

SIMON FRASER UNIVERSITY
Department of Economics

Econ 345
International Finance

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PROBLEM SET 3
(Due December 3)

The following questions are short answer. 30 points each.

1. Briefly describe the ‘Open-Economy Trilemma’. What constraints does it impose on macroeconomic policy in open economies? Read the article, “The Trilemma of International Finance”, by Mankiw, which is posted on the class website. According to Mankiw, how can the Open-Economy Trilemma be used to understand the differences between the USA, China, and Europe?

According to the ‘Open-Economy Trilemma’, countries can only achieve two of the following three desirable policy objectives: (1) Stable exchange rates, (2) An independent monetary policy, and (3) Open capital markets. The textbook (pg, 226) describes these trade-offs in a picture. According the Mankiw, the USA has opted for an independent monetary policy and open capital markets, while China has opted for an independent monetary policy and stable exchange rates. To preserve monetary policy independence, China has been forced to erect capital controls. Finally, the countries within Europe have opted for exchange rate stability (ie, a common currency!) and open capital markets. As a result, countries like Greece can no longer decide their own monetary policy.

2. Use our model of ‘First-Generation’ currency crises to describe how and why a financial ‘panic’ can appear to erupt out of nowhere, without obvious new information or news events.

The main point of first-generation currency crisis theories is to show that crises do not necessarily reflect panic or mass hysteria. They can be the outcome from an economy’s gradual drift toward a ‘critical state’, i.e., they are the response to the cumulation of many small gradual changes, rather than the response to one sudden big change. Of course, this doesn’t necessarily mean that crises never result from panic! It just means that they sometimes don’t. The reason that central banks tend to lose their reserves all of a sudden is that following the crisis the exchange rate will begin to float, and (short-term) domestic interest rates will suddenly jump up. Higher interest rates reduce the demand for money, and the sudden drain on the central bank’s reserves is just the reflection of this sudden decrease in money demand (ie, the money supply drops to match the sudden drop in money demand). See pgs. 216-218 in the textbook for a more detailed discussion.