UNIVERSITY OF CAMBRIDGE

ECONOMICS
ADMISSIONS ASSESSMENT

Specimen Paper – New Format for 2020 **60 minutes**

SECTION 2

Candidate number	K						Centre number					

	d	d		m	m		y	y	y	y
Date of birth			–			–				

First name (s)	

Surname / Family name	

INSTRUCTIONS TO CANDIDATES

Please read these instructions carefully, but do not open the question paper until you are told that you may do so. This paper is Section 2 of 2.

This question paper requires you to read a single passage and complete a related task.

You should write your answer in the space provided in this question paper. Please complete this section in **black pen.**

You can use the blank inside front and back covers for rough working or notes, but no extra paper is allowed. Only answers in the space indicated in the paper will be marked.

Dictionaries and calculators are NOT permitted.

Please wait to be told you may begin before turning this page.

This question paper consists of 10 printed pages and 2 blank pages.

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Read the article 'Should America want a strong dollar? It's complicated' taken from *The Economist* (February 9th 2017). Based on this text, complete the task below.

TASK

- **Explain why in some circumstances a rise in the value of the US dollar might benefit American residents, while in other circumstances it would be harmful to them.**
- **Suggest possible reasons why the US dollar might be persistently overvalued.**

Your answer will be assessed taking into account your ability to construct a reasoned, insightful and logically consistent argument with clarity and precision.

Should America want a strong dollar? It's complicated

In an experience we have all had, Donald Trump, unable to sleep, reportedly rang his National Security Advisor at 3:00 in the morning to ask whether America should want a strong dollar or a weak one. Look, there are no stupid questions. This one is actually more interesting than you might think. There are a few ways to answer it.

One way is to ask what it would mean if there were a random rise in the dollar (caused, say, by noise trading). Tyler Cowen takes this approach. Since most Americans have their incomes and wealth in dollars, a rise in the dollar would generally be good for America and bad for non-Americans: with caveats, including the fact that a stronger dollar might cause financial trouble for indebted emerging markets which could feed back into the American economy.

That's fine and all, but the dollar usually does what it does for a reason, or some set of reasons, and the answer to the question depends on *why* the dollar is strong or weak. Matt Yglesias gives his answer using this approach. If the dollar is rising because the Fed is inducing a deflationary recession, that's probably not good for anyone. (This is not outside the realm of plausibility, as it happens; Britain suffered years of painful deflation in the 1920s in order to defend sterling's peg to gold at an overvalued rate, only to then subsequently devalue during the Depression.) If the dollar is rising because America has discovered something amazing (like oil, or pluots) and the world cannot get enough of it, then that's probably good for everyone – though it is worth remembering that in all of these cases there are winners and losers, in America and elsewhere.

But another way to approach the question is to ask whether the dollar is overvalued or undervalued. If the dollar is overvalued, then a bout of weakening would be a healthy thing. How can you tell if a currency is overvalued or undervalued? Well, you can consult your nearest Big Mac index. Alternatively, you can check the current-account balance. If a country is persistently running current-account surpluses, its currency is probably undervalued; deficits, overvalued. America has been running current-account deficits since the early 1980s, therefore its currency is overvalued and a weaker dollar would be better.

Ok, but hold on. How is it that the dollar hasn't adjusted to its appropriate value after nearly *40 years*. That, it turns out, is the critical question.

The dollar has been overvalued all this time because the dollar is a reserve currency. Not just *a* reserve currency, but rather the world's dominant reserve currency, by a long shot. It holds that position partly for reasons of path dependence: because the dollar was the anchor currency in the postwar Bretton Woods agreement, other economies accumulated lots of dollar reserves to help maintain their fixed exchange rate. It holds the position partly because of network externalities; if lots of people do their trade invoicing in dollars, it is convenient for you to also do your business stuff in dollars to keep everything simple. And it holds that position in large part because no other currency, or country, is as capable of providing reserve-currency services. America has a very large and rich and stable economy, a high tax-revenue generating capacity, an extremely credible central bank, a stable democracy (knock wood), massive military and diplomatic power, broad and deep financial markets, and so on. The point is: America can provide large amounts of dollars, and government bonds, and other dollar-denominated assets without getting anywhere near the sorts of crises that might lead to sudden or unexpected changes in value in those dollars and bonds and such. Just as important, America has historically accepted the role of reserve-currency provider and the responsibilities that entails: like cooperating with other countries in crises to provide emergency dollar liquidity. America is the total package, or has been anyway.

What that has tended to mean, then, is that foreign firms and governments buy American government bonds by the truckload. Foreign appetite for dollars and dollar assets – even the super boring low-yield ones – allows Americans to buy more than they produce. It seems like a win-win situation. The dollar-as-a-reserve currency is a public good of sorts, a lubricant for global trade and finance, provided by America to the rest of the world. In return, Americans get to buy more than they make, forever. As explained elsewhere in this issue of the Economist, there are downsides, though:

> *"An overvalued currency and persistent trade deficits are fine for America's consumers, but painful for its producers. The reserve accumulation of the past two decades has gone hand-in-hand with a soaring current-account deficit in America. Imports have grown faster than exports; new jobs in exporting industries have not appeared in numbers great enough to absorb workers displaced by increased foreign competition. Tariffs cannot fix this problem. The current-account gap is a product of underlying financial flows, and taxing imports will simply cause the dollar to rise in an offsetting fashion.*
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> *America's privilege also increases inequality, since lost jobs in factories hurt workers while outsize investment performance benefits richer Americans with big portfolios. Because the rich are less inclined to spend an extra dollar than the typical worker, this shift in resources creates weakness in American demand – and sluggish economic growth – except when consumer debt rises as the rich lend their purchasing power to the rest.*
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> *Chalk the headaches generated by low interest rates up to the dollar standard, too. Some economists reckon they reflect global appetite outstripping the supply of the safe assets America is uniquely equipped to provide – dollar-denominated government bonds. As the price of safe bonds rises, rates on those bonds fall close to zero, leaving central banks with ever less room to stimulate their economies when they run into trouble."*

So one could ask whether a strong dollar is better or a weak one. But one could also ask whether it is in America's long-term interest to continue supporting the global dollar standard. In my view, it is neither sustainable or desirable for America to continue to play this role on its own. On the other hand, the status quo is preferable to the chaotic destruction of the dollar standard in the absence of a ready replacement. Put in the shoes of Mike Flynn, Mr Trump's National Security Advisor, I'm not sure quite how I'd respond. But the answer would start with, 'First, Mr President, give me your phone'.

Write your answer in the space below

Extra space (if required)

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