Econ 4382 - International Finance Spring 2025
Granados

Problem Set # 5

Due date: 5/7

Answer the following questions. Show your work. As mentioned in class, you are encouraged to work in groups but must write your own answers.

1. **(The Gold Standard)** Why did the Gold Standard collapse during World Wars I and II? Relate this to the features shaping the costs and benefits of a fixed exchange rate.

2. **(Financial Crises)** We often see banking and currency crises happening together. How may a banking crisis (illiquid or insolvent banks) make a currency crisis more likely to occur?

3. **(Liquidity traps)**

   (a) Define a liquidity trap

   (b) Show in an IS-LM figure how a liquidity trap looks

   (c) What is the role of fiscal policy for taking an economy out of a liquidity trap

   (d) Why is fiscal policy super effective during a liquidity trap in increasing GDP? and how is that similar to the effects of fiscal policy in a fixed exchange rate regime?

4. **(Cooperation in ER systems)** Suppose Latvia and Denmark both peg their exchange rates to the Euro.

   (a) Denmark is in an equilibrium in which $Y = \bar{Y}$, where $\bar{Y}$ is the target output level. Latvia is suffering from a negative demand shock that shifts its IS curve to the left, putting its equilibrium output (Y^*) below its target output ($\bar{Y}^*$). Use an IS-LM figure for each country to show this situation.

   (b) Suppose Latvia chooses to devaluate its exchange rate against the Euro (i.e., to adjust the level of the exchange rate at which they peg). Show the effect on your figures from part (a)

   (c) How is Denmark affected by Latvia's choice? Explain.

5. **(Other benefits of a fixed exchange rate)** Explain how implementing a fixed exchange rate regime may facilitate fiscal discipline and how it may stabilize the value of foreign currency debt.