

SIMON FRASER UNIVERSITY
Department of Economics

Econ 305
Intermediate Macroeconomic Theory

Prof. Kasa
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PROBLEM SET 4
(Solutions)

1. (25 points). Some people argue that China should let its exchange rate float more freely against the US dollar. Others argue that the peg has served China well, and it would be a mistake to let the RMB float. Use the Keynesian Mundell-Fleming model discussed in class to evaluate the pros and cons of allowing greater exchange rate flexibility. Under what conditions would greater exchange rate flexibility be good for China, and under what conditions would it be bad. Use graphs to illustrate your answer.

Output will be more stable with a fixed exchange rate if most shocks occur in the money/financial markets. By fixing the exchange rate, the central bank will automatically accommodate shifts in money demand or money supply. However, if most shocks are to the goods market (IS shocks) then a fixed rate would make output more unstable, since it would produce a procyclical monetary policy. In this case, a flexible exchange rate would be better. (They should provide and describe the relevant graphs for full credit).

2. (25 points). Many people are currently wondering when the USA will raise its short-term interest rate. Use the Keynesian Mundell-Fleming model to predict the consequences for Canada of an increase in US interest rates. Use graphs to illustrate your answer. Will it be good or bad for Canada? Why? (Remember, Canada has a flexible exchange rate with the USA).

Higher interest rates in the USA will cause the US dollar to appreciate relative to the Canadian dollar. This will stimulate net exports in Canada, shift out Canada's IS curve, and so increase output in Canada. So don't worry Canada!