

Homework Assignment #5
Due February 28 (Tuesday)

Question 1:

Explain how and why fiscal policy can have different effects on the output level depending on whether it is implemented in a fixed or floating exchange rate regimes.

Question 2:

Explain why temporary and permanent fiscal expansions do not have different outcomes under fixed exchange rates, as they do under floating.

Question 3:

Discuss why countries with undervalued fixed exchange rates tend to experience inflationary expectations? Answer this question using models we learned in class.

Question 4:

Think that you are conducting a research on Country X that is currently experiencing speculative attack on its currency, *osep*. International investors have been rumoring that the fundamentals of the country's economy are not that strong, and that Country X's currency, *osep*, is being overvalued compared to its fixed value (to the U.S. dollar).

The rumors have been shared by many international investors for years. The country has been run by a dictator-like president, a former army general who took over the government through a military coup, for more than 30 years. Although he has achieved economic growth especially for the last few years by allowing foreign multinational corporations to do joint ventures with local, quasi-public corporations run by his family members, he has been also notorious for corruption and discretionary ruling through overly concentrated political power.

The government is also highly indebted because of the president's pork barrel public works spending policies and underdeveloped tax base – a large portion of the people living in the rural areas are sympathetic toward anti-government guerrillas who do not let any government officials, including tax collectors, enter their territories. For the last few years, the portion of the national debt denominated in U.S. dollars and held by international investors has been increasing rapidly.

The Central Bank of Country X has been fiercely trying to defend the currency by massive foreign exchange interventions, but only to keep losing foreign reserves. The President of Country X finally, but very reluctantly, decided to start negotiations with the IMF for short-term rescue loans to weather the speculative attack.

- 1) Why do highly indebted countries like Country X tend to experience speculative attacks especially when they are under a fixed exchange rate system? Answer this question using a model for the *osep* foreign exchange market as we learned in class.

2) Read the following dialog between Finance Minister of Country X and a delegate from the IMF.

IMF delegate: “Minister, here is a list of conditions (or just *conditionality*) for us (the IMF) to provide your country with a rescue loan of \$25 billion.”

Finance Minister: “What is this?! We cannot accept such conditionality. It says that we must privatize most of our public corporations and halt most of our public works projects. These corporations have led our economy to grow for years, and these projects are so essential for our economic development!”

IMF delegate: “Well, you cannot ignore the fact that your country needs foreign reserves to weather the current speculative attack. We cannot lend you that much funds without any commitment from your side. Our loan is so necessary for you to calm down the *osep* and other financial markets, right? Well, even if you insist on not agreeing on the terms for the rescue loan, your economy will soon experience a severe recession anyway. I think it’s wise for you to accept our conditionality.”

Finance Minister: “You are just acting for the sake of international investment bankers, aren’t you? You are suggesting we calm down the financial markets, but not for our people’s sake, but for the sake of those western capitalists! And you just want us to privatize our public corporations so that those international investors can make a fortune from reselling the privatized firms! Well, I must warn you, if you press us too hard, our president might be willing to declare default or moratorium on our debt, that can upset the international financial markets quite a bit! You shouldn’t make us too upset. But in any case, let me talk to our president.”

IMF delegate: “Please do. But keep in mind that you don’t have time to waste.”

Why does the IMF delegate think that economic recession is about to occur in Country X? Explain the reason using the EX-ROR-M/P diagram. Does recession *always* follow a currency crisis?

3) Why is the IMF often very unpopular among the countries that receive rescue loans? You may explain descriptively.

Question 5:

Some people claim that Mr. Winston Churchill triggered the beginning of the end of the British Empire. What do they mean?