

Fundamentals of Multinational Finance, 6e (Moffett et al.)
Chapter 3 The Balance of Payments

3.1 Fundamentals of BOP Accounting

1) Which of the following is NOT a major subaccount of the Balance of Payments?

- A) the financial account
- B) the accounts payable
- C) the capital account
- D) the current account

Answer: B

Diff: 1

L.O.: 3.1 Fundamentals of BOP Accounting

Skill: Recognition

AACSB: Application of knowledge

2) Which of the following international transactions would NOT be counted as a balance of payments (BOP) transaction?

- A) An American tourist purchases cheese in Milwaukee, Wisconsin.
- B) The U.S. subsidiary of a British firm pays profits (dividends) back to its parent firm in London.
- C) A Canadian lumber baron purchases a U.S. corporate bond through an investment broker in Seattle.
- D) All of the above are considered BOP transactions.

Answer: A

Diff: 1

L.O.: 3.1 Fundamentals of BOP Accounting

Skill: Recognition

AACSB: Application of knowledge

3) The *balance of payments* as applied to a course in international finance may be defined as:

- A) the amount still owed by an exporting firm after making an initial down payment.
- B) the amount still owed by governments to the International Monetary Fund.
- C) the measurement of all international economic transactions between the residents of a country and foreign residents.
- D) the amount of a country's merchandise trade deficit or surplus.

Answer: C

Diff: 1

L.O.: 3.1 Fundamentals of BOP Accounting

Skill: Conceptual

AACSB: Application of knowledge

- 4) Balance of payment (BOP) data may be important for any of the following reasons:
- A) BOP data helps to forecast a country's market potential, especially in the short run.
 - B) the BOP is an important indicator of a country's foreign exchange rate.
 - C) changes in a country's BOP may signal a change in controls over payment of dividends and interest.
 - D) all of the choices provided above

Answer: D

Diff: 1

L.O.: 3.1 Fundamentals of BOP Accounting

Skill: Conceptual

AACSB: Application of knowledge

- 5) A country experiencing a serious BOT _____ is more likely to _____ exports than otherwise.

- A) surplus; contract
- B) surplus; expand
- C) deficit; expand
- D) none of the above

Answer: A

Diff: 2

L.O.: 3.1 Fundamentals of BOP Accounting

Skill: Analytical

AACSB: Analytical thinking

- 6) Which of the following would NOT be considered a typical BOP transaction?

- A) Toyota U.S.A. is a U.S. distributor of automobiles manufactured in Japan by its parent company.
- B) The U.S. subsidiary of European financial giant, Credit Suisse, pays dividends to its parent in Zurich.
- C) A U.S. tourist purchases gifts at a museum in London.
- D) All are example of BOP transactions.

Answer: D

Diff: 1

L.O.: 3.1 Fundamentals of BOP Accounting

Skill: Conceptual

AACSB: Application of knowledge

- 7) Which of the following is NOT an item to be considered in BOP calculations?
- A) A foreign resident purchases a U.S. Treasury Bill.
 - B) A U.S.-based firm manages the development of an oil field in Kazakhstan.
 - C) A consumer buys a VCR made in Korea from a Florida Wal-Mart store.
 - D) A U.S. citizen living in Minnesota travels to Winnipeg, Canada, and buys a case of LaBatt's Canadian beer.

Answer: C

Diff: 1

L.O.: 3.1 Fundamentals of BOP Accounting

Skill: Conceptual

AACSB: Application of knowledge

- 8) The *balance of payments*:

- A) determines the eligibility of countries for IMF aid.
- B) adds up the value of all assets and liabilities of a country on a specific date.
- C) records all international transactions for a country over a period of time.
- D) all of the above

Answer: C

Diff: 1

L.O.: 3.1 Fundamentals of BOP Accounting

Skill: Recognition

AACSB: Application of knowledge

- 9) An American tourist purchases a leather jacket while in Italy. Which of the following statements is *true*?

- A) The leather purchase would be considered an import for the U.S. BOP.
- B) This transaction would be properly accounted for in the *Current Account* of the U.S. BOP.
- C) The leather purchase is considered an import of a good, and thus, considered part of the balance of trade as well.
- D) All of these statements are true.

Answer: D

Diff: 1

L.O.: 3.1 Fundamentals of BOP Accounting

Skill: Recognition

AACSB: Application of knowledge

10) Which of the following statements about the balance of payments is NOT true?

A) The BOP is the summary statement of all international transactions between one country and all other countries.

B) The BOP is a flow statement, summarizing all international transactions that occur across the geographic borders over a period of time, typically a year.

C) Although the BOP must always balance in theory, in practice there are substantial imbalances as a result of statistical errors and misreporting of current account and financial account flows.

D) All of the above are true.

Answer: D

Diff: 1

L.O.: 3.1 Fundamentals of BOP Accounting

Skill: Recognition

AACSB: Application of knowledge

11) When the world went to a system of floating exchange rates, the Balance of Payments became a relic of a system of fixed exchange rates and is no longer watched by serious economic groups.

Answer: FALSE

Explanation: The BOP is still closely watched by several groups including investment bankers, politicians, and corporate executives to name a few.

Diff: 1

L.O.: 3.1 Fundamentals of BOP Accounting

Skill: Conceptual

AACSB: Application of knowledge

12) The BOP should always balance.

Answer: FALSE

Diff: 1

L.O.: 3.1 Fundamentals of BOP Accounting

Skill: Recognition

AACSB: Application of knowledge

13) Changes in the BOP may predict the imposition or removal of foreign exchange controls.

Answer: TRUE

Diff: 1

L.O.: 3.1 Fundamentals of BOP Accounting

Skill: Conceptual

AACSB: Application of knowledge

14) A country experiencing a serious trade deficit is not as likely to expand imports as it would be if running a surplus.

Answer: TRUE

Diff: 2

L.O.: 3.1 Fundamentals of BOP Accounting

Skill: Analytical

AACSB: Analytical thinking

15) The authors identify a tip for understanding BOP accounting. They recommend that you "follow the cash flow."

Answer: FALSE

Diff: 1

L.O.: 3.1 Fundamentals of BOP Accounting

Skill: Recognition

AACSB: Application of knowledge

16) The BOP must be in balance, but the current account need not be.

Answer: FALSE

Diff: 1

L.O.: 3.1 Fundamentals of BOP Accounting

Skill: Recognition

AACSB: Application of knowledge

17) Expenditures by U.S. tourists in foreign countries for foreign goods or services are factored into BOP calculations.

Answer: FALSE

Diff: 1

L.O.: 3.1 Fundamentals of BOP Accounting

Skill: Recognition

AACSB: Application of knowledge

18) Like a balance sheet, the Balance of Payments adds up the value of all assets and liabilities of a country on a specific date.

Answer: FALSE

Diff: 1

L.O.: 3.1 Fundamentals of BOP Accounting

Skill: Recognition

AACSB: Application of knowledge

19) Because current and financial/capital account balances use double-entry bookkeeping it is unusual to find serious discrepancies in the debits and credits.

Answer: FALSE

Explanation: Even though current and financial/capital account balances use double-entry bookkeeping, it is NOT unusual to find serious discrepancies in the debits and credits.

Diff: 1

L.O.: 3.1 Fundamentals of BOP Accounting

Skill: Recognition

AACSB: Application of knowledge

20) The measurement of all international economic transactions that take place between the residents of a country and foreign residents is called the *balance of payments* (BOP). List and explain three reasons why host-country BOP data is important to managers and investors.

Answer: BOP data is also important for the following reasons: 1) The BOP is an important indicator of pressure on a country's foreign exchange rate, and thus of the potential for a firm trading with or investing in that country to experience foreign ex-change gains or losses. Changes in the BOP may predict the imposition or removal of foreign exchange controls. 2) Changes in a country's BOP may signal the imposition or removal of controls over payment of dividends and interest, license fees, royalty fees, or other cash disbursements to foreign firms or investors. 3) The BOP helps to forecast a country's market potential, especially in the short run. A country experiencing a serious trade deficit is not as likely to expand imports as it would be if running a surplus. It may, however, welcome investments that increase its exports.

Diff: 2

L.O.: 3.1 Fundamentals of BOP Accounting

Skill: Conceptual

AACSB: Application of knowledge

3.2 The Accounts of the Balance of Payments

1) Which of the following is NOT a part of the *Current Account* of BOP?

- A) net export/import of goods
- B) balance of trade
- C) net portfolio investment
- D) net export/import of services

Answer: C

Diff: 1

L.O.: 3.2 The Accounts of the Balance of Payments

Skill: Recognition

AACSB: Application of knowledge

2) Which of the following is NOT part of the *Financial Account* of the BOP?

- A) net foreign direct investment
- B) net import/export of services
- C) net portfolio investment
- D) other Financial items

Answer: B

Diff: 1

L.O.: 3.2 The Accounts of the Balance of Payments

Skill: Recognition

AACSB: Application of knowledge

3) Which of the following is NOT part of the *balance of payments* account?

- A) the current account
- B) the financial/capital account
- C) the official reserves account
- D) All of the above are BOP accounts.

Answer: D

Diff: 1

L.O.: 3.2 The Accounts of the Balance of Payments

Skill: Recognition

AACSB: Application of knowledge

4) The _____ includes all international economic transactions with income or payment flows occurring within the year.

- A) capital account
- B) current account
- C) financial account
- D) IMF account

Answer: B

Diff: 1

L.O.: 3.2 The Accounts of the Balance of Payments

Skill: Recognition

AACSB: Application of knowledge

5) If your company were to import and export textiles, the transactions would be recorded in the current account subcategory of:

- A) services trade.
- B) income trade.
- C) goods trade.
- D) current transfers.

Answer: C

Diff: 2

L.O.: 3.2 The Accounts of the Balance of Payments

Skill: Conceptual

AACSB: Application of knowledge

6) The travel services provided to international travelers by United Airlines would be recorded in the current account subcategory of:

- A) services trade.
- B) income trade.
- C) goods trade.
- D) current transfers.

Answer: A

Diff: 2

L.O.: 3.2 The Accounts of the Balance of Payments

Skill: Conceptual

AACSB: Application of knowledge

7) Anaconda Copper Inc. created a subsidiary in Chile last year to mine copper ore. The proportion of net income paid back to the parent company as a dividend would be recorded in the current account subcategory of:

- A) services trade.
- B) income trade.
- C) goods trade.
- D) current transfers.

Answer: B

Diff: 2

L.O.: 3.2 The Accounts of the Balance of Payments

Skill: Conceptual

AACSB: Application of knowledge

8) The subcategory that typically dominates the current account is:

- A) goods (merchandise) trade.
- B) services trade.
- C) income trade.
- D) transfer accounts.

Answer: A

Diff: 1

L.O.: 3.2 The Accounts of the Balance of Payments

Skill: Recognition

AACSB: Application of knowledge

9) In 2010 the United States posted a current account deficit of -\$471 billion. The bulk of the negative value came from:

- A) a net transfer deficit.
- B) an income balance deficit.
- C) a goods trade deficit.
- D) an income trade deficit.

Answer: C

Diff: 1

L.O.: 3.2 The Accounts of the Balance of Payments

Skill: Recognition

AACSB: Application of knowledge

10) Over the last two decades the surplus on U.S. services trade has typically been _____ the deficit on U.S. goods trade.

- A) greater than
- B) equal to
- C) less than
- D) The relationship is constantly shifting from greater than to less than.

Answer: C

Diff: 2

L.O.: 3.2 The Accounts of the Balance of Payments

Skill: Recognition

AACSB: Application of knowledge

11) The _____ of the balance of payments measures all international economic transactions of financial assets.

- A) current account
- B) merchandise trade account
- C) services account
- D) capital and financial accounts

Answer: D

Diff: 1

L.O.: 3.2 The Accounts of the Balance of Payments

Skill: Recognition

AACSB: Application of knowledge

12) The financial account consists COMPLETELY of which four components?

- A) stock investment, bond investment, derivative investment, and mutual fund investment
- B) direct investment, stock investment, net financial derivatives, and bond investment
- C) direct investment, portfolio investment, net financial derivatives, and other asset investment
- D) mutual fund investment, portfolio investment, derivative investment, and stock investment

Answer: C

Diff: 2

L.O.: 3.2 The Accounts of the Balance of Payments

Skill: Recognition

AACSB: Application of knowledge

13) When categorizing investments for the financial account component of the balance of payments the _____ is an investment where the investor has no control whereas the _____ is an investment where the investor has control over the asset.

- A) direct investment; portfolio investment
- B) direct investment; indirect investment
- C) portfolio investment; indirect investment
- D) portfolio investment; direct investment

Answer: D

Diff: 2

L.O.: 3.2 The Accounts of the Balance of Payments

Skill: Recognition

AACSB: Application of knowledge

14) In general there is consensus that _____ should be free, but there is no such consensus that _____ should be free.

- A) international investment; international goods trade
- B) international investment; international trade
- C) international trade; international goods trade
- D) international trade; international investment

Answer: D

Diff: 2

L.O.: 3.2 The Accounts of the Balance of Payments

Skill: Conceptual

AACSB: Application of knowledge

15) The two major concerns about foreign direct investment are:

- A) national defense and taxes.
- B) who controls the assets and who receives the profits.
- C) who receives the profits and taxes.
- D) who pays the taxes and who receives the taxes.

Answer: B

Diff: 2

L.O.: 3.2 The Accounts of the Balance of Payments

Skill: Conceptual

AACSB: Application of knowledge

16) Portfolio investment is capital invested in activities that are _____ rather than made for _____.

- A) short term; the long term
- B) long term; profit
- C) profit motivated; control
- D) control motivated; profit

Answer: C

Diff: 2

L.O.: 3.2 The Accounts of the Balance of Payments

Skill: Recognition

AACSB: Application of knowledge

17) Consider the following: A foreign automobile company builds a manufacturing plant in Tennessee and European investors buy U.S. Treasury Bonds.

- A) Both activities would be considered direct investment.
- B) Both activities would be considered portfolio investment.
- C) The auto manufacturer is engaging in portfolio investment, and the European investors are engaged in direct investing.
- D) The auto manufacturer is engaging in direct investment, and the European investors are engaged in portfolio investing.

Answer: D

Diff: 2

L.O.: 3.2 The Accounts of the Balance of Payments

Skill: Recognition

AACSB: Application of knowledge

- 18) China is currently experiencing a surplus in its current account and its capital/financial accounts. Which of the following is NOT a contributing factor for this unusual situation?
- A) The exceptional growth in the Chinese economy contributes to the current account surplus.
 - B) The positive prospects for China's continued growth contribute to the capital/financial account surplus.
 - C) China's inevitable acquisition of Taiwan is driving the market for Chinese investment.
 - D) All of the above are contributing factors for China's twins surpluses.

Answer: C

Diff: 1

L.O.: 3.2 The Accounts of the Balance of Payments

Skill: Conceptual

AACSB: Application of knowledge

- 19) If China wished to reduce their accumulation of foreign exchange reserves they could:
- A) allow their currency, the yuan, to float freely in the market place.
 - B) reduce their current account surplus by importing more goods than they export.
 - C) undertake both of the activities identified in choices A and B.
 - D) dig a big hole and bury the reserves.

Answer: C

Diff: 1

L.O.: 3.2 The Accounts of the Balance of Payments

Skill: Conceptual

AACSB: Application of knowledge

- 20) The largest single component of the United States current account is:
- A) current transfers.
 - B) income payments and receipts.
 - C) goods (merchandise) imports and exports.
 - D) services imports and exports.

Answer: C

Diff: 1

L.O.: 3.2 The Accounts of the Balance of Payments

Skill: Recognition

AACSB: Application of knowledge

- 21) In general, as a country's income increases, so does the demand for imports.

Answer: FALSE

Diff: 1

L.O.: 3.2 The Accounts of the Balance of Payments

Skill: Conceptual

AACSB: Application of knowledge

22) For at least the last decade, the United States has consistently run a surplus in services trade income.

Answer: TRUE

Diff: 1

L.O.: 3.2 The Accounts of the Balance of Payments

Skill: Recognition

AACSB: Application of knowledge

23) Expenditures by U.S. students abroad and foreign students pursuing studies in the United States would be considered a services trade and part of the U.S. current account.

Answer: TRUE

Diff: 1

L.O.: 3.2 The Accounts of the Balance of Payments

Skill: Recognition

AACSB: Application of knowledge

24) International debt security purchases and sales are defined as portfolio investments for financial account purposes because by definition debt securities do not provide the buyer with ownership or control.

Answer: TRUE

Diff: 1

L.O.: 3.2 The Accounts of the Balance of Payments

Skill: Recognition

AACSB: Application of knowledge

25) Significant amounts of United States Treasury issues are purchased by foreign investors, therefore the U.S. must earn foreign currency to repay this debt.

Answer: FALSE

Explanation: U.S. Treasury issues are denominated in dollars, not in foreign currencies.

Diff: 1

L.O.: 3.2 The Accounts of the Balance of Payments

Skill: Conceptual

AACSB: Application of knowledge

26) In the United States and most developed countries, the current account and the combined financial/capital accounts tend to be inversely related in that when one is positive, the other tends to be negative.

Answer: TRUE

Diff: 1

L.O.: 3.2 The Accounts of the Balance of Payments

Skill: Recognition

AACSB: Application of knowledge

27) The biggest problem that China faces in maintaining a stable value for their currency, the yuan, is their lack of foreign exchange reserves.

Answer: FALSE

Diff: 1

L.O.: 3.2 The Accounts of the Balance of Payments

Skill: Recognition

AACSB: Application of knowledge

28) As of year-end 2010, the United States still held the world's largest foreign exchange reserve, but the total was rapidly being approached by China.

Answer: FALSE

Diff: 1

L.O.: 3.2 The Accounts of the Balance of Payments

Skill: Recognition

AACSB: Application of knowledge

29) China's current political plan includes reducing their foreign exchange reserve balance by allowing the yuan to float freely and by switching their goods balance from one of a net surplus to a net deficit.

Answer: FALSE

Diff: 1

L.O.: 3.2 The Accounts of the Balance of Payments

Skill: Recognition

AACSB: Application of knowledge

30) An excess of merchandise exports over merchandise imports results in a balance of trade deficit.

Answer: FALSE

Explanation: An excess of merchandise IMPORTS over merchandise EXPORTS results in a balance of trade deficit.

Diff: 1

L.O.: 3.2 The Accounts of the Balance of Payments

Skill: Conceptual

AACSB: Application of knowledge

31) The transition to floating exchange rate regimes in the 1970s (described in Chapter 3) changed the focus from the total BOP to its various subaccount like the current and financial account balances.

Answer: TRUE

Diff: 1

L.O.: 3.2 The Accounts of the Balance of Payments

Skill: Conceptual

AACSB: Application of knowledge

32) What is a country's balance of (merchandise) trade, and why is it so widely reported in the financial and popular press?

Answer: The balance of trade (BOT) is the largest and most important subset of a country's current account. It measures the difference in a country's imports and exports over a specified time period. It is often reported because it is intuitively easy to understand (i.e., we either sell more or buy more from foreign countries) and it is a reasonable representation of the total current account balance. (For example, for the U.S. the BOT was -\$343B in 1999 while the current account balance was -\$331B.

Diff: 3

L.O.: 3.2 The Accounts of the Balance of Payments

Skill: Conceptual

AACSB: Application of knowledge

33) What is the Official Reserves Account (ORA), and why is it more important for countries under a fixed exchange rate regime than for ones under a floating exchange rate regime?

Answer: The ORA is the total reserves held by official monetary authorities within the country. Under a fixed exchange regime a country's currency is convertible into a fixed amount of another country's currency. To keep the relationship between currencies at equilibrium, it may become necessary for the government to buy or sell official reserves until the equilibrium is restored. Under a variable rate regime this is not necessary as exchange rates are allowed to change and official reserves no longer serve the same purpose as under the fixed rate regime.

Diff: 3

L.O.: 3.2 The Accounts of the Balance of Payments

Skill: Conceptual

AACSB: Application of knowledge

3.3 The BOP Impacts on Key Macroeconomic Rates

1) Under an international regime of fixed exchange rates, countries with a BOP _____ should consider _____ their currency while countries with a BOP _____ should consider _____ their currency.

A) deficit, revaluing; surplus, revaluing

B) deficit, devaluing; surplus, devaluing

C) surplus, devaluing; deficit, revaluing

D) surplus, revaluing; deficit, devaluing

Answer: D

Diff: 2

L.O.: 3.3 The BOP Impacts on Key Macroeconomic Rates

Skill: Analytical

AACSB: Analytical thinking

2) Use the following terms for this question:

C = consumption

I = capital investment spending

G = government spending

X = exports of goods and services

M = imports of goods and services

BOP = balance of payments

GDP = gross domestic product

NPV = net present value

INF = inflation

R = real rate of return

The static equation for the nations GDP is:

A) $GDP = C + I + G + (X + M) \times INF$

B) $GDP = C + I + G + X + M$

C) $GDP = C + I + G + X - M$

D) $GDP = C + I + X - M + R$

Answer: C

Diff: 2

L.O.: 3.3 The BOP Impacts on Key Macroeconomic Rates

Skill: Analytical

AACSB: Analytical thinking

3) Use the following terms for this question:

(X-M) = Current Account Balance

(CI-CO) = Capital Account Balance

(FI-FO) = Financial Account Balance

(I-S) = Investment-Saving Balance

FXB = Reserve Balance

BOP = balance of payments

GDP = gross domestic product

C = consumption

I = capital investment spending

G = government spending

The static equation for the BOP is:

A) $BOP = (X-M) - (CI-CO) - (FI-FO) + FXB$

B) $BOP = (X-M) + (I-S) + (FI-FO) + FXB$

C) $BOP = (X-M) + (CI-CO) + (FI-FO) + FXB$

D) $BOP = GDP - [C + I + G] + (FI-FO)$

Answer: C

Diff: 2

L.O.: 3.3 The BOP Impacts on Key Macroeconomic Rates

Skill: Analytical

AACSB: Analytical thinking

4) Imports have the potential to lower a country's inflation rate because of each of the following EXCEPT:

- A) the import of lower priced goods limits what domestic competitors can charge for goods.
- B) the import of lower priced services limits what domestic competitors can charge for services.
- C) the higher prices of foreign goods spurs domestic competitors to cut prices.
- D) all of the above

Answer: C

Diff: 2

L.O.: 3.3 The BOP Impacts on Key Macroeconomic Rates

Skill: Recognition

AACSB: Application of knowledge

5) Under a fixed exchange rate system, the government bears the responsibility to ensure that the BOP is near zero. If the sum of the current and capital accounts do not approximate zero, the government is expected to intervene in the foreign exchange market by buying or selling official foreign exchange reserves. If the sum of the first two accounts is GREATER THAN ZERO, a _____ demand for the domestic currency exists in the world. To preserve the fixed exchange rate, the government must then intervene in the foreign exchange market and _____ domestic currency for foreign currencies or gold so as to bring the BOP back near zero.

- A) surplus; sell
- B) surplus; buy
- C) deficit; sell
- D) deficit; buy

Answer: A

Diff: 2

L.O.: 3.3 The BOP Impacts on Key Macroeconomic Rates

Skill: Conceptual

AACSB: Application of knowledge

6) Under a fixed exchange rate system, the government bears the responsibility to ensure that the BOP is near zero. If the sum of the current and capital accounts do not approximate zero, the government is expected to intervene in the foreign exchange market by buying or selling official foreign exchange reserves. If the sum of the first two accounts is LESS THAN ZERO, a _____ demand for the domestic currency exists in the world. To preserve the fixed exchange rate, the government must then intervene in the foreign exchange market and _____ domestic currency for foreign currencies or gold so as to bring the BOP back near zero.

- A) surplus; sell
- B) surplus; buy
- C) deficit; sell
- D) deficit; buy

Answer: D

Diff: 2

L.O.: 3.3 The BOP Impacts on Key Macroeconomic Rates

Skill: Conceptual

AACSB: Application of knowledge

7) An increase in GDP should lead to a decrease in imports.

Answer: FALSE

Explanation: An increase in GDP should lead to AN INCREASE in imports.

Diff: 1

L.O.: 3.3 The BOP Impacts on Key Macroeconomic Rates

Skill: Recognition

AACSB: Application of knowledge

8) The effect of an imbalance in the BOP is the same for countries on a fixed exchange rate regime as for those on a floating exchange rate regime.

Answer: FALSE

Explanation: The effect of an imbalance in the BOP is NOT the same for countries on a fixed exchange rate regime as for those on a floating exchange rate regime.

Diff: 1

L.O.: 3.3 The BOP Impacts on Key Macroeconomic Rates

Skill: Recognition

AACSB: Application of knowledge

9) Under a floating exchange rate system, the government bears the responsibility to ensure that the BOP is near zero.

Answer: FALSE

Explanation: Under a FIXED exchange rate system, the government bears the responsibility to ensure that the BOP is near zero.

Diff: 1

L.O.: 3.3 The BOP Impacts on Key Macroeconomic Rates

Skill: Recognition

AACSB: Application of knowledge

10) A country with a managed float that wishes to WEAKEN its currency may choose to raise domestic interest rates to attract additional capital from abroad.

Answer: FALSE

Diff: 1

L.O.: 3.3 The BOP Impacts on Key Macroeconomic Rates

Skill: Conceptual

AACSB: Application of knowledge

11) A country's overall level of interest rates should have an impact on the financial account of the BOP. Relatively low real interest rates should normally stimulate an outflow of capital seeking higher interest rates in other country currencies.

Answer: TRUE

Diff: 1

L.O.: 3.3 The BOP Impacts on Key Macroeconomic Rates

Skill: Conceptual

AACSB: Application of knowledge

12) Imports have the potential to lower a country's inflation rate. In particular, imports of HIGHER-priced goods and services place a limit on what domestic competitors charge for comparable goods and services.

Answer: FALSE

Diff: 1

L.O.: 3.3 The BOP Impacts on Key Macroeconomic Rates

Skill: Recognition

AACSB: Application of knowledge

13) Very often governments seek to alter the market's valuation of their currency by influencing relative interest rates, thus influencing the economic fundamentals of exchange rate determination rather than through direct intervention in the foreign exchange markets. Describe how this strategy works. Describe the case of the U.S. or China where the opposite effect, to the suggest here, have occurred.

Answer: A country may choose to raise domestic interest rates to attract additional capital from abroad (the short-term portfolio component of these capital flows). This step will alter market forces and create additional market demand for the domestic currency in order to restore an imbalance caused by the deficit in the current account. The process also raises the cost of local borrowing for businesses so the policy is seldom without domestic negative consequences. Relatively low real interest rates should normally stimulate an outflow of capital seeking higher interest rates in other country currencies. However, in the case of the United States, the opposite effect has occurred. Despite relatively low real interest rates and large BOP deficits on the current account, the U.S. BOP financial account has experienced offsetting financial inflows due to relatively attractive U.S. growth rate prospects, high levels of productive innovation, and perceived political safety. Thus, the financial account inflows have helped the United States to maintain its lower interest rates and to finance its exceptionally large fiscal deficit. However, it is beginning to appear that the favorable inflow on the financial account is diminishing while the U.S. balance on the current account is worsening.

Diff: 1

L.O.: 3.3 The BOP Impacts on Key Macroeconomic Rates

Skill: Conceptual

AACSB: Application of knowledge

3.4 Trade Balances and Exchange Rates

1) Of the following, which is NOT a part of J-Curve adjustment path?

- A) the currency contract period
- B) the exchange rate pass-through period
- C) the quantity adjustment period
- D) Each of the above is part of the J-Curve adjustment path.

Answer: D

Diff: 1

L.O.: 3.4 Trade Balances and Exchange Rates

Skill: Recognition

AACSB: Application of knowledge

2) Which of the following is NOT likely to occur in the quantity adjustment phase of the J-Curve adjustment path?

- A) Imports become relatively more expensive.
- B) Exports become relatively less expensive.
- C) The balance of trade gets worse.
- D) All of the above are true.

Answer: C

Diff: 2

L.O.: 3.4 Trade Balances and Exchange Rates

Skill: Conceptual

AACSB: Application of knowledge

3) When a currency is devalued the immediate impact may be an increase in a country's trade deficit. However, this situation tends to correct itself in 2 to 5 weeks.

Answer: FALSE

Explanation: This situation tends to correct itself in 3 to 12 MONTHS or more.

Diff: 2

L.O.: 3.4 Trade Balances and Exchange Rates

Skill: Recognition

AACSB: Application of knowledge

4) The immediate impact of a devaluation of the domestic currency is to decrease the value of the spot exchange rate $S\$/fc$.

Answer: FALSE

Explanation: The immediate impact of a devaluation of the domestic currency is to increase the value of the spot exchange rate $S\$/fc$.

Diff: 2

L.O.: 3.4 Trade Balances and Exchange Rates

Skill: Analytical

AACSB: Analytical thinking

5) Countries occasionally intentionally devalue their currencies. So what is the logic and likely results of intentionally devaluing their domestic currency? International economic analysis characterizes the trade balance adjustment process as occurring in three stages. List and explain the three stages too.

Answer: International economic analysis characterizes the trade balance adjustment process as occurring in three stages: 1) the currency contract period; 2) the pass-through period; and 3) the quantity adjustment period. Assuming that the trade balance is already in deficit prior to the devaluation, a devaluation at time results initially in a further deterioration in the trade balance before an eventual improvement. The path of adjustment, as shown, takes on the shape of a flattened "j."

In the *currency contract period*, a sudden unexpected devaluation of the domestic currency will deteriorate the trade balance simply because all the contracts for exports and imports are already in effect. Firms operating under these agreements are required to fulfill their obligations, regardless of whether they profit or suffer losses. In the *pass-through period*, as exchange rates change, importers and exporters eventually must pass these exchange rate changes through to their own product prices. Import prices rise and export prices are now cheaper compared to foreign competitors' because the dollar is cheaper. The third and final period, the *quantity adjustment period*, achieves the balance of trade adjustment that is expected from a domestic currency devaluation or depreciation. As the import and export prices change as a result of the pass-through period, consumers both in the United States and in the U.S. export markets adjust their demands to the new prices. Imports are relatively more expensive; therefore the quantity demanded decreases. Exports are relatively cheaper; therefore the quantity demanded increases. The balance of trade — the expenditures on exports less the expenditures on imports — improves.

Diff: 2

L.O.: 3.4 Trade Balances and Exchange Rates

Skill: Conceptual

AACSB: Application of knowledge

3.5 Capital Mobility

1) The authors identify four distinct periods of capital mobility since 1860. Which do they term as a "period of global economic destruction"?

A) 1860 - 1914

B) 1914 - 1945

C) 1945 - 1971

D) 1971 - 2007

Answer: B

Diff: 2

L.O.: 3.5 Capital Mobility

Skill: Recognition

AACSB: Application of knowledge

2) _____ is the cross-border purchase of assets that are then managed in a way that hides the movement of money and its ownership.

- A) Capital flight
- B) Capital mobility
- C) Irrational exuberance
- D) Money laundering

Answer: D

Diff: 1

L.O.: 3.5 Capital Mobility

Skill: Recognition

AACSB: Application of knowledge

3) This was an era dominated by industrialized nation economies that were dependent on gold convertibility to maintain confidence in the system.

- A) The Gold Standard, 1860-1914
- B) The Interwar Years , 1914-1945
- C) The Bretton Woods Era, 1945-1971
- D) The Floating Era, 1971-1997

Answer: A

Diff: 1

L.O.: 3.5 Capital Mobility

Skill: Recognition

AACSB: Application of knowledge

4) This dollar-based fixed exchange rate system gave rise to a long period of economic recovery and growing openness of both international trade and capital flows in and out of more and more countries.

- A) The Gold Standard, 1860-1914
- B) The Interwar Years , 1914-1945
- C) The Bretton Woods Era, 1945-1971
- D) The Floating Era, 1971-1997

Answer: C

Diff: 1

L.O.: 3.5 Capital Mobility

Skill: Recognition

AACSB: Application of knowledge

5) An era of retrenchment, in which major economic powers returned to policies of isolationism and protectionism, restricting trade and nearly eliminating capital mobility.

- A) The Gold Standard, 1860-1914
- B) The Interwar Years , 1914-1945
- C) The Bretton Woods Era, 1945-1971
- D) The Floating Era, 1971-1997

Answer: B

Diff: 1

L.O.: 3.5 Capital Mobility

Skill: Recognition

AACSB: Application of knowledge

6) A _____ is any restriction that limits or alters the rate or direction of capital movement into or out of a country.

- A) capital budget
- B) capital control
- C) balance of trade deficit
- D) balance of trade surplus

Answer: B

Diff: 1

L.O.: 3.5 Capital Mobility

Skill: Recognition

AACSB: Application of knowledge

7) Long-term capital flows reflect the following factors EXCEPT:

- A) short term interest rate differentials
- B) fundamental economic expectations
- C) growth prospects
- D) perceptions of political stability

Answer: A

Diff: 1

L.O.: 3.5 Capital Mobility

Skill: Conceptual

AACSB: Application of knowledge

8) Capital controls may take a variety of forms EXCEPT:

- A) currency boards
- B) taxes
- C) quotas
- D) prohibitions

Answer: A

Explanation: A) Capital controls may take a variety of forms that mirror restrictions on trade. They may simply be a tax on a specific transaction, they may limit the quantity or magnitude of specific capital transactions, or they may prohibit transactions altogether. The controls themselves have tended to follow the basic dichotomy of the balance of payments current account transactions versus financial account transactions.

Diff: 1

L.O.: 3.5 Capital Mobility

Skill: Recognition

AACSB: Application of knowledge

9) The Bretton Woods era realized a great expansion of international trade in goods and services.

Answer: TRUE

Diff: 2

L.O.: 3.5 Capital Mobility

Skill: Recognition

AACSB: Application of knowledge

10) Longer-term capital flows reflect short-term interest rate differentials and exchange rate expectations.

Answer: FALSE

Explanation: Experience has shown that current account-related capital flows can be more volatile, with capital flowing in and out of an economy and a currency on the basis of short-term interest rate differentials and exchange rate expectations. This volatility is somewhat compartmentalized, not directly impacting real asset investments, employment, or long-term economic growth. Longer-term capital flows reflect more fundamental economic expectations, including growth prospects and perceptions of political stability.

Diff: 2

L.O.: 3.5 Capital Mobility

Skill: Conceptual

AACSB: Application of knowledge

11) One of the motivations for capital controls is to insulate an economy from foreign political risks.

Answer: FALSE

Explanation: There is a spectrum of motivations for capital controls, with most associated with either insulating the domestic monetary and financial economy from outside markets or political motivations over ownership and access interests.

Diff: 2

L.O.: 3.5 Capital Mobility

Skill: Conceptual

AACSB: Application of knowledge

12) Dutch Disease is a term applied to a problem in the 1970 whereby the Netherlands were experiencing massive and sudden inflows of capital from abroad. What was the cause of this sudden influx of capital, and what types of potential problems did it have for the Dutch or could it have for any small single resource country?

Answer: With the rapid growth of the natural gas industry in the Netherlands in the 1970s, there was growing fear that massive capital inflows would drive up the demand for the Dutch guilder and cause a substantial currency appreciation. A more expensive guilder would then reduce the international competitiveness of other Dutch manufacturing industries, causing their relative decline to that of the natural resource industry. This is a challenge faced by a number of resource-rich economies of relatively modest size and relatively small export sectors.

Diff: 2

L.O.: 3.5 Capital Mobility

Skill: Conceptual

AACSB: Application of knowledge