International Macroeconomics
Homework # 3
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1. Capital inflows into developing countries can take a number of forms, including bond finance (or bank finance) and equity finance (chiefly through Foreign Direct Investment). Which one of these forms can lead to the debt problem discussed in class? How do they are different from the point of view of the host country's risk?

2. Consider a debt-crisis problem. The debtor debt repayments, by the two state of the Economy, are:

	State of Economy A	State of Economy B
Probability	0.5	0.5
Debt Repayments	100	50

The probability, **Prob**, of full repayments varies with the debt according to the equation:

$$\mathrm{Pr}\,ob = 0.5 - 0.01(D - 100)$$

,
where, D denotes the country's (contracted) debt.
Originally, the debt is $_0D$ =100.

a) Does a debt reduction raises or lowers the market value of the country's debt (in the secondary global market where the country debt is traded) ?

b) Assume that the country has 10 in cash reserves. Should the country use these reserves to buy back its debt in the secondary global market?