SIMON FRASER UNIVERSITY
Department of Economics

Econ 345 — Prof. Kasa
International Finance — Fall 2016

PROBLEM SET 3
(Solutions)

The following questions are short answer. 25 point each.

1. So, Trump won the election. Since the election, the US dollar has appreciated, and the US stock market and interest rates have risen. Was Trump's election a shock to the DD curve or the AA curve? Illustrate your answer with a graph. Given that Canada has a floating exchange rate against the US dollar, is this good news or bad news for Canada? Again, illustrate your answer with a graph.

   A strong US dollar could either be caused by downward shift of the AA curve (e.g., monetary contraction), or an outward shift of the DD curve (e.g., fiscal expansion). The fact that growth is picking up (note, the stock market is rising), suggests that it is the DD curve that is shifting out, rather than the AA curve shifting in. (A downward shift of the AA curve would have caused growth to slow down, not speed up).

   The second part of the question is very similar to Question 2 from the last problem set. The only difference is that Canada has floating exchange rate, not a fixed one. An outward shift of the USA DD curve is probably good news for Canada, for two reasons: (1) It weakens the Canadian dollar, and therefore increases net exports, (2) It produces higher output in the USA, which leads to a positive income effect in the demand for Canadian exports. (Of course, there is a lot more going on here. It could well be that Trump is a disaster for Canada, if he starts ripping of NAFTA, and so on).

2. Read the blog post by Brad Setser entitled "China, Manipulation, Day One, the 1988 Trade Act, and the Bennet Amendment" (which is linked on the course webpage). According to Setser, should the new Trump administration accuse China of being a "currency manipulator"? Why or why not? (Hint: What has been the nature of China's recent foreign exchange market intervention?)

   Setser argues that accusing China of being a currency manipulator would be a big mistake. Besides all the political fallout, he notes that recently China has been intervening in order to support the value of the RMB (i.e., selling foreign reserves). So if the aim is to keep China from intervening in the fx market, the likely effect would be an accelerating depreciation of the RMB, which would make it even tougher for USA firms to sell products in China. This is probably not the outcome the new Trump administration is aiming for.