

SIMON FRASER UNIVERSITY
Department of Economics

Econ 345
International Finance

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PROBLEM SET 3
(Solutions)

The following questions are short answer. 25 points each.

1. Bitcoin has been in the news a lot recently. Let's suppose that someday the international finance system becomes based on bitcoin (i.e., bitcoin is used to buy goods and store wealth). According to Krugman in his article posted on the class webpage entitled "Golden Cyberfettters", would this be a good thing? What lessons from history does he use to make his point? (See also the Case Study in Chapter 19 (International Monetary Systems: An Historical Overview) entitled *The International Gold Standard and the Great Depression*).

Given the dramatic rise in the price of bitcoin it is tempting to conclude that switching to a bitcoin-based monetary system would make everyone rich. Krugman points out that the goal of a monetary system is not to make people rich. It's to facilitate trade and exchange. In the long-run, it's trade and exchange that make people rich. In fact, the Wall Street Journal just ran an editorial bemoaning the fact that no one is spending bitcoins right now. And why should they?! You'd be a fool to spend something that's rising in value by 100% per month. Unfortunately, when people hoard money, it tends to produce bad outcomes at the macroeconomic level. Keynes called it the 'Paradox of Thrift'. If everyone tries to save, the economy contracts, and everyone ends up saving less!. Krugman noted that bitcoin resembles the Gold Standard in some ways. Both are systems designed to constrain the supply of money. However, when the supply is fixed, the value changes instead in response to fluctuations in demand. These changes in the value of money show up as changes in the price level. Changes in the price level tend to produce redistributions of wealth between debtors and creditors, since debt contracts are often not indexed to the price level. Just imagine if you were a debtor in a bitcoin monetary system right now. The real burden of your debt would have increased by an order of magnitude in recent months! These sorts of wealth redistributions create a lot political frictions. My guess is that anyone who owed bitcoins right now would simply default. Defaults tend to be bad for the aggregate economy. According to Krugman, the optimal monetary system should instead target the price of money, not its supply. Finally, the textbook notes that those countries who abandoned the Gold Standard quickest tended to recover from the Great Depression the fastest. Those who held out the longest, suffered most. Krugman asks - Why should we go back to a Gold Standard sort of monetary system when it produced such bad outcomes? we want to go back to a Gold Standard world when it produced such bad outcomes?

2. Read the article by Obstfeld posted on the class webpage entitled "Does the Current Account Still Matter?". According to Obstfeld, does the current account still matter? Why or why not?

The key point here is that the current account summarizes net capital flows between countries. In recent years, there has been an explosion in 2-way gross capital flows. According to Obstfeld, the current account is still important, for the same reasons as always (e.g., countries can accumulate unsustainable net foreign asset positions), but with large gross capital flows it is no longer a sufficient statistic. Countries can be quite exposed to capital flows even when their net positions look balanced. This often happens with currency and maturity mismatches.