SIMON FRASER UNIVERSITY
Department of Economics

Econ 345 — Prof. Kasa
International Finance — Spring 2017

PROBLEM SET 1
(Due February 6)

1. (25 points). Suppose the 12-month forward price of the euro in terms of dollars is 0.97 dollars per euro. Suppose the spot price of of the euro in terms of dollars is 1.0. Next, suppose that currently the annual interest rate on dollar deposits is 4%, while the interest rate on a comparable euro deposit is 5%. 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.

2. (25 points). Until recently, China actively purchased US Treasury securities in order to limit the appreciation of its currency. (Currently it is *losing* foreign reserves). For this question you are asked to read two articles about how the USA should have responded to this strategy. Both are by Paul Krugman, and are 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 since the financial crisis 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?