

SIMON FRASER UNIVERSITY  
Department of Economics

Econ 345  
International Finance

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MIDTERM EXAM

Questions 1-4. Answer True, False, or Uncertain. Briefly explain your answer. No credit without explanation (5 points each).

1. A depreciation of the (real) exchange rate increases net exports.
2. Equilibrium in the foreign exchange market predicts that interest rates and exchange rates (defined as the price of foreign currency) are negatively correlated.
3. According to the Balassa-Samuelson theory of real exchange rates, rapid productivity growth in the tradeable goods sector produces an appreciation of the real exchange rate.
4. In open economies with flexible exchange rates, fiscal policy is more effective than monetary policy at influencing the level of output.

The following questions are short answer. 15 points each.

5. Since an exchange rate is the relative price of two currencies, standard theories of exchange rate determination try to explain exchange rates in terms of relative money supplies and variables that influence relative money demands (e.g., relative income levels). One potential problem with these theories is that exchange rates are much more volatile than relative money supplies or relative income levels.

Briefly explain how the concept of exchange rate ‘overshooting’ can help to explain why exchange rates are so volatile. Illustrate how the economy responds over time to a permanent money supply increase. Explain intuitively why overshooting occurs.

6. Using the DD-AA model, illustrate the short-run and long-run effects of a permanent 20% reduction in the money supply. Assume the economy is initially in long-run equilibrium (i.e., output equals its full employment level).