

SIMON FRASER UNIVERSITY
Department of Economics

Econ 345
International Finance

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Spring 2014

PROBLEM SET 3
(Solutions)

1. (25 points). Read the article by Paul Krugman entitled “Crash of the Bumblebee” (posted on the class webpage). According to Krugman, what needs to be done to save the euro? Do you agree? Why or why not?

According to Krugman, the immediate short-term response to the debt crisis should be to monetize it. That is, allow the ECB to buy up the bonds of southern European countries, and pay for its purchases by ‘creating money’. This will likely produce an increase in inflation, but according to Krugman, that is a price that must be paid to preserve the euro. Over the longer-run, in order to prevent a recurrence of this situation, Europe’s banking and fiscal institutions will need to become more coordinated and centralized, as they are in the USA and Canada.

2. (25 points). Briefly discuss the following statement - “The IMF should not bail out countries that are hit by a currency crisis”. Be sure to relate your answer to the theories of currency crises that we discussed in class.

Whether the IMF should bail out countries in response to a currency crisis depends on why you think crises occur in the first place. If they occur because of inconsistent domestic macroeconomic policy (e.g., printing money to finance government deficits), then bailing out would be counterproductive. It would just create moral hazard. This is the perspective of so-called ‘first-generation’ theories of speculative attacks. However, if crises represent a sudden switch to a ‘bad equilibrium’, so that they are primarily due to a self-fulfilling panic, then one could perhaps justify IMF bailouts, applying the same logic used to justify deposit insurance schemes. This is the perspective of so-called ‘second-generation’ theories of speculative attacks. Unfortunately, in practice, it is very difficult to distinguish between these two theories.