

SIMON FRASER UNIVERSITY
Department of Economics

Econ 345
International Finance

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FINAL EXAM
(Solutions)

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

1. Fiscal expansion in the USA causes output in China to increase.

FALSE. *Fiscal expansion in the USA will raise US interest rates. To keep its exchange rate fixed, China must raise its interest rate. This will depress spending and output in China. (If they try to draw a graph using the DD-AA model, it's a little tricky, since it puts E on the vertical axis. An increase in R^* shifts China's AA to the right. China must sell fx reserves to keep its currency from depreciating. This shifts AA back to the left. If interest rates didn't affect spending, that would be the end of the story. But when they do, then DD shifts left too, and so AA must continue shifting left until it intersects the new DD. Output is lower.) They do not need to draw a graph for full credit.*

2. Currency crises are caused by inconsistent macroeconomic policies.

UNCERTAIN. *According to the 1st generation model, they are. According to the 2nd generation model they aren't.*

3. Sterilized intervention is ineffective if investors only care about expected returns.

TRUE. *Sterilized intervention works by influencing the risk premium (by changing the currency composition of the public's wealth portfolio). If investors don't care about risk, they don't care about the currency composition changes caused by sterilized intervention. (There are exotic signalling type stories that make sterilization work, even under risk neutrality, but I would be shocked if anyone mentioned them).*

4. Flexible exchange rates make output more stable.

UNCERTAIN. *True if there are mainly real/DD-curve shocks. False if there are mainly domestic financial market shocks (shifts in the AA curve).*

5. The Balance of Payments might not balance if a country has fixed exchange rates.

FALSE. *The BOP always balances, by the rules of double-entry book-keeping (ignoring imperfectly recorded transactions). Fixed exchange rates just means that the Central Bank might have to actively intervene. It's actions do show up in the BOP (official settlements). A number of people asked me about this question during the exam. Most seemed to be thinking of Hume's price-specie-flow mechanism. That's fine. If they can explain why BOP imbalances are automatically corrected via money supply and price level changes, that would be great.*

The following questions are short answer. 30 points each.

6. What is the ‘Trilemma of International Finance’? Draw a picture to illustrate it. How can it be used to understand the historical evolution of the global financial system.

This is straight from the textbook/notes. (See the historical overview chapter). All I’m looking for is a labeled triangle and a brief summary of where the Gold Standard/Bretton Woods/Modern Era fit in. It would be great if they could also say something about how the current world economy fits in, using China, USA, and Europe as examples (as Mankiw did in his article). But they don’t need to do that for full credit.

7. China would like to ‘internationalize’ the RMB. Why do you think this is? [Please focus on economic arguments, e.g., refrain from arguments having to do with ‘national prestige’, etc.] What steps need to be taken for this effort to be successful? Are there any downsides to this strategy?

This is obviously a pretty vague and open-ended question. I suspect the answers will be all over the map, so it will be a little difficult to grade. Just use your best judgement. Clarity should always be rewarded. I guess the main thing I was looking for is the stuff we talked about in class. To internationalize the RMB China will need to liberalize its capital markets. It’s debatable whether they need to let their currency float. Some people think so, but they don’t need to take a stand on that. If they do, then they might approach the question in terms of the fixed vs. flexible trade-offs we talked about in class. That would be fine.

The downside for China is that they must be willing to give up some control over their economy. We are seeing the potential dangers right now, as capital is fleeing the country. Some people think they should reinstate stricter capital controls, but that would interfere with their goal to internationalize their currency. Bottom line - be generous with partial credit. There is no particular correct answer. Still, you should be able to spot the people who know what they are talking about.