SIMON FRASER UNIVERSITY
Department of Economics

Econ 345
International Finance

Prof. Kasa
Fall 2024

PROBLEM SET 2
(Solutions)

1. (25 points). To the surprise of many, Donald Trump was re-elected president of the USA on November 5th. One of his main campaign promises was to impose tariffs on imports. Since Republicans will also control Congress, this is very likely to happen.

   (a) Use the DD-AA model to illustrate the short-run effects of this policy on the US economy. Compare and contrast how this policy will affect China and Canada. (Hint: China has a fixed exchange rate with the USA, while Canada has a flexible rate). To keep things simple, ignore the possibility that foreign countries might retaliate.

   The Trump tariff will shift the US DD curve out and to the right. At the same time, it will shift the DD curve to the left in China and Canada. What happens next depends on the exchange rate regime. Because Canada has a flexible rate with the USA, the US dollar will appreciate (and the C$ will depreciate). This will partially offset the effects of the tariff/tax on relative prices, so that US net exports vis-a-vis Canada will not increase as much as Trump expects. (Note, the C$ has been dropping since Trump announced the tariff, in anticipation of this). As a result, the stimulus experienced by the USA will likely be less than Trump expects, and the negative effect on Canada will be less than feared. The effects on China depend on what the PBOC does. If they stick to the dollar peg, then they must contract monetary policy (ie, match the higher interest rate in the USA). This would <u>increase</u> the negative effects on China, and make the Trump tariff more effective for the USA. Of course, last time (in 2017-18) China allowed its currency to depreciate, which would partially offset the effects of the tariff. In this case, the effects on China would be like those on Canada. Bad, but not so bad because of the exchange rate response.

   (b) Again use the DD-AA model to illustrate the long-run consequences of this policy. Will America's standard of living improve, as predicted by Trump?

   Even if the Trump tariff stimulates the US economy, in the long-run it could produce inflation if output increases beyond 'full employment', as wages and prices rise in response. The increasing price level will shift both the DD and AA curves to the left until they intersect at the full employment level of output. So unless the US economy is currently operating well below potential, it is very unlikely that the Trump tariff will have any lasting positive effect (and this even ignores the very real possibility that Canada and China will retaliate.)

   Side note: Many people suspect these tariffs are politically motivated, not economically motivated. Trump wants Canada and Mexico to clamp down on the border and China to stop shipping fentanyl to Mexico. If they do, then maybe the tariffs will not materialize. Obviously, students don't need to mention this for full credit.

2. (25 points). Read the article entitled "The Trilemma of International Finance", by Mankiw, which is posted on the class webpage. According to this article, what is the Trilemma of International Finance? Provide examples of countries that have chosen each policy combination of the trilemma triangle.

The Trilemma refers to policy trade-offs in small open economies. Each country would like to achieve the following 3 goals: (1) Open capital markets, which maximize the wealth of the economy, and allow the savings decisions of households to be separated from the investment decisions of firms, (2) Stable exchange rates, which reduce risk and encourage long-term international investment, and (3) An independent monetary policy, which allows a country's central bank to respond to domestic macroeconomic conditions. As discussed in class, in general a country can only guarantee itself two of these goals. One must be sacrificed. Current examples of countries/regions that have resolved this trade-off in different ways are the following: (1) China has opted for a stable exchange rate (against the US dollar) and an independent monetary policy. As a result, they must impose capital controls. Europe has opted for a stable exchange rate (in fact, a common currency!) and open capital markets, but as a result, individual countries within Europe cannot set their own monetary policy. The ECB in Frankfurt sets monetary policy for all of Europe (or at least those countries that belong to the Eurozone). Finally, the US and Canada have opted for open capital markets and independent monetary policy. As a result, they must allow their exchange rates for fluctuate. (For more on this question, read the posted article "Two Out of Three Ain't Bad").