SIMON FRASER UNIVERSITY
Department of Economics

Econ 345 Prof. Kasa
International Finance Fall 2010

PROBLEM SET 3 - Solutions

The following questions are short answer. 30 points each.

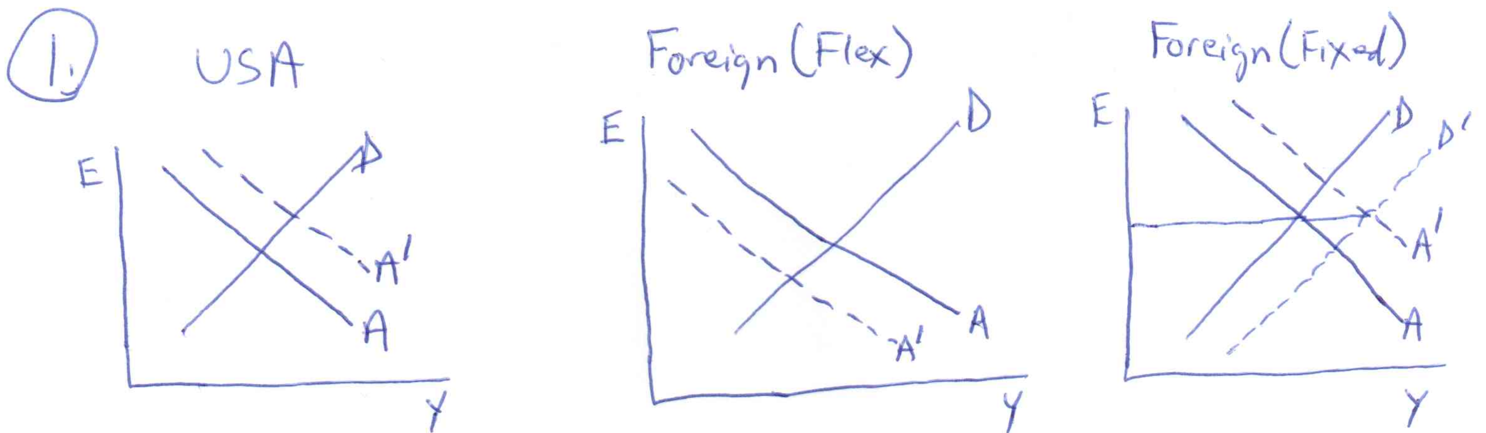
1. *If the QE2 policy has its intended effect, it will shift out the AA curve in the U.S. The effect of this on other countries depends on whether they maintain a fixed or flexible exchange rate vis-a-vis the U.S. If they allow their currency to float, then their AA curve shifts* <u>*left*</u> *(why?). As their currency strengthens, exports decline and output falls. If these countries are already suffering from low demand, then this would make a bad situation worse. (Example - Japan, Korea, Brazil, etc?). If a foreign country pegs to the dollar, then its AA curve shifts out, just as it does in the U.S. (due to purchases of foreign exchange). In addition, its DD will shift out as well, due to lower interest rates, which increase spending for any given exchange rate. These shifts tend to* <u>*stimulate*</u> *output in the foreign economy. If they are suffering from low demand too, then this would be a good thing, and they should send the U.S. a thank you note. However, if they are already at full employment, and are instead worried about inflation, they might be upset by this policy. (Example - China?).*

   See the next page for graphs. (Note, for simplicity, these graphs neglect the potential effect of higher U.S. income on U.S. demand for foreign goods. This would tend to shift out the foreign DD curves, thus softening the blow in countries like Japan and Korea, while further fanning the flames in countries like China).

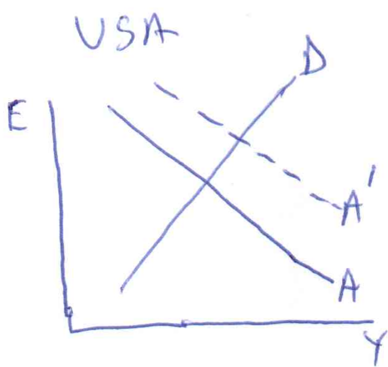
2. *Canada has a flexible exchange rate against the U.S., so a U.S. monetary expansion will shift Canada's AA curve to the* <u>*left*</u>*. The Canadian dollar rises in value, net exports decline, and output falls. If Canada is also in a recession (which is usually, but not always, the case), then this would be a bad policy for Canada. On the other hand, if the Canadian economy was experiencing high employment and rising inflation, then the U.S. monetary expansion could actually be good for Canada. A U.S. fiscal expansion causes the U.S. DD curve to shift out. This raises U.S. interest rates and strengthens the U.S. dollar. In Canada, the AA curve shifts out (why?), the Canadian dollar depreciates, net exports rise, and output increases. Thus, if Canada was in a recession at the same time as the U.S., they would prefer a U.S. fiscal expansion.*

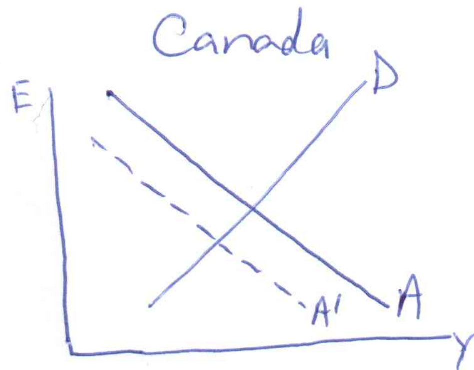
   See the next page for graphs. (Again, for simplicity, I neglect the potential effects of higher U.S. output on the demand for Canadian exports, and hence on Canada's DD curve. In this particular case, this is likely to be an important consideration, so much so that Canada would likely benefit from either policy (assuming of course that it too is in a recession).

Graphs



2.) a.) Monetary





b.) Fiscal