Economics 182: Midterm Exam

March 2005 Professor M. Obstfeld

Instructions:

Read each questions carefully. You must answer all in the 75 minutes available, and in *legible* handwriting. Be as brief as possible without sacrificing pertinence and clarity. Statements that are correct but irrelevant to the question at hand will only reduce your grade. The exam is worth a total of 75 points.

I. TRUE, FALSE, UNCERTAIN? Your mark depends on the justification you give; be very clear, and read carefully. (25 points)

1. Expansionary fiscal policy can never affect real output under a floating exchange rate.

2. If domestic- and foreign-currency bonds are imperfectly substitutable, then sterilized sale of foreign reserves by the domestic central bank cannot affect interest or exchange rates.

3. The Balassa-Samuelson account of deviations from PPP is based on the idea that countries with greater productivity in their nontraded-goods sectors should, other things equal, have higher price levels.

4. A country that simultaneously has a current-account surplus and a surplus in its private (i.e., nonreserve) financial account must be accumulating foreign reserves.

II. SHORT QUESTIONS. Make your answers brief and to the point. (25 points)

1. Show in a diagram how permanent monetary expansion (under a floating exchange rate) and devaluation (of a pegged rate) will affect the open economy in the short run, including the current-account balance. (You thus need to include the *XX* schedule.) Assume the economy starts from a position where the current account is zero.

2. "If we have a current account deficit, we are importing more in value than we are giving foreigners in exchange, and that is a good thing." Discuss.

3. Define the idea of purchasing power parity (PPP), and briefly discuss three reasons why it fails accurately to characterize exchange-rate movements in reality.

III. NOT-SO-CURRENT EVENTS ANALYSIS. Read the article below on this page, then answer the following questions. (The article comes from the period leading up to the 1997-98 Asian financial crisis, which started in Thailand but then spread worldwide, as we will learn later this semester.) (25 points)

a. The article states that the exchange rate of the Thai baht has been closely tied to the U.S. dollar. Why should a depreciation of the dollar against the yen help Thailand's economy?

b. Why might the interest rate on baht deposits have risen recently as high as 1,300 percent (!!!)?

c. Do you imagine that the interest rate in part (b) is the interest rate on one-year deposits, one-month deposits, or overnight deposits? Why?

d. In a diagram, show how a statement by "senior economic advisor" that a devaluation might be necessary would affect the foreign exchange market and the Thai central bank's foreign exchange reserves.

e. Explain how banks that have borrowed dollars and made baht-denominated loans would be affected by a devaluation of the baht.

THE ECONOMIST MAY 17TH 1997

Thailand's economy

Feeling the heat

BANGKOK

THE scorching hot morning of Monday May 12th might have been the start of a better-than-usual week for Thailand's embattled financial authorities. The steady climb of America's dollar against the Japanese yen had gone into reverse. That should have eased pressure on the Thai currency, the baht, which is linked to a dollar-dominated basket of currencies. Its strength has for months made it subject to sporadic attack, as the Thai economy has weakened. But by Thursday, the central bank had spent nearly $10 billion defending the baht's peg. It had raised interest rates for offshore borrowers to more than 1,300% to deter speculators. Devaluation, which the government had resisted almost as a matter of national pride, was looking inevitable. And, as the stockmarket index fell to its lowest level for eight years, Thailand's dismal economic spiral took yet another turn downward.

The government's own actions contributed mightily to the baht's travails. A senior economic advisor had been quoted as suggesting a devaluation might be necessary. This deviation from official policy was swiftly denied. But it fuelled rumours of an imminent ditching of the finance minister, Amnuay Viravan, and a shift in policy. The impression of confusion was heightened by an emergency meeting on May 11th which saw the prime minister, Chavalit Yongchaiyudh, announce that he was going to take personal charge of the economy.

Meanwhile, the economic news keeps getting worse. The government had predicted that Thailand's GDP would grow by 6% this year. That now seems very optimistic. Exports, whose growth had led a decade-long boom, have failed to expand since the start of 1996. The inefficiency of

Thailand's labour-intensive industries, combined with the overvalued baht, has been bad for business. The drive to become an exporter of more advanced goods received a blow this month when Texas Instruments pulled out of a highly publicised electronics joint venture because of Thailand's economic difficulties.

Due to the slowing economy, the government is heading for its first budget deficit in more than ten years. The size of the projected shortfall (20 billion baht, or $770m) is not enormous. But the very fact of a deficit adds to the sense of drift. Hapless efforts to rescue the floundering financial and property sectors only reinforce that feeling. As much as 400 billion baht of property loans have gone bad, leaving banks and finance companies in serious trouble. Rescue plans are moving slowly.

Devaluation will make their life even harder. Many banks have borrowed in dollars to make high-interest baht loans or finance baht costs. Of Thailand's foreign debt of about $90 billion, some $70 billion is owed by the private sector, much of it by financial institutions. While the value of the banks' assets keeps shrinking as the property market collapses, the value of their foreign liabilities continues to rise.