Homework #7: Government Debt, Trade, and Banking

Econ 352: Macroeconomics

1 Question from Lecture 16.5 (Government Debt) (3 pts)

Suppose your intermediate macroeconomics teacher says to you "I don't understand why developing foreign economies don't default after receiving large loans for infrastructure development. All they have to do is refuse to pay–what can the private lenders of another country do if it isn't worth the cost of 'repoing' the infrastructure (militarily)." Based on the evidence we saw in Lecture 16.5, does he have a leg to stand on?

2 Williamson Ch 17. problem 4: (3 pts)

Suppose that better transaction technologies are developed that reduce the domestic demand for money. Use the monetary small open-economy model to answer the following:

1. Suppose that the exchange rate is flexible. What are the equilibrium effects on the price level and the exchange rate?

2. Suppose that the exchange rate is flexible, and the domestic monetary authority acts to stabilize the price level. Determine how the domestic money supply changes and the effect on the nominal exchange rate.

3. Suppose that the exchange rate is fixed. Determine the effects on the exchange rate and the price level, and determine the differences from your results in parts (a) and (b)

3 Williamson Ch 17. problem 6: (3 pts)

The domestic central bank increases the supply of money under a flexible exchange rate regime, leading to a depreciation of the nominal exchange rate. If the government had imposed capital controls before the increase in the money supply, would this have had any effect on the exchange rate depreciation? Explain your results and comment on their signifciance.

4 Williamson Ch 18. problem 4: (3 pts)

In the Diamond-Dybvig banking model (in Williamson), suppose that, instead of a bank, consumers can trade shares in the production technology. That is, each consumer invests in the production technology in period 0. Then, if the consumer learns that he or she is an early consumer in period 1, he or she can either interrupt the technology or can sell their investment at a price p. A consumer who learns that he or she is a later consumer in period 1 can purchase shares in investment projects at a price p, and can interrupt his or her production technology in order to acquire the goods required to buy shares.

1. Determine what p is in equilibrium, and what each customer's quantity of early and late consumption is, in a diagram like Figure 18.7.

2. Do consumers do better or worse than they would with a banking system? Do they do better than they would with no banks and with no trading in shares?

3. Explain your results.