ECONOMICS 353 L. Tesfatsion/Fall 06
EXERCISE 10: Six Questions (8 Points Total) DUE: Tuesday, Dec 5, 2006, 2:10pm

**IMPORTANT REMINDER: LATE ASSIGNMENTS WILL NOT BE ACCEPTED – NO EXCEPTIONS**

EXERCISE INSTRUCTIONS:

• (1) Please fill in your name and student ID number on Side 1 of your bubble sheet and write 353-Ex10 in the top margin of Side 1.

• (2) Use a number 2 pencil to mark your answers on Side 1 of the bubble sheet to the first five questions Q1 through Q5, below, which are in multiple choice format.

• (3) The sixth question Q6 is a Web Exercise that asks you to consider the microcredit movement (e.g. Grameen Banking), whose founder Dr. Muhammad Yunus just won the 2006 Nobel Peace Prize. Please put your name and student ID number at the top of your answer sheet for Q6 along with 353-Ex10:Q6 and separately hand in this answer sheet for Q6 in addition to your answer bubble sheet for questions Q1 through Q5.

• (4) Each question Q1 through Q5 is worth 1 point, and Q6 is worth 3 points.

Q1 (1 Point). A depreciation of a country’s domestic currency ___ the cost of foreign goods relative to domestic goods. Consequently, central banks sometimes attempt to offset deprecations of their domestic currencies by ___ their own currency in the foreign exchange market.

A. raises; selling
B. raises; buying
C. lowers; buying
D. lowers; selling
E. none of the above

Q2 (1 point). A persistent U.S. current account ___ indicates that the U.S. is DECREASING its net claims on foreign assets because the U.S. is persistently ___ the rest of the world.

A. deficit; lending (in net terms) to
B. deficit; borrowing (in net terms) from
C. surplus; lending (in net terms) to
D. surplus; borrowing (in net terms) from
Q3 (1 Point). As conventionally defined in GDP national income accounting in the United States, the U.S. CAPITAL ACCOUNT keeps track of

A. (U.S. net exports)+(net factor payments to the U.S.)+(net transfers to U.S.)
B. all current purchases by U.S. citizens from the rest of the world.
C. net trades in financial assets between the U.S. and ROW.
D. net trades in existing real assets between the U.S. and ROW.
E E. both C and D.

Q4 (1 Point). According to U.S. national income accounting principles, which item(s) below would be directly entered as items in the U.S. CURRENT account CA:

A. U.S. government foreign aid to Bosnia
B. Dividend income received by U.S. holders of Russian company stock shares.
C. Purchases by U.S. tourists of mahogany furniture newly produced in Indonesia
D. A U.S. citizen’s purchase of a Mongolian government bond.
E E. All but D.

Q5 (1 Point). Which of the following would directly DECREASE the size of the U.S. current account DEFICIT?

A A. Contributions by foreign governments to the U.S. to help finance U.S. military activities in Afghanistan.
B. Increased purchase of China Airlines ticket reservations by vacationing U.S. college students.
C. Foreign aid by the U.S. government to Malawi.
D. Both A and B of the above

SEE THE FOLLOWING PAGE FOR
Q6: WEB EXERCISE
Q6: **Web Exercise (3 Points).** *Microcredit* is the extension of small loans to entrepreneurs too poor to qualify for traditional bank loans because they lack collateral. Dr. Muhammad Yunus, who founded the Grameen Bank (microcredit) project in Bangladesh in 1976, continues to be a central force in the growth of microcredit programs in many developing countries. Dr. Yunus was awarded the 2006 Nobel Peace Prize for these efforts. This question asks you to consider the unique aspects of the microcredit loan process in relation to traditional bank lending practices.

**Key References:**


**[3]** The Microfinance Gateway Website includes research and publications, specialized resource centers, organization and consultant profiles, and the latest news, events, and job opportunities in microfinance. It is available at http://www.microfinancegateway.org/


Q6: **PART A (1 Point).** When Dr. Yunus first organized the Grameen Bank (GB) Project in Bangladesh in 1976, commentators thought he would surely fail because of the unusual and seemingly incompatible nature of the three lending principles he strove to enforce. What were these three principles?

**Answer Outline for Q6:PART A**

1. GB loans were to be repaid, and on time. (The GB was to be a for-profit business, not a charity.)
2. Only the poorest villagers, in particularly those without land, were to be eligible for GB loans (thus reversing the usual banking practice of requiring borrowers to have some kind of assets the bank could lay claim to in case of default);
3. GB lending would be primarily to women (despite the widely accepted view at the time that women's proper place was in the home with her children, not in the workplace).

Q6: **PART B (1 Point).** Dr. Yunus understood the moral hazard problems associated with bank lending, but he argued that his unusual Grameen Bank loan process incorporated sufficient mechanisms to protect against these problems. Describe the nature of these mechanisms.

**Answer Outline for Q6:PART B.** Banks typically rely on borrowers having collateral (assets) that can be seized in case of loan defaults both to encourage loan repayment (reduce
moral hazard) and to ensure restitution in case of loan default. In total contrast, the Grameen Bank loan process does not require any collateral. Rather, reputation and “shame” effects are relied on to ensure loans are repaid. As detailed in ref. [1], each GB borrower is required to join a small group of GB borrowers (typically from the same village), attend weekly group meetings, assume responsibility for the GB loans of all of the group’s members, and adhere to “sixteen decisions” (rules for living) to help ensure financial solvency and ability to repay loans.

Q6: PART C (1 Point). Although microcredit has apparently been successfully established in many developing countries, efforts to replicate this success in the United States have so far had mixed results. In particular, many microcredit programs established in the U.S. have failed to achieve financial self-sufficiency. Briefly but carefully discuss at least two distinct factors that you believe might account for this failure.

Answer Outline for Q6:PART C. Any carefully reasoned discussion will be accepted here. However, some factors suggested by commentators are as follows: (a) physical difficulties in implementing the “joint group liability” idea in the U.S., especially in rural areas where individuals tend to live far apart; (b) cultural difficulties in implementing the “joint group liability” idea in the U.S. (some commentators have negatively labeled the approach as “socialism”); (c) cultural and language barriers (lack of homogeneity) prevalent among lower-income U.S. residents; (d) lack of an entrepreneurial tradition among many lower-income U.S. residents; (e) higher costs of microcredit programs in the U.S. (reluctance of many U.S. participants to devote their time and energy to implementing joint group liability enforcement mechanisms – weekly meetings, oversight, monitoring of group members, etc. – requiring resort to more formal and costly enforcement mechanisms); (f) failure to make self-sufficiency a high priority – expectation of dependence on subsidies from outside funding agencies; (g) failure to articulate and establish a coherent set of goals and objectives (many U.S. program managers tend to view microcredit more as a social welfare policy than as a commercial transaction requiring loan repayment for viability); and (h) failure to articulate and establish a coherent set of criteria for assessing program success.