

**Homework 5 (Chapters 5 and 12)**  
**(ECON 410, Spring 2009)**  
**(Due 04/23/2009, in class)**

(A) Multiple Choice Questions: (3 points per multiple choice problem), 25 questions.

1. In a small open economy with floating exchange rate, the government can reduce trade deficit by:
  - A) Prohibiting imports of a certain good.
  - B) Cut government budget deficit.
  - C) Encourage consumers to buy domestically produced goods.
  - D) Cut income taxes.
  
2. The weak version of purchasing power parity (PPP) states:
  - A) Real exchange rate fluctuates from time to time.
  - B) A big Mac costs \$3.54 in the US, it must cost the 354 Yen in Japan, if the nominal exchange rate is 1 dollar = 100 Yen.
  - C) Real exchange rate is 1.
  - D) Although nominal exchange rate fluctuates, real exchange rate is roughly constant.
  
3. According to the Mundell-Fleming model, import restrictions in an economy with flexible exchange rates cause net exports to \_\_\_\_\_ and in an economy with fixed exchange rates import restrictions cause net exports to \_\_\_\_\_.
  - A) increase; increase
  - B) increase; remain unchanged
  - C) remain unchanged; remain unchanged
  - D) remain unchanged; increase
  
4. In the Mundell-Fleming model, expectations that a currency will lose value in the future will cause the current exchange rate to:
  - A) increase in the present.
  - B) decrease in the present.
  - C) remain constant in the present.
  - D) decrease only in the future.
  
5. The Mundell-Fleming model assumes that:
  - A) prices are flexible, whereas the *IS-LM* model assumes that prices are fixed.
  - B) prices are fixed, whereas the *IS-LM* model assumes that prices are flexible.
  - C) as in the *IS-LM* model, prices are fixed.
  - D) as in the *IS-LM* model, prices are flexible.

6. If short-run equilibrium in the Mundell-Fleming model is represented by a graph with  $Y$  along the horizontal axis and the exchange rate along the vertical axis, then the  $LM^*$  curve:
- slopes upward and to the right because at a higher income a higher interest rate is needed to increase velocity.
  - is vertical because monetary velocity is independent of the interest rate.
  - is vertical because the exchange rate does not enter into the  $LM^*$  equation.
  - slopes upward and to the right because a higher exchange rate leads to a higher income.
7. If a dollar bought 1,000 won ten years ago, and 1,500 won now, and inflation for the period is 25% in the US and 100% in Korea, then:
- The purchasing-power parity theory is correct.
  - Traveling in Korea today costs about the same as it did ten years ago
  - Traveling in Korea is cheaper now than it was ten years ago.
  - Traveling in Korea is more expensive now than it was ten years ago.
8. In a small open economy with a floating exchange rate, the supply of real money balances is fixed and a rise in government spending:
- raises the interest rate, so that income must rise to maintain equilibrium in the money market.
  - raises the interest rate so that net exports must fall to maintain equilibrium in the goods market.
  - cannot change the interest rate so that net exports must fall to maintain equilibrium in the goods market.
  - cannot change the interest rate so income must rise to maintain equilibrium in the money market.
9. In a small, open economy with a floating exchange rate, the exchange rate will depreciate if:
- the money supply is increased.
  - import quotas are imposed.
  - government spending is increased.
  - taxes are decreased.
10. If domestic saving exceeds domestic investment, then net exports are \_\_\_\_\_ and net capital outflows are \_\_\_\_\_.
- positive; positive
  - positive; negative
  - negative; negative
  - negative; positive

11. In a small open economy, if domestic saving exceeds domestic investment, then the extra saving will be used to:
- A) Make loans to the government
  - B) Make loans to the foreigners.
  - C) Repay the national debt.
  - D) Repay loans to the Federal Reserve.
12. A country with trade deficit is more likely to have:
- A) Budget deficit.
  - B) More price-conscious consumers.
  - C) Lower tariffs.
  - D) Less efficient industries.
13. An increase in the trade surplus of a small open economy could be the result of:
- A) a domestic tax cut.
  - B) an increase in government spending.
  - C) an increase in the world interest rate.
  - D) the implementation of an investment tax-credit provision.
14. Starting from a small open economy with balanced trade, if large foreign countries increase their domestic government purchases, this policy will tend to increase:
- A) investment in the small open economy.
  - B) saving in the small open economy.
  - C) exports by the small open economy.
  - D) imports by the small open economy.
15. If 5 French francs trade for \$1, the U.S. price level equals \$1 per good, and the French price level equals 2 francs per good, then the real exchange rate between French goods and U.S. goods is \_\_\_\_\_ French goods per U.S. good.
- A) 0.5
  - B) 2.5
  - C) 5
  - D) 10
16. If the interest rate is internationally determined because of capital mobility, then:
- A) Inflation is also internationally determined.
  - B) Per capita investment in each country is the same.
  - C) Domestic saving rate should not affect the investment rate of the country.
  - D) Purchasing Power Parity (PPP) holds.

17. If an iPhone of the same specifications costs \$300 British Pounds in UK while it costs 400 US\$ in the US. What is the exchange rate between dollar and pound, according to the iPhone price?
- A) 1.33 Pound/\$
  - B) 0.75 Pound/\$
  - C) 1.0 Pound/\$
  - D) Neither of those.
18. If the nominal exchange rate falls 10 percent, the domestic price level rises 4 percent, and the foreign price level rises 6 percent, the real exchange rate will fall:
- A) 0 percent.
  - B) 8 percent.
  - C) 10 percent.
  - D) 12 percent.
19. According to data presented in class, the trade deficit that US has with China may be substantially reduced if:
- A) US cut government deficit substantially.
  - B) US dollar depreciates 20% against Chinese Yuan.
  - C) US raises tariffs substantially against imports.
  - D) Neither of the above.
20. For the dollars in California and in Texas:
- A) It is a fixed exchange rate of one.
  - B) It is a floating exchange rate because prices in California and in Texas are changing.
  - C) No exchange rate exists because they are two states within a country.
  - D) The real exchange rate is one between these two states.
21. One of the disadvantages of using Big Mac to measure relative prices
- A) Big Mac is not a healthy food.
  - B) Big Macs in different countries are very similar in quality.
  - C) Big Mac is not typically considered as a tradable good.
  - D) Big Mac can be seen almost in all countries.
22. One of the advantages of using Big Mac to measure relative prices:
- A) Big Mac is well-liked by many people.
  - B) Big Mac is not typically considered as a tradable good.
  - C) Big Mac can be found in most countries.
  - D) Big Mac represents an important part of the US culture.

23. The Mundell-Fleming model is a \_\_\_\_\_ model for a(n) \_\_\_\_\_ open economy.
- A) Short-run; small
  - B) Short-run; large
  - C) Long-run; large
  - D) Long-run; small
24. For a small open economy with the floating exchange rate regime, output will increase if:
- A) The government reduces taxes or increases government spending.
  - B) The government raises tariffs for imported goods.
  - C) The government imposes import quotas.
  - D) The central bank increases money supply.
25. In the Mundell-Fleming model, the exogenous variables are the:
- A) World interest rate, the price level, and the exchange rate.
  - B) level of government spending, taxes, and income.
  - C) exchange rate and level of income.
  - D) price level, world interest rate, monetary policy, and fiscal policy.

#### Essay Questions

1. (15 points) Mankiw textbook, Chapter 5, #2 on page 147.
2. (10 points) Mankiw textbook, Chapter 12, #5 on page 366