SIMON FRASER UNIVERSITY
Department of Economics

Econ 345 Prof. Kasa
International Finance Spring 2014

FINAL EXAM
(Solutions)

Questions 1-5. Answer True, False, or Uncertain. Briefly explain your answer. No credit without explanation (8 points each).

1. Fiscal policy is ineffective with fixed exchange rates.

   FALSE. *Fiscal policy is especially potent with fixed exchange rates, since it does not produce any crowding out of net exports. In effect, expansionary fiscal policy requires the Central Bank to increase the money supply (to prevent the exchange rate from appreciating).*

2. If two countries belong to a Monetary Union they must have the same inflation rates.

   UNCERTAIN. *In principle, if two regions share the same currency then they must have the same inflation rates as long as goods market arbitrage is perfect (and consumers have the same preferences, so that expenditure weights in the price index are the same). However, in practice, with limited goods market arbitrage, inflation rates can and do differ. Anything that would require a change in the equilibrium real exchange rate (e.g., productivity growth differentials) would show up as differences in inflation rates.*

3. Monetary expansion in the USA causes output in China to increase.

   TRUE. *Since China has a fixed exchange rate against the US dollar, lower US interest rates must be matched by lower Chinese interest rates (ignoring sterilization and capital controls). Lower interest rates increase spending (and short-run output in a Keynesian model). Adding to this is the fact that if expansionary US monetary policy is effective at increasing US output, this would likely produce a positive income effect on the demand for Chinese exports.*

4. Uncovered Interest Parity doesn't hold with fixed exchange rates.

   FALSE. *There is no reason why UIP cannot hold with fixed exchange rates. It just implies that interest rates must be the same in both countries. (Of course, UIP is just a theory, and it may or may not hold in practice, but this question asked whether there was theoretical reason it could not hold with fixed exchange rates).*

5. Currency crises are unpredictable.

   UNCERTAIN. *It depends on what causes them. According to first-generation theories, macroeconomic data should be useful at predicting crises. (Of course, in an uncertain world, they will not be able to predict the exact date. Only the likelihood). On the other hand, according to second-generation theories, crises might be caused by a sudden, unpredictable, shift to a different equilibrium, due perhaps to the realization of a 'sunspot' variable.*

   The following questions are short answer. 20 points each.

6. According to Mundell, in his article entitled "A Reconsideration of the Twentieth Century", why did the attempt to restore the gold standard after World War I fail? According to Mundell, what should have been done differently?

   It failed because countries tried to peg at the pre-war price of gold. The war was partially financed by the inflation tax. Price levels had risen significantly. Pegging the exchange rate at the pre-war price of gold required price levels to go back down, which required a monetary contraction. Due to nominal rigidities this tended to produce a recession, and in fact, most countries did experience a recession in the early 1920's. According to Mundell, a simple fix would have been to return to gold at a devalued rate, roughly in proportion to the increase in the overall price level. Eventually, this is what happened, but it wasn't until the depression was in full swing.

7. Briefly explain how the relative importance of real vs. nominal shocks influences the choice of an optimal exchange rate regime. From the perspective of macroeconomic stabilization, when should a country adopt a flexible exchange rate regime? When whould a fixed exchange rate regime be preferred? Use graphs to illustrate your answers.

   If real (DD curve) shocks are more important, then flexible exchange rates would produce more stability. The change in the exchange rate leads to changes in net exports which partially offset the decline in demand. If nominal (AA curve) shocks are more important, then fixed exchange rates would produce more stability. Fluctuations in the demand for liquidity would automatically produce accommodating changes in the supply (otherwise the exchange rate would change). See pages 2-3 in Lecture Slides 11A for the graphs.

8. The Canadian dollar has depreciated by about 10-15% during the past year (against the US dollar). Some people have argued that this reflects a new policy direction from the Bank of Canada. (Recently, a new governor was appointed). Other people argue that it reflects weakness in world demand for Canadian exports, particularly commodities. Explain how you could use the DD-AA model to decide which explanation is more likely. Use graphs to illustrate your answer.

   If the Canadian dollar has depreciated because of a looser monetary policy, then we would expect to see rapid growth too (the AA curve shifts right). If the Canadian dollar has depreciated because of a decline in export demand, then we would expect to see slower growth, or even a recession (the DD curve shifts left).