SIMON FRASER UNIVERSITY
Department of Economics

Econ 345 — Prof. Kasa
International Finance — Spring 2020

MIDTERM EXAM
(Solutions)

The first five questions are True, False, or Uncertain. Briefly explain your answers. No credit without explanation. (8 points each).

1. A current account deficit means a country is investing less than it is saving.

   FALSE. *By definition,* $CA = S - I$. *Hence, if* $I < S$, *we know* $CA > 0$. *Intuitively, if a country saves more than it invests, it must be lending the surplus funds to foreigners.*

2. Lower interest rates cause the exchange rate to depreciate.

   UNCERTAIN. *It depends why interest rates are lower. If lower rates reflect a lower real return, then the exchange rate depreciates. If lower rates reflect lower expected inflation, then the exchange rate appreciates.*

3. Uncovered Interest Parity implies that exchange rate changes are unpredictable.

   FALSE/UNCERTAIN. *UIP implies that expected exchange rate changes equal the difference between nominal interest rates, e.g., if a country has a relatively high nominal interest rate, its currency should depreciate on average (in order to equalize expected returns). Hence, this would only be true if interest rates were equal across countries.*

4. Tax cuts produce current account deficits.

   TRUE/UNCERTAIN. *A tax cut increases spending, which shifts out the DD curve. Output increases and the exchange rate appreciates. The Current Account deficit increases as long as the Mashall-Lerner condition holds. (Caveat: Students who have taken 305 might note that if taxes are lump-sum and Ricardian Equivalence holds, then tax cuts might have no effect on spending. However, they don't need to mention this for full credit).*

5. As a country develops, its currency tends to appreciate.

   TRUE/UNCERTAIN. *This is true under the conditions of the Balassa-Samuelson model. This model assumes that productivity growth occurs more in the tradeable goods sector (which is the case empirically). It also presumes a 'small' country, which takes tradeable goods prices as given.*

6. (20 points). The US Financial Crisis of 2008 led to a recession in Canada as well. Some people argued that it was because of increased financial market risk, which shifted Canada's AA curve to the left. Others argued that it was because the demand for Canada's exports decreased, which shifted the DD curve to the left. Explain how you could use information from

the foreign exchange market to distinguish these two hypotheses. Use a graph to illustrate your answer.

If transmission occurred mainly through the financial markets (ie, a leftward shift of the Canada's AA curve), we would expect to see an <u>appreciation</u> of the Canadian dollar. If transmission occurred mainly through the goods markets (ie, a decline in net exports, which shifts Canada's DD curve left), then we would expect to see a <u>depreciation</u> of the Canadian dollar. Although both channels were likely at work, the fact that the C$ initially depreciated suggests that the goods market effect dominated. (Note: I don't care whether they say the goods market of the financial markets was more important in reality, as long as they get the analysis correct).

7. (20 points). Many policy pundits in the USA argue that the USA is at the mercy of China, because the USA owes China so much money. Do you agree? Why or why not?

   This is a rather open ended question, so the answers might be all over the map. Please read carefully, and give partial credit. We discussed this issue in class one day, but only about half the class attends, so hopefully this question will reward those who go to class. The basic point here is that the US owes China US dollars, and the US has an unlimited capacity to print dollars (at virtually zero cost). So there is no real problem in paying China back. In fact, it is China that is most exposed here, because they are worried about getting paid back in worthless dollars. This same issue explains why the threat to dump US treasuries is not very credible.

8. (20 points). The Trump Tariffs have not produced much of a change in the US trade deficit. Use the DD-AA model to explain why.

   The whole point of the Trump tariffs was to switch spending towards US goods. This will shift out the US DD curve. Although this does indeed provide a stimulus to the US economy, it causes the dollar to appreciate, which partially crowds out net exports. So the net effect on NX might be rather small. Interestingly, Trump complained about the dollar appreciation after the tariffs. He wanted the Fed to cut interest rates to offset it. Of course, another reason the tariffs had little effect is that China retaliated!

   I think this is one of the questions at the end of Chapter 17. You could look at the solutions manual if you want more details.