Note: These are true-false questions. Although the problem set did not require you to explain your reasons, it is important to verify them with the answer key. The answer key for the practice questions will be posted separately with other new practice questions.

1. The gold and gold exchange standard do not suffer with the N-1 problem.
   ANSWER: True. As long as the central bank of the reserve currency country has to fix its exchange rate with a specie such as gold, the system is symmetric. The N-1 problem arises when the reserve currency country has a special status such that its currency does not need to be backed by hard metals at a fixed rate.

2. If the U.S. did not return to the gold standard after the World War I, the deflation in that period would have been less severe.
   ANSWER: True. Returning to the gold standard forced the Federal Reserve to cut down the money supply abruptly, to make it in line with the level before the World War I. However, this is equivalent to creating a sharp fall in price level or deflation.

3. With the gold standard, a discovery of new gold supply causes gold price to fall and then creates deflation.
   ANSWER: False. With the gold standard, a discovery of new gold supply causes gold price to fall and then creates inflation. Gold price here is defined in terms of goods, so the fall in gold price implies the reduction of purchasing power of gold. This is the major drawback of the gold standard. The central bank balance sheet is not directly affected by gold price because the dollar price of gold is always fixed under the gold standard. See Page 515, Item 2, in the textbook.

4. The price-specie-flow mechanism works when countries do not regulate cross-border flows of gold.
   ANSWER: True. The price-specie-flow mechanism relies on the flow of gold across borders to change money supply and price level. When gold flows into a country,
the money supply increases and the price goes up, and vice versa. Therefore, free
flows of gold across borders are necessary.

5. For a central bank in a small open economy such as Brazil, the external balance is
more important than the internal balance.
ANSWER: False. The external and internal balance are equally important to every
central bank. However, every country has a different target particularly in the
external balance.

6. The optimal level of current account balance is zero.
ANSWER: False. The optimal level of current account does not need to be zero.
Countries with current account surplus can exploit investment opportunities over-
seas, while countries with current account deficits can benefit from borrowing to
fund high-return investment projects.

7. The optimal internal balance is the full employment level of output and employment.
ANSWER: True. However, the full employment level output and employment can
vary from country to country.

8. With fixed exchange rate, we can reach the internal and external balance in the
short run by implementing fiscal policy.
ANSWER: False. With fixed exchange rate, we can reach only the internal balance
in the short run by implementing fiscal policy. We cannot achieve the external bal-
ance without adjusting exchange rate. See Figure 18.3 in Page 555 in the textbook.

9. When a country fixes its exchange rate to the U.S. dollar, its central bank cannot
alter its liabilities and assets in the balance sheet.
ANSWER: False. When a country fixes its exchange rate to the U.S. dollar, its
central bank can alter the composition of its liabilities and assets in the balance
sheet. Fixing exchange rate imposes a restriction only on the total stock of its
assets and liabilities. Central bank can engage in sterilized intervention while fixing
exchange rate by swapping holding of foreign assets with domestic bonds, and vice
versa.

10. The Bretton Woods system would not break down if other industrialized countries
were willing to import expansionary monetary policy from the U.S.
ANSWER: True. The U.S. was pursuing an expansionary and inflationary monetary
policy in the decade preceding the breakdown of the Bretton Woods System. To
keep the fixed exchange rate viable, central banks in the rest of the world had
to intervene in the foreign exchange market in order to prevent the dollar from
depreciating. By doing so, money supply in central banks’ balance sheet around the
world will expand as well.