

SIMON FRASER UNIVERSITY
Department of Economics

Econ 345
International Finance

Prof. Kasa
Spring 2024

PROBLEM SET 2
(Due April 5)

1. (25 points). On Saturday March 22, 2024, an article entitled “How Economic Trouble in China Could Be Propelling the Dazzling Rise of Bitcoin”, appeared in *The Globe and Mail*. The following passage appears,

The Guardian recently reported that the crackdown on Chinese billionaires, sluggish growth and waning stock markets are triggering an enormous outflow of funds from China. In the first half of 2023, there was a shortfall of US\$19.5 billion in China’s balance of payments - an indicator of capital flight. The true figure may be many times higher. Mainland Chinese are snapping up luxury condos in Singapore and elsewhere in great numbers, and immigration consultants say many thousands of wealthy Chinese families are leaving the country.

Use the DD-AA model to illustrate the effects of ‘capital flight’ on China’s economy. (Remember, China pegs to the US dollar). Describe the two offsetting effects on the AA curve. If investment depends on the interest rate (as it surely does), how is the DD curve affected? How is equilibrium output then affected? Can capital flight explain the recent weakness in the Chinese economy?

2. (25 points). In mid 2014 the value of the Canadian dollar was above 0.9 US dollars. At the time, world oil prices were about US\$100/barrel. Over the next 5 years both oil prices and the Canadian dollar fell sharply. At the outbreak of the pandemic, oil was selling at about US\$60/barrel and the C\$ had sunk to about 0.76. Since the pandemic, oil prices have recovered while the C\$ remains stuck at around 0.75.

Explain how the Balassa-Samuelson model of real exchange rates might help to explain the recent behavior of the C\$. (Hint: Canada exports oil and is a price taker in world markets. Hence, you can think of an oil price change as a change in the productivity of Canadian tradeable goods). How might you explain the puzzling experience since the pandemic, when oil prices rose and the Canadian dollar stayed constant? (Hint: How do you think the ‘green transition’ has affected the productivity of Canada’s tradeable goods industry?)