

SIMON FRASER UNIVERSITY  
Department of Economics

Econ 345  
International Finance

Prof. Kasa  
Fall 2012

PROBLEM SET 1  
(Due October 15)

Questions 1-3. Answer True, False, or Uncertain. Briefly explain your answer. No credit without explanation (5 points each).

1. If markets are efficient, then exchange rate changes should be unpredictable (i.e., exchange rates should follow a 'random walk').
2. According to Purchasing Power Parity, if the US inflation rate is 5% and the Canadian inflation rate is 3%, then the US dollar should depreciate by 2% against the Canadian dollar.
3. If a country is running Current Account deficits now, it must eventually run Current Account surpluses in the future. It cannot borrow forever.

The following questions are short answer. Clarity and conciseness will be rewarded!

4. (10 points). Suppose the 12-month forward price of the euro in terms of dollars is 1.3 dollars per euro. Suppose the spot price of the euro in terms of dollars is 1.35. Next, suppose that currently the annual interest rate on dollar deposits is 7%, while the interest rate on a comparable euro deposit is 6%. There are no transactions costs. Is there an arbitrage opportunity here? If so, explain exactly how you would take advantage of this situation to make riskless profits.
5. (25 points). Read the following two Krugman articles posted on the course webpage: "China, Japan, America" and "Fear-of-China Syndrome". According to Krugman, should the USA be worried about China suddenly deciding to sell its holdings of US treasury bonds? Why or why not? Do you agree? Why or why not? According to Krugman, how do you explain the fact that over the past few years the US government budget deficit has exploded, yet at the same time the US Current Account deficit has actually *decreased*. What happened to the 'twin deficits' hypothesis?
6. (25 points). Read the following two articles posted on the course webpage: "A Mao in Every Pocket" (from *The Economist*), and "China, New Financial Superpower" (by Brad Setser). According to Setser, what is unusual about the current position of China within the international financial system? According to *The Economist*, why are the Chinese authorities reluctant to loosen their capital controls? Briefly describe recent steps toward market liberalization.
7. (25 points). Since an exchange rate is the relative price of two currencies, standard theories of exchange rate determination try to explain exchange rates in terms of relative money supplies and variables that influence relative money demands (e.g., relative income levels). One potential problem with these theories is that exchange rates are much more volatile than relative money supplies or relative income levels.

Briefly explain how the concept of exchange rate 'overshooting' can help to explain why exchange rates are so volatile. Illustrate how the economy responds over time to a permanent money supply increase. Explain intuitively why overshooting occurs.