

Homework 4

due: Tuesday, May 4, in class

Problem 1: Institutional Aspects.

- a) Find how many countries in the world use a fixed exchange rate regime of some sort and how many have flexible exchange rates.
- b) Explain what is a Currency Board. Briefly describe the Argentinian and Hongkong experience with this regime.
- c) Discuss the pros and cons of returning to a global fixed exchange rate system.

Problem 2: Debt Crisis.

Consider a highly indebted country. The face value of its debt is 80. The following table gives the amounts it can pay in different states of the world as well as their respective probabilities:

	bad state	good state
payment	40	80
probability	1/5	4/5

- a) What is the price of the country's debt?
- b) Suppose the IMF uses funds of 10 to buy back part of the country's debt? What is the price after it announces the buy-back and how much debt can it buy back. What are the effects on the country and on its creditors?
- c) Suppose now that the buy-back reduces the probability of the bad state to 1/10. Repeat b).