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Econ 345 | Prof. Kasa
International Finance | Spring 2017

PROBLEM SET 2
(Solutions)

The following questions are short answer. 25 points each.

1. Read the article from *The Economist* entitled "It's Been a Privilege", which is posted on the class website. According to the article, how does the current importance of the US dollar in the international financial system compare to its importance during the Bretton Woods System immediately following World War II? Explain. Is the current role of the US dollar good or bad for the US economy? Why? According to the article, how might the Trump administration threaten the future position of the US dollar in the international financial system?

   *American power and influence have steadily decreased since WWII, with one exception. The article points out that the dollar is actually more important now than it was in the 1940s and 1950s! The reason is that capital flows have exploded in recent decades (partly due to policy and partly due to technology). Greater capital flows have increased the demand for reserve assets (ie, US dollar assets), which can be used to mangage these flows, and limit their influence on exchange rates. A natural question is why only US dollars are used as reserve assets. Why not RMB or euros? The problem is that China still has capital controls, which discourage use of the RMB as a reserve asset. At the same time, the euro is facing an existential crisis due to ongoing debt problems within Europe (partly due to the euro itself!) This makes the euro too risky to be a reserve asset.*

   *The continuing use of the dollar as the international reserve asset has costs and benefits for the US economy. The main benefit is that the US gets to issue low return debt to the world and then invest in higher yielding foreign assets. That return differential allows the US to finance a persistent current account deficit. The costs are more subtle. One problem is that persistent high demand for dollar assets keeps US interest rates low. This can potentially encourage asset bubbles (like the US housing bubble), and at the same time limit US monetary policymakers from using interest rate cuts to respond to recessions (due to the zero lower bound on nominal interest rates). The article also argues that persistent trade deficits exacerbate inequality in the USA, since import competing industries tend to employ poorer, less skilled workers. So as they shrink due to the "overvalued" US dollar, income inequality increases.*

   *According to the article, Trump could put an end to US dollar dominance in two ways. First, it could end for the same reason Bretton Woods collapsed. Fiscal expansion tends to create inflationary pressures. If US inflation starts rising, holders of dollar* *reserve assets might become unhappy, and start to search for another reserve asset. Second, it could end for the same reason the gold standard ended. Trade wars create international conflict and a shrinkage of global trade. If world trade collapses, then global capital flows and the demand for dollars won't be far behind.*

2. For the past year, China has been selling foreign reserves in an effort to support the value of the RMB. Using the DD-AA model, compare and contrast the effects of this intervention when the People's Bank of China sterilizes its sale of foreign reserves and when it does not. Is sterilization a good strategy? What are its pros and cons?

   *One reason China has been losing fx reserves is that RMB holders think the value of the RMB might decline in the near future (see the section on 'capital flight' in the textbook). This puts upward pressure on China's interest rate (due to UIP). Higher interest rates depress spending and shift the DD curve up. This puts downward pressure on the value of the RMB. To keep the RMB from depreciating, the Bank of China must sell fx reserves, which shifts its AA to the left, until it intersects the new DD curve at the current exchange rate. The problem with this is that it produces a* procyclical *monetary policy. China would be tightening monetary policy at the same time the economy is suffering. So in response, they could sterilze the fx sale by buying RMB government bonds. This keeps the AA curve from shifting. In theory, it would also prevent a depreciation of RMB, by reducing the private sector's holdings of RMB assets, and thereby reducing the risk premium. The problem with this strategy is that it does nothing to relieve the underlying pressure for the RMB to depreciate. Eventually they will run out of reserves (they lost \$ 1 trillion in just one year!). At that point, they will be forced to either devalue (thus confirming the doubts of market participants), or reimpose the capital controls they have been trying to gradually dismantle.*