

SIMON FRASER UNIVERSITY  
Department of Economics

Econ 345  
International Finance

Prof. Kasa  
Spring 2014

PROBLEM SET 1  
(Due February 6)

1. (10 points). The current account deficit and the government budget deficits are often described as being “twin deficits”. Why is this? Using National Income Accounting, explain under what circumstances an increase in the government budget deficit will cause an increase in the current account deficit.
2. (10 points). Suppose the 12-month forward price of the yen in terms of C\$ is 0.0106 C\$ per yen. Suppose the spot price of the yen in terms of C\$ is 0.01. Next, suppose that currently the annual interest rate in Canada is 4%, while the annual interest rate in Japan is 2%. 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.
3. (15 points). Read the article entitled “China, New Financial Superpower” by Brad Setser, which is posted on the course webpage. According to this article, will China’s currency become the new international reserve currency? Why or why not? How does the current situation in China compare to the cases of the UK in the 1800s, and the USA in the 1900s?
4. (15 points). A recent article in a Canadian newspaper argued that Bank of Canada policy is causing the Canadian dollar to depreciate. (It has depreciated by about 10% during the past few months). Explain how the Bank of Canada could do this. Illustrate your answer with a graph that depicts simultaneous equilibrium in the foreign exchange and domestic asset markets. Why might the Bank of Canada want to do this?