

SIMON FRASER UNIVERSITY  
Department of Economics

Econ 345  
International Finance

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PROBLEM SET 2  
(Solutions)

1. (25 points). When Trump became president in January, one of the first things he did was to propose that Canada join the USA as the 51st state. This is *very* unlikely to ever happen. However, for this question, let's suppose it did. One obvious consequence is that Canada would need to ditch the Loonie and start using the US dollar instead. Based on the material discussed in class (not what ChatGPT says!), do you think adopting the US dollar would be good or bad for Canada? Would output be more or less stable? How would it change the way US monetary and fiscal policies get transmitted to Canada? Do you think Canada is part of an 'Optimum Currency Area' as defined by Mundell?

*A common currency is the ultimate fixed exchange rate. If Canada adopted the US dollar it would have a fixed exchange rate with the US. Currently it has a flexible exchange rate. As a result, US monetary policy would be transmitted unambiguously positive (in the same direction), since there would no longer be an offsetting exchange rate change. However, now US fiscal policy would be transmitted negatively. For example, expansionary US fiscal policy would raise interest rates in both the US and Canada. This could be contractionary for Canada unless the fiscal expansion benefits Canada as well. (As the 51st state, the distinction between US and Canadian fiscal policy would obviously become less clear!)*

*Whether Canadian output would become more or less stable depends on the sources of shocks hitting the Canadian economy. Having a fixed exchange rate would magnify the response to spending shocks, since the exchange rate could no longer change to offset them. However, a fixed exchange rate would make Canadian output more stable in response to Canadian financial market (AA curve) shocks.*

2. (25 points). Recently, as Argentina's elections were approaching, there was speculative pressure against the Argentine peso. In response, the Trump administration announced a \$20 billion bailout, in an effort to support the peso. (Technically, it was a contingent bailout, ie, a swap line, which hasn't been drawn on yet, given the outcome of the election). Based on our discussion of 1st vs. 2nd generation currency crisis theories, do you think Trump's bailout plan was a good idea or a bad idea? What does the answer depend on? (Ignore the politics here, and just focus on economics).

*Whether a bailout is a good idea depends on why Argentina was experiencing a speculative attack. If the attack occurs because Argentina is engaged in inconsistent macroeconomic policies (as described in 1st generation models), then a bailout is a waste of money. However, if the attack represents a self-fulfilling loss of confidence in the currency and a potential shift among multiple equilibria (as described in 2nd generation models), then an announced bailout might be a good idea, since it could eliminate the bad equilibrium, just like deposit insurance can be an effective way to eliminate bank runs (ignoring moral hazard!). Unfortunately, it tends to be very difficult to distinguish between these two source of crises in practice.*