Econ 3143 Macroeconomic Theory II

Assignment 4

(Chapter 19 and 20)

(Due: before 11:59 pm, Dec. 9th, 2020.)

1. Label each of the following statement true, false, or uncertain. Explain briefly.

a) With a fixed exchange rate regime, the monetary authority will lose independence in domestic monetary policy.
b) Higher labor mobility within Europe makes the euro area a good candidate for a common currency.
c) When domestic inflation equals foreign inflation, the real exchange rate is fixed.
d) If financial investors expect the dollar to depreciate against the yen over the coming year, one-year interest rate will be higher in the US than in Japan.
e) A sudden fear that a country is going to devalue may force an exchange rate crisis, even if the fear initially had no basis.
f) Because economies tend to return to their natural level of output in the medium run, it makes no difference whether a country chooses a fixed or flexible price equilibrium.
g) Changes in the expected level of exchange rate far in the future has little effect on the current level of exchange rate.

2. Question 5 of Chapter 19 in the textbook. (7^{th} edition, Flexible exchange rate and the response to changes in foreign macroeconomic policy).

3. Question 8 of Chapter 19 in the textbook. (7^{th} edition, Demand for UK assets, the pounds , and the trade deficit).

4. Question 3 of Chapter 20 in the textbook. (7^{th} edition, Policy Choices when the real exchange rate is “too high”)

5. Question 7 of Chapter 20 in the textbook. (7th edition, Real and nominal exchange rates for Russia and China).

6. **For your practice only. You do not need to hand it in.** The following question is from previous final exam. Use that as an example for the essay question in the final exam. Read the article and answer the following question.

Burger-thy-neighbour policies

Feb 5th 2009
From *The Economist* print edition

Attacks on China's cheap currency are overdone

CHINA has been accused of "manipulating" its currency by Tim Geithner, America's new treasury secretary, and this week Dominique Strauss-Kahn, the managing director of the IMF, said that it was "common knowledge" that the yuan was undervalued. You would assume that such strong claims were backed by solid proof, but the evidence is, in fact, mixed.

Of course China manipulates its exchange rate—in the sense that the level of the yuan is not set by the market, but influenced by foreign-exchange intervention. The real issue is whether Beijing is deliberately keeping the yuan cheap to give exporters an unfair advantage. From July 2005, when it abandoned its fixed peg to the dollar, Beijing allowed the yuan to rise steadily, but since last July it has again been virtually pegged to the greenback. But American politicians are wrong to focus only on the yuan's dollar exchange rate. Since July the yuan has gained 10% in trade-weighted terms. It is up 23% against the euro, and 30% or more against the currencies of many other emerging economies.

Those who argue that the yuan is still too cheap point to three factors: China's foreign-exchange reserves have surged; it has a huge current-account surplus; and prices are much cheaper in China than in America. Start with official reserves. If China had not bought lots of dollars over the past few years, the yuan's exchange rate would have risen by more. So does the yuan's fixed level against the dollar in recent months mean that intervention has risen? On the contrary, in the fourth quarter of 2008, China's reserves barely rose, despite a record current-account surplus. This suggests that private capital is now flowing out of China.

Charles Dumas, an economist at Lombard Street Research, argues that outflows of hot money could become a flood if China did not have capital controls. China also has strict capital controls which, although leaky, keep private savings at home. If Beijing scrapped those controls, firms and households would want to invest abroad to diversify their assets. In other words, if the value of the yuan was not "manipulated" and instead was set entirely by the free market, it might fall, not rise.

Some argue that China's large current-account surplus is incontrovertible proof that the yuan is too cheap. Morris Goldstein and Nicholas Lardy estimate that the yuan's real trade-weighted value needs to rise by another 10-20% to eliminate the surplus. But other economists say it is wrong to define the yuan's fair value by the revaluation required to eliminate the current-account surplus. Trade does not have to be perfectly balanced to be fair. And China's surplus partly reflects its high saving rate. To reduce China's external gap, policies to boost domestic spending will be more important than its exchange rate.

……..

a) For an economy with fixed exchange rate regime, write down the good market clearing condition, the money market clearing condition and the UIRP condition. Assume that $\pi^e = 0$, use IS-LM diagram in the open economy to show the effects of an increase in domestic spending on output, consumption, investment, exchange rate, and net export. Explain the intuition. (6 marks)

b) Many people think that China's large current-account surplus is incontrovertible proof that the yuan is too cheap. However, the author argues that boosting China's domestic spending is also important. Use your answer in a) to explain why this is the case. Then explain why an appreciation (revaluation of the RMB) might not help to eliminate the imbalance of trade between the US the China. Finally, the author mentioned that China's big trade surplus partly reflects its high saving rate, explain why this is the case. (7 marks)

c) We know from the article that China follows a fixed exchange rate regime and rigorous capital control. Can the Chinese government have monetary policy autonomy? Explain your answer. Then analyze why the value of Yuan might fall instead of rise if China does not impose rigorous capital control. (5 marks)