

SIMON FRASER UNIVERSITY
Department of Economics

Econ 345
International Finance

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FINAL EXAM
(Solutions)

The first four questions are True, False, or Uncertain. Briefly explain your answers. No credit without explanation. (10 points each).

1. Fixed exchange rates lead to greater economic stability.

UNCERTAIN. *It depends on the source of the shocks. True if shocks are to domestic financial markets (AA curve shocks). False if shocks are primarily to spending (DD curve shocks).*

2. If markets are efficient, then exchange rate changes are unpredictable.

FALSE. *Efficiency just means absence of (risk-adjusted) profits. With risk-neutrality, efficiency implies Uncovered Interest Parity. However, UIP does not imply exchange rate changes are unpredictable! Expected exchange rate changes equal the current interest rate differential. If domestic interest rates are relatively high, then the domestic currency is expected to depreciate.*

3. According to Mundell, attempts to restore the gold standard following World War I failed because Britain pegged the pound to the prewar price of gold.

TRUE. *The expense of WWI was partly monetized, and so inflation rose during the war. Returning to gold at the prewar parity forced goods prices back down to the prewar level. The resulting deflation was contractionary, especially because some other countries did in fact devalue, so British goods became uncompetitive after the war.*

4. Moving to a digital currency world will lead to greater price level instability.

UNCERTAIN. *It depends on how the digital currency is set up. If it's like Bitcoin, which imposes an upper bound on the quantity of money, and makes new issues of money increasingly costly, then rapid growth and growing money demand would likely cause deflation, which could prove contractionary in a Keynesian world featuring nominal rigidities. However, if digital currencies are under the control of Central Banks (i.e., a so-called CBDC system), then in principle Central Banks could adjust the supply of money to match the current demand, and thereby keep the price level relatively stable.*

5. (30 points). Wars are expensive. Currently, the USA is funding *two* wars, one in Ukraine and one in Gaza. These expenditures have been primarily deficit financed. (1) Use the DD-AA model to illustrate the effects of this fiscal expansion on the US economy. What are the predicted effects on US output and the value of the US dollar. (2) Use the DD-AA model to compare and contrast the effects of the US fiscal expansion on Canada and China. Can US fiscal policy help explain the recent performance of the Chinese economy? (Hint: Canada has a flexible exchange rate with the USA, and China has a fixed exchange rate with the USA).

US fiscal expansion shifts out the US DD curve. Output increases and the US dollar strengthens. This is broadly consistent with recent US economic experience. Canada benefits for two

reasons. First, the stronger US dollar makes Canadian goods more competitive, and should increase Canadian net exports. Second, higher incomes in the US will increase Americans' spending on Canadian goods (ie, a positive 'income effect'). Of course, Canada's economy has been underperforming recently, but this is due to other factors (eg., low productivity growth). In contrast, US fiscal expansion would tend to be transmitted to China negatively. Higher US interest rates (due to fiscal expansion) would force China to raise its interest rate (to keep its exchange rate fixed). That is, expansionary fiscal policy in the US would cause contractionary monetary policy in China.

6. (30 points). On April 10, 2024, it was announced that US inflation was higher than expected, at 3.5%. Not surprisingly, the US stock market declined in response. However, the value of the US dollar rose. Why? In class we learned that PPP implies higher inflation leads to a weaker currency. Why do you think that instead the dollar rose in response to the news?

The key point here is that exchange rates are asset prices. They are forward-looking. UIP says that the current exchange rate depends on the current interest rate differential and the expectation of next period's exchange rate. But next period's exchange rate depends on next period's interest differential. Iterating this logic forward, the current exchange rate depends on expectations of the entire future path of interest rates. As a result, a positive inflation shock might well lead to an appreciation if investors think the Central Bank will respond by raising future interest rates.