ANSWER OUTLINE

ECONOMICS 353   **L. Tesfatsion/Fall 06**
EXERCISE 9: Six Questions (8 Points Total) DUE: Tuesday, Nov. 28, 2006, 2:10pm
****IMPORTANT REMINDER: LATE ASSIGNMENTS WILL NOT BE ACCEPTED
– NO EXCEPTIONS****
EXERCISE INSTRUCTIONS:

- (1) Please **fill in your name and student ID number** on Side 1 of your bubble sheet and write **353-Ex9** in the top margin of Side 1.

- (2) Use a number 2 pencil to **mark your answers** on Side 1 of the bubble sheet to the first five questions Q1 through Q5, below, which are in multiple choice format. These questions are based on Mishkin chapters 17 and 18 and the required on-line html notes for these two chapters.

- (3) The sixth question Q6 asks you to consider the role of the International Monetary Fund (IMF) in today's global financial markets. Please put your **name and student ID number** at the top of your answer sheet for Q6 along with **353-Ex9:Q6** and **separately** hand in this answer sheet for Q6 in addition to your answer bubble sheet for questions Q1 through Q5.

- (4) Each question Q1 through Q5 is worth 1 point, and Q6 is worth 3 points.

Q1 (1 point). In a two-country world divided between HC and ROW, the HC REAL EXCHANGE RATE is defined to be

   A. the HC nominal exchange rate E plus the ROW inflation rate minus the HC inflation rate.

   B. the HC nominal exchange rate E multiplied by PROW/P to correct for value changes through currency appreciations or depreciations.

   C. the HC nominal exchange rate E minus the HC inflation rate.

   D D. the HC nominal exchange rate E multiplied by P/PROW to correct for relative movements in the HC and ROW aggregate price levels P and PROW.

Q2 (1 point). In a two-country world divided between HC and ROW, suppose the HC inflation rate is 7 percent during 2005, and the ROW inflation rate is 5 percent during 2005. Then the PURCHASING POWER PARITY (PPP) THEORY in rate-of-change form predicts that the HC nominal exchange rate E will

   A. depreciate by 12 percent in 2005.

   B. appreciate by 2 percent in 2005.

   C C. depreciate by 2 percent in 2005.

   D. appreciate by 12 percent in 2005.

Q3 (1 point). In a two-country world divided between HC and ROW, the derivation of the IN-TEREST PARITY CONDITION assumes that

A A. a ROW or HC investor will take into account expected movements in the real exchange rate when determining the expected real return rate of a financial asset issued by a country other than his/her own.

B. an investor choosing between financial assets in the HC and ROW with equal expected returns rates will choose the one with less interest rate risk.

C. the inflation rates in the HC and ROW are equal over time.

D. All of the above.

E. Only A and C above.

Q4 (1 point). Consider a two-country world divided between HC and ROW in which all currency reserves are held by the HC central bank. By definition, BALANCE OF PAYMENTS (BOP) EQUILIBRIUM holds for the HC if and only if

A. the HC central bank is adjusting its ROW currency reserves to ensure that HC citizens have enough ROW currency to carry out their planned purchases of ROW goods.

B. the HC central bank is adjusting its HC currency reserves to ensure that ROW citizens have enough HC currency to carry out their planned purchases of HC goods.

C C. The demand for ROW currency equals the supply of ROW currency in the foreign exchange market without any need for the HC central bank to increase or decrease its ROW currency reserves.

D. Both A and B above.

Q5 (1 point). In principle, in a two-country world divided between HC and ROW, the home country HC should be able to maintain itself in a continual balance of payments (BOP) equilibrium if

A. the HC central bank pegs the HC nominal exchange rate to the ROW nominal exchange rate.

B B. the HC has a flexible nominal exchange rate that is free to move up or down in response to market forces.

C. the HC central bank sterilizes the movements in the money supply due to any BOP imbalance.

D. the HC central bank continually ensures that interest parity holds.

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SEE THE FOLLOWING PAGE FOR
Q6 EXERCISE

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Q6: (3 Points). The role currently played of the International Monetary Fund (IMF) in global financial markets has been the subject of heated controversy by numerous commentators in recent years. This question asks you to consider these controversies in relationship to the organization and functions of the IMF.

Key References:

[**1**] Mishkin, Chapter 18 ("The International Financial System")

[**2**] L. Tesfatsion, "Notes on Mishkin Chapter 18" (html),
http://www.econ.iastate.edu/classes/econ353/tesfatsion/mish18a.htm

Q6: PART A (1 Point). Give a brief but careful discussion of the ORGANIZATION of the IMF. In particular, when was it founded, what kinds of entities currently are members of the IMF, and what are the current eligibility rules for membership in the IMF?

Answer Outline for Q6:Part A. The IMF was founded in 1945 as part of the "new international monetary system" set out in the Bretton Woods Agreement devised by Allied countries towards the end of World War II. The IMF is a cooperative (volunteer) organization among sovereign countries that currently consists of over 180 member countries. The eligibility requirements for membership are that a country must be sufficiently autonomous that it conducts its own foreign policy, and it must be willing to abide by the IMF charter of rights and obligations.

Q6: PART B (1 Point).

(a) Currently, what are the principal FUNCTIONS of the IMF?

(b) Can a member country ALWAYS count on getting a loan from the IMF if it finds itself in financial difficulty? Explain.

(c) Can a member country be FORCED by the IMF to change its domestic economic policies? Explain

Answer Outline for Q6:Part B(a). Currently the IMF continues to pursue two of the three main functions envisioned for the organization at its founding:

- Make loans to countries experiencing balance-of-payments difficulties ("lender of last resort" function) as long as these countries abide by IMF rules;

- Monitor the compliance of borrowing countries with IMF rules (a task requiring the creation of standards for collecting and reporting international economic data).

A third original function of the IMF was the maintenance of fixed exchange rates, but this function was voided after the breakdown of the Bretton Woods Agreement in 1971 when exchange rates were permitted to float.

Answer Outline for Q6:Part B(b). No. The IMF considers requests for assistance from member countries who are having trouble meeting their financial obligations to other members, but it only offers loans to countries on condition that they undertake economic reforms that the IMF deems to be important for eliminating these difficulties for the good of the member country and for the good of the entire IMF membership. The *quota subscription* of each member country (i.e. the amount of money contributed by the member country at the time of its original entry into the IMF) determines how much the member country can borrow in time of need, and it also determines the voting power of the member country in terms of deciding which other member countries are to be awarded loans.

Answer Outline for Q6:Part B(c). The IMF cannot directly force a member country to change its domestic economic policies. However, since loan approval is typically conditioned on a member country undertaking IMF-recommended changes in domestic economic policies, a member country in financial difficulty might have little choice but to carry out the changes in order to get needed financial assistance.

Q6: PART C (1 Point). Five different types of criticisms of the IMF are listed in the "Notes on Mishkin Chapter 18." Making use of the materials you have studied to date in Econ 353, provide a brief but careful critique of ONE of these criticisms (i.e. to what extent do you find the criticism compelling or not).

Answer Outline for Q6:Part C. Any clear and carefully argued critique will be awarded full credit as long as it makes some explicit use of Econ 353 materials.