Problem Set 5 (Chapters 20-21)

Instructor: Kanda Naknoi

December 2, 2010

Due date: December 9, 2010

1. (2 points) A currency crisis is usually followed by a recession or loss of output. Use the first generation model of currency crisis and the IS-LM-FX model to explain why.

2. (2 points) Consider two countries with fixed exchange rate regimes. In one country the fiscal balance is in deficit, but in the other country the fiscal balance is in surplus. How might this difference in fiscal balance affect the central bank’s credibility?

3. (2 points) Use the IS-LM-FX model to explain why a lack of credibility of a fixed exchange rate regime increases the cost of defending a peg.

4. (2 points) Consider the second generation crisis model. Suppose the benefit of maintaining an exchange rate peg is 3% of output.
   (a) If the central bank defends the exchange rate peg, output will fall by 1%. If the peg is not credible, output will fall by 2%. Will market participants view the peg as credible? Will the central bank continue the peg or leave the peg?
   (b) If the central bank defends the exchange rate peg, output will fall by 2%. If the peg is not credible, output will fall by 5%. Will market participants view the peg as credible? Will the central bank continue the peg or leave the peg?

5. (2 points) In 2002, there were reports that a group of six gulf countries (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates) were considering the introduction of a single currency. Currently, these countries effectively peg their exchange rates to the US dollar. These countries rely heavily on oil exports to the rest of the world, and their political readers are concerned about diversifying trade. Based on this information, discuss the optimum-currency-area criteria for this group of countries. What are the greatest potential benefits? What are the potential costs?