SIMON FRASER UNIVERSITY
Department of Economics

Econ 446 — Prof. Kasa
Seminar in International Finance — Fall 2009

FINAL EXAM - December 11

Answer the following questions True, False, or Uncertain. Briefly explain your answers. No credit without explanation. (5 points each).

1. Countries that peg their exchange rate give up control of their domestic monetary policy.
2. According to Mundell's Optimum Currency Area Criteria, a country should not join a Monetary Union if its business cycles are highly correlated with those of the countries that belong to the union.
3. According to Purchasing Power Parity, high inflation countries should have depreciating currencies.
4. Uncovered Interes Parity does not hold under fixed exchange rates.
5. Currency crises cannot occur if investors have rational expectations.

   The following questions are short answer. Be sure to explain and interpret your answer. Clarity and conciseness will be rewarded.

6. (15 points). Travelers from the U.S. and Canada often find that services and other nontraded goods are much less expensive in developing countries. Briefly explain how the Balassa-Samuelson theory of real exchange rate determination accounts for this observation.
7. (20 points). It is often argued that asset prices should follow random walks if financial markets are efficient. According to the Monetary Model of exchange rate determination, under what conditions will the exchange rate follow a random walk? In general, does the ability to predict the future exchange rate signal a violation of market efficiency? Why or why not?
8. (20 points). According to Obstfeld and Rogoff (2009), in their article entitled "Global Imbalances and the Financial Crises", what role did global imbalances play in the recent financial crisis? Briefly discuss their recommendations for reducing the risk of future crises.
9. (20 points). **First-Generation Currency Crises**. Consider a small open economy that is unilaterally pegging its exchange rate at $\bar{e}$ (expressed as the price of foreign currency, and in log terms). Assume PPP always holds, so that $e = p - p^*$ (again, expressed in logs). For simplicity, assume the foreign price level and interest rate are constant. Next, suppose domestic money demand is given by (ignoring the effects of income for simplicity):

$$m - p = -\phi i$$

where m is the log of the domestic money supply, and i is the domestic nominal interest rate. Finally, assume the government runs a persistent fiscal deficit that is financed by money creation, so that $dm/dt = \mu$, and that the government pegs the exchange rate until it runs out of reserves, at which point it lets the exchange rate float.

(a) Derive expressions for the 'shadow' exchange rate and the central bank's holdings of foreign exchange reserves.

(b) Will there be a currency crisis? If so, can you calculate when it will happen?

(c) Sketch the time paths of the money supply, international reserves, the interest rate, and the exchange rate.

(d) What are the pros and cons of this model of currency crises?