

SIMON FRASER UNIVERSITY
Department of Economics

Econ 446
Seminar in International Finance

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MIDTERM EXAM
(October 16)

Answer the following questions True, False, or Uncertain. Briefly explain your answer. No credit without explanation. (10 points each).

1. It is not possible for a country to have perpetual current account deficits.
2. Positive productivity shocks produce current account deficits (or reduce current account surpluses).
3. Increased government spending leads to current account deficits (or reduced current account surpluses).
4. It is not possible for a country to have both a trade deficit and a current account surplus.
5. A terms of trade improvement (i.e., an increase in the relative price of a country's exports), will produce a current account surplus (or reduce a deficit).

The following questions are short answer. Clarity will be rewarded.

6. (25 points). Briefly describe the 'Feldstein-Horioka Puzzle'. On what evidence is it based? According to Feldstein and Horioka, what do their results imply about the degree of international capital market integration? Briefly discuss three caveats to their conclusion.
7. (25 points). Consider a 2-period world economy consisting of two countries. Each has preferences

$$U(C_1, C_2) = \ln(C_1) + \ln(C_2)$$

The Home country has endowments $Q_1 = 1$ and $Q_2 = 2$. The Foreign country has endowments $Q_1^* = 2$ and $Q_2^* = 1.3$. Both countries have open capital markets, and both begin with zero net foreign assets.

- (a) Compute the equilibrium world interest rate. (Hint: Equilibrium requires $S(r) + S^*(r) = 0$, where $S(r)$ and $S^*(r)$ are the Home and Foreign saving functions, e.g., $S(r) = Q_1 - C_1(r)$).
- (b) Given this interest rate, what are the equilibrium values of Home consumption, C_1 and C_2 . Use the above utility function to then compute Home utility.
- (c) Now suppose the Foreign country experiences a higher growth rate. In particular, suppose $Q_2^* = 2.5$, with all other endowments remaining the same. What is the new world interest rate? What is Home utility now? Is Foreign growth good or bad for the Home country? Explain.