

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. If a country has a current account deficit then it is accumulating foreign assets.
2. Exchange rate overshooting cannot occur unless goods prices are “sticky”.
3. Suppose the one-year riskless interest rate in Canada is 4%, and the one-year riskless interest rate in the U.S. is 7%. Then according to Uncovered Interest Parity, investors must be expecting the Canadian dollar to appreciate against the U.S. dollar by 3% during the next year.
4. Fiscal expansions (e.g., an increase in government spending or a cut in taxes) leads to an increase in net exports.

The following questions are short answer. 15 points each.

5. Travelers from the U.S. and Canada often find that services and other non-traded goods are much less expensive in developing countries. Briefly explain how the Balassa-Samuelson theory of real exchange rate determination accounts for this observation.
6. Suppose the U.S. Federal Reserve raises U.S. interest rates. Use the DD-AA model to illustrate how this affects the Canadian economy. In particular, what happens to output and the exchange rate. How does the answer depend on whether the rate increase is perceived to be permanent or temporary? How could Canadian policy makers use monetary and fiscal policy to stabilize the economy? Does it matter which one is used? Briefly discuss the pros and cons of monetary vs. fiscal policy. (Note: When answering this, assume the only effect is an increase in foreign interest rates. Ignore the possibility that output in the U.S. might change, and how this might in turn affect the Canadian economy. We will talk about this *after* the midterm!).