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Econ 842 International Monetary Economics Prof. Kasa Spring 2016

FINAL EXAM (April 13)

Questions 1-4. Answer True, False, or Uncertain. Briefly explain your answer. No credit without explanation (10 points each).

- 1. China's recent current account surpluses suggest that its currency is undervalued.
- 2. When countries can only trade bonds, their consumption will be less correlated with each other.
- 3. Public information makes currency crises more likely.
- 4. According to Gourinchas and Jeanne's (2012) "Allocation Puzzle", international capital flows in the 'wrong' direction because countries experiencing relatively rapid productivity growth don't invest enough.

The following questions are short answer. 30 points each.

- 5. Describe the motivation, results, and methodology of Kehoe and Perri's (2002) paper, "International Business Cycles with Endogenous Incomplete Markets". What do they mean by the phrase 'endogenous incomplete markets'? What are the paper's successes and failures? Do you think it justifies a case for restrictions on international capital flows? Why or why not.
- 6. Debt Overhang and Debt Forgiveness. Or, Is Bono Right? Consider a small open economy that inherits a large debt, *D*, which is scheduled to be paid off in the second period. A representative agent in the country has the utility function

$$U = \log C_1 + \beta \log C_2$$

First-period endowment income is Y_1 . Capital depreciates by 100% during production, so second-period output is just $Y_2 = I^{\alpha}$, where $I = K_2$ is date-1 investment. In the secondperiod, foreign creditors will be able to force the country to pay ηY_2 in debt repayments. (Assume the debt is so large that the country cannot fully repay it even if it invests all its resources).

- (a) Write down the country's optimization problem, and solve for its optimal choice of investment, I^* , and the associated level of debt repayment, $\eta(I^*)^{\alpha}$.
- (b) Now assume that at the beginning of period-1, creditors decide to partly forgive the country's debt, writing down the face value to $\eta(I^*)^{\alpha}$, the amount they expect to be repaid if they do nothing. Does this cost the creditors anything? Is the debtor country better off? Explain intuitively.
- (c) Suppose the creditors are heartless profit maximizers. Is the strategy in part (b) optimal for them? Briefly describe their optimal strategy.