

No1

Q3. Explain how a country with a current account deficit is a ripe candidate for currency devaluation.

Answer:

If, for example, Great Britain had a current account deficit, the holders of pounds would become nervous and shift their wealth into other currencies. In order to hold the pound's exchange rate against the dollar pegged, the Bank of England would have to buy pounds and supply the foreign assets that market participants wished to hold. This resulting loss in foreign reserves, if large enough, would most likely force a devaluation by leaving the Bank of England without enough reserves to prop up the exchange rate.

Q3. Explain how a country with a current account surplus is a ripe candidate for currency revaluation.

Answer:

If a country like Germany had a current account surplus, it would sell its currency in the foreign exchange market in order to keep it from appreciating. The German central banks would thus find themselves swamped with official reserves, and Germany would face the problem of having its money supply grow uncontrollably, a trend that would most likely drive up the domestic price levels and upset internal balance. Revaluation of the currency would thus be a viable solution to this problem.

Q4. Russia's financial crisis in 1980s

After liberalization in 1991, Russia's economic laws were weakly enforced or non-existent:

- There was weak enforcement of banking regulations, tax laws, property rights, loan contracts and bankruptcy laws.
- Financial markets were not well established.
- Corruption and crime became rowing problems.
- Because of a lack of tax revenue the government financed spending by seigniorage.
- Due to unsustainable seigniorage interest rates rose on government debt to reflect/ high inflation and the risk default.

NO 2

Q3. Types of crisis

- debt crisis: an inability to repay government debt or private sector debt. debt crisis is when a national government cannot pay the debt it owes and seeks some form of assistance.
 - e.g: crisis in Latin American countries in 1980s, in Greece in 2008,
- balance of payment crisis: A situation in which a government has developed an unsustainable balance of payments deficit. That is, a balance of payments crisis occurs when so much money is flowing outside a country. A balance of payments crisis becomes acute in circumstances like an exceptionally large budget deficit that lasts for an extended period of time or a default on interest payments on publicly-held debt:
 - Crisis in Argentina 2000, crisis in Mexico, in 1998 Russian Financial crisis
- Banking crisis : bankruptcy and other problems. Banking crisis reflects the crisis of liquidity and insolvency of one or more banks in the financial system. This has disrupted its ability in repaying the debt contracts and the withdrawals demanded by depositors.
 - Global financial crisis 2008

Q11: Rule of the Game

Carried out by Central Bank

- Sell domestic assets when gold exits as payment for import > decrease M_s > increase interest rate
- Buy domestic assets when gold enters the country as income from export > increase M_s > decrease interest rate

No 3

Q7. Describe some of the features hindering developing countries from growing faster.

Answer:

One of the features that can hold developing countries from growing faster is corruption. The way governments control the economy by developing restrictions that would not allow international trade among other countries; knowing that by having the doors open for international trading the country can be better off. Moreover, governments also owning or controlling the largest industries, that produce more in the countries, and controlling international transactions, they do not lead new opportunities to come into their society.

These governments also do tax evasion, which most of the time in some countries it's been out of control. Basically, developing countries have been managed by corrupt and inexperienced peoples that just want to be disturbed instead of encouraging new opportunities for a better future.

Q8. The 1980s are considered as the "lost decade" of Latin American growth. Explain why?

Answer:

Just as the Great Depression made it hard for developing countries to make payments on their foreign loans, the great recession of the 1980s also sparked a crisis over developing country debt. The fall in the industrial countries' aggregate demand had a direct negative impact on the developing countries. The problem was made worse by the dollar's sharp appreciation in the foreign exchange market, which raised the real value of the dollar debt burden substantially. The crisis began in August 1982 when Mexico announced that its central bank had run out of foreign reserves and that it could no longer meet payments on its \$80 billion in foreign debt. Seeing potential similarities between Mexico and other large Latin American debtors such as Argentina, Brazil, and Chile, banks in the industrial countries, the largest private lenders to Latin America scrambled to reduce their risks by cutting off new credits and demanding repayment on earlier loans. The result was a widespread inability of developing countries to meet prior debt obligations, and a rapid move to the edge of a generalized default. Latin America was perhaps hardest hit, but so were Soviet bloc countries like Poland that had borrowed from the European banks. Nonetheless, by the end of 1986 more than 40 countries had encountered severe financing problems. Growth had slowed sharply in much of the developing countries because they have to stop producing in order to pay the debtors.

NO 4

Q4. What is IRP? Explain why the foreign exchange market tends to settle at equilibrium if IRP condition is satisfied.

The IRP (interest rate parity) establish an equality between the rates of return of return on domestic currency deposits and foreign currency deposits.

$$R = R^* + (E - e - E)/E$$

The IRP shows the difference in interest rates equals to the expected rate of depreciation of domestic currency.

$$R - R^* = (E - e - E)/E$$

The foreign exchange market tends to be at equilibrium if IRP condition is satisfied because when IRP condition is satisfied, the expected return on domestic currency deposits and foreign currency deposits are equal.

IRP-interest rate parity : Interest rate parity (IRP) is a theory in which the [interest rate differential](#) between two countries is equal to the differential between the forward exchange rate and the [spot exchange rate](#). Interest rate parity plays an essential role in foreign exchange markets, connecting interest rates, spot exchange rates and foreign exchange rates.

$$F_0 = S_0 \times \left(\frac{1 + i_c}{1 + i_b} \right)$$

where:

F_0 = Forward Rate

S_0 = Spot Rate

i_c = Interest rate in country c

i_b = Interest rate in country b

Interest rate parity is the fundamental equation that governs the relationship between interest rates and [currency exchange rates](#).

If one country offers a higher risk-free [rate of return](#) in one currency than that of another, the country that offers the higher risk-free rate of return will be exchanged at a more expensive future price than the current spot price. In other words, the interest rate parity presents an idea that there is no arbitrage in the foreign exchange markets. Investors **cannot lock** in the current exchange rate in **one currency** for a **lower price** and then **purchase another currency** from a country offering a **higher interest rate**. The foreign exchange market tends to settle at equilibrium if IRP condition is satisfied. Interest rate parity is **satisfied** when the **foreign exchange market is in equilibrium**, IRP holds when the **supply of currency is equal to the demand** in the foreign exchange market. This is true because the **violation of interest rate parity**

will cause investors to **shift funds** from one country to another, thereby causing a **change in the exchange rate**

Q9: Capital inflow to finance external deficits which one are debt finance and which one are equity finance and explain why these method were used in different time?

	Debt finance	equity finance
Ingredient	includes <ul style="list-style-type: none"> - bon finance - Bank finance - official finance 	includes <ul style="list-style-type: none"> - direct investment - portfolio equity investment
characteristic	<ul style="list-style-type: none"> - Bond finance: government or commercial bonds are sold to private foreign citizens. - Bank finance: government and firms borrow from foreign banks. - Official lending: the world Bank or other official agencies lend to government. 	<ul style="list-style-type: none"> -Foreign direct investment: a foreign firm directly acquires or expands operations in a subsidiary firm. - Portfolio equity investment: a foreign investor purchase equity(stock) for his portfolio.

Q10: Explain of “ internal balance” and “external balance”

Inter:

- Full employment (normal product)
- Price stability (low inflation)
- Potential output

Exter:

- balance current account (CA)
- not too large deficit (easy to become a ripe candidate for currency devaluation or financial crisis) or large surplus (easy to become a protectionism, such as China)