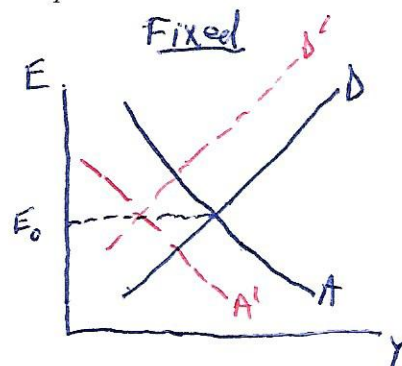
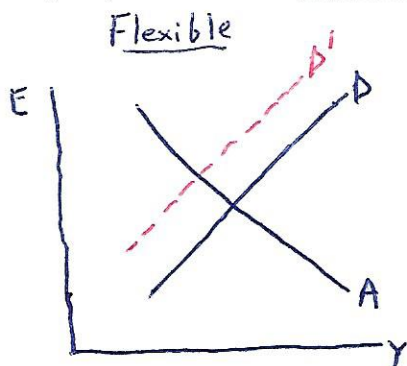


PROBLEM SET 2  
 (Solutions)

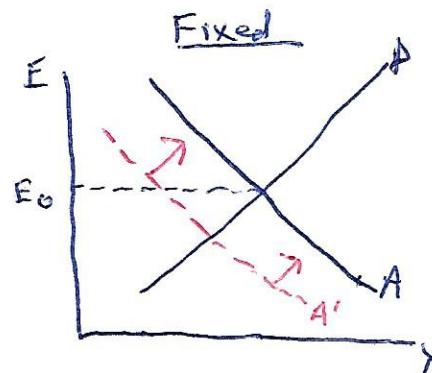
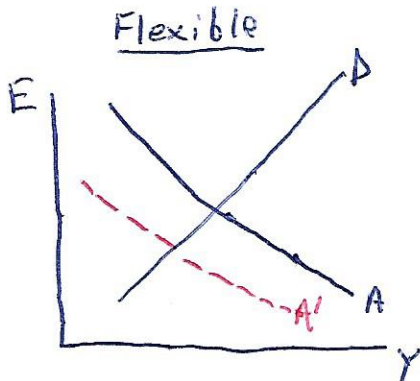
The following questions are short answer. 25 points each.

- Many people have argued that China should allow its exchange rate to become more flexible. Do you think this is a good idea? Describe an example where greater exchange rate flexibility would promote greater output stability. Conversely, provide an example where greater exchange rate flexibility would lead to *less* output stability. Use graphs to illustrate your examples.

*This is straight from the notes (see Lecture Slides 11A, pgs. 2-3). The key point is that whether fixed or flexible exchange rates produce greater output stability depends on which kinds of shocks are more important. If goods market (DD curve) shocks are more important, then flexible exchange rates produce more stability. For example, an adverse demand shock causes the domestic currency to depreciate, which makes domestic goods more competitive, which helps to restore some of the decline in demand. If exchange rates were fixed, then the Central Bank would have to sell fx reserves to keep the exchange rate fixed, and this would accentuate the decline in demand. Here is the picture*

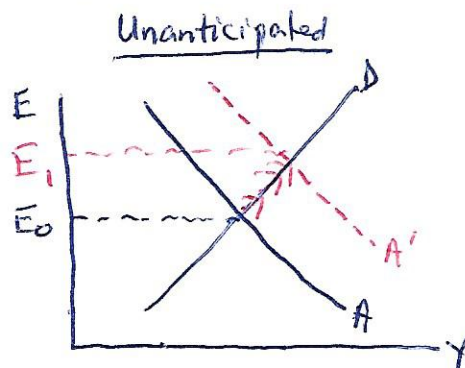


*On the other hand, if domestic asset market (AA curve) shocks are more important, then fixed exchange rates produce more stability. An increased demand for money causes the AA curve to shift down. With flexible rates, the currency appreciates and output declines in response to the decline in NX. However, if the Central Bank pegs the currency, it must purchase fx reserves to prevent the currency appreciation, which then automatically shifts the AA curve right back to where it started! Here is the picture*

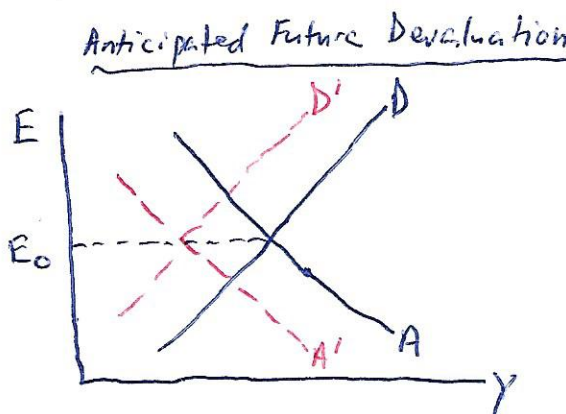


2. We showed in class that domestic monetary policy is ineffective under fixed exchange rates. However, we also showed that an *unanticipated* devaluation would be expansionary, at least in the short-run. Explain why in practice policymakers might be reluctant to use devaluation as a short-run stabilization tool. (Hints: (1) Compare and contrast the effects of unanticipated and anticipated devaluations, (2) Consider the effects on other countries.)

Again, this is straight from the Notes/textbook (see Lecture Slides 7B pgs. 6, 9, or Chpt. 18, pgs. 475-78 in the textbook). A surprise devaluation, which is not expected to recur in the future, will make domestic goods more attractive. This increases  $NX$ , raises income, which raises money demand, and the Central Bank buys  $fx$  reserves to accommodate the increased money demand. Here is the picture



Unfortunately, the response is quite different if people expect the devaluation to be repeated in the future. An anticipated future devaluation causes domestic interest rates to rise (remember Uncovered Interest Parity). It also causes capital flight. People try to get their money out of the country in order to avoid an expected capital loss. They exchange domestic assets for foreign assets with the Central Bank. The Central Bank must sell  $fx$  reserves, which causes the domestic money supply to decline, and the AA curve shifts left. Higher interest rates will also depress domestic spending, especially in interest rate sensitive sectors like housing, construction, and consumer durables. This causes the DD curve to shift left also. As a result, output will decline in response to an anticipated future devaluation. That's why finance ministers work so hard to try and convince markets that a devaluation will never happen again! Here is the picture



Another problem with devaluation, of course, is that it tends to be a 'beggar-thy-neighbor' policy. The increased domestic spending and output comes at the expense of foreigners. If this causes a foreign recession, they are likely to retaliate by devaluing their currency. Of course, this is a zero-sum (in reality, negative sum) game. In the end, nobody obtains a competitive advantage. History provides many examples. That's another major reason why countries try to avoid using devaluations.