EC 349
International Finance
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Assignment 6 (Optional)

Total Marks: 90

Part A True/ False/ Uncertain Questions 70 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.

Each question is worth 10 marks.

A1.

A devaluation must be accompanied by purchases of foreign assets by the central bank. [Diagrams required]

A2.

If the economy, which is under a flexible exchange rate system, starts at long-run equilibrium, a permanent tax cut will cause its currency to appreciate but will have no effect on output in the short-run. [Diagrams required]

A3.

Monetary policy is very effective in terms of changing output under a fixed exchange rate system. [Diagrams required]

A4.

Given that assets are imperfectly substitutable across countries, a sterilized purchase of foreign assets by Home central bank appreciates the domestic currency. [Diagrams required]

A5.

The central bank's sale of domestic assets raises the risk premium on domestic currency assets.

A6.

A large balance of payments deficit may be the result of excessive domestic credit creation.

A7.

According to the balance of payments crisis model discussed in the Appendix to Chapter 17, a sharp speculative attack collapses the fixed exchange rate regime at time T, when the shadow floating exchange rate is slightly below the pre-collapse fixed exchange rate. [Diagrams required]

Part B Analytical Questions 20 Marks

B1. Assume that home and foreign bonds are imperfect substitutes and the risk premium on home bonds depends on the stock of home government debt and the holdings of the home central bank of home bonds. Suppose there is a temporary increase in home government spending financed by increased home government debt issued to the home central bank.

I. Suppose the home central bank is following a policy of buying and selling foreign bonds to maintain a constant money supply. The home central bank is also following a floating exchange rate regime. Determine the effects of the increase in government spending on the nominal exchange rate and output in the short-run. Support your answer with DD-AA diagrams.

II. Suppose instead that the home central bank is allowing changes in the money supply and is pursuing a policy of fixed exchange rates. Determine the effects of the increase in government spending on the nominal exchange rate and output in the short-run. Support your answer with DD-AA diagrams.

III. Compare and contrast the effect on output in (A) and (B) above and provide intuition for any differences in the effects.