Note: given the fact that you’re ‘obliged’ to answer the weekly questions, try to profit the most from the task:

- Start by reading the lecture notes.

- Looking at them as little as possible, answer the questions.

Reserve **3 hours** for this homework.

The answers to the following questions should be handed to me at the beginning of **Wednesday’s lecture of Nov 24th.** They should be **manuscript (not typewritten)**, **concise** and preferably based on schemes (as I do in the whiteboard). Keep a copy for yourself.

Please write **WEEK 9 in bold** at the beginning of your answers.

**WEEK 9**

**Part II of the syllabus: Open ec. MACROECONOMICS**

**Ch. 2: Fixed exchange rates**

**L17**

**1.** Explain the several reasons why a devaluation tends to lead to a sharp increase in unemployment in the short-term. **Long answer (one page)**

**2.** Which are the two other costs of a devaluation in the short-term? (incl that explained in L18)

**3. a)** Why does the required size of the devaluation increases with the size of the decline in external demand?

**b)** Why do the short-term costs of a depreciation increase with the size of the devaluation?

**4. a)** If the size of the decline in a devaluation is big, what will happen to the benefits versus the costs of a devaluation?

b) Why may the government try to delay the moment of devaluation?

c) Will the government succeed? Explain.

**5. A similar question:** When an external shock leads to benefits of an adjustment through a depreciation bigger than the respective costs, what happens? Explain.

**6.** a). If under fixed rates speculators start suspecting that the peg will eventually break, how do they act?

b) Does that imply a substantial risk? Explain.

**7.** Suppose that an external shock leads to benefits of an adjustment through a depreciation not much smaller than the respective costs.

a) How can speculators act to increase the benefits of a depreciation – above the respective costs?

b) Do they have a big incentive to act in that way? Explain.

**L18: The capital flight from the UK in 1992**

**8.**Explain why countries linked by fixed rates countries must have the same interest rate. (Assume away the risk premium).

**9. a)** Explain why a country under flexible rates can reduce its interest rate below that of others.

b) Is that an advantage? Explain.

10**.** How did the reunification of Germany eventually force the BoE to raise its interest rates?

**11.** a) Using a graph, explain the consequences of that decision of the BoE on the British economy.

b) Did that fact increase the benefits of a Britain’s exit of the EMS? Explain.

c) What were the costs of a Britain’s exit?

**12.** How did Soros engineer an increase in Britain’s benefits from an exit?

**13.** Explain how Soros ended up gaining $2.25b minus the interest payments on a debt of $15b.

**14.** Explain the **two reasons** why AD in Britain grew more robustly after the British exit of the EMS than it would otherwise had grown.