

SIMON FRASER UNIVERSITY
Department of Economics

Econ 345
International Finance

Prof. Kasa
Spring 2020

PROBLEM SET 2
(Due March 18)

1. (25 points). Read the article from *The Economist* entitled “Two Out of Three Ain’t Bad”, which is posted on the class webpage. According to this article, what is the open-economy ‘policy trilemma’? Provide examples of countries that have chosen each corner of the trilemma triangle. Near the end of the article, it discusses recent research by Helene Rey, from the London Business School. In what sense does her work suggest that in the modern world, the trilemma might actually be just a dilemma (i.e., countries really only have one choice). According to Rey, why don’t flexible exchange rates support an independent monetary policy?
2. (25 points). The coronavirus is currently wreaking havoc on the world economy. There are many reasons for this, so let’s simplify by focusing on just one. Suppose the primary effect of the coronavirus is to create “uncertainty”, which leads investors to increase their demand for “liquidity” (i.e., it increases the demand for money relative to other assets). Use the DD-AA model to show how this would affect the US economy. What happens to US output and the value of the dollar? US policymakers are currently debating whether to respond by cutting interest rate or increasing government spending. Which of these policy responses would Canada favor? Which would China favor? (Hint: The Canadian dollar floats against the US dollar, whereas the RMB is pegged to the US dollar).