

Answer Outline

ECONOMICS 353 (SECTION 2)
EXERCISE 10: 6 POINTS TOTAL

L. Tesfatsion/Spring 04
DUE: Tuesday, March 30, 2:10pm

****IMPORTANT REMINDER: LATE ASSIGNMENTS CANNOT BE ACCEPTED – NO EXCEPTIONS****

EXERCISE INSTRUCTIONS:

- (1) Please **fill in your name and student ID number** on Side 1 of your bubble sheet and write **353-2 Exercise 10** in the top margin of Side 1.
- (2) Use a number 2 pencil to **mark your answers** on Side 1 of the bubble sheet to the six questions Q1 through Q6, below, which are in multiple choice format.
- (3) Each question Q1 through Q6 is worth 1 point.

Q1. In a world divided between HC and ROW, the HC real exchange rate is defined to be

- A.** the HC nominal exchange rate times the ROW aggregate price level divided by the HC aggregate price level.
- **B.** the HC nominal exchange rate times the HC aggregate price level divided by the ROW aggregate price level.
- C.** the HC nominal exchange rate minus the HC inflation rate.
- D.** the HC nominal exchange rate plus the ROW inflation rate minus the HC inflation rate.
- E.** none of the above.

Q2. A DEPRECIATION of the HC's currency _____ the cost of ROW goods relative to HC goods, and this in turn can result in _____.

- A.** lowers; deflation in the HC if HC producers lower their prices in turn
- B.** lowers; a competitive advantage for ROW producers
- **C.** raises; inflation in the HC if HC producers raise their prices in turn
- D.** raises; a competitive advantage for ROW producers
- E.** none of the above.

- Q3.** According to the Law of One Price, if Malaysian coffee is 4 ringitts per pound and Slovakian coffee is 44 korunas per pound, the coffees are of equal quality, and transport costs are zero, then the exchange rate between the Malaysian ringitt and the Slovakian koruna should approximately be
- A. 4 ringitts per 1 koruna
 - **B.** 0.09 ringitts per 1 koruna
 - C. 11 ringitts per 1 koruna
 - D. 1 ringitt per 1 koruna
- Q4.** Suppose the inflation rate in China is 3 percent during 2004, and the inflation rate in Argentina is 35 percent during 2004. Then the theory of PURCHASING POWER PARITY (in rates of change form) predicts that, during 2004, the value of the Chinese currency (yuan) measured in terms of the Argentinian currency (pesos) - i.e., the number E of pesos per yuan - will
- A. rise by 38 percent.
 - B. fall by 32 percent.
 - **C.** rise by 32 percent.
 - D. fall by 38 percent.
- Q5.** The PURCHASING POWER PARITY (PPP) CONDITION, which relies on the “law of one price” for its justification, is unable to explain exchange rate movements with precision in the real world because
- A. not all countries produce similar bundles of goods.
 - B. speculative movements into ”attractive” currencies can partially or fully offset exchange rate movements due to trade considerations alone.
 - C. aggregate price levels differ across countries.
 - D. all of the above.
 - **E.** only A and B above.
- Q6.** If the average nominal interest rate on bank deposit accounts in the ROW is 5 percent, and if the HC nominal exchange rate E with respect to ROW is expected to depreciate by 3 percent, then the INTEREST PARITY CONDITION (in nominal form) predicts that the average nominal interest rate on HC bank deposit accounts should be about
- A. -8 percent.
 - **B.** 8 percent.
 - C. -2 percent
 - D. 2 percent.