

SIMON FRASER UNIVERSITY  
Department of Economics

Econ 345  
International Finance

Prof. Kasa  
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FINAL EXAM  
(Solutions)

The first four questions are True, False, or Uncertain. Briefly explain your answers. No credit without explanation. (10 points each).

1. Uncovered Interest Parity does not hold when a country fixes its exchange rate.

FALSE. *UIP still holds with fixed exchange rates. It simply says that the domestic interest rate must equal the foreign interest rate. A good example is Hong Kong. In practice, many fixed exchange rate regimes are combined with capital controls, in which case UIP need no longer hold. But students do not need to mention this for full credit.*

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

UNCERTAIN. *This is True if a crisis is generated by inconsistent macroeconomic policies (1st generation), but False if a crisis is generated by multiple equilibria (2nd generation).*

3. Sterilized intervention is ineffective if investors are risk-neutral.

TRUE. *Sterilized intervention works by influencing the risk premium in the foreign exchange market. If investors are risk neutral, then obviously there is no risk premium. The only caveat here is that some people have argued that sterilized intervention might play the role of a signal about future monetary policy, in which case it could be effective even with risk neutrality. But students do not need to mention this for full credit.*

4. Output in Canada would become more stable if it adopted the US dollar as its currency.

UNCERTAIN. *A common currency is the ultimate fixed exchange rate. Whether Canada's economy would become more stable depends on which kind of shocks are more important. It would be True (more stable) if most shocks are to financial markets (AA curve), but would be False if most shocks are 'real' (DD curve shocks).*

5. (30 points). On November 29, 2024, an article entitled "Brazilian Real Hits All-Time Low as Investors Doubt Cost Savings Plan" appeared in the *Financial Times*. It states

*Brazil's currency dropped to a record low on Thursday as a government promise to find cost savings over the next 2 years failed to calm investors' nerves over the public finances of Latin America's largest economy.*

In class, we showed that increased government spending (or a small decrease than expected, as in the article) causes the exchange rate to appreciate, since the DD curve shifts out. Why do you think Brazil's currency depreciated when an anticipated fiscal contraction failed to materialize? (Hint 1: Remember, fiscal and monetary policy are linked via the government budget constraint. Hint 2: What causes a currency crisis in 1st generation currency crisis models?)

*The key issue here is the financing of fiscal policy. Our in class discussion of the effects of fiscal policy implicitly assumed bond financing. That's a safe assumption for countries like the USA and Canada.*

*However, countries like Brazil have a tough time selling bonds, due to their history of defaults. Instead, their deficits are mainly financed by printing money. This is what 1st generation currency crisis models assume. As a result, news that Brazil's fiscal deficit will remain high caused investors to expect higher future money growth (outward shift of AA). That's why it triggered a currency depreciation rather than appreciation.*

6. (30 points). Recently, Donald Trump announced that he would impose 100% tariffs on the BRIC countries (Brazil, Russia, China, etc.) if they continue their efforts to replace the US dollar in world trade and payments.
- (a) Why would he do this? Does the USA obtain any *economic* benefit from having the US dollar be used in world trade and payments?
- (b) Are there any economic costs to the USA in having its currency be used around the world? How might this help explain the persistence of US current deficits and the decline of US manufacturing?

*Trump has recently complained about two things: (1) US current account deficits, which he thinks are caused by unfair trading practices in other countries, and (2) Attempts by other countries to erode the dominance of the US dollar in world trade and payments. I suspect that mainly for political and 'prestige' reasons, he wants the dollar to remain dominant. The point of this question is that these two issues are related, and not in the way Trump seems to be aware of. In particular, the dominance of the US dollar as an asset, means that the USA has a comparative advantage in selling safe/liquid assets. As a result, it has a financial account surplus. By the rules of double-entry bookkeeping, it necessarily has a current account deficit to offset this. The economic mechanism driving the current account deficit is a strong dollar, which makes US goods expensive for foreigners. The irony of Trump's tariffs that attempt to maintain dominance of the US dollar is that, if successful, they are likely to cause the US current account deficit to persist!*

*There are both costs and benefits to having your currency be the world's reserve currency. One big benefit is that it enables the USA to spend more than it earns for long periods of time. That is, it facilitates financing of US fiscal deficits. The US just sells its bonds to China and Japan, and interest rates can stay low. (The exact opposite of Brazil!). If the BRICs are successful, it would force the USA to reduce its fiscal deficits, either by reducing spending or raising taxes. The costs of being a reserve currency are more indirect. In the case of the USA, it has probably contributed to the problem of income and wealth inequality. The people who sell assets to other countries are already rich, while the people who try to sell manufactured goods to foreigners are mainly on the low end of the income distribution. Trump doesn't seem to be overly concerned about wealth inequality, but if he were, he might take a more favorable view to the BRICs policy!*

*This is a very open ended question, and these are just my opinions. Please be generous with partial credit! They do not need to say exactly what I said in order to get full credit. As long as their argument makes sense, and is well defended, that is enough.*