SIMON FRASER UNIVERSITY
Department of Economics

Econ 345 — Prof. Kasa
International Finance — Fall 2017

PROBLEM SET 2
(Solutions)

The following questions are short answer. 25 points each.

1. Every so often proposals are made to link Canada's exchange rate more closely to that of the USA. Some people have even called for a common currency, like in Europe. Use the DD-AA model to discuss how this would change the way Canada responds to shocks emanating from the USA. Under what conditions would a fixed exchange rate produce more stability? When would it lead to greater instability?

   There are two kinds of shocks that might affect Canada. Goods market shocks in the USA influence the demand for Canadian goods. This will shift Canada's DD curve. For example, if the USA imposes tariffs on Canadian goods, then Canada's DD curve shifts left. If Canada has a flexible exchange rate, this will cause the C$ to depreciate. The exchange rate depreciation helps to offset the effect of the tariff, since it makes Canadian goods more competitive. If, however, Canada had a fixed exchange rate, the central bank must sell foreign exchange reserves to keep the exchange rate from depreciating. This will cause Canada's AA curve to shift left until it intersects the new DD curve at the fixed exchange rate. This shift in the AA curve will reinforce the decline in Canada's output. Hence, if US shocks are mainly to the DD curve, flexible exchange rates will produce more stability.

   Now consider financial market shocks coming from the USA. For example, suppose the USA cuts its interest rate. From Canada's perspective, this represents a decline in R^*. If Canada has a flexible exchange rate, this will shift Canada's AA curve down and to the left, and the C$ will appreciate. As a result, NX and output decline in Canada. (Caveat: Lower USA interest rates might increase USA output, which would increase demand for Canadian goods. This could offset the exchange rate effect). On the other hand, if Canada had a fixed exchange rate, it would need to match the USA interest rate. This might actually increase Canadian output, rather than decrease it. As long as the USA and Canadian economies are reasonably "in phase", fixed exchange rates would therefore produce more output stability in response to financial market shocks.

   See Lecture Slides 11A (pages 2-4) for the graphs.

2. China's central bank recently announced that it was going to target domestic interest rates more closely, mimicking the sort of monetary policies pursued in the USA and Canada. Discuss the implications of this new policy for China's exchange rate and domestic financial markets. (Hint: Read the article by Mankiw posted on the course webpage entitle *The Trilemma of International Finance*). Do you think this policy is a good idea? Why or why not?

   According to the Trilemma of International Finance, a country can only achieve two of the following three goals: (1) Independent monetary policy, (2) Stable exchange rates, and (3) Open capital markets. The central bank's announcement signalled that China is going to place more emphasis on an independent monetary policy. This suggests that they will either need to tighten capital controls or allow more *exchange rate flexibility. Since their long-term goal is to internationalize the RMB, they may want to avoid reimposing tight capital controls. Hence, the announcement suggests that perhaps more exchange rate flexibility will be coming. Let's wait and see...*