Economics 434 **Spring 1999**
Dr. Ickes

Review Questions: Volume III

1. Use the overshooting model to trace the effects of a monetary contraction on the nominal exchange rate. Carefully explain what happens to the new full-equilibrium value of the exchange rate. Trace the adjustment path to this equilibrium. Does the exchange rate overshoot? Carefully explain.

2. What are the critical assumptions of the overshooting model? Explain their role in generating the key results of this model.

3. Country X is a small open economy operating under flexible exchange rates. During the administration of the current laissez-faire party, the government has followed strong austerity measures and restraint in monetary matters. All this seems to be over, however, as the returns from the country's current election shows the anti-austerity, pro-state intervention party winning by a landslide. What effects would the election have on the country's exchange rates? Even though the day of inauguration of the new administration is 5 months in the future, would there by any significant current impact on the economy? Why?

4. "The fact that the exchange rate overshoots its full equilibrium value is critical to money-market equilibrium." Carefully explain.

5. What is meant by the term "rational bubble?" How can a bubble in the price of assets arise if agents are rational? What must happen to the price of the asset for the bubble not to burst.

   i) Suppose that the price of an asset is growing at some rate γ. Suppose that riskless T-bills pay a rate of return equal to r. Why must we have $\gamma>r$ for the bubble to exist?
   ii) Suppose that at each point in time investors expect that there is some finite (though presumably small) probability that the bubble will burst. Carefully explain why the bubble must now grow at a faster rate than if this probability was zero.

6. Why did Premier Dimitry Kissoff keep the existence of the Doomsday Machine a secret? Why was this a fatal flaw to the overall program?

7. Explain how a currency board operates. What is the relationship between a currency board and a fixed exchange rate? Why does a currency board offer greater credibility? What are the costs associated with adopting a currency board, over and above those associated with a fixed exchange rate?

8. Carefully explain the how a currency crisis takes place in the standard model of currency crises. Why, according to the standard model, is the date of the crisis not uncertain?

9. Contrast the standard approach to currency crises with the self-fulfilling model. What are the three key characteristics of self-fulfilling models? What is needed to create the possibility of a self-fulfilling speculative attack with rational agents? Explain. Why might we expect the scope for self-fulfilling speculative attacks to be rather limited?

10. Compare and contrast the standard model of currency crises with the financial panic view. What are the main similarities and key differences? Are there important differences in policy implications?

11. Why do some observers view a rapid increase in the ratio of short-term external debt to gdp to be an important warning signal for currency crises? Explain. Are there any problems with this signal?