Study Questions
(with Answers)

Lecture 20
International Policies for Economic Development: Financial

Part 1: Multiple Choice

Select the **best** answer of those given.

1. Developing countries have often chosen to establish pegged exchange rates because

   a. This prevents the depreciation that would otherwise occur due to their high inflation.
   b. With small economies, it is easier for them to peg their currency than it would be for a large country.
   c. A pegged rate imposes discipline on their government and central bank, helping to prevent inflation.
   d. Economists advise that countries with pegged exchange rates are able to grow faster than countries with floating exchange rates.
   e. A pegged exchange rate can be used to make their exports more competitive on world markets.

   Ans: *c*

2. Which of the following did **not** contribute to the debt problems that many developing countries encountered in the early 1980s?

   a. The rise in oil prices
   b. Recession in the United States
   c. Appreciation of the U.S. dollar
   d. The drop in developed country tariffs negotiated in the Tokyo Round
   e. Developing country inflation

   Ans: *d*

3. Which of the following is **not** one of the possible results of a developing country **permitting** capital inflows?

    a. Its labor force becomes more productive as a result of having more capital to work with.
    b. Its banks can borrow abroad at low interest rates and lend at home at higher interest rates.
    c. If its currency depreciates, those of its residents who borrowed on world capital markets may go bankrupt.
    d. Multinational corporations buy up domestic firms and manufacturing facilities.
    e. Domestic firms invest their profits in foreign markets.

    Ans: e

4. Which of the following is **not** one of the possible costs of a developing country **restricting** capital inflows?

    a. The restrictions are difficult and costly to enforce.
    b. Consumers pay more for imported goods.
    c. Firms distort markets when they try to evade the restrictions.
    d. Domestic financial markets are insulated from competition.
    e. Domestic firms pay more to finance investment.

    Ans: b

5. Which of the following is **not** one of the reasons given by Krueger and Srinivasan, in their article "The Harsh Consequences of Forgiveness," for not forgiving the debts of the heavily indebted poor countries?

    a. Poor countries must help themselves, not rely on others, in order for their progress to be lasting.
    b. High debts are often the result of misguided government policies in the past, which are likely to be repeated.
    c. Not all poor countries are heavily in debt, yet they too need help.
    d. Past episodes of debt relief have not benefited the poor.
    e. Direct use of resources to benefit the poor is more likely to help them.

    Ans: a

6. Financial crises in developing countries occur when expectation of depreciation causes foreigners to withdraw their capital from the country. Why, then, would it not be a good idea for countries to restrict capital outflows in order to prevent such crises?

   a. It would be unfair to the owners of the capital.
   b. Capital controls are against the rules of the World Trade Organization.
   c. Restrictions on capital outflows would discourage capital inflows and ultimately slow development.
   d. Capital controls would reduce the incentive for research and development, slowing technological progress.
   e. Capital outflows are a major source of assistance from the International Monetary Fund.

   Ans: *c*

7. According to the Clive Crook, in "A Cruel Sea of Capital," international capital markets are more prone to mistakes than goods markets because

   a. Asset prices are moved artificially by speculators.
   b. Values of assets depend on the future, which is hard to know.
   c. Governments are making decisions in capital markets, instead of private-sector firms.
   d. It is easier to commit fraud in financial markets than in goods markets
   e. The value of a good is based directly on the value of the labor needed to produce it.

   Ans: *b*

Part II: Short Answer

Answer in the space provided.

1. Define:

    a. Exchange rate anchor: *Ans: Use of a pegged exchange rate to constrain monetary policy and expectations, so as to reduce inflation.*

    b. Economic populism: *Ans: Economic policies that were common in Latin America, emphasizing growth and redistribution while ignoring the associated economic risks and constraints.*

    c. Liquid capital: *Ans: Financial assets that can readily be converted into cash.*

    d. Leverage *Ans: Borrowing to finance a purchase of a financial asset, creating potential for both larger gain and larger loss.*

    e. HPAE: *Ans: High-performance Asian Economies (Hong Kong, Japan, Indonesia, Korea, Malaysia, Singapore, Taiwan, and Thailand).*

    f. HIPC: *Ans: Heavily indebted poor countries.*

2. Suppose that a country with a pegged exchange rate has reserves of $8 billion and is running a deficit on its current account of $1 billion per month. Without any additional information about the country, would you expect it to experience an exchange-rate crisis? And if so, when and why?

    Ans: Without knowing whether the country is also attracting inflows of foreign investment, especially foreign direct investment, we cannot know if it will run out of reserves. However, in the absence of such investment, we can see that it ***will*** *run out of reserves in 8 months at the latest. Since owners of assets within the country can see this as well as we can, they will begin to move their capital out of the country before that, and an exchange rate crisis will occur* ***sooner*** *than 8 months.*

3. Why, according to Crook in "The Cruel Sea of Capital," are international financial transactions inherently more risky than domestic ones?

    Ans: Because they involve risk of exchange-rate changes.

4. The table below lists the names of several countries (or administrative regions, in the case of Hong Kong). Indicate with check marks in the corresponding columns

    a. Which country was the **first** to be hit by the Asian Crisis of 1997

    b. Which country was hit the **worst** by the crisis?

    c. Which countries suffered **more than a 30%** depreciation of their currencies in the Asian Crisis?

    d. Which countries suffered significant but smaller depreciations, **at most 20%**?

    e. Which countries experienced **no depreciation** at all?

	First	Worst	> 30%	< 20%	0
Chile					
China					✓
Hong Kong					✓
Indonesia		✓	✓		
Kenya					
Malaysia			✓		
Philippines			✓		
Taiwan				✓	
Thailand	✓		✓		
Singapore				✓	
South Korea			✓		