

Homework #3: Fixed exchange rates (end of Chapter 4) and Chapter 5

Econ 160B: International Macroeconomics

Due November 4 in class

1. Fixed exchange rates

Suppose that Mexico commits to fixing its exchange rate against the US dollar. Explain the impact on the foreign reserve holdings of the Mexican central bank if this fixed exchange rate (peso/\$) turns out to be lower than the exchange rate that would be obtained had the exchange rate been allowed to float freely. What implications does this have for the Mexican money supply and the Mexican central bank's holdings of foreign reserves (dollar assets)?

2. Fixed exchange rates

Suppose that the foreign interest rate falls under a regime of fixed exchange rates (where the central bank intervenes in the foreign exchange market to defend the official exchange rate level).

- a) Use the asset market diagram to show the effects of this change on domestic interest rates and the domestic nominal money supply in the short run.
- b) Describe any required changes in the balance sheet of the domestic central bank (where it is assumed that it is the domestic central bank that commits itself to fixing the exchange rate).

3. Balance of Payments

Show (using the credit/debit tables) how each of the following would affect the U.S. balance of payments (BOP). Your records should include a description of the transaction being recorded and the accompanying credit/debit entry in the CA, FA or KA accounts.

- a) A California computer manufacturer purchases a hard disk from a Malaysian company, using a bank account in Malaysia.
- b) The U.S. central bank sells some of its holdings of U.S. Treasury bonds to a British financial firm.

4. BOP accounting

In 2006 the country of Ikonomia has a current account deficit of \$1 billion, and its capital account is in a \$100 million surplus. In addition, Ikonomian factors located in foreign countries earn \$700 million. Ikonomia has a trade deficit of \$800 million. Assume Ikonomia neither gives, nor receives unilateral transfers. Ikonomia's GDP is \$9 billion.

- a) What happened to Ikonomia's net foreign assets during 2006? Did they acquire or lose foreign assets during the year?
- b) How much income did foreign factors of production earn in Ikonomia during 2006?
- c) Compute net factor income from abroad (NFIA).
- d) Compute Ikonomia's gross national income (GNI).

10/23/08