SIMON FRASER UNIVERSITY

Department of Economics

Econ 842   Prof. Kasa
International Monetary Economics   Spring 2011

FINAL EXAM
(April 12)

Answer the following questions True, False, or Uncertain. Briefly explain your answers. No credit without explanation. (10 points each).

1. The IMF should not bail out countries that are hit by speculative attacks.

2. If financial markets are complete, then countries with relatively rapid consumption growth will experience depreciating real exchange rates.

3. Everyone is always happier in an Arrow-Debreu equilibrium.

4. For most countries, net exports are procyclical.

The following questions are short answer. Briefly explain your answer. Clarity will be rewarded.

5. (20 points). A stylized fact in open-economy macroeconomics is that adverse terms of trade shocks cause net exports to decline initially, and then to gradually increase. Undergraduate macro books often refer to this pattern as the 'J-curve', and explain it by arguing that imports and exports are slow to respond to relative price changes. (A condition called the 'Marshall-Lerner Condition' is often derived, under which net exports will rise after a terms of trade deterioration). How do modern 2-country DSGE models explain the J-curve?

6. (20 points). Briefly describe the 'international consumption correlation puzzle'? Explain how the work of Baxter-Crucini (1995) and Kehoe-Perri (2002) relate to this puzzle.

7. (20 points). Suppose there are 2 countries, Home (H) and Foreign (F). Each has preferences,

$$U = E_0 \sum_{t=0}^{\infty} \beta^t [\alpha \ln(x_t) + (1-\alpha) \ln(y_t)]$$

H receives stochastic endowments of x and F receives stochastic endowments of y. Let X_t and Y_t denote these endowments in period-t. (Both goods are nondurable).

(a) Write down the Pareto problem that characterizes the Pareto Optimal allocation. Assume λ is the Pareto weight on H, and denote the allocations to H by $(x_{H,t}, y_{H,t})$ and the allocations to F by $(x_{F,t}, y_{F,t})$. Solve for the Pareto Optimal allocations.

(b) Now assume a market economy, where there are no financial markets. Countries can only trade goods each period, so that trade must be balanced each period. Assume x is the numeraire, and let p denote the price of good y (in terms of x). Derive an expression for the equilibrium value of p.

(c) Prove that the equilibrium in part (b) is the same as the Pareto Optimum in part (a) when $\lambda = \alpha$. What's going on here? Why is the complete markets outcome (part (a)) the same as the outcome without financial markets (part (b))? Discuss the relevance of this result for measurements of the gains from international portfolio diversification.

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