

SIMON FRASER UNIVERSITY
Department of Economics

Econ 345
International Finance

Prof. Kasa
Spring 2013

PROBLEM SET 2
(Due March 22)

1. (20 points). Use the DD-AA model to compare and contrast how Canada and China respond to a U.S. monetary expansion (i.e., an increase in the U.S. money supply or a cut in U.S. interest rates). [Hint: Canada has a flexible exchange rate against the U.S. dollar, and China has a fixed exchange rate against the U.S. dollar].
2. (20 points). Explain why China might want to ‘sterilize’ its purchase of U.S. dollar assets. Use a graph to illustrate your answer. How could you tell whether China was indeed sterilizing? Are there any costs to China from pursuing this policy?
3. (20 points). The Greek economy has suffered a lot recently. Many people argue that what they need to do is devalue their currency. However, Greece is part of the eurozone, so that is not an option. Recently, some people have argued that Greece could use *fiscal policy* to replicate many of the effects of a currency devaluation. Use the DD-AA model to show how fiscal policy could be used, even with a totally fixed exchange rate as in a common currency area, to stimulate domestic demand and employment (while not exacerbating an already problematic government budget deficit). [Hint: See the recent working paper, “Fiscal Devaluations” by Emmanuel Farhi, Gita Gopinath, and Oleg Itskhoki].