Study Questions
(with Answers)

Lecture 16
Fixed Versus Floating Exchange Rates

Part 1: Multiple Choice

Select the **best** answer of those given.

1. “Freely floating exchange rates” describes the exchange regimes of

    a. All but a small minority of the countries of the world.
    b. The major industrialized countries.
    c. Most very small countries.
    d. Most very poor countries.
    e. More currencies than have pegged exchange rates.

    Ans: b

2. Movements of a country’s exchange rate tend to be undesirable from a macroeconomic standpoint because

    a. They usually cause inflation.
    b. They usually cause unemployment.
    c. They make it hard to strike a balance between inflation and unemployment.
    d. They crowd out investment.
    e. They increase the budget deficit.

    Ans: c

3. A country with a pegged exchange rate is likely to be forced to devalue if

    a. Speculators believe that it will devalue.
    b. Its rate of inflation is smaller than inflation in other countries.
    c. It has no comparative advantage in trade.
    d. Its workers are less productive than workers elsewhere.
    e. Its central bank has contracted its money supply.

    Ans: a

4. On what do Nobel Prize winners Friedman and Mundell agree, with regard to exchange rate systems?

   a. That floating exchange rates are bad
   b. That fixed exchange rates are bad
   c. That pegged exchange rates are bad
   d. That pegged exchange rates are good
   e. That fixed and floating exchange rates are equally good

   Ans: c

5. At the microeconomic level, exchange rate movements can cause

   a. Uncertainty about the profitability of international transactions.
   b. One party to an international transaction to gain, and the other to lose, relative to what both had planned.
   c. Whole industries within a country to become uncompetitive.
   d. Workers to be laid off in community or region of the country.
   e. All of the above.

   Ans: e

6. An advantage of a floating exchange rate is that

   a. It causes wages in different regions of a country to be equal.
   b. It raises the value of the currency to a higher level than could be achieved with a pegged rate.
   c. It permits the country to conduct an independent monetary policy.
   d. It constrains the government from issuing excessive debt.
   e. It prevents inflation.

   Ans: c

7. Why, according to the reading by John Makin, "Exchange Rate Stability in International Finance," had China been able to maintain a pegged exchange rate?

   a. The Chinese currency was not convertible to, and from, other currencies.
   b. By controlling prices, China avoided inflation.
   c. When Makin was writing – 2000 – China had not yet opened its borders to international trade.
   d. China did not have its own currency; it used the dollar.
   e. By pegging to the Japanese yen rather than the US dollar, China's currency acquired greater strength.

   Ans: a

8. What was a "Greenspan Put"?

   a. A restriction on international capital flows needed to maintain a pegged exchange rate.
   b. The use of interest-rate cuts to rescue financial markets.
   c. The use by a central bank of open market operations to offset the effects of exchange market intervention on the money supply.
   d. The episode in which the US Federal Reserve used tight money to bring down inflation in the early 1980s
   e. The actions taken by Federal Reserve Chairman Alan Greenspan to puncture the DotCom asset price bubble.

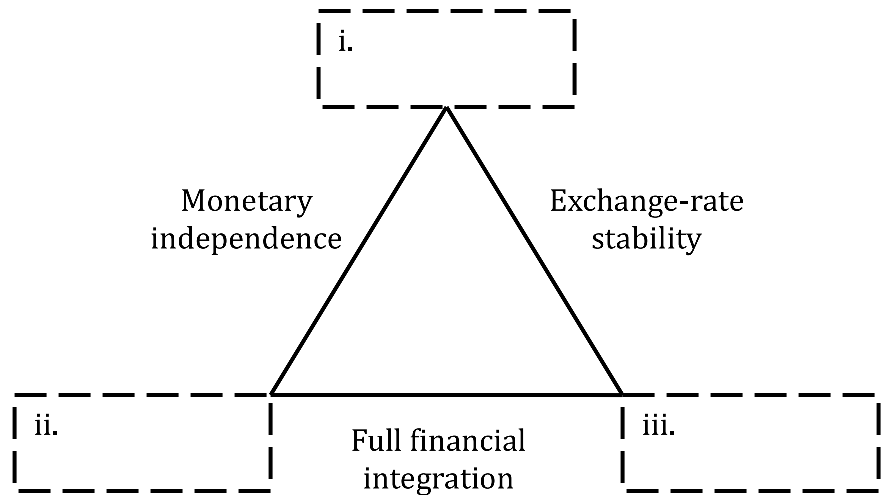
   Ans: b (See reading by Buttonwood)

Part II: Short Answer

Answer in the space provided

1. The figure at the right shows Jeffrey Frankel's triangle representing the "Impossible Trinity."

   a. Fill in the three dashed boxes at the points of the triangle with the appropriate labels.



Ans: i. Full capital controls; ii. Pure float; iii. Monetary union

   b. Write a short explanation of the economic message that is represented by the triangle.

Ans.: The triangle represents the supposed impossibility of having all three of the objectives that label the sides of the triangle: monetary independence, exchange-rate stability, and full financial market integration. A country can have any ***two*** *of these, by adopting the policy at corner of the triangle between two sides, but that policy will make the objective on side opposite it impossible.*

2. Fill in the blanks:

   a. A "currency board" consists of a commitment to a ____*Ans: pegged*__________________________ exchange rate, together with renouncing independent ____*Ans: monetary*__________________________ policy.

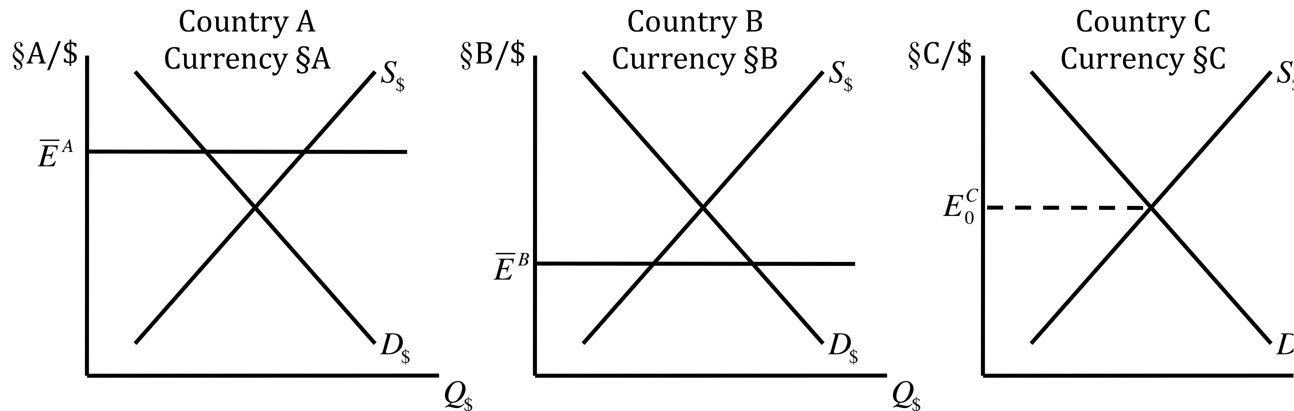
   b. In the first half of the 1980s, the value of the U.S. dollar ____*Ans: rose*__________________________ by around 50%, causing sales of U.S. auto companies to ____*Ans: decrease*__________________________.

c. In the Plaza Accord, major ____*Ans: central banks* ______________________ met at the Plaza Hotel in New York and agreed to stop the US dollar from ____ *Ans: appreciating* ____________________. Presumably this meant that they then intervened in the exchange market, ____*Ans: selling* ____________________ dollars.

d. If a country with a pegged exchange rate has a high rate of inflation, then it will ultimately have to ____*Ans: devalue, or abandon the peg*__________________________. If speculators know this, their actions will cause this to happen ____*Ans: sooner*__________________________ than it would have otherwise.

e. It is widely believed that the Chinese currency, known both as the ___*Ans: yuan* _____________ and the ___*Ans: Renminbi* ______________, is __*Ans: under* ________-valued. If this situation continues, China is ___*Ans: not likely* _______________ (likely / not likely) to experience an exchange rate crisis.

3. The three figures below show supply and demand for the currencies of three countries, A, B, and C, in their respective foreign exchange markets *vis a vis* the dollar. The currencies are represented as §A, §B , etc. (say "A-notes," etc.). Countries A and B have pegged exchange rates to the dollar at the rates shown as $\overline{E}^A$ and $\overline{E}^B$ respectively, while country C has a floating rate.



Suppose now that you are a speculator with ample resources in each of these countries as well as in the U.S. You are trying to pick one of these currencies on which to speculate by either buying it or selling it, hoping that the exchange rate will later move to your advantage.

a. Which one currency would you choose to speculate on?

Ans: B

b. Would you buy it or sell it?

Ans: Sell

c. Why would you pick the currency you picked in part (a)?

Ans: Because the B central bank is losing reserves of dollars and may eventually run out, forcing a devaluation. [Not C, because I don't know which direction it will move. Not A because, while I know that if the peg is abandoned the currency will appreciate, there is no reason to expect the peg to fail, since the A central bank is gaining reserves. I'd pick B for the reason given: it will run out of reserves unless conditions change. If it does run out, then it will either abandon the peg or devalue, and in both cases I will gain from having sold the currency at its current high price. Because B is selling $ reserves, there is little chance that the currency will appreciate, so the worst that can happen if I sell B-notes is that the exchange rate will not change at all, and I break even.]