International finance
Problem set 8

1. Consider the model of speculative attacks considered in class. The central bank is expanding domestic credit at rate μ in order to finance the ongoing government deficit. Denote by T the time at which foreign reserves are exhausted. At time T the central bank may either (a) continue to expand domestic credit at the same rate μ; (b) stop expanding domestic credit and keeping it constant from time T onwards.

   (a) If agents are sure that the central bank will behave as under (b) would central bank reserves be exhausted? If yes, would they be exhausted by a speculative attack (i.e. would reserve eventually fall discretely)? (Hint: what is the shadow floating exchange rate if the central bank behaves as under (b)?).

   (b) If agents are unsure whether the central bank will behave as under (a) or (b) would central bank reserves be exhausted? If yes, would there be a speculative attack (i.e. would reserve eventually fall discretely)? (Hint: do investors make a foreseeable loss if an attack on reserves does not take place at time T and the central bank does behave as under (a)? Do investors make a foreseeable loss if an attack on reserves does take place at time T and the central bank does behave as under (b)?).