

SIMON FRASER UNIVERSITY
Department of Economics

Econ 345
International Finance

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FINAL EXAM
(Solutions)

Questions 1-5. Answer True, False, or Uncertain. Briefly explain your answer. No credit without explanation (8 points each).

1. When the USA cuts interest rates, output in other countries declines.

UNCERTAIN. *It depends on whether the country has fixed or flexible exchange rates against the dollar. With flexible rates, a cut in US interest rates will tend to reduce foreign output, since a depreciation of the US dollar will reduce foreign net exports. (Note: Students might mention the fact that if US output expands, this might offset the exchange rate effect, and so foreign output could still increase. However, they don't need to say this for full credit.) If the foreign country has a fixed exchange rate, then it too must lower its interest rates, and so its output would tend to also increase.*

2. According to Mundell's Optimum Currency Area criteria, a country should not join a Monetary Union if it trades a lot with the countries that belong to the union.

FALSE. *With more trade, the efficiency gains from sharing a common currency are greater. The stability loss is also likely to be lower.*

3. Devaluations increase domestic output.

UNCERTAIN/TRUE. *If the devaluation is unanticipated, and not expected to occur again, then devaluations will tend to increase domestic output, since they make domestic goods more competitive on world markets. However, if a devaluation signals the possibility of future devaluations, then the resulting capital flight can be contractionary.*

4. Currency crises occur when investors suddenly realize that a peg is unsustainable.

FALSE/UNCERTAIN. *Of course, it is possible that currency crises occur in response to a sudden realization that a peg is unsustainable, the main point of first-generation currency crisis theories is to show that this is not necessarily the case. In those models, everyone knows ahead of time that the peg is ultimately unsustainable, and it only collapses when the 'shadow exchange rate' reaches the pegged value. Bottom-line - currency crises don't necessarily have to be surprises.*

5. Fiscal policy is more effective at influencing output when the exchange rate is fixed than when the exchange rate is flexible.

TRUE. *With flexible rates, expansionary fiscal policy tends to appreciate the exchange rate and crowd-out net exports. With fixed rates, expansionary fiscal policy must be*

accompanied by expansionary monetary policy, to keep the exchange rate from appreciating. Hence, there is no crowding-out, and output increases more.

The following questions are short answer. 20 points each.

6. Suppose China decides to let its currency float, so that its exchange rate becomes flexible. Describe how its economy would respond to both internal and external shocks. (Hint: Consider both goods market and financial market shocks). Would China's economy become more or less stable?

It depends on whether goods market (DD curve) or financial market (AA curve) shocks are more important. If goods shocks are more important, then output in China would likely be more stable with flexible exchange rates. If financial market shocks are more important, then China's output would likely be less stable with flexible exchange rates. China's output would likely be more stable in response to external shocks if it had flexible exchange rates.

7. China is widely suspected of 'sterilizing' its recent purchases of U.S. dollar assets. Explain how you would examine the validity of this claim (e.g., what data would you look at, and how would you use it to decide whether China sterilizes its reserve inflows). Why might China want to do this? Are there any costs associated with this policy?

Sterilization operations show up on the balance sheet of the Central Bank. To check whether China is sterilizing, you should look to see if the Bank of China's purchases of US treasury bills is matched by sales of domestic government bonds. China might want to do this in order to prevent excessive money creation and inflation. Without sterilization, central bank purchases of US assets would increase the Chinese money supply, and this would tend to lower interest rates, and potentially create financial market 'bubbles'. The cost from doing this is that the Chinese government ends up holding low interest US assets, and paying higher interest on its domestic bonds.

8. What was the 'Bretton Woods System'? When was it in operation? How did it function? Why did it collapse? What lessons does it offer for recent efforts to reform the international financial system?

You can just use the entry under 'Bretton Woods' in the attached glossary.