

SIMON FRASER UNIVERSITY
Department of Economics

Econ 345
International Finance

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PROBLEM SET 3
(Solutions)

The following questions are short answer. 25 points each.

1. Read the article “China, New Financial Superpower” by Brad Setser, which is posted on the class website. According to Setser, what are the three ways China differs from Britain and the USA when they were the world’s dominant creditor nations? Do you think these differences will disappear over time? Why or why not?

China is currently the world’s largest creditor nation. In this respect, it resembles the USA in the 20th century and Britain in the 19th. In those earlier periods, the currency of the world’s dominant creditor also played the role of a global reserve and vehicle currency, which was widely used both as a store of value, and a common unit of account (e.g., commodities were priced in it). In fact, they were even used as a global means of payment. That is not true currently with China. Setser’s article points to 3 differences between China now and the USA/Britain then, which might explain why: (1) China is still a relatively poor country (in per capita terms!), (2) It lends in the borrower’s currency (mainly US dollars), and (3) Its financial system is largely state controlled. Most of its lending is channelled through the Chinese central bank. In contrast, most lending by Britain and the USA was by private firms and households.

Its not clear when (or even if) this will change. I am not looking for a particular answer here, as long as they say something sensible. So please be generous with partial credit. My own view is that China will only come to resemble the USA/Britain in earlier centuries if it liberalizes its financial markets, and allows money to flow more freely into and out of China. That will expose them to greater risks, and involve giving up some control over their economy. (The students probably have a better sense for whether they will do this than I do!)

2. Read the article “Fear-of-China Syndrome” by Paul Krugman, which is posted on the class website. According to Krugman, should Americans worry about the threat that China will stop buying its bonds? Why or why not?

According to Krugman, Americans don’t need to worry about whether China will stop buying its bonds, for 2 main reasons: (1) Recent crisis-induced deleveraging in the USA has reduced the US demand for Chinese money. Most of the recent US fiscal deficit has been financed by US household saving. (2) If China stops buying US bonds, the dollar will depreciate. Given the current state of their economies, this will help the USA and hurt China. So any threat to stop buying them is pretty empty, at least according to Krugman.