EC 349
International Finance
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Suggested Solutions to
Assignment 5 (OPTIONAL)

Total Marks: 30

Part A True/ False/ Uncertain Questions 20 Marks

Explain why the following statements are True, False, or Uncertain according to economic principles. Use diagrams and / or numerical examples where appropriate. Unsupported answers will receive no marks. It is the explanation that is important.

A1. [10 Marks]

Both the temporary and permanent expansionary fiscal policy raises the current account balance. [Diagrams required]

False

Both the temporary and permanent expansionary fiscal policy leads to a fall in the current account balance.

See Figure 16-17 and pages 446-447 of Krugman's text (8th ed.) for a graphical explanation.

or,

See Figure 16-17 and pages 433-434 of Krugman's text (7th ed.) for a graphical explanation.

A2. [10 marks]

Under a fixed exchange rate regime, the expectation of future devaluation leads to a balance of payments crisis. [Diagrams required]

True

Under a fixed exchange rate regime, the expectation of future devaluation leads to a balance of payments crisis marked by a sharp fall in reserves and a rise in the home interest rate above the world interest rate.

See Figure 17-5 and pages 474-476 of Krugman's text (8^{th} ed.) for a graphical explanation.

or,

See Figure 17-5 and pages 461-462 of Krugman's text (7^{th} ed.) for a graphical explanation.

Part B Analytical Questions 10 Marks

B1. [10 marks]

Imagine the economy is at a point on the AA-DD diagram which is below both the DD schedule and the AA schedule. Explain what will happen next.

If the economy has an exchange rate and output combination which is below the *DD* schedule, then the country's output market in not in equilibrium; in particular there is excess supply in the output market. If the economy has an exchange rate and output combination which is below the *AA* schedule, then the country's asset market is not in equilibrium; in particular, the exchange rate is "too low" so the returns on the foreign asset are above the returns on the home asset and there is excess supply of the domestic currency in the foreign exchange market. The excess supply of the domestic currency leads to an immediate depreciation of the home currency and, thus, a rise in the nominal exchange rate. This serves to equalize the expected returns on the home and foreign assets and moves the economy vertically to the *AA* curve.

If the economy began at the equilibrium level of output, Y_1, (point *A* on Figure B1), then there are no further adjustments since the output market is now in equilibrium at the higher exchange rate at point *E*.

If the economy began at a level of output above the equilibrium level of output, Y_1, (point *B* in Figure B1) then the output market is still out of equilibrium and is characterized by excess supply. Firms then decrease production, and this decreases the demand for real balances, lowers the interest rate, and raises the nominal exchange rate. This is depicted in Figure B1 as a movement from point B' to *E* along the *AA* curve.

If the economy began at a level of output below the equilibrium level of output, Y_1, (point *C* in Figure B1) then the output market is still out of equilibrium but is characterized by excess demand. Firms then increase production, and this increases the demand for real balances, raises the interest rate, and lowers the nominal exchange rate. This is depicted in Figure B1 as a movement from point C' to *E* along the *AA* curve.