Department of Economics | Spring 2006
University of California, Berkeley | Economics 182

Problem Set 5

Due in class on Thursday, April 20th

To be handed at the beginning of lecture.

Please write your name, GSI name and section time in your problem set.

Question 1

Chapter 19 described how the US tried after 1985 to reduce its current account deficit by accelerating monetary growth and depreciating the dollar. Assume that the U.S. was in internal balance but external balance called for an expenditure-reducing policy (a cut in the government budget deficit) as well as the expenditure switching effect caused by currency depreciation. Explain using the II-XX framework how the use of monetary expansion alone would affect the U.S. economy in the short and long runs.

Question 2

After 1985, the U.S. asked Germany and Japan to adopt monetary and fiscal policy expansion as ways of increasing foreign demand for U.S. output and reducing the American current account deficit. Would fiscal expansion by Germany and Japan have accomplished these goals? What about monetary expansion?

Question 3

Suppose the U.S. and Japanese governments both want to depreciate their currencies to help their tradables industries but fear the resulting inflation. The two policy choices available to them are (1) expansionary monetary policy and (2) no change in monetary policy. Develop a game theoretic analysis like the one presented in the appendix to chapter 19 to show the consequences of different policy choices. Can Japan and the U.S. do better by cooperating than by acting individually? (Hint: the payoffs would be given by the change in exports relative to the change in inflation.)

Question 4 - The European Monetary Union

(a) In May 2003, Gordon Brown, Britain's Chancellor of the Exchequer, announced that the UK would postpone joining the Euro. At the heart of that decision were five tests that the UK should pass before joining. The first three tests are:

i. Are business cycles and economic structures compatible so that Britain can live permanently with euro interest rates?

ii. If problems emerge, is there sufficient flexibility to deal with them?
iii. Will joining the euro promote higher growth and stability?
(There are two other tests that have to do with London as a financial center and whether the UK will keep attracting foreign capital).

Discuss the rationale behind the three tests above. Do they make sense? Regarding test iii, would you expect joining the Euro to have a permanent effect on growth and stability?

(b) Last year, output growth was -0.2% in Germany and 4.5% in Greece; Inflation was 1.2% in Germany and 3.5% in Greece. The three-month nominal money market rate in the eurozone was 2 percent. Based on these numbers, discuss whether a common monetary policy is appropriate and why.

Question 5 – Italy under EMU and the Growth and Stability Pact

a. Explain why it would be beneficial for a country like Italy (with a history of inflation and loose fiscal policy) to be a member of a monetary union with Germany. What could the disadvantages be?

The Italian economy has been in recession for some time now. Remember that Italy is a member of the European Monetary Union (EMU), so it does not have a currency of its own.

b. If Italy is in a recession, what policy tools are available to bring the economy back to full employment? Assume the recession is not due to structural issues. Describe this policy in the AA/DD framework.
c. What adverse effects might such policy have? (Hint: think of prices and exchange rates).

In addition, Italy has to comply with the conditions of the Growth and Stability Pact (in practice, this means that it needs to maintain a fiscal deficit lower than 3% of GDP).

d. Suppose Italy were to run large and persistent budget deficits. Why might this action be a threat to a common currency arrangement?
e. Under what circumstances might Italy's large and persistent budget deficits not be a threat to the currency arrangement? (Note that Italy is a large economy, so it would probably be incorrect to assert that Italy is too small to matter.)
f. How do you view the rules of the Growth and Stability Pact given your analysis above? Has the Stability and Growth Pact been upheld so far? Why or why not?

Question 6 – True/False/Uncertain questions

For each of the following, indicate whether the statement is true, false, or uncertain, and *explain why* in one or two sentences.

a. Ireland's economy has boomed in the past decade, with incomes growing far faster than the EU average (Note: assume this is an indisputable fact). Based on what we have learned about foreign exchange and money markets under fixed exchange rates, we would expect that membership in the EMU will inevitably come at the cost of high inflation in Ireland.

b. Canada and the US are each other's largest trading partner, with more than $1.2 billion of goods and services crossing the border *every day* (Note: assume this is an indisputable fact). Therefore, from a purely economic standpoint, Canada and the US probably form an optimal currency area.

c. From India's perspective, freedom of international capital movement in and out of the country is only sustainable if the central bank sacrifices either exchange rate stability or an activist monetary policy.