

## ANSWER OUTLINE

ECONOMICS 353

L. Tesfatsion/Fall 07

EXERCISE 9: Six Questions (8 Points Total)

DUE: Tues, Nov 13, 2007, 2:10pm

**\*\*IMPORTANT REMINDER: LATE ASSIGNMENTS WILL NOT 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 Exercise 9** 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 first five questions Q1 through Q5, below, which are in multiple choice format.
- (3) The sixth question Q6 is a Web browse exercise that asks you to consider the current controversy surrounding the International Monetary Fund (IMF). Please put your **name and student ID number** at the top of your answer sheet for Q6 along with **353 Exercise 9** and **separately** hand in this Q6 answer sheet in addition to (and separately from) your answer bubble sheet for questions Q1 through Q5.
- (4) Each question Q1 through Q5 is worth 1 point, and Q6 is worth 3 points.

**Q1 (1 Point).** In a world divided between HC and ROW, multiplying any valuation  $V$  measured in HC currency units by the HC NOMINAL EXCHANGE RATE \_\_\_\_.

- A. corrects  $V$  for changes in the HC price level
- B. corrects  $V$  for changes in the HC inflation rate
- C C. transforms  $V$  into a valuation measured in ROW currency units
- D. transforms  $V$  into pure quantity terms

**Q2 (1 Point).** Conditions needed in order for the PURCHASING POWER PARITY (PPP) CONDITION to reduce to a straightforward application of the Law of One Price include the following:

- A. the HC and ROW inflation rates must equal each other over time.
- B. the HC and ROW aggregate price levels must equal each other over time.
- C C. HC and ROW must produce the same bundle of goods and services.
- D. all of the above.
- E. only B and C above.

**Q3 (1 Point).** Suppose the inflation rate in Sweden is 5 percent during 2007 and the inflation rate in South Korea is 3 percent during 2007. Then the PURCHASING POWER PARITY CONDITION predicts that, during 2007, the value of the Swedish currency (kronas) measured in terms of the South Korean currency (wons) – i.e., the number of won per krona – will

- A. fall by 2 percent
- B. rise by 2 percent
- C. rise by 8 percent
- D. fall by 8 percent

**Q4 (1 Point).** Suppose the average nominal interest rate on bank deposit accounts across foreign countries who are major trading partners of the U.S. is 5 percent, and the U.S. effective exchange rate index for these countries (i.e., a weighted average of their exchange rates measured in foreign currency units per U.S. dollar) is expected to depreciate by 2 percent. Then INTEREST PARITY predicts that, on average, nominal interest rates on U.S. bank deposit accounts should be about

- A. 3 percent.
- B. 7 percent.
- C. -3 percent
- D. 3.5 percent
- E. none of the above.

**Q5 (1 Point).** Potential BENEFITS to European Union member countries from joining the eurozone include:

- A. an increased ability to pursue independent monetary policies.
- B. the emergence of the euro as a strong competitor to the U.S. dollar as a reserve currency held around the world.
- C. a more flexible system of exchange rates between their national currencies.
- D. a relaxation in the 3% deficit-to-GDP ratio imposed on EU member countries that do not participate in the eurozone.
- E. none of the above.

**SEE THE FOLLOWING PAGE FOR  
Q6: WEB EXERCISE**

**Q6: Web Exercise (3 Points Total). Should the IMF Be Abolished?**

This question asks you to consider and discuss the current controversy surrounding the International Monetary Fund (IMF).

**Basic Web References:**

- [1] IMF Homepage, <http://www.imf.org/external/index.htm>
- [2] L. Tesfatsion, “Notes on Mishkin Chapter 18: Section V”  
<http://www.econ.iastate.edu/classes/econ353/tesfatsion/mish18a.htm#IMF>
- [3] Reem Haekel, “What is the IMF?,” *Investopedia*, March 7, 2003,  
<http://www.investopedia.com/articles/03/030703.asp>
- [4] International Monetary Fund/World Bank Protest, Washington Square, Georgetown, October 19, 2007, <http://youtube.com/watch?v=QNX-B70muug>

**Part A: (1 Point)** Provide a brief but careful description of the organizational structure of the IMF, and the main objectives of the IMF, as put forward by the IMF itself in Ref.[1].

**Answer Outline for Part A:** According to Ref.[1], the IMF currently consists of 185 member countries voluntarily coming together in a “credit union” type of organization. The IMF’s resources are provided by its member countries through the payment of “quotas” that are roughly proportional to a country’s size. These quotas are an important determinant of the IMF’s lending capacity. The IMF meets its annual expenses mainly by the difference between the interest receipts on its loans and the interest payments on its quota “deposits.”

**Note:** The IMF has no outside revenue stream. Consequently, the IMF is basically run like a for-profit business. In particular, unlike the World Bank, the IMF is not set up as a development agency. This important fact should be kept in mind when evaluating criticisms of the IMF in Part C below.

According to Article I of the IMF’s Articles of Agreement, the main responsibilities of the IMF are currently as follows:

- promoting international monetary cooperation;
- facilitating the expansion and balanced growth of international trade;
- promoting exchange stability;
- assisting in the establishment of a multilateral system of payments;
- making its resources available (under adequate safeguards) to members experiencing balance of payments difficulties.

**Part B: (1 Point)** Every time the IMF now meets, large numbers of people (including college students) gather outside in protest – many carrying signs calling for the abolishment

of the IMF. Provide a brief but careful description of at least TWO of the main criticisms of these IMF protesters. Be sure to give full citations for any sources used.

**Answer Outline for Part B:** Answers provided for Part B will be evaluated on the basis of clarity, organization, and provision of full citations for any sources used.

**Part C: (1 Point)** Do you agree with the criticisms of the IMF you outlined in Part B? Explain briefly but carefully why or why not. Be sure to give full citations for any sources used.

**Answer Outline for Part C:** Answers provided for Part C will be evaluated on the basis of logical sense, clarity, organization, and provision of full citations for any sources used.