SIMON FRASER UNIVERSITY
Department of Economics

Econ 345 | Prof. Kasa
International Finance | Fall 2025

MIDTERM EXAM
(Solutions)

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

1. Fiscal deficits cause current account deficits.

   UNCERTAIN. *From the Balance of Payments we know*

$$\text{Current Acct Deficit} = \text{Fiscal Deficit} + \text{Investment} - \text{Private Saving}$$

   So if investment and private saving do not respond to the fiscal deficit then the statement is TRUE. However, it is quite possible that investment and/or saving do react. Question 2 in Problem Set 1 provides an example. In this case, the answer would be FALSE.

2. China has current account surpluses because it saves more than it invests.

   TRUE. *Again, from the Balance of Payment we know*

$$\text{Current Acct Surplus} = S - I$$

   where now S denotes the total saving in the economy (both private and government). So if China has a current account surplus it must be saving more than it invests. That's not economic theory, that's accounting.

3. If the Fed lowers interest rates then output in Canada will decline.

   UNCERTAIN. *There are two offsetting affects on Canada. First, lower US rates will depreciate the US dollar. This makes Canadian goods more expensive for Americans (and US goods cheaper for Canadians). This will tend to reduce Canada's net exports (assuming Marshall-Lerner holds). However, to the extent that lower US interest rates stimulates the US economy and raises US income, there will be a positive 'income effect' on the demand for Canadian goods. Higher US income will cause Americans to spend more on all goods, including Canadian goods. As an empirical matter, the answer is probably FALSE, ie, the income effect dominates. When the US economy does well, so does the Canadian economy (and vice versa).*

4. Monetary policy becomes less effective if firms engage in 'Pricing-to-Market'.

   TRUE. *In an open economy, part of the transmission mechanism of monetary policy is through the exchange rate and net exports. If firms price-to-market, then the DD curve becomes steeper because a given change in the nominal exchange rate has less effect on the real exchange rate (since exporters adjust their prices in response to exchange rate changes). Therefore, net exports become less responsive to interest rates. See Lecture 6A for more discussion.*

5. China has an undervalued currency.

   FALSE/UNCERTAIN. *If you evaluate relative price levels using a broad based price index (like the CPI) which includes non-traded goods, then this will provide a very misleading picture about whether the exchange rate is over- or undervaluded. That's because wages can differ across countries, and differences in wages will be reflected in the prices of goods. Despite its rapid growth in productivity, China's level of productivity still lags behind the USA. As a result, Chiina's wages are lower (particularly in non-traded goods industries). As a result, the prices of non-traded goods (eg, McDonald's hamburgers) appear lower than in the USA when expressed in a common currency. This is the so-called Balassa-Samuelson model, which the students should mention for full credit. The sense in which this could be uncertain is if one can find tradeable goods that appear cheaper in China. In practice, this can be very difficult to do, since virtually all goods have at least some non-tradeable inputs, and also encounter at least some sort of trade barrier (eg, shipping cost).*

6. (20 points). Use the DD-AA model to explain why Trump's tariffs should have produced an appreciation of the US dollar. In reality, the dollar has actually depreciated somewhat this year. Why do you think this is? Provide two reasons why US tariffs might not lead to dollar appreciation.

   A tariff is a tax on imports. It is designed to make foreign goods more expensive. In response, domestic residents will switch their expenditures toward domestic goods instead. The increased spending on domestic goods will then shift out the DD curve. However, that's not the end of the story. Higher spending and income will tend to raise interest rates (assuming the Fed does not respond), and this will appreciate the dollar. The stronder dollar will tend to offset the effects of the tariff, by lowering the price of foreign goods. That's what happened the first time Trump was President in 2016-20.

   This time the dollar did not appreciate. Why? At least in my opinion, I think there are two main reasons. First, foreign retaliation has been stronger this time. If foreigners do the same thing as the USA and impose their own tariffs on US goods, then this will reduce foreign spending on US goods, which then tends to shift the DD curve back to where it was. As we've seen in the case of Canada, it doesn't even have to be an explicit tariff. If foreigners feel bullied by Trump and react by boycotting US goods and services, then this can have the same adverse effects as an explicit tariff. The second main reason has to do with monetary policy. Trump pressured the Fed during his first term, but this time his pressure campaign has been even more aggressive. He's even tried to fire some of the FOMC memebers. He's doing this because he wants the Fed to 'juice' the economy by lowering interest rates. This could indeed provide some short-run benefits (while Trump is in office), but could have long-term adverse effects, if it causes inflation and reduces the credibility of the Fed (but that's after Trump leaves). So far the Fed has only modestly lowered rates, which has only modestly weakened the dollar. But asset markets are forward-looking, and growing concerns about the independence of the Fed have probably played a more important role in reducing the strength of the dollar.

   This will be a hard question to grade, so please be generous with partial credit. Other explanations that make sense should also be given full credit. If you're not sure, then just email me. I think one argument you might see is that Trump is in reality 'more bark than bite'. He makes a lot of noise about tariffs, but hasn't actually imposed that many, or if he does, they are quickly reversed. So that might be weakening the effects. Also, there are pending *legal challenges to Trumps authority to unilaterally impose these tariffs, so that might also be weakending the effect. These sorts of stories should be given full credit.*

7. (20 points). Recently, the so-called BRIC countries (Brazil, Russia, China, etc) have made efforts to reduce the importance of the US dollar in world trade and payments. Donald Trump has threatened to impose tariffs on them in response.

   (a) Why would Trump do this? Does the USA obtain any economic benefits from having the US dollar be used in world trade and payments?

   (b) Are there any economic costs to the USA in having its currency be used around the world? How might this help explain the persistence of US current account deficits and the decline in US manufacturing?

   Trump has recently complained about two things: (1) US current account deficits, which he thinks are caused by unfair trading practices in other countries, and (2) Attempts by other countries to erode the dominance of the US dollar in world trade and payments. I suspect that mainly for political and 'prestige' reasons, he wants the dollar to remain dominant. The point of this question is that these two issues are related, and not in the way Trump seems to be aware of. In particular, the dominance of the US dollar as an asset, means that the USA has a comparative advantage in selling safe/liquid assets. As a result, it has a financial account surplus. By the rules of double-entry bookkeeping, it necessarily has a current account deficit to offset this. The economic mechanism driving the current account deficit is a strong dollar, which makes US goods expensive for foreigners. The irony of Trump's tariffs that attempt to maintain dominance of the US dollar is that, if successful, they are likely to cause the US current account deficit to persist!

   There are both costs and benefits to having your currency be the world's reserve currency. One big benefit is that it enables the USA to spend more than it earns for long periods of time. That is, it facilitates financing of US fiscal deficits. The US just sells its bonds to China and Japan, and interest rates can stay low. (The exact opposite of Brazil!). If the BRICs are successful, it would force the USA to reduce its fiscal deficits, either by reducing spending or raising taxes. The costs of being a reserve currency are more indirect. In the case of the USA, it has probably contributed to the problem of income and wealth inequality. The people who sell assets to other countries are already rich, while the people who try to sell manufactured goods to foeigners are mainly on the low end of the income distribution. Trump doesn't seem to be overly concerned about wealth inequality, but if he were, he might take a more favorable view to the BRICs policy!

   This is a very open ended question, and these are just my opinions. Please be generous with partial credit! They do not need to say exactly what I said in order to get full credit. As long as their argument makes sense, and is well defended, that is enough.

8. (20 points). Use the DD-AA model to show how monetary and fiscal policies could be used together in order to stimulate output without affecting the current account.

   This is straight from the notes (Lecture 6A). The key is to introduce the XX curve, which shows combos of (E, Y) along which the CA is constant. It is upward sloping, but flatter than the DD curve. For full credit, students should show this. Clearly, to stimulate output without changing the CA, both monetary and fiscal policy need to expand. That is, both the DD and AA curve need to shift out, so that their new point of intersection is along the XX curve.