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Suggested Solutions to Problem Set 6

1. Because raspberries are nontradable, asset swaps or intertemporal trade cannot be used to reduce the riskiness associated with its production. Hence, differently from the example in which just tradable kiwis are produced, we cannot eliminate all the risk in the economy (unlike the example in the book, the world now is a risky place in the aggregate). So, any swap of assets (Home and foreign land) or intertemporal trade (current account surpluses or deficits) will necessarily be the consequence of the countries' willingness to share the risks associated with the productions of kiwis. On the other hand, the GNP of both Home and Foreign is now composed not only by kiwis but also by raspberries. Therefore, we can say that, relative to GDP, the international asset trade is smaller.

2. When there is great financial integration, capital is free to move across borders and flows to places where profitable opportunities are larger. These capital movements tend to equalize real interest rates around the world. However, real interest rates might still be different for reasons related to differences in risk, so the equality of real interest rates will not happen even in a fully financially integrated world.

3. The data show that the CA was in deficit in many years from 1993 to 2003. Hence, it can't be the case that Canada is paying out its external liabilities by exporting more than importing. On the other hand, the data on exchange rates show that the Canadian dollar has been depreciating relative to many foreign currencies. Thus, the apparent paradox can be explained by the fact that Canada issues external debt in its own currency, while its assets are at least partially denominated in foreign currency. Hence, when the currency depreciates assets suddenly increase in value relative to liabilities, meaning that net worth increases. This increase in net worth can then be used to pay a greater chunk of foreign liabilities (external debt).

4. A credibly fixed exchange rate implies that Home's nominal interest rate has to be kept equal to the nominal interest rate of the country to which the Home economy wants to peg (that is, $R=R^*$). Because the exchange rate between the currencies of Foreign and Truly Weird floats, their nominal interest rates will not be equal all the time, making it impossible for the Home economy to simultaneously fix its currency to the Foreign and the Truly Weird currencies.

5. The currently industrialized countries are the riches countries in the world today and have similar living standards among themselves. Hence, if you pick a sample of currently industrialized countries, you will find (by construction) that the poorest countries in the beginning of the century grew more quickly than the rich. Otherwise, they would not have similar living standards today. To truly measure whether countries tend to converge over time, you would need a broader sample of countries, not only those that are industrialized today.