SIMON FRASER UNIVERSITY
Department of Economics

Econ 345 | Prof. Kasa
International Finance | Spring 2017

PROBLEM SET 3
(Solutions)

The following questions are short answer. 25 points each.

1. Read the article by Mankiw entitled "The Trilemma of International Finance", which is posted on the class website. According to Mankiw, what is the trilemma of international finance? Use a triangle to illustrate this trilemma (see class lecture slides). Provide an example from the current international finance system for each point of the triangle. The USA often recommends that other countries follow its lead, and adopt flexible exchange rates. According to Mankiw, is this always good advice?

   The Trilemma of International Finance refers to the trade-offs countries face in open economies. In particular, there are 3 desirable policy objectives: (1) Open capital markets, which allows capital to be allocated efficiently across countries, (2) Stable exchange rates, which facilitate long-term planning, and (3) Independent monetary policy, which can be focused on domestic output and inflation stability. However, in general countries can only achieve two. One must be sacrificed. China has chosen to sacrifice open capital markets. Europe has chosen to sacrifice independent monetary policy, while the US and Canada have sacrificed stable exchange rates. (See Lecture Slides 10A (page 4) for the triangle, or alternatively, Chpt. 19 in the textbook).

   According to Mankiw, recommending flexible exchange rates to all countries is not necessarily good advice. Countries differ, and so should their exchange rate policies. As discussed in class, countries that are subject to a predominance of financial market (AA curve) shocks would experience more stability with fixed exchange rates. Some have used this result to argue that China has been well served by its peg to the US dollar.

2. The USA recently began a process of monetary tightening (ie, higher interest rates). Use the DD-AA model to compare and contrast the effects of this policy on Canada and China. (Remember, the C$ floats against the US dollar, while for the purposes of this question you can assume the RMB is fixed against the dollar).

   Higher interest rates in the USA must be matched by higher rates in China if China is to maintain its peg to the US dollar. All else equal, both the dollar and the RMB appreciate against other currencies, while remaining fixed against each other. With the US dollar on the vertical axis, China's AA curve doesn't shift, since its monetary contraction just offsets the higher US (foreign) interest rate. However, it would shift down if some other currency were on the axis.

   Higher US interest rates would shift out the AA curve in Canada. Output in Canada would rise, since the depreciation of the C$ would promote Canadian net exports. One caveat is that Canada's DD curve could shift left, if the monetary tightening in the US causes US output (and import demand) to decline. However, if the US monetary tightening is triggered by rapid US output growth, this might not be a major concern.