**Econ 371: Problem Set 5 (Chapter 18)**

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**PART 1:** The keywords in each question are underlined. (1 point each)

1. Despite the N-1 problem, the rest of the world fixes its exchange rate with the U.S. dollar in order to import low inflation from the U.S.
   ANSWER: False. Not every country now stabilizes its currency against the U.S. dollar. The situation was true only under the Bretton Woods System.

2. Under the gold standard, central banks have no control over its monetary policy because of the price-specie-flow mechanism.
   ANSWER: False. Even under the gold standard, central banks can slow down the price-specie-flow mechanism by sterilizing gold inflows.

3. Under the gold standard, a new discovery of silver raises gold price and creates inflation.
   ANSWER: False. A new discovery of silver surely reduces the relative price of silver relative to goods and gold. But that does nothing to inflation, since silver is not the relevant specie under the gold standard.

4. The price-specie-flow mechanism works even when gold price fluctuates as a result of a new discovery of gold.
   ANSWER: True. It works as long as the central bank does not restrict gold flows. However, a new discovery of gold will bring price instability as it creates inflation.

5. Countries reach their external balance when exports and imports are equal.
   ANSWER: False. External balance does not imply trade balance. It does not imply balanced current account either. It implies an optimal level of current account.

6. The Bretton Woods system does not allow member countries to adjust their exchange rate unless the country runs a large fiscal deficit.
   ANSWER: False. The Bretton Woods system does not allow member countries to adjust their exchange rate unless the country runs a large current account deficit.
PART 2 (2 points each)

1. Explain the impacts of the return of the U.S. to the gold standard after the World War I on the central bank’s balance sheet and price level. Is it true that it is a cause of the Great Depression?
ANSWER: The government bond holding in the central bank’s balance sheet rises because of the war finance. (Note that at the time there was no Federal Reserve System. From 1862 to 1913, a system of private national banks were in charge. The Federal Reserve System was established in 1913.) As a result, money supplied expand and the U.S. left the gold standard during the war. To return to the gold standard, the increased money supply has to be removed. Thus, returning to the gold standard implies a large monetary contraction which plays an important role as a cause of the Great Depression.

2. Explain the suspension of convertability between the dollar and gold by President Nixon in 1971 in the context of a currency crisis.
ANSWER: Convertability between the dollar and gold under the Bretton Woods system means that the Federal Reserve System is willing to exchange the dollar assets, i.e. U.S. treasury bills with gold at the rate $35 per 1 ounce of gold. The suspension of convertability in 1971 practically marked an end of the Bretton Woods system, since the exchange rate of the dollar and gold is determined instead by the market. The situation in 1971 is a classic case of currency crisis, because the U.S. ran an expansionary monetary and fiscal policy in the decade before that. The U.S. had been engaged in two inconsistent policies, which are fixed exchange rate policy and inflationary policy. The foreign central banks rationally predicted that the stock of gold possessed by the U.S. central bank would eventually falls below its liabilities, i.e. the U.S. treasury bills held by central banks in the rest of the world. Then central banks in France and Germany decided to exchange the treasury bills with gold and created ”capital flight” or a ”run” on the dollar. The capital in this context is gold. The capital flight is based on a rational decision of the foreign central banks trying to avoid capital losses following depreciation of the U.S. dollar.