Sample GMAT Verbal Questions (Reading Comprehension)

Passage 2

Economists have long debated the precise relationship between a nation's trade deficit and the value of its currency. A trade deficit occurs when a country imports more goods and services than it exports. Orthodox economic theory posits a direct causal link: a persistent trade deficit leads to a depreciation of the nation's currency. The reasoning is straightforward. As a country imports more, it sells its currency to buy foreign currency to pay for the imports. This increased supply of the domestic currency on the international market, combined with a decreased demand from foreign buyers who are importing less from the deficit nation, lowers its value. A weaker currency, in turn, makes the nation's exports cheaper and its imports more expensive, a mechanism that should, over time, correct the imbalance.

However, recent economic data and some revisionist theories challenge this simple narrative. For one, global capital flows have become a far more significant determinant of currency values than trade in goods and services. A nation with a large trade deficit can maintain a strong currency if it is also attracting a large influx of foreign investment. For example, investors seeking a safe haven for their capital or high returns on their investments may pour money into a country, increasing the demand for its currency and propping up its value, regardless of its trade performance.

Furthermore, the relationship between currency value and trade balance is not always as clear-cut as the orthodox theory suggests. A country with a strong currency might see its trade deficit grow, not because of the currency's value alone, but because of other factors such as its consumers' strong preference for foreign goods, or a lack of competitiveness in its domestic industries. The global economy is a complex system where multiple factors—from interest rates and political stability to consumer demand and investor confidence—interact to influence currency values, making a simple, one-to-one causal link between trade deficits and currency depreciation an oversimplification.

Questions for Passage 2

6. The primary purpose of the passage is to:
   A. explain the causes of a trade deficit.
   B. argue that trade deficits have no effect on currency values.
   C. describe a new economic theory about currency valuation.
   D. challenge a conventional economic theory by introducing alternative factors.
   E. compare and contrast the trade policies of different nations.
7. According to the orthodox economic theory described in the first paragraph, a trade deficit would be expected to lead to:
   A. an increase in a country's exports.
   B. a rise in the value of the country's currency.
   C. a decrease in the demand for a country's imports.

D. a surge in foreign investment.
E. an increase in the international supply of a country's currency.

8. The author mentions "investors seeking a safe haven" in order to:
A. provide an example of a factor that could lead to a trade surplus.
B. illustrate a situation in which a country's currency value is determined by factors other than its trade deficit.
C. suggest that a strong currency is a prerequisite for attracting foreign investment.
D. argue that foreign investment is the most important factor in currency valuation.
E. explain why some countries are able to attract more foreign investment than others.
9. Which of the following, if true, would most strengthen the orthodox economic theory as it is described in the passage?
A. A major global economic crisis causes a sharp increase in the value of the U.S. dollar.
B. A country with a balanced trade account sees its currency value remain stable over a decade.
C. A nation with a large and growing trade deficit experiences a steady decline in its currency's value over several years.
D. A study finds that consumer preferences for domestic goods have a greater impact on trade balances than previously thought.
E. A country with a large influx of foreign investment sees its currency's value fall despite a balanced trade account.
10. The author's attitude toward the orthodox economic theory can be best described as:
A. dismissive and critical.
B. neutral and objective.
C. supportive but with some reservations.
D. respectful but skeptical.
E. apathetic and uninterested.

Passage 2 Explanations

6. **Correct Answer:** D. The passage begins by introducing an "orthodox economic theory" that links trade deficits and currency value. The following paragraphs, however, introduce counter-arguments and "revisionist theories," such as the impact of global capital flows and other factors, that challenge this conventional view. The passage's purpose is to present this challenge.
7. **Correct Answer:** E. The first paragraph explains the orthodox theory's reasoning: to pay for imports, a country sells its own currency to buy foreign currency. This "increased supply of the domestic currency on the international market... lowers its value." Therefore, an expected result of a trade deficit is an increase in the international supply of the nation's currency.
8. **Correct Answer:** B. The passage mentions "investors seeking a safe haven" as an example of a "large influx of foreign investment." It uses this example to show that a country can have a large trade deficit and a strong currency at the same time, because the currency's value is being propped up by factors *other than* trade performance.
9. **Correct Answer:** C. To strengthen the orthodox theory, you need to find an example where a trade deficit is directly followed by currency depreciation, as the theory

predicts. Option C provides a direct correlation: a nation with a large and growing trade deficit experiences a steady decline in its currency's value, which is exactly what the orthodox theory predicts.

10. **Correct Answer:** D. The author presents the orthodox theory fairly in the first paragraph, acknowledging its straightforward logic. However, the author then spends the rest of the passage introducing evidence and arguments that challenge this theory. This suggests a **respectful** understanding of the theory but a **skeptical** attitude toward its ability to fully explain the complex reality of currency valuation.