

SIMON FRASER UNIVERSITY
Department of Economics

Econ 345
International Finance

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MIDTERM EXAM
(Solutions)

Questions 1-4. Answer True, False, or Uncertain. Briefly explain your answer. No credit without explanation (10 points each).

1. Uncovered Interest Parity does not apply to China, since it fixes its exchange rate to the US dollar.
FALSE. There are several reasons why UIP might not apply to China, e.g., capital controls, risk premia, etc. However, a fixed exchange rate is not one of them. A fixed exchange rate just means China's interest rate must equal the US interest rate.
2. If Canada's inflation rate is 1% and the US inflation rate is 3%, then Purchasing Power Parity requires the Canadian dollar to depreciate by 2% against the US dollar.
FALSE. Since Canada's inflation rate is 2% lower, its currency must appreciate in order for PPP to hold.
3. When the Canadian dollar appreciates, Canada's net exports decrease.
UNCERTAIN. It depends on whether the Marshall-Lerner condition holds. If it does, then the statement is true. However, if it doesn't, then the statement is false.
4. If a country has a current account deficit then it is accumulating foreign assets.
*FALSE. A current account deficit means you are borrowing from foreigners (or selling off your assets).
The following questions are short answer. 20 points each.*
5. Some people describe the Canadian dollar as a 'commodity currency', since its value is so closely correlated with world oil prices. Use the DD-AA model to illustrate why there might be a connection between world oil prices and the Canadian dollar exchange rate. Why does the Canadian dollar usually appreciate following an increase in oil prices?
The key to this question is to realize that Canada is a net exporter of oil. If higher oil prices are caused by higher world demand, this represents an increase in Canada's net exports, which shifts out its DD curve, which then causes the Canadian dollar to appreciate. There are supply-side stories you could tell, particularly if Canada's supply is reduced (eg., due to a fire in Alberta), where higher oil prices might be associated with a C\$ depreciation, but they do not need to mention this for full credit.
6. The following passage appeared in *The Economist* magazine on September 9, 2017:
The flipside of euro strength is a weaker (US) dollar. It surged in the weeks after the election in November on a belief that big tax cuts were likely and that a fiscal stimulus of this kind would oblige the Federal Reserve to raise interest rates more quickly than otherwise, pulling capital to America and lifting the dollar.

- (a) Use the DD-AA model to illustrate why a fiscal stimulus in the USA would strengthen the US dollar.

There is a subtlety in this question associated with the fact that the quote talks about expected future stimulus. This would cause E^e to fall, and the US AA curve to shift left. This could actually prove contractionary before the stimulus occurs (and it still hasn't occurred!) I doubt anyone will answer it this way, but if they do, do not penalize them. Give them full credit. However, the most straightforward answer is to simply note that a US fiscal stimulus shifts out the US DD curve, which then causes the US dollar to appreciate, and US output to rise. Give them full credit if they show this.

- (b) Use the DD-AA model to explain why such a stimulus might require the Fed to raise interest rates. (Hint: What might happen if they didn't?)

Higher US output may push the US economy beyond the full employment output level, which then would put upward pressure on wages and prices. To keep inflation from rising above target, the Fed may respond by raising interest rates. Of course, this would exert further upward pressure on the value of the US dollar.

7. Suppose you are an advisor to the Canadian government. You have been asked to formulate a policy package that stimulates the economy, but does not change the current account balance. What would you do? Illustrate your answer using the DD-AA model.

Either a fiscal stimulus (e.g., higher G), or a monetary stimulus (higher M /lower R), will increase output. However, a fiscal stimulus will reduce CA , while a monetary stimulus will increase CA . To keep CA constant, both monetary policy and fiscal policy should be expansionary. For full credit, they should show a graph with the DD curve, the AA curve, and the XX curve.