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Econ 345 International Finance Prof. Kasa Spring 2010

## FINAL EXAM

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

1. China's output would become more stable if it adopted a flexible exchange rate.

UNCERTAIN. It depends on what kinds of shocks are the most important for China. If 'real' shocks are more important, then a flexible rate would produce more stability. However, if 'nominal' or financial market shocks are more important, then a fixed rate would produce more stability.

2. The IMF should not bail out countries that are hit by a currency crisis.

UNCERTAIN. It depends on why the crisis is happening. If it occurs because of inconsistent domestic macroeconomic policy (i.e., first-generation), then bailing out would be counterproductive. It would just create moral hazard. However, if a crisis represents a sudden switch to a 'bad equilibrium' (ie, second-generation), so that the event is primarily due to a self-fulfilling panic, then one could justify a bailout. In fact, a preannounced policy of bailouts could actually make crises less likely, despite the moral hazard they create.

3. Countries that have fixed exchange rates and Balance of Payments deficits will have relatively high inflation rates.

FALSE/UNCERTAIN. Balance of Payments deficits cause the domestic money supply to contract. This is because the central bank must sell fx reserves to keep the exchange rate fixed (in exchange for domestic money, which then goes out of circulation). Lower money growth will then produce lower inflation. Then, as domestic prices fall relative to foreign prices, domestic goods become more competitive and the BOP deficit will eventually be eliminated. This is just Hume's 'price-specie-flow mechanism'. (For full marks they should mention this). It could be uncertain if the domestic central bank is sterilizing its reserve loss by purchasing domestic assets, although this can't last forever since it will eventually deplete its fx reserves.

4. If Europe responds to the Greek debt crisis by partially monetizing it, then output in the USA will fall.

TRUE. The USA has a flexible exchange rate vis-a-vis the euro. If Europe partially monetizes Greece's debt (i.e., the ECB prints euros to pay Greece's bills) then the euro will depreciate. The will switch expenditure toward European goods, and reduce U.S. net exports. Ceteris paribus, this will reduce output in the USA.

5. Currency crises cannot occur if investors have Rational Expectations.

FALSE. In conventional currency crisis models, crises occur <u>because</u> investors have Rational Expectations. In fact, in the first-generation model discussed in class, there is no uncertainty, and investors perfect foresight, the ultimate in Rational Expectations. In the second-generation model we discussed, there are multiple equilibria, and the switch to the crisis equilibrium is based on a self-fulfilling (i.e., rational) belief that a crisis will occur.

The following questions are short answer.

6. (20 points). Recently the Canadian dollar has been appreciating and output has been growing rapidly. Use the DD-AA model to provide a potential explanation of why this is happening. That is, what kind of underlying shifts in the economy must be taking place? Based on your answer, is expansionary monetary policy likely playing a major role in the recovery? (It might help to use a graph to illustrate your answer).

The combination of rising output and an appreciating currency is indicative of a rightward shift in the DD curve, perhaps due to increasing optimism about the future which increases investment, or fiscal stimulus, or an exogenous rise in net exports due to a foreign recovery. If monetary policy had played a major role, the rightward shift of the AA curve would have produced a weaker currency, so by itself, monetary policy was not likely a major factor. The main caveat concerning this conclusion arises from the fact that what matters for the exchange rate is <u>relative</u> monetary policy, and it could well be that a simultaneous cut in interest rates in both the U.S. and Canada has an expansionary effect on output with little or no effect on the exchange rate.

7. (20 points). According to Mundell, in his article "A Reconsideration of the Twentieth Century", why did attempts to restore the pre-World War I gold standard fail? According to Mundell, what should have been done differently?

They failed because countries tried to peg at the pre-war price of gold. The war was partially financed by the inflation tax. Price levels had risen significantly. Pegging the exchange rate at the pre-war price of gold required price levels to go back down, which required a monetary contraction. Due to nominal rigidities this tended to produce a recession, and in fact, most countries did experience a recession in the early 1920's. According to Mundell, a simple fix would have been to return to gold at a devalued rate, roughly in proportion to the increase in the overall price level. Eventually, this is what happened, but it wasn't until the depression was in full swing.

8. (20 points). The data suggest that current account balances are typically 'countercyclical' (i.e., surpluses (or reduced deficits) during recessions, and deficits (or reduced surpluses) during booms). According to the DD-AA model, what kinds of shocks must be driving the cycle (i.e., real shocks or financial market shocks)? Again, it might help to use a graph to illustrate your answer.

They should start with a DD-AA graph with the XX curve included, which shows (E, Y) combinations that produce a constant current account balance. As long as Marshall-Lerner holds, this is an upward sloping curve that is flatter than the DD curve. Points above XX represent an increased surplus (or reduced deficit). Points below it represent a reduced surplus (or increased deficit). Clearly, if on average increases in Y are associated with a reduction in NX, then shifts in the DD curve (ie, 'real/demand' shocks) must be doing most of the work. If instead monetary shocks were driving the cycle then the current account would tend to be procyclical. (Of course, there is a perhaps better explanation based on dynamic intertemporal models and the effects on persistent productivity shocks that increase investment and output, while reducing net exports. This explanation is based on supply-side considerations and has nothing to do with sticky prices. Don't penalize anyone if they mention this possibility!