

SIMON FRASER UNIVERSITY
Department of Economics

Econ 345
International Finance

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PROBLEM SET 1
(Due February 5)

Questions 1-3. Answer True, False, or Uncertain. Briefly explain your answer. No credit without explanation (5 points each).

1. Government budget deficits lead to current account deficits.
2. ‘Overshooting’ of the exchange rate cannot occur if asset markets are always in equilibrium.
3. According to the theory of Purchasing Power Parity, high inflation countries should have depreciating currencies.

The following questions are short answer. 15 points each.

4. Suppose the 12-month forward price of the dollar in terms of yen is 144 yen per dollar. Suppose the spot price of the dollar in terms of yen is 160. Next, suppose that currently the annual interest rate on yen deposits is 4%, while the interest rate on a comparable dollar deposit is 12%. 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.
5. There is an article on the class webpage by Brad DeLong, entitled *Should We Still Support Untrammelled International Capital Mobility? Or are Capital Controls Less Evil than We Once Believed?*. In this article DeLong argues that NAFTA has been good for Mexico in the sense that it is now running a trade surplus with the United States, but it has also been bad because on net Mexican capital is flowing into the United States, rather than staying in Mexico to help finance domestic investment.
Using your knowledge of Balance of Payments accounting, explain why Mexico cannot have it both ways, i.e., have a trade surplus and a net capital inflow from the United States. (Assume the U.S. and Mexico are the only two countries in the world).
6. Travelers from the U.S. and Canada often find that services and other non-traded goods are much less expensive in developing countries. Briefly explain how the Balassa-Samuelson theory of real exchange rate determination accounts for this observation.
7. Suppose there is a permanent reduction in aggregate money demand (i.e., an inward shift of the aggregate real money demand function). Illustrate the short-run and long-run effects on the exchange rate, interest rate, and price level.

8. One way to interpret what Central Banks do is to think of them as solving a “signal extraction” problem. They look at market interest rates and try to decide whether they are changing because of changes in (real) money demand or because of changes in expected inflation. If the Central Bank wants to achieve a steady inflation rate (or price level), it should accommodate money demand changes (e.g., increase money supply in response to increases in money demand), but should *not* accommodate changes in inflation expectations (i.e., cause more inflation just because people expect inflation).

Suppose you are head of the central bank, and you see market interest rates start to rise. Should you increase the money supply in order to bring them back down, or should you hold the line, in order to prevent future inflation? How could you use information from the foreign exchange market to help you decide?