



AFRICAN ECONOMIC RESEARCH CONSORTIUM

**Collaborative MA Programme in Economics for Anglophone Africa
(Except Nigeria)**

JOINT FACILITY FOR ELECTIVES (JFE) 2011

JUNE – SEPTEMBER

INTERNATIONAL ECONOMICS II

Second Semester: Final Examination

Duration: 3 Hours

Date: Tuesday, September 20, 2011

INSTRUCTIONS:

1. Answer **ANY FOUR** questions.
 2. Explore mathematical models with clearly identified variables and/or clearly labeled diagrams to support your discussion where appropriate.
 3. Clearly highlight all simplifying assumptions.
 4. Your answers should be well structured and concise.
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Question 1

Explain whether the following statements are **True** or **False**.

- (a) Relative Purchasing Power Parity (PPP) holds better in the long run than in the short run. **(3 marks)**
- (b) The external balance problem is more severe for a deficit country than for a surplus country. **(3 marks)**
- (c) The 'twin deficits' problem may not apply if 'Ricardian Equivalence' holds. **(3 marks)**
- (d) In order for the depreciation of a country's currency to improve its current account balance, the Marshall Lerner condition must hold. **(3 marks)**
- (e) An efficient foreign exchange market requires only that the Covered Interest Parity condition holds. **(3 marks)**



Question 2

Assume that the economy of a country is described by the following Mundell – Fleming model. All variables are in their natural logarithms, that is $x = \ln X$, and foreign variables are indicated by asterisks.

Goods market equilibrium

$$y = \beta_1(e + p^* - p) + \beta_2 y^* - \beta_3 y + \beta_4 y - \beta_5 i + g \quad (1)$$

Money market equilibrium

$$m - p = \phi y - \lambda i \quad (2)$$

External balance

$$bop = B = nx + \theta(i - i^*) \quad (3)$$

Where $nx = x - imp = \beta_1(e + p^* - p) + \beta_2 y^* - \beta_3 y$

The (y) is the real national output; (e) is the nominal exchange rate (units of domestic currency per unit of foreign currency), (p) is the price level, (i) is nominal interest rate, (g) is government expenditure, (m) is nominal money stock, (bop=B) is the balance of payments and (nx) is net exports, given as exports (x) less imports (imp) . All parameters of the model are assumed to be positive and $\beta_1 > 1$; and $0 \leq \theta \leq \infty$.

(a) Derive expressions for the effect of depreciation of the domestic currency on:

- (i) Domestic output. (4 marks)
- (ii) The balance of payments. (3 marks)

(b) Analyze the effect of a domestic monetary shock on:

- (i) Balance of payment under a **fixed exchange rate** regime. (4 marks)
- (ii) Exchange rate under **flexible exchange rate** regime. (4 Marks)

In **All** the cases above, provide succinct economic intuition for your results.



Question 3

Evolution of the international payments system suggests that successive regimes have been a reaction to prior inherent weaknesses. The current regime enjoys support especially if countries embraced greater policy cooperation. Yet, it is during the current international payment system that global imbalances seem to be more prevalent. As a result, most African economies face serious challenges maintaining simultaneously internal balance and external balance.

- (a) Discuss the inherent weaknesses of previous international payments systems that led to their replacement. (6 marks)
- (b) What are the inherent weaknesses with the current international payment system? (3 marks)
- (c) What has been the experience so far with the current international payment system? (6 marks)

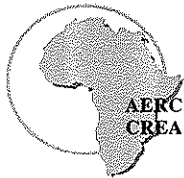
Question 4

A Business Daily Newspaper article recently opined as follows:

“Most economies in Africa have recently (since January, 2011) been experiencing volatile and depreciating exchange rates against the US dollar. To keep their currencies from falling against the dollar, some central banks in the region have been selling the dollars, a procedure known as intervention. But given the relative size of most of these economies and that most have an open capital account; the pool of dollars in the foreign exchange market is vastly larger than what their central banks hold as reserves. Million of dollars are traded daily in most of the foreign exchange markets in these economies each day. Even if they were to get support from the International Monetary Fund (IMF), it is unlikely that market intervention would have much impact on the market. However, just the stated intention of their central banks to intervene could disrupt the foreign exchange market, with its psychological effect.

Economist says that intervention works only when markets turn erratic, as they do following announcements of a new Minister of Finance or a new Governor, or when intervention is used to push the markets along in a direction where the market is already headed anyway.”

- (a) Do you agree with the statement that African central banks have little ability to influence their exchange rate to the dollar? (2 marks)
- (b) Do you agree with the last paragraph’s evaluation of the efficacy of intervention? (2 marks)
- (c) Describe how “just the stated intention” to intervene could have a “psychological effect” on the foreign exchange market. (2 marks)



- (d) What other factors are likely to be behind the recent depreciation of these currencies? (4 marks)
- (e) The opposite of what this article wrote on the African currencies exchange rate to the US dollar can be said to be the experience with the Swiss Franc, which has been recently a safe haven currency for many investors in the world. Analyze how your arguments to (a) to (c) above change, if you were to prescribe a policy option for the Central Bank of Switzerland. (5 marks)

Question 5

In the recent past, a certain net importing economy (call it country X) has gone through some serious balance of payments challenges. Under a floating exchange rate regime, a monetary expansion policy by Country X led to a currency crisis and hyper inflation. Coupled with economic isolation, this led to a complete loss of monetary autonomy; Country X abandoned its own currency replacing it with a basket of currencies, with the US dollar emerging as the most widely used currency.

Using the Monetary Approach to balance of payment adjustment model, evaluate

- (a) How monetary policy expansion under a floating exchange rate may have led to country X currency problems. (5 marks)
- (b) How country X is affected by inflation developments in the US given that the dollar has emerged as its most widely used currency. (5 marks)
- (c) What are some of the main limitations of the monetary approach to balance of payments adjustment model that may not allow us to make such direct inferences? (5 marks)

Question 6

- (a) Currently, the EURO debt crisis is sending conflicting signals and causing serious reflection on the future of monetary unions, at a time when a number of regional economic groupings in Africa are contemplating establishing their own monetary unions. Using the various approaches to the theory of optimal currency areas, evaluate whether such concerns are justified. (9 marks)
- (b) "The heavily indebted poor countries view their indebtedness as not of their making but as a result of a combination of external factors beyond their control". Critically evaluate this statement from the different view points of all the actors to the debt problem. (6 marks)