

SIMON FRASER UNIVERSITY
Department of Economics

Econ 345
International Finance

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PROBLEM SET 3
(Solutions)

1. (25 points). Read the article from *The Economist* entitled “It’s Been a Privilege”, which is posted on the class webpage. 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 manage 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 deemed risky due to ongoing debt problems within Europe (partly due to the euro itself!)

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 and disasters, like the coronavirus (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, the global capital flows and the demand for dollars won't be far behind.

2. (25 points). Scientists are currently working hard to develop a vaccine for COVID-19. Economists are also working hard to contain its economic effects. Although our simple DD-AA model is inadequate to capture all of the consequences, it does shed light on some of them. For example, Problem Set 2 asked you to think of the virus from the perspective of the financial markets, as producing an increased demand for liquidity. This question asks you to think about it from the perspective of the goods market. In particular, heightened uncertainty not only leads to a portfolio shift toward safe assets, it also produces an overall increase in saving. (Economists call this 'precautionary saving'). Of course, higher saving means the demand for goods and services decreases. Use the DD-AA model to illustrate the macroeconomic effects of a virus-induced increase in the saving rate. What happens to output, interest rates, and the exchange rate?

Usually in economics, the consequences of given shock or policy depends on whether it is country-specific or whether it is global (ie, common to all countries). The COVID-19 shock is a *global* shock if there ever was one! How does this affect your analysis of the macroeconomic effects of an increased saving rate? Are the effects on a given country bigger or smaller when all countries simultaneously increase their saving rates? Why? Illustrate your answer with a graph, if possible.

Increased saving and reduced expenditures shift a country's DD curve to the left. In these Keynesian models, where output is demand determined in the short-run, this causes output to decline. The fact that more saving can temporarily lower output was called the 'Paradox of Thrift' by Keynes.

Note that if the saving/DD curve shift is country-specific, then the resulting depreciation of the country's currency partly offsets the decline in expenditure and output, as the country's goods become more competitive in world markets.

However, if all countries increase their saving, then the shock absorber role of the exchange rate is nullified. A negative foreign DD shock reduces R^ , which shifts the home country's AA curve left. As a result, the exchange rate doesn't change, and output declines by more than if the shock were country-specific. In addition, the decline in foreign incomes would exert a further negative income effect on the domestic economy, as exports shrink. This would simply reinforce the adverse effects of the original shock. Punch-line: the effects are unambiguously worse if the shock is global (as we're seeing unfold right now!).*