SIMON FRASER UNIVERSITY
Department of Economics

Econ 345
International Finance

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MIDTERM EXAM
(Solutions)

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

1. If a country has a trade deficit, then it also has a current account deficit.

   FALSE. *From Balance of Payments accounting*

   $$\text{Current Account} = \text{Trade Balance} + \text{Net Factor Income}$$

   *Therefore, a country could have a current surplus and trade deficit at the same time if its Net Factor Income is sufficiently positive. This has in fact been the case in the USA, especially if factor income includes capital gains.*

2. Current account surpluses signal a country's strength and competitiveness in world markets.

   FALSE/UNCERTAIN. *A current account surplus just means you are saving more than you are investing, i.e., you are lending to other countries. This could be a sign that your country is prospering. However, it could instead mean that nobody trusts you and you are unable to borrow on world markets, and must instead run a surplus to pay back your previous borrowing. For example, many countries in Latin America have been forced to run current account surpluses following defaults on their foreign debts, in order to (partially) pay back foreign creditors. Adam Smith wrote 'The Wealth of Nations' to try to convince people that having a current account surplus was not the key to prosperity.*

3. If inflation in the USA is 8% and inflation in Canada is 4%, then Purchasing Power Parity predicts that the US dollar will depreciate by 4% against the Canadian dollar.

   TRUE. *If inflation is 4% higher in the USA, then prices are rising faster in the US than in Canada. The price of the Canadian dollar must also rise by 4% in order for goods prices to remain the same in the two countries. If the US dollar depreciated by less, goods would be cheaper in Canada. If it depreciated by more, goods would be cheaper in the USA.*

4. US monetary expansion causes output in Canada to fall.

   UNCERTAIN. *US monetary expansion causes the US dollar to depreciate against the Canadian dollar. The switches expenditure toward American goods. By itself, this would tend to reduce Canada's output. However, in the short-run at least, US monetary expansion would raise incomes in the US and this would tend to increase Canada's exports to the US. So it depends on whether the income effect is smaller or larger than the exchange rate effect.*

5. Productivity growth causes the real exchange rate to depreciate.

   FALSE/UNCERTAIN. *According to the Balassa-Samuelson model, productivity growth in a country's tradeable goods sector will lead to a real exchange rate appreciation, not depreciation. However, if a country is sufficiently large so that it can influence the prices of its export goods, then rapid productivity*

*growth could produce an adverse Terms of Trade response, which could produce a real depreciation. Also, if productivity is concentrated in the nontradeables sector, then of course Balassa-Samuelson would indeed predict a real depreciation.*

6. (20 points). In the 19th century, Britain was the dominant creditor nation and the British pound was the world's reserve currency. In the 20th century, America was the dominant creditor nation and the dollar was (and still is) the world's reserve currency. Currently, China is the dominant creditor nation, yet the RMB is nowhere near to being the world's reserve currency. In his article entitled "China, New Financial Superpower", Brad Setser discusses 3 reasons why this is. What are they? What are 3 differences between the current Chinese economy and the economies of Britain and the USA during the 19th and 20th centuries.

   *According to Setser, there are 3 main differences between China today and the US/UK in the past: (1) Back when the US/UK were the dominant creditors, they were also the world's wealthiest countries. China is still a relatively poor country (in per capita terms!). Why is a poor country lending to rich countries? (2) Most of the capital that flowed out of the US/UK was private capital. In contrast, most of the capital flowing out of China is managed by the government. To a large extent it takes the form of reserve accumulation at China's central bank. (3) The US/UK were lending in the own currencies. In contrast, China is lending dollars to the USA! This puts China in a vulnerable position. China would like to lend in its own currency, but to do so, the government will likely have to relax some of its capital controls, and let the market play a bigger role in governing international capital flows.*

7. (20 points). Suppose Donald Trump gets elected again, and the USA once again imposes tariffs on Chinese goods. Use the DD-AA model to explain the effects of the tariffs on China. How could China retaliate without imposing tariffs of its own?

   *I think I asked this quetion on a previous exam, so most people should get it. The basic idea is that a tariff shifts out the US DD curve. This causes the US dollar to appreciate, which then partially offsets the tariff. Since China pegs to the dollar, one way for them to retaliate is to simply let the RMB depreciate against the dollar!*

8. (20 points). Supose the covid pandemic hit all countries equally hard. What would be the effects on international capital flows, current account balances, interest rates, and exchange rates? Now suppose (as was actually the case) the pandemic affected Western countries more than Asian countries. How would your predictions change?

   *Trade and capital flows are produced by differences across countries. That's what 'comparative advantage' is all about. If the pandemic affected all countries the same way, there would be no reason for capital to flow between countries. All countries would try to borrow in order to smooth out the negative shock. But for every borrower there must be a lender! If everyone tries to borrow, the market-clearing response is for the world interest rate to rise enough to choke off the desire to borrow. If in fact Asia was less affected, then Western countries would be able to borrow from Asia. The world interest rate would rise enough to induce Asia to lend, but not enought to choke off Western countries' desire to borrow. Capital would flow from Asia to the West. We know from the textbook DD-AA model that a temporary decline in spending (which shifts the DD curve left) would tend to depreciate a country's exchange rate. However, once again, exchange rate changes reflect differences across countries. If other countries' DD curves are also shifting left then the net effect on the exchange would be close to zero. Hence, we would expect the currencies of Western countries to depreciate only if they were more adversely affected. (A complication here is that China, the largest Asian economy, pegs to the dollar. But they can ignore that.*