EC1010: Tutorial Questions 6

March 13, 2010

1. Suppose GDP is at potential output, while prices and money velocity are *fixed*. The central bank then increases the money supply. According to the equation of exchange, what happens in the short run? According to the quantity theory, what will happen in the long run?

2. In many cases, a country uses many of its resources for investment, and then imports goods for consumption from abroad. What does this observation suggest about whether current account deficits are good or bad?

3. Suppose that, in a two-country world, the U.S. runs a current account deficit of 100 with China. Assume there is no intervention by any central bank in either economy. Find the i) the current account balance in China and ii) the capital account balance in *both* the U.S. and China.

4. In the above question, what would be the balance of payments equation for China if the Chinese central bank prints money and uses it to buy 20 dollars of the Chinese export revenues?

5. Suppose there is a sudden rise in interest rates in a foreign country. What implications does this have for capital inflows to the domestic country? What implications does this have for capital outflows from the domestic country? Use your answer to ascertain what happens to the domestic exchange rate?

6. Import demand is *procyclical*; that is, in a boom, domestic residents tend to import more goods from abroad. Does this observation suggest the nominal exchange rate is proyclical (i.e., rise in a boom) or countercyclical (i.e., falls in a boom)? How would your answer change if, during a boom, foreigners believed the domestic economy was a good place to invest?

7. Suppose prices of domestic goods rise. What implications does this have for import demand and export demand? Use your answer to ascertain what would happen to the value of the domestic exchange rate.

8. A recent Bloomberg article contained the following:

> "*The yen is likely to weaken to 100 per dollar, a level last seen in April, as the Bank of Japan pumps money into the financial system to combat deflation, according to Credit Agricole Corporate and Investment Bank.... "Current policies are very much aimed at weakening the yen as well as combating deflation," Kotecha added.*"

   a. How would pumping money into the financial system weaken the yen?
   b. If people expect deflation, what implications does it have for spending *today*?
   c. How would a weaker yen combat deflation?
   d. Why would the Japanese authorities engage in a policy to deliberately weaken the yen?

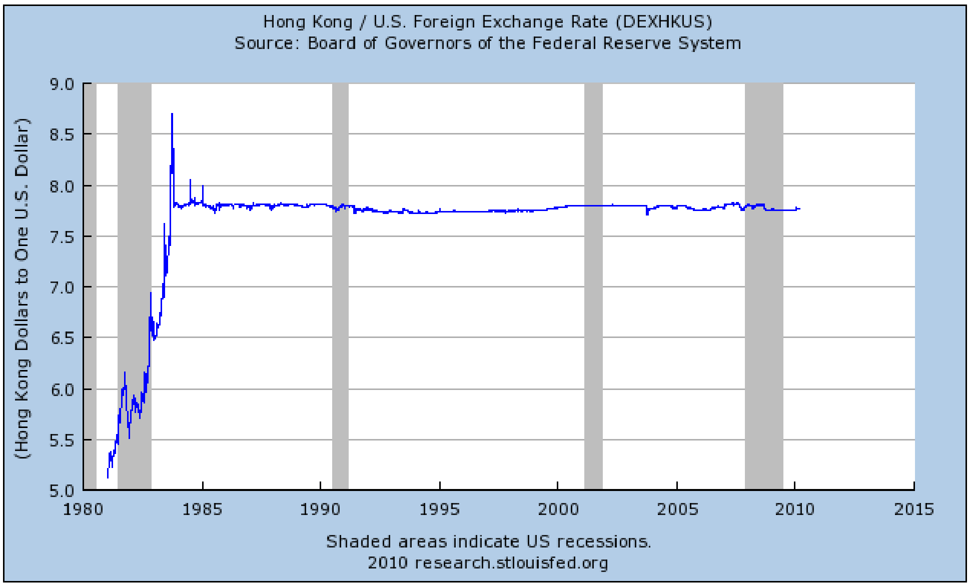

Figure 1: Number of Hong Kong Dollars for One U.S. Dollar.

9. a. In the early eighties, did the Hong Kong dollar appreciate or depreciate relative to the U.S. dollar? Give one reason why this might have happened.
   b. What were the implications of your answer in a) for the current account balance in Hong Kong.
   c. In 1984, Hong Kong adopted a *fixed* exchange rate regime. Suppose that, because of lower tax rates, international investors want to invest in Hong Kong today. If Hong Kong has *flexible* exchange rates what would happen to the Hong Kong dollar?
   d. Continuing your answer from c), since Hong Kong has *fixed* exchange rates, what would the central bank have to do?