In-class review questions:

*Basic Notions of Exchange Rates.*

1. A strong dollar is a mixed blessing. It _______ the price of imports, thus _______ the cost of living, and it makes trips to foreign countries _______ for Americans but it makes our exports _______, thus _______ our trade balance.
   a. Fill in the blanks with the appropriate terms.
   b. Repeat the exercise considering the case in which the dollar is weak.

2. The rise of the dollar could batter the profits of some US companies this year and slice into capital spending.
   a. Which companies will have their profits battered, and why?
   b. Why would this slice into capital spending? What are the long-run consequences?

3. Also through the mid-1980’s the policies followed by the Reagan administration, particularly tight monetary policy combined with large government deficits, made the value of the dollar very high.
   a. How would these policies increase the value of the dollar?
   b. What are the implications for the CA of those large federal deficits of the mid 1980’s?

4. Now it is the Japanese Yen turn to come under attack. Following yesterday’s cuts in the Central Bank’s reference interest rates, the Yen slipped further against the dollar.
   a. Explain the logic behind this statement using supply and demand graphs.
   b. Take your analysis a step further and consider the consequences on Japan’s trade balance of a weaker Yen and its subsequent impact on the foreign exchange market.

5. The statistical evidence is that there is a strong correlation between increases in CA surpluses and declines in the value of the dollar. This is just the opposite of conventional wisdom.
   a. What is the conventional wisdom? Use supply and demand graphs to illustrate.
   b. How can this statistical evidence be explained?