Exchange Rates and Financial Crisis

POL 3: Intro to IR

I. Balance of Payments

- Balance of payments: records transactions between a state and its trading partners

- Two components
  1) Current account: record of money flows to and from a state arising from trade, transfers, and investments
  2) Capital account: record of capital flows to and from a state

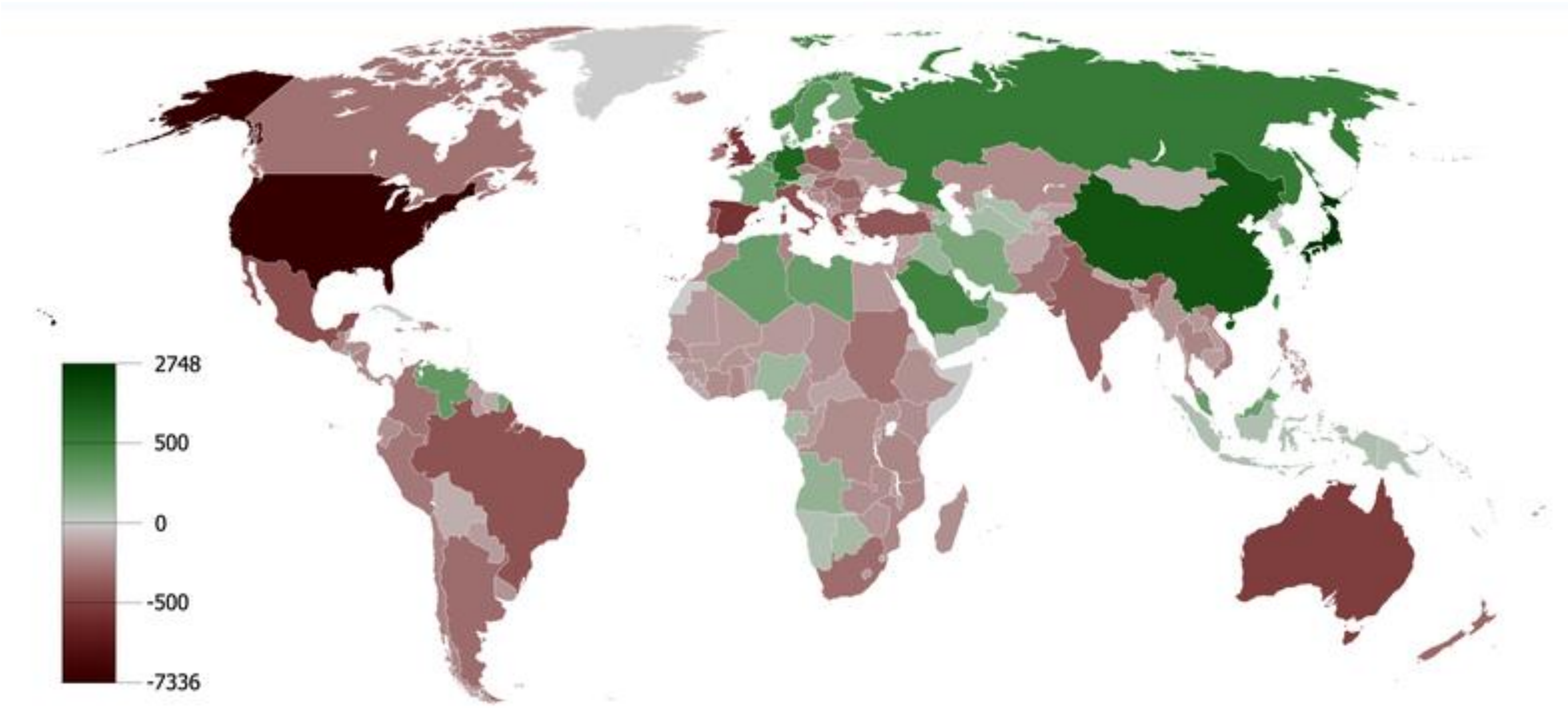
- Accounts should mirror each other
  - i.e. deficit in current account → surplus in capital account

Current account

1) Net balance of trade
   - Exports: goods flow out and money flows in (credit)
   - Imports: goods flow in and money flows out (debit)
2) Net government transfers
   - Money flows from foreign government payments
3) Net income
   - Money flowing in (credit) and out (debit) from:
     i. Investments
     ii. Remittances

- Current account balance
  - Sum of all sub-balances:
    i. (+) is current account surplus
    ii. (-) is current account deficit

Cumulative current account balance



Source: *International Monetary Fund*

Capital account

1) Net flows of portfolio investment
   - Transfer of money to buy investments
     - E.g. stocks, bonds, etc.
2) Net flows from financial account
   i. Money flows from FDI
   ii. Net flow of foreign reserve holdings

- Capital account balance
  - Sum of all sub-balances

Perceptions of a rising dragon

- China seems to have made a successful transition to market economics and is growing rapidly.
- It is emerging as the world's second-largest economy.

- Do you think this is a good thing or a bad thing for your country?
  - Does your reasoning reflect assumptions found in economic nationalism or economic liberalism?

II. Exchange Rates

- Exchange rate: price of a currency expressed in terms of another currency
  - e.g. 1 EUR = 1.14 USD

- Two issues with currency:
  1) Convertibility
  2) Inflation

- Types of exchange systems:
  - Fixed, floating, managed

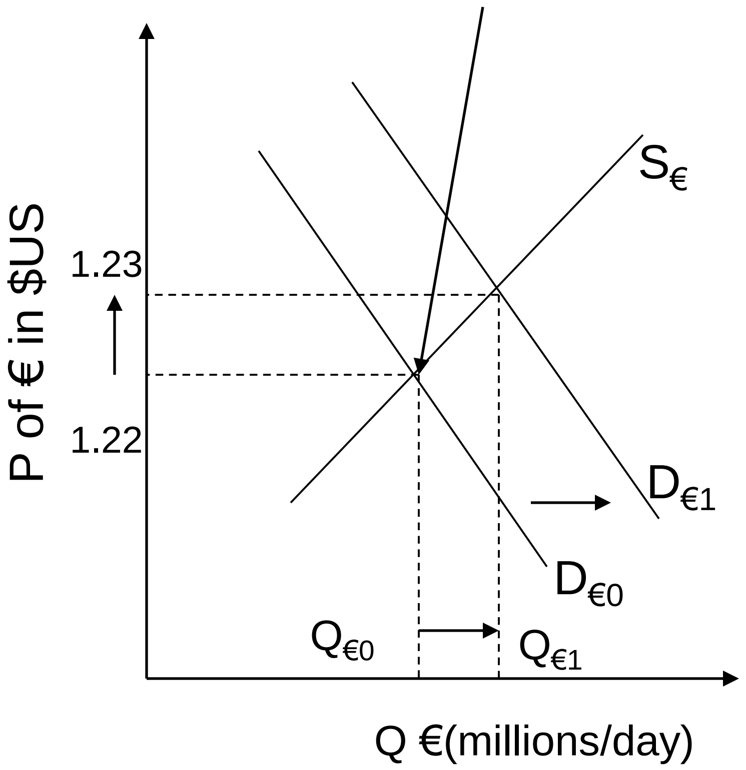
Exchange rates for the Euro and the USD

Initial equilibrium:

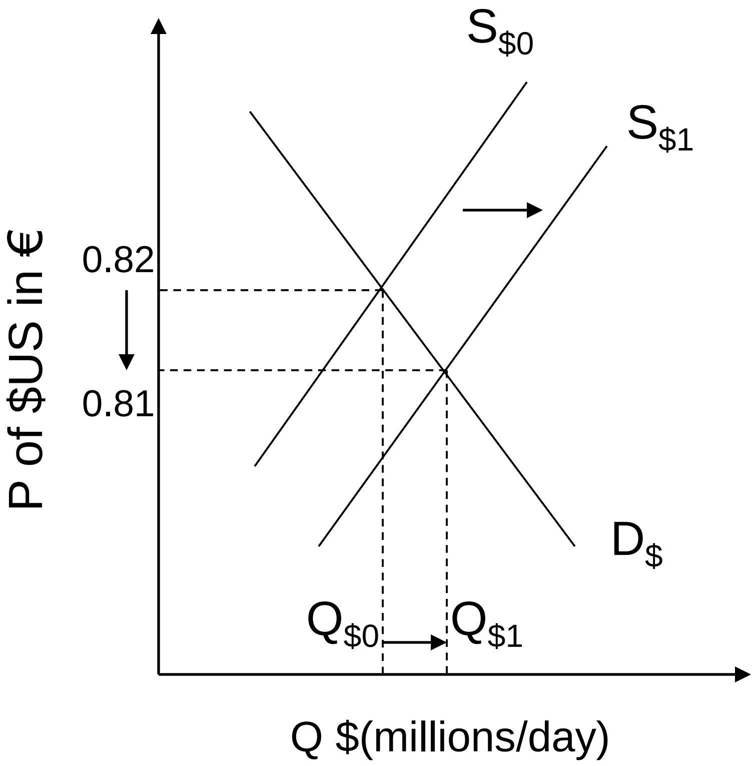
$US 1 = € 0.82

And thus… €1 = $US 1.22

EURO



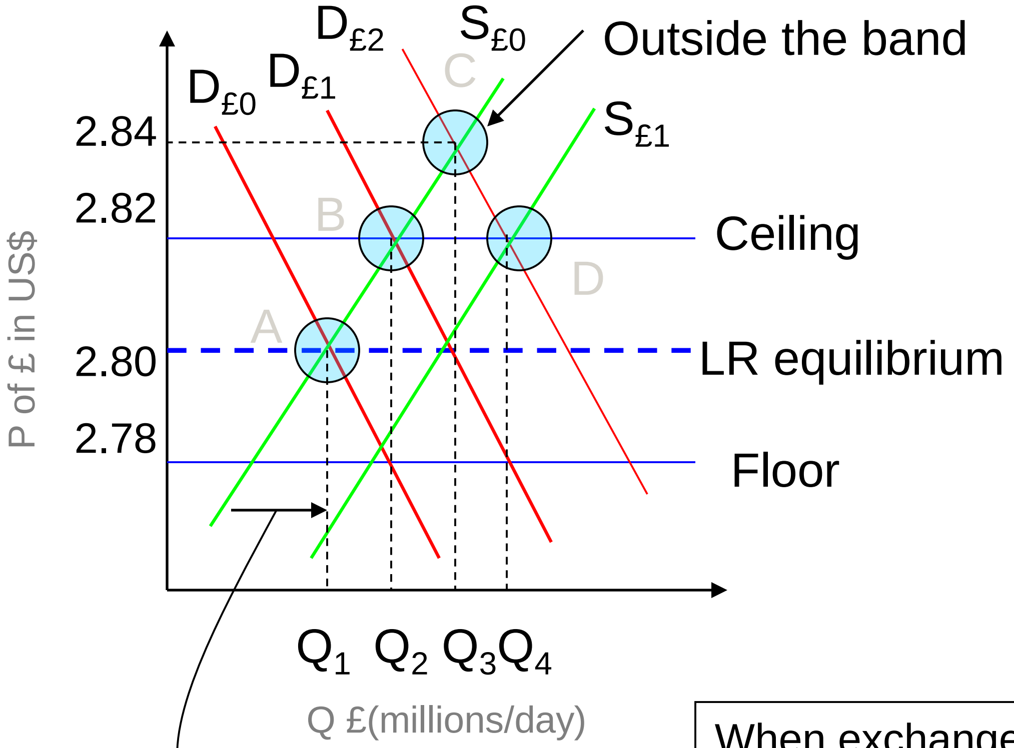
US DOLLAR



Currency intervention

- State intervention may manipulate/manage a currency's exchange rate
  - Devalue vs. Depreciation
  - Revalue vs. Appreciation
- Reasons for intervention:
  - Currency pegged/bound in range
  - Correct current account problems
  - Domestic monetary policy
  - Boost/reduce foreign reserve holdings
  - Manipulate foreign trade
    - e.g. Chinese currency and US retaliation

How a Managed Exchange Rate Works

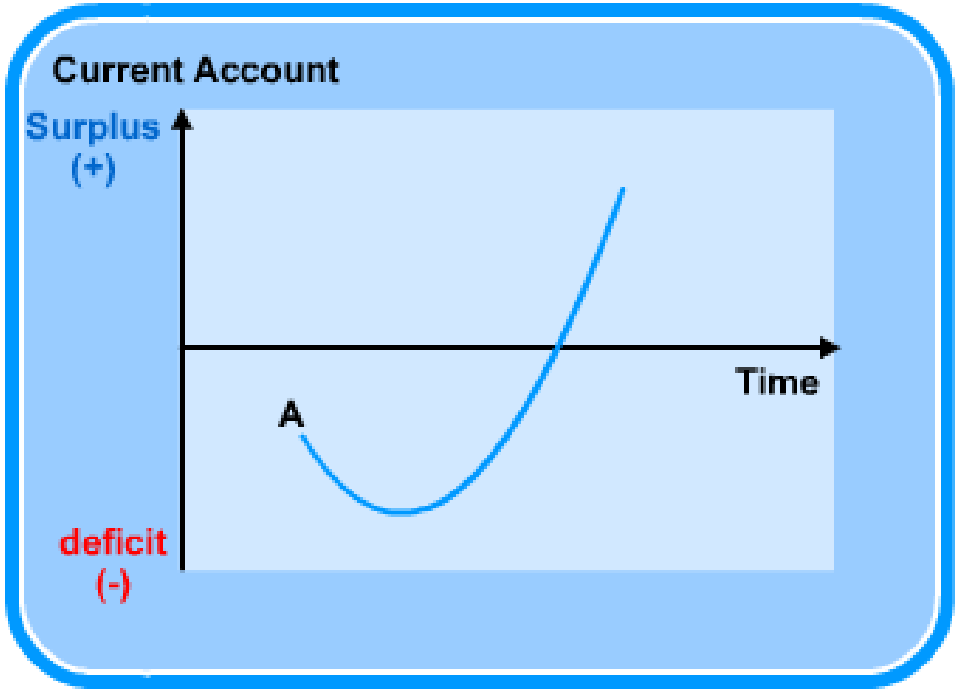


Keeping the pound down

When exchange rate rises above 2.82 the Bank of England will have to sell Q1→Q3 (S£0 shifts to S£1) on the foreign exchange market to keep the pound within the band

Devaluation and the Current Account
The J-curve

- Devaluation generally improves current account deficit.
  - But current account deficit will get worse before it gets better
- 1) Recognition lag; 2) Decision lag; 3) Production lag ; 4)Delivery lag
- Often takes 4-5 years for devaluation to correct a current account deficit

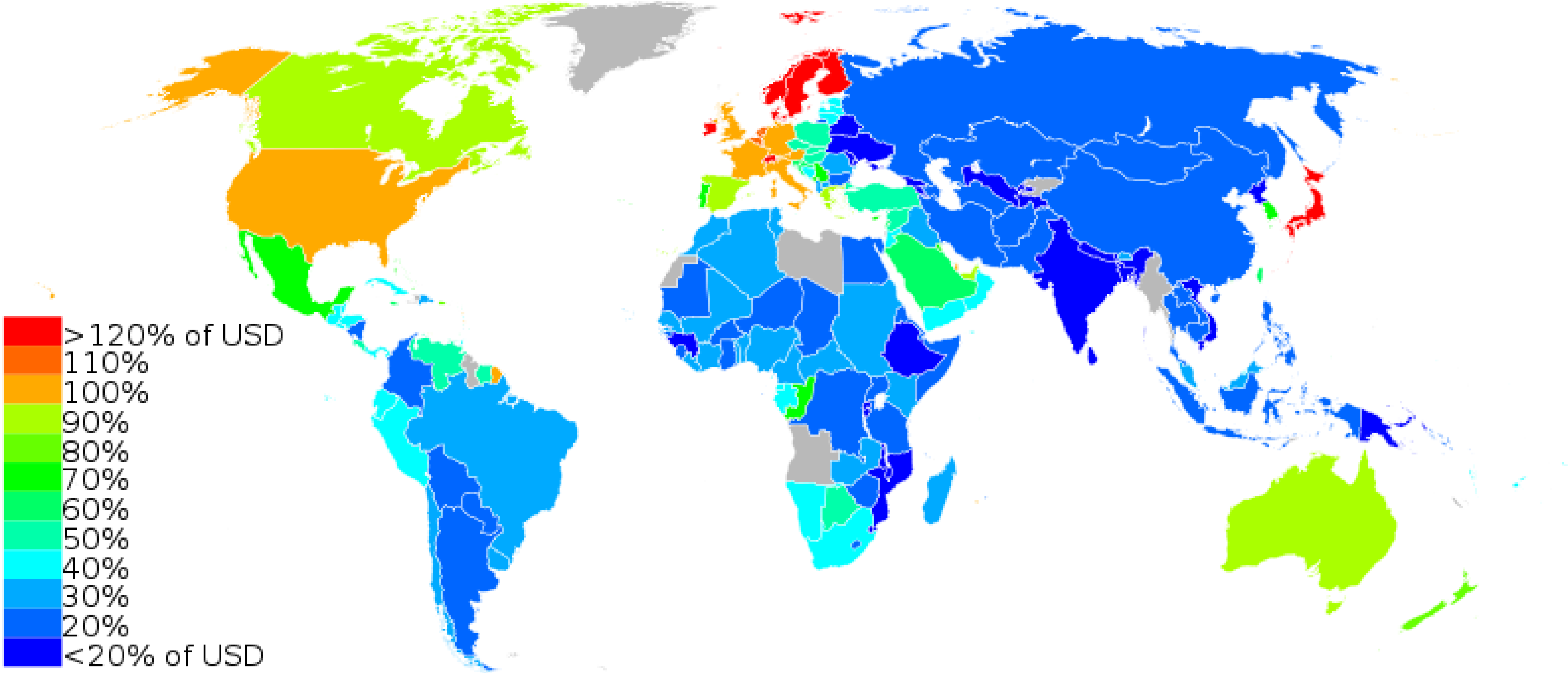


Purchasing power

- Purchasing power: the number of goods/services that can be purchased with a domestic currency
  - Measures the *standard of living* and the *actual* value of a currency within a country

- Arbitrage allows for the convergence (law) of one price
  - Two identical products will have same price on market
  - Example:
    - Assume 1 USD = 2 CAD. If 1 kg of flour cost 2 USD in Detroit. but 1 kg of flour cost 3 CAD in Toronto, there is a discrepancy in price.

Purchasing power (2003)



Data from the University of Pennsylvania

III. 2008 Financial Crisis

- Investors traditionally seek Treasure bills
- Investors shift toward debt and derivative markets
  - Debt market: exchanges of bonds and mortgages
  - Derivative market: exchange financial claims against future performance of security
  - Foreign actors are major source of investment
    - China, Japan, Middle East → current account surpluses
- Mortgage investment
  - Lenders sell mortgages to investment banks (e.g. JP Morgan Chase)
  - Mortgages lumped together and sold as “collateralized debt obligations” (CDO)
    - Derivative security that promises to pay buyer future interest/principal payments
  - AAA rating and high return lead to demand for new mortgages

Housing collapse

- Market for sound mortgages is exhausted
  - When homeowner defaults, lender gets the house which it can sell again
  - Defaults are "covered"
- Adding risk to new mortgages
  - NINJA loans = subprime mortgages
    - Higher interest rates and use of ARMs
- Agents of collapse:
  1) Banks (e.g. Goldman Sachs) - continue to package CDOs
  2) Insurance (e.g. AIG) - accredit and back AAA ratings
- Homeowners begins to default
  - Less money coming in → CDOs not paying out
  - Supply v. demand → price of houses plummet

Global problem

- Financial credit freeze
  - Investment banks can’t sell CDOs
  - Investors not making money on CDOs
- International shock
  - Foreign investors suffer (e.g. sovereign wealth funds)
  - Trade → US consumer demand drops
  - Exchange rates → value of USD drops vis-à-vis other currencies
    - Other states’ goods are more expensive to sell in U.S.
    - Directly hurts competeiveness of foreign firms
      - e.g. states dependent upon US for exports suffer
  - Sovereign debt defaults
- Bailouts and IMF support

IV. 2009 Eurozone Crisis

- Problem:
  - Debt obligations soared (e.g. PIGS)
  - Trade imbalances varied in EU
    - Germany → current account surplus
    - PIGS → current account deficits
  - Uniform monetary policy across EU with varied domestic fiscal policies

Do we need a new economic order?

- Critics blame unregulated markets for the 2008 financial crisis and cite that the market failed to self-correct
- Others, pointing to resurging international markets, argue that the global economy corrected hyper-demand in housing.

- Share your own thoughts in small groups:
- How has your belief in the economic liberal model been modified by the global crises? (i.e. 2008 Financial Crisis and Eurozone Crisis)
  - How attractive is the Chinese-led model of “state capitalism” for the global economy?