits that respond to differences in real interest rates and to shifting expectations of future exchange rates.

The next five questions pertain to the figure below which illustrates the supply and demand schedules of German marks under a system of floating exchange rates.

**Figure 13.2**
The Market for German Marks

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T F 7. Refer to Figure 13.2. If the United States decreases tariffs on imports from Germany, there would occur a decrease in the demand for marks and a decrease in the dollar price of the mark.

T F 8. Refer to Figure 13.2. If German manufacturing costs increase relative to those of the United States, there would occur an increase in the supply of marks and an appreciation in the dollar's exchange value.
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T  F  9. Refer to Figure 13.2. If the Federal Reserve adopts a restrictive monetary policy that leads to relatively high interest rates in the United States, the demand for marks would decrease, the supply of marks would increase, and the dollar’s exchange value would appreciate.

T  F  10. Refer to Figure 13.2. As the profitability of assets in Germany rises relative to the profitability of assets in the United States, U.S. residents make additional investments in Germany; this leads to an increased demand for marks and a depreciation of the dollar’s exchange value.

T  F  11. Refer to Figure 13.2. If the rate of inflation in the United States is higher than the rate of inflation in Germany, the demand for marks decreases, the supply of marks increases, and the dollar’s exchange value appreciates.

T  F  12. Under floating exchange rates, short-run exchange rates are primarily determined by national differences in real interest rates and shifting expectations of future exchange rates.

T  F  13. Day-to-day influences on foreign exchange rates always cause rates to move in the same direction as changes in long-term market fundamentals.

T  F  14. With floating exchange rates, a country experiencing faster economic growth than its trading partners find its currency’s exchange value appreciating.

T  F  15. If U.S. real income growth is 2 percent per annum and German real income growth is 6 percent per annum, the dollar will depreciate against the mark under a system of floating exchange rates.

T  F  16. In 1985 and 1986 U.S. interest rates fell relative to interest rates in Japan. Under floating exchange rates, this would lead to the dollar’s exchange value depreciating against the yen.

T  F  17. A country experiencing faster economic growth than its trading partners finds its imports rising faster than its exports and thus its demand for foreign exchange rising more rapidly than its supply of foreign exchange.

T  F  18. Economies with strong growth rates in real income always find their currencies’ exchange values appreciating under a floating exchange-rate system.

T  F  19. Under floating exchange rates, relatively low domestic interest rates tend to promote depreciation of a currency’s exchange value while relatively high domestic interest rates lead to currency appreciation.

T  F  20. Suppose expansionary monetary policy in the United States leads to interest rates falling to 2 percent while tight monetary policy in Switzerland leads to interest rates rising to 8 percent. With floating exchange rates, the dollar would appreciate against the franc.

T  F  21. The purchasing-power-parity theory is used to predict exchange-rate movements in the short run.

T  F  22. According to the law of one price, identical goods should cost the same in all nations, assuming there are no shipping costs nor trade barriers.
T  F  23. The purchasing-power-parity theory predicts that if the U.S. inflation rate exceeds the Japanese inflation rate by 4 percent, the dollar’s exchange value will appreciate by 4 percent against the yen.

T  F  24. Assume the initial yen/dollar exchange rate to be 100 yen per dollar. If the U.S. inflation rate is 2 percent and the Japanese inflation rate is 7 percent, the exchange rate should move to 105 yen per dollar according to the purchasing-power-parity theory.

T  F  25. Assume the initial dollar/pound exchange rate to be $2 per pound. If the U.S. inflation rate is 8 percent and the U.K. inflation rate is 3 percent, the exchange rate should move to $2.10 per pound according to the purchasing-power-parity theory.

T  F  26. If consumer tastes in the United States change in favor of goods produced in France, the demand for francs will increase which causes an appreciation of the dollar against the franc under a floating exchange rate system.

T  F  27. As the profitability of Japanese assets rises relative to the profitability of French assets, French residents will make additional investments in Japan; this results in an increased demand for yen and a depreciation of the franc under a system of floating exchange rates.

T  F  28. If the United States experiences an enormous wheat crop failure, it will have to import more wheat and the dollar’s exchange value will depreciate under a system of floating exchange rates.

T  F  29. If Japan realizes technological improvements in the production of automobiles, which lowers its production costs relative to foreign producers, Japanese exports will rise and the yen’s exchange value will appreciate under a system of floating exchange rates.

T  F  30. If Mexico applies tariffs to imports of manufactured goods, Mexico’s demand for foreign exchange will rise and the peso will depreciate under a system of floating exchange rates.

T  F  31. According to the “Big Mac” index, if a Big Mac costs $2.28 in the United States and 25.75 krone in Denmark (equivalent to $4.25), the Danish krone is an undervalued currency.

T  F  32. According to the “Big Mac” index, if a Big Mac costs $2.28 in the United States and 48 baht in Thailand (equivalent to $1.91), the baht is an undervalued currency.

T  F  33. Starting from the point of equilibrium between the money supply and money demand, if the Federal Reserve increases the money supply the dollar’s exchange value will depreciate according to the monetary approach to exchange-rate determination.

T  F  34. Starting from the point of equilibrium between the money supply and money demand, if there occurs an increase in the money demand the dollar’s exchange value will depreciate according to the monetary approach to exchange-rate determination.

T  F  35. Changes in market expectations have their greatest impact on exchange-rate changes over the long run as opposed to the short run.
36. If it is widely expected that the French economy will experience more rapid inflation than the German economy, the franc will depreciate against the mark under a system of floating exchange rates.

37. According to the asset-markets approach, stock adjustments among financial assets are a key determinant of long-run movements in exchange rates.

38. The asset-markets approach views exchange-rate determination as similar to the stock market in which prices are volatile and expectations are important.

39. According to the principle of exchange-rate overshooting, a short-run depreciation of a currency is likely to be greater than a long-run depreciation of that currency.

40. Exchange-rate overshooting is based on the notion that the supply schedule of a currency is more elastic in the short run than in the long run.

41. According to exchange-rate overshooting, an appreciation of the German mark is likely to be greater over a long time period than over a short time period.

42. Concerning exchange rate forecasting, fundamental analysis involves consideration of a variety of macroeconomic variables and policies that tend to affect currency values.

43. Econometric models are best suited for forecasting long-run exchange rates rather than short-run exchange rates.

44. Concerning exchange rate forecasting, technical analysis extrapolates from past exchange-rate trends while ignoring economic and political determinants of exchange rates.

45. Given an efficient foreign exchange market, the spot rate is the rational approximation of the markets expectation of the forward rate that will exist at the end of the forward period.

46. A forward premium on the German mark serves as a rough benchmark of the expected rate of appreciation in the mark’s spot rate.

47. A forward discount on Mexico’s peso serves as a rough benchmark of the expected appreciation in the peso’s spot rate.

48. If you were considering hiring a forecasting firm to predict future spot rates of the yen, you would hope that the firm could predict better what would be implied by the yen’s forward rate.

49. Although the law of one price predicts that identical goods should cost the same in all nations, transportation costs and tariffs tend to prevent this prediction from actually occurring.

50. If real interest rates decline in the United States relative to real interest rates abroad, the dollar’s exchange value will appreciate under a floating exchange-rate system.
### ANSWERS

#### Answers to Multiple-Choice Questions

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#### Answers to True-False Questions

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SUGGESTIONS FOR FURTHER READINGS


