SIMON FRASER UNIVERSITY
Department of Economics

Econ 345 — Prof. Kasa
International Finance — Fall 2024

MIDTERM EXAM
(Solutions)

The first five questions are True, False, or Uncertain. Briefly explain your answers. No credit without explanation. (8 points each).

1. If a country has a current account surplus then it is accumulating foreign assets.

   TRUE. *If a country sells more goods and services to other countries than it purchases, then it must be acquiring financial claims in return. The only ambiguity here is that if a country is currently a net debtor, like the USA, a current account surplus means you are paying down debt, not building assets. However, students don't need to mention this for full credit.*

2. Higher interest rates cause the exchange rate to appreciate.

   UNCERTAIN. *True if the nominal interest rate is rising because the real rate increases. False if the nominal rate is rising because expected inflation increases. Remember the Fisher equation!*

3. An exchange rate depreciation increases net exports.

   UNCERTAIN. *It depends on whether the Marshall-Lerner condition holds. True if it does, false if it doesn't.*

4. According to Purchasing Power Parity, countries with relatively high inflation rates will have appreciating currencies.

   FALSE. *It's exactly the opposite. Countries with relatively high inflation must have depreciating currencies. Otherwise, foreign goods would become cheaper.*

5. Having a current account surplus makes a nation richer.

   FALSE/TRUE. *This question is related to Question 1. From a narrow accounting perspective it is True. A current account surplus means you are acquiring foreign assets, which is a form a financial wealth. However, as Adam Smith pointed out in 1776, that doesn't mean that a country should outlaw imports, in order to ensure it always runs a CA surplus! That fallacious argument is called 'mercantilism'. The real source of wealth in an economy is the productivity of its human and physical capital. It might very well be that importing technology and capital goods from other countries will make you richer in the long-run. For full credit, students should say something about this.*

6. (20 points). Last week the Bank of Canada announced it was lowering its interest rate by 0.5%. Use the DD-AA model to illustrate how this policy change will affect Canadian output, net exports, and the value of the Canadian dollar.

   This is straight from the notes (Lecture 5B). A monetary expansion shifts the AA curve out to the right. The lower R causes the exchange rate, E, to depreciate, which then causes net exports, NX, to increase (assuming the Marshall-Lerner condition holds). Lower R would also increase investment *and consumer durables purchases. As a result, output, Y, iincreases. At least that's what the Bank of Canada is hoping will happen!*

7. (20 points). Many people (e.g., Donald Trump) argue that China has an undervalued currency because the price of identical goods (e.g., McDonald's hamburgers) are lower in China than in the USA (when expressed in dollar terms). Use the Balassa-Samuelson model to explain why dollar prices *should* be lower in China than in the USA.

   Again, this is straight from the notes (Lecture 4B, pg. 4). Although China's tradeable goods productivity has been growing relatively rapidly, it's level is still below that in the USA (at least on average. Some sectors, like EVs, might actually be more productive in absolute terms). As a result, Chinese wages are lower (in dollar terms). Lower wages means that the costs of producing nontradeable goods like McDonald's hamburgers are lower, and therefore so are their prices. (If you want a Big Mac, why buy from China? The shipping costs will dwarf the cost of the burger!)

8. (20 points). In his article entitled, "China, New Financial Superpower", Brad Setser points out that China is now the world's largest creditor country. Historically, the currency of the world's largest creditor becomes the world's reserve currency, e.g., Britain in the 1800s and the USA in the 1900s. This hasn't happened yet in the case of China. According to Setser, why hasn't China's currency become more internationalized? Describe three differences between China currently and the examples of Britain in the 1800s and America in the 1900s?

   Setser hightlights 3 key differences between China now, and the previous cases of the UK and USA

   (a) *China is still a relatively poor country, in per capita terms. In contrast, when the UK and USA were the world's largest creditor countries, they were also the world's richest countries. Why is a relatively poor country lending money to rich countries! (We will discuss this later).*

   (b) *Most of China's international lending takes place through the government, in particular the PBOC. In contrast, most (but not all!) UK and USA lending was conducted by private businesses. This makes capital flows a bit more political.*

   (c) *Currently, China does very little lending in its own currency. Most of its loans are in US dollars. In contrast, the UK and USA lent their own currencies. This exposes China to a considerable amount of exchange rate risk. If the US dollar depreciates, the value of China's foreign reserves are reduced. This is one of the main reasons why China is currently attempting to internationalize the RMB.*