

Answer Key – Practice Final Exam

Multiple Choice

- | | |
|------|-------|
| 1. D | 10. D |
| 2. D | 11. A |
| 3. D | 12. C |
| 4. C | 13. D |
| 5. C | 14. D |
| 6. C | 15. B |
| 7. A | |
| 8. D | |
| 9. A | |

Outlines of Short Answer Responses

Short Answer #1

See text explanation of this

Short Answer #2

See text for this answer. In general, large countries have more stable currencies and are not worried about destabilizing speculation or inflation. This is not true for small economies.

Short Answer #3

The exchange value of the currency will fall (currency will depreciate) in the long run. This is from the formula $MV=PY$. Thus, an increase in the money supply will yield inflation (rise in P), which will, according to PPP, cause the exchange rate to fall.

Short Answer #4

PPP applies better to homogeneous traded products, so it would apply better to gold than to Big Macs.

Problem #1

- The IR£/US\$ exchange rate is $1.5\text{IR}\text{£}=\$1$, or $\$0.67=1\text{IR}\text{£}$
- The pound is overvalued. The PPP exchange rate is $1.5\text{IR}\text{£}=\$1$, but it is currently $1\text{IR}\text{£}=\$1$. Thus, the dollar is undervalued, and the IR£ is overvalued.
- From the formula $MV=PY$, V for Ireland equals 2, and the V for the US is 4.
- Yes, the same V s hold in 1995.

Problem #2

- | | |
|-------------------|------------|
| a. \$ appreciates | e. sell \$ |
| b. \$ appreciates | f. sell \$ |
| c. \$ appreciates | g. sell \$ |
| d. \$ appreciates | h. sell \$ |