Economics 101b; Fall 2000; Problem Set 9

Due in class December 7

1. Explain how the experience of the 1980s and 1990s differs from the typical American pattern as far as the debt-to-GDP ratio is concerned?

2. Why might there be a long-run link between government budget deficits on the one hand and the inflation rate on the other?

3. Why might it make sense for a government to finance roads and other investments in public infrastructure through borrowing rather than through taxing today's taxpayers?

4. Today many politicians call for the government to exclude Social Security spending and taxes from the federal government budget. They argue that Social Security moneys should not be used to avoid recognizing the fact of possible deficits in other programs. What arguments can you think of to support the claim that the non-Social-Security budget balance is the more interesting and relevant measure? What arguments support the claim that the unified budget balance is the more interesting and relevant measure?

5. Suppose that you claim that large deficits lead to high interest rates and lowered investment spending, but that the person you are debating claims that it is not fiscal policy that leads to high interest rates--it is too-tight monetary policy on the part of the central bank. How would you respond?

6. Why do many economists think that a gold standard tends to put contractionary and deflationary pressure on economies that adhere to it?

7. What are the principal benefits of fixed exchange rates?

8. Suppose that foreign exchange speculators' beliefs about the long-run equilibrium value of the real exchange rate suddenly rise by 30%, from 100 to 130. How does the interest rate increase required to keep the exchange rate constant in the face of this shift depend on the interest sensitivity of the exchange rate parameter ε_r? Under what circumstances would you think that the parameter ε_r would be large? Under what circumstances would you think that the parameter ε_r would be small?

9. Suppose that a developing country under low capital mobility finds that foreign exchange speculators' views of the long-run value of its currency have suddenly shifted upwards to 130, but that it wishes to maintain its pegged exchange rate ε^* of 100 and also to keep domestic interest rates from rising above foreign interest rates.

$$r = r^f + \frac{\varepsilon_0 - \varepsilon^*}{\varepsilon_r} + \frac{\varepsilon_R}{\varepsilon_r} \times \Delta R$$

If $\varepsilon_R = 10$, $\varepsilon_r = 10$, and the relevant period of time is one month, how fast will the country lose reserves if it tries to maintain both its pegged exchange rate and the (relatively) low real interest rate? How high would it have to raise the domestic real interest rate above foreign rates to stop its loss of reserves?

10. Suppose you are asked whether some small Latin American country should *dollarize*—that is, fix its exchange rate with the U.S. once and for all by adopting the

U.S. dollar as its own internal currency. What kinds of evidence would you look for to try to determine whether such *dollarization* is a good idea or not?