

SIMON FRASER UNIVERSITY
Department of Economics

Econ 345
International Finance

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PROBLEM SET 2
(Solutions)

1. (25 points). Some people argue that the USA is at the mercy of China, because the USA owes China so much money. Do you agree? Why or why not? (Hint 1: Take a look at the Krugman article entitled “Taking on China”, which is posted on the class webpage. Hint 2: Which currency is the debt denominated in?)

This is a rather open ended question, so please read carefully and give partial credit. The basic point here is that the US owes China US dollars, and the US has an unlimited capacity to print dollars (at virtually zero cost). So there is no real problem in paying China back. In fact, it is China that is most exposed here, because they are worried about getting paid back in worthless dollars. This also helps to explain why the threat to ‘dump’ US treasuries is not very credible. As Krugman notes, dumping treasuries would depreciate the dollar. Not only would this inflict a capital loss on China’s reserves, it would also make US goods more competitive on world markets.

2. (25 points). The US Financial Crisis of 2008 led to a recession in Canada as well. Some people argued that it was because of increased financial market risk, which shifted Canada’s AA curve left. Others argued that it was because the demand for Canada’s exports decreased, which shifted the DD curve to the left. Explain how you could use information from the foreign exchange market to distinguish these two hypotheses. Use a graph to illustrate your answer.

If transmission occurred mainly through the asset markets (i.e., a leftward shift of the Canada’s AA curve), we would expect to observe an appreciation of the Canadian dollar. If the transmission occurred mainly through the goods markets (i.e., a decline in net exports which shifted the DD curve left), then we would expect to observe a depreciation of the Canadian dollar. Both no doubt occurred, but the fact that the Canadian dollar initially depreciated suggests that transmission mainly occurred via the goods market. (NOTE: I don’t care whether they say the goods market or asset market was more important, as long as they get the analysis correct).