

1. Suppose that the current nominal interest rate on one-year U.S. government bonds is 3%, that the current spot exchange rate is 100 yen/\$, and that one can obtain a contract for yen futures for one year from now at 102 yen/\$. What must be the nominal interest rate on one-year Japanese government bonds? How closely must this interest-rate parity relationship hold?
2. Use the Mundell-Fleming model (of a small economy with perfect capital mobility) to evaluate the following statement: "A recession due to a spending shock will be more severe in a country with fixed exchange rates than if the exchange rate floats."
3. One of the roles of a central bank is to act as a lender of last resort. During the 1990s, Argentina followed an exchange-rate policy called a currency board, in which each Argentine peso was explicitly backed by one dollar of foreign exchange reserves held by the central bank. In the late 1990s, Argentina's banks began to experience liquidity difficulties (and in some cases solvency problems as well). Explain why the currency board arrangement made it impossible for the Argentine central bank to provide lender-of-last-resort services to banks.
4. Suppose that Reedia and Morelandia are both on the gold standard but that there is no international flow of borrowing and lending. Both countries are initially at full employment. Reedia produces veritons, Morelandia produces elmoids, and they trade with one another. A new use is discovered for veritons that increases the demand for them in Morelandia.
 - a. How will Reedia's primary current account be affected in the short run?
 - b. Using the *IS/LM* model, show how its short-run macroeconomic equilibrium will be affected by the change in the primary current account.
 - c. Suppose that, according to the rules of the traditional gold standard, any imbalance of trade is settled by one country's central bank sending gold to the other in exchange for accumulated balances of its currency. Which way will gold flow? How will this affect Reedia's money supply, assuming that its currency is fully backed by gold?
 - d. How will this change in the money supply affect short-run macroeconomic (*IS/LM*) equilibrium in Reedia?
 - e. In the long run, how will Reedia's output, prices, and current-account balance compare to the initial values? Why?
5. Following World War I, both France and England had insufficient gold reserves to back the outstanding amounts of their currencies. France chose to devalue the franc relative to gold; England chose to restore the pre-war parity between the pound and gold by contracting its money supply. In the 1920s, England suffered a great depression before the Great Depression, while France was

relatively prosperous. How did their foreign-exchange policies contribute to this difference in outcomes?

6. Section 11.4.5 suggests that devaluation can stimulate the domestic economy. Can all countries in a fixed exchange rate system use it at the same time? What happens in a world-wide recession if some countries choose to devalue and others don't?