

SIMON FRASER UNIVERSITY
Department of Economics

Econ 842
International Monetary Economics

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FINAL EXAM
(April 11)

Answer the following questions True, False, or Uncertain. Briefly explain your answers. No credit without explanation. (8 points each).

1. According to Morris & Shin, greater ‘transparency’ will reduce the likelihood of currency crises.
2. According to Van Nieuwerburgh & Veldkamp, allowing investors to endogenously acquire information leads to greater portfolio diversification across countries.
3. According to Cole & Obstfeld, free trade in goods makes international financial markets redundant.
4. The J-curve arises because import demands are relatively inelastic in the short-run.
5. Non-traded goods can explain the lack of international portfolio diversification.

Answer each of the following three questions.

6. (20 points). Briefly describe the “Allocation Puzzle” discussed in the paper by Gourinchas & Jeanne. What evidence do they use to identify this puzzle? On what assumptions is it based? According to Gourinchas & Jeanne, what is driving this puzzle? How does the paper “Growing Like China” relate to this puzzle? Briefly describe other potential explanations.
7. (20 points). Consider a two-country, one-good world where agents in each country have preferences

$$U = \sum_{t=0}^{\infty} \beta^t \frac{c_t^{1-\rho}}{1-\rho}$$

Country-1’s endowment is $y_{1t} = 1$ for all t . Country-2’s endowment is $y_{2t} = \gamma^t$, where $\gamma > 1$.

- (a) Describe the competitive equilibrium with complete markets. (Hint: Consider the Pareto problem).
 - (b) Now suppose agents cannot commit to their Arrow-Debreu contracts, and can go live under autarky at any time. (If they do, assume they can never come back). Derive each agent’s participation constraints (for each t).
 - (c) Does the complete markets allocation in part (a) satisfy the participation constraints? If not, what is the constrained-optimal allocation?
8. (20 points). Consider a symmetric two-country, one-good world in which output fluctuations reflect fluctuations in productivity and labor input (there is no capital). The representative agent in country- i has preferences

$$u(c_{it}, 1 - n_{it}) = \log c_{it} + \gamma \log(1 - n_{it})$$

where c_{it} and n_{it} are consumption and labor in period- t . Output in each country is produced with the linear technology $y_{it} = z_{it}n_{it}$. Each country’s productivity shock is i.i.d. Assume that labor is immobile between countries, and that financial markets are complete.

- (a) Write down the optimization problem that characterizes a Pareto optimum. What is the aggregate resource constraint? Derive the first-order conditions. (Hint: Since there is no capital, and the productivity shocks are i.i.d., the problem is essentially static, so it is sufficient to consider only one period).
- (b) For simplicity, assume the Pareto weights are equal. Solve for the Pareto optimal (and competitive equilibrium) allocations of consumption and labor in both countries.
- (c) Explain why output in country 1 depends on the productivity shock in country 2, even though labor is internationally immobile.