Economics 161 — Spring 2013

Global Integration of Latin America

Review Sheet 3: Financial Crises and Policy Responses in Latin America

May 28, 2013

Instructor: Marc-Andreas Muendler
E-mail: muendler@ucsd.edu

1 Sovereign Risk

Explain why higher default risk increases the interest are. Provide a numerical example to illustrate your verbal explanation.

Explain in words the moral hazard problem associated with international debt service and default. Distinguish between ability and willingness to repay and explain two scenarios under which lacking willingness to repay can be concealed as lacking ability.

2 Current Account Sustainability

Explain how the current account balance differs from the trade balance when there is a net foreign wealth position. Explain why the difference between the current account balance and the trade balance is the same as between GNI and GDP.

Suppose long-term debt sustainability means a stable net foreign wealth position, possibly negative and large, so that the current account balance from a certain point in time on is zero. Explain how how the trade balance needs to relate to interest payments in this case.

3 Quantity Theory of Money

Explain why the Quantity Theory of Money implies that the annual rate of inflation equals the annual rate of money growth.

Suppose the foreign country does not change its money supply so that it has zero inflation. Explain why, under this scenario, the annual rate of deprecation of the home currency also equals the annual rate of money growth. Finally, suppose the foreign country changes its money supply with a constant growth rate. Explain why, under this final scenario, the annual rate of deprecation of the home currency equals the annual rate of money growth in the home economy less the annual rate of money growth in the foreign economy (the inflation differential).

Consider a foreign investor. Explain why the nominal interest rate less the expected nominal exchange rate depreciation rate less the foreign inflation rate is the relevant rate of return for a foreign investor.

4 Bond Values, Yields and Interest Rates

Suppose a 1 dollar bond with 1 year maturity has a 1 dollar face value and is trading at a 33 percent discount. What is the cost of the bond? The contractual interest rate is 8 percent. What is the effective nominal yield on the bond?

What is the real yield on the bond for a domestic resident who cares only about domestic inflation? What is the real yield on the bond for a foreign resident who only cares about exchange rate depreciation (devaluation), regarding inflation in the investor's home country as close to zero? What is the real yield on the bond for a foreign resident who cares about both exchange rate depreciation (devaluation) and inflation in the investor's home country? Does domestic monetary policy affect real returns for domestic and foreign investors in the same way?

5 Debt Laffer Curve

Peru's market prize of debt is equal to the average market value, and below face value. Would you recommend a debt buyback at the market price? Why or why not? For what set of countries would you recommend debt forgiveness? Why? Use the Debt Laffer curve to substantiate your verbal explanation.