

SIMON FRASER UNIVERSITY
Department of Economics

Econ 446
Seminar in International Finance

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MIDTERM EXAM

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

1. Governments that fix their exchange rates should not choose policy optimally, since we know from Obstfeld's model that if they do optimize, there will be multiple equilibria and the potential for self-fulfilling currency crises.
2. In Krugman's original 'first-generation' model, a speculative attack will not occur if money demand only depends on income.
3. In Krugman's original 'first-generation' model, a currency crisis is inevitable. The model only determines the nature and timing of the crisis.
4. According to Krugman (in "Analytical Afterthoughts on the Asian Crisis"), if the economy is subject to adverse 'balance sheet effects' (i.e., borrowing constraints with unhedged foreign currency exposures), then in the event of a speculative attack the appropriate monetary policy response should be to cut interest rates and expand the money supply.

Answer 3 of the following 5 questions. Clarity will be rewarded. (20 points each).

5. Using the concept of the "shadow exchange rate", illustrate with a graph how first generation crisis models determine the date of a currency crisis. Be sure to first define the shadow exchange rate. Also, be sure to explain the role of arbitrage in ruling out all other potential attack dates.
6. During the Gold Standard (1870 - 1913) exchange rate changes were rare. In contrast, these days countries that attempt to fix their exchange rates are often forced to devalue within a few years. What might explain the difference?
7. In his article, "The Global Capital Market: Benefactor or Menace?", Maurice Obstfeld refers to an "Open-Economy Trilemma", which describes the constraints and trade-offs facing monetary policy in open economies. Briefly describe the nature of these constraints. That is, given the goals of (i) Open capital markets, (ii) A stable exchange rate, and (iii) An independent monetary policy that is free to stabilize the economy, explain why in general a country can achieve only two of them. How does Obstfeld use this Trilemma to explain the evolution of the international monetary system?

8. Briefly discuss the contrasting policy implications of first- and second-generation currency crisis theories. Which is more supportive of IMF-style “rescue packages”?
9. Third-Generation currency crisis models were developed to explain why devaluations are often followed by recessions. Briefly explain how they do this. What is the role of “Balance Sheet Effects”?