

SIMON FRASER UNIVERSITY
Department of Economics

Econ 345
International Finance

Prof. Kasa
Spring 2013

PROBLEM SET 1
(Due February 8)

Questions 1-3. Answer True, False, or Uncertain. Briefly explain your answer. No credit without explanation (5 points each).

1. Current Account surpluses are a sign that a country's economy is strong.
2. According to Uncovered Interest Parity, exchange rate changes should be predictable.
3. Purchasing Power Parity does not apply to China, since it pegs its currency to the US dollar.

The following questions are short answer. Clarity and conciseness will be rewarded!.

4. (10 points). Suppose the 12-month forward price of the pound in terms of C\$ is 1.5 C\$ per pound. Suppose the spot price of the pound in terms of C\$ is 1.4. Next, suppose that currently the annual interest rate in Canada is 3%, while the annual interest rate in Britain is 5%. There are no transactions costs. Is there an arbitrage opportunity here? If so, explain exactly how you would take advantage of this situation to make riskless profits.
5. (25 points). Read the article entitled "Birth Pains", which is posted on the course webpage (from *The Economist*). According to this article, why is there a tension between borrowers and lenders, and how has the international financial system resolved this tension in the past? According to this article, what was the connection between rapid growth in China and India and the recent international financial crisis? According to this article, what might the future international system look like? Why?
6. (25 points). Read the article by Paul Krugman entitled "Taking On China", which is posted on the course webpage (from the *New York Times*). According to Krugman, is China's exchange rate policy good or bad for the rest of the world? Why? According to Krugman, how should the USA respond to China's exchange rate policy? What would happen if China responded by selling US assets?