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CHAPTER 2 THE INTERNATIONAL FINANCIAL MANAGEMENT (10/11/12)

12. Countries with high inflation need to keep devaluing their currencies to maintain competitiveness. But countries that try to maintain their competitiveness by devaluing their currencies will end up with even higher inflation. Discuss.

**ANSWER:** Devaluation improves competitiveness to the extent that it does not cause higher inflation. If the devaluation causes domestic wages and prices to rise, any gain in competitiveness is immediately washed. To address the competitive consequences of devaluation, therefore, two possible cases must be distinguished. First, devaluation on the exchange rate is uncorrelated and the exchange rate is in equilibrium. Consider, for example, a country with high inflation that tries to fix its nominal exchange rate. The currency will become overvalued and thus lead industry's competitiveness. In this case, devaluation will reduce the currency overvaluation and improve competitiveness, even though prices will rise somewhat. That is, devaluation will reduce the real exchange rate. But if the currency was in equilibrium to start with, then devaluation will occur only if monetary policy is used. Raising will cause prices to rise (or directly, by raising the price of imports and the goods that compete with them in the domestic market, and (b) indirectly, by forcing the central bank to expand the money supply to sustain the devaluation. Here, the real exchange rate may rise and there is no improvement in competitiveness.

13. The Russian government is trying to figure out how to stabilize the value of its currency. What advice would you offer her?

**ANSWER:** The value of the ruble depends on the available supply of rubles relative to the demand for rubles. In order to stabilize the ruble's value, the Russian government must restore the public's confidence that the ruble can be held and exchanged for something of value. That is, the Russian government must demonstrate its willingness to maintain the ruble's value. Confidence in money can only be won by controlling its supply and assuring the public that a stable currency is the only goal of monetary policy. The West Germans achieved this feat in the postwar era by giving the Bundesbank a currency stabilization mandate and a high degree of political independence. Russia could do the same and even go one step further by creating a currency board, thereby fixing the value of the ruble to the dollar and not even establishing a central bank with discretionary money creation authority.

14. "Unsterilized interventions are just open market operations conducted through the foreign exchange market rather than through the U.S. government securities market." Comment on this statement.

**ANSWER:** This statement accurately depicts the monetary consequences of unsterilized interventions. In ordinary open market operations, the central bank buys (sells) government bonds to expand (contract) the domestic money supply. Unsterilized interventions entail buying (selling) foreign exchange, which causes an increase (decrease) in the supply of domestic currency that is not offset by open market operations.

15. As the year 1992 began, the Russian government and the central bank tightened credit as an attempt to slow the growth in the supply of rubles. However, the masses were not popular with the country's giant state-owned industrial enterprises, which are still dependent on official subsidies and cheap credit. In July 1992, the Russian Parliament appointed Viktor Gerashchenko head of the central bank. One of his first acts was to say that he didn't think the time was right to make the ruble convertible. Then he said that he would continue to extend credit to budget and inefficient state enterprises.

a. How independent is the Russian central bank likely to be? What political pressures is it facing?

**ANSWER:** The Russian central bank is unlikely to be very independent since the Russian Parliament can fire its head at will. Mr. Gerashchenko will face pressure to keep funding the budget (rather than industrial enterprises) with expansionary money. If credit is cut off, these companies will go under. Their managers and workers will continue putting pressure on Parliament and the central bank to ensure their continued funding.

b. What is the likely effect of Mr. Gerashchenko's statements on inflationary expectations in Russia?

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