

Replies to memo questions, 09/09/03

Dear Students,

As you know, we did not cover the balance of payments so I'll skip the answer to my question on it. Your answers to the second question (why currency crises happen?) varied: currency crises occur because of other, twin crises, just like bank crises & financial system crises; or alternatively currency crises are due to contagion; or currency crises happen because of lack of strong economic fundamentals. My take on it, while all these answers are correct, the lack of strong fundamentals seems to be the major cause.

Here are the answers to your questions.

What is the format of the quizzes? Is it like the problem sets?

Quizzes will have 3-6 short answer questions and some multiple-choice questions. The reason that I say 3 – 6 is because I am not myself certain yet to whether I shall give any multiple-choice questions. If I do not include multiple-choice questions, I will have more like 5-6 short answer questions, but more on that in the review on Thursday before Tuesday quiz, 9/23. The short questions will be similar to those in the problem sets or will come from slides in class. Quiz questions will be tailored so that you can finish them in 20-25 min.

Do all countries belong to IMF? How many currency regimes are there and do member countries just pick one?

Not all countries are IMF members. The table w/ exchange rate classifications I have distributed has a complete list of countries forex regime arrangements. Every country has to decide itself what is the most suitable exchange rate regime. However, IMF might impose certain requirements – e.g. small country in financial trouble might not be allowed to float freely its currency.

Why is that Germany can exceed 3% of GDP in its fiscal deficit? If they were so insistent on having 3% deficit, they should stick to it.

The requirements set by the Maastricht Treaty were a bit strict, since there was a fear that too many of the Eastern European countries might decide to join at the same time, and the way to pre-screen them, was to raise the bar. At the time the Union had trouble coordinating the fiscal & monetary policies of the member countries (Germany), so having even more countries join the union (and the monetary union in particular) would have caused a lot of trouble.

Germany, as one of the countries insisting on following the criteria, had to run a deficit above 60% of GDP because, at the time, it unified itself w/ East Germany. Deficit came by b/c West Germany subsidized East Germany's renovation.

What countries rely the most on foreign financial investments such as stocks and bonds? And which countries receive the most investments in stocks & bonds? US?

Small, very open economies, such as Hong Kong, Singapore, Thailand, Malaysia, rely on investments in stocks & bonds. US & UK receive the most investments in stocks & bonds.

Could you go into a greater detail over the difference b/n a currency board & a conventional fixed peg?

Currency board implies the government fixes the amount of local money in circulation to the amount of hard currency reserves they have. In other words, you can't print an extra Hong Kong \$, unless you have an extra, fixed amount of US\$ coming in your forex reserves.

Crawling peg allows you to change your exchange rate, in small chunks. This means, you can still print your own local money. Of course, the more you print, the more likely are you to depreciate your currency in future.

Can a currency crisis be also represented by large flows into the currency as well as out of the currency?

You can always use the money coming in to spend. So, crisis is less likely, but not impossible. Why? Extra liquidity in the economy may cause asset price bubbles or inflation. That is likely the case of China w/ its huge forex reserve of US\$ 300 bn (remember the asset price bubble in Shanghai's A-shares). But there is even a funnier example. Back in 1590s when Spain was getting so much gold from the Americas, the Spanish economy at the time, under King Philippe II, experienced one of the biggest inflations known – almost all prices went up. Why? Too much gold chasing the same amount of goods caused prices to go up.

Can a few large speculators like George Soros push a currency crisis?

Sure, as we have seen the British pound go out of the exchange rate mechanism, because of the speculative pressure he put on it in 1992.

What role did Soros have in 1997 Asian crisis? 1998 Russian crisis?

Well, the Thailand's prime minister at the time blamed Soros for his reported involvement into the run on the Thai baht... But nothing was proved, as of yet...

When a country's undergoes a crisis, obviously their currency is devalued, but what does this mean right away? In terms of time, how long it takes for a long-term crisis to take effect?

Do we have to know the details of all crises we went over in class?

Nope.

Form the US perspective, is it better to have EMS, or not?

It's better. Even though some Eastern European countries use now Euro, rather than US\$ as a forex reserve currency (which means that they will substitute their \$ reserves w/ Euro reserves), it is still better, because US exporters & importers will deal now w/ a major, stable currency (the Euro), instead of dealing w/ many, smaller-in-scale, and more volatile currencies. Simply, this will lower forex risk impound in the US\$/Euro rate volatility.

Why is Euro expected to go up in future?

US will have to eventually cover the deficit in its BOP. To do that, US will have to depreciate the US\$ to the currencies of its main trading partners, one of which is, of course, the European Union. Notice it cannot do it w/ China, since yuan is fixed to the US\$. So, Euro will have to take the pressure...

Can European Union do something to alleviate the pressure from Asian fixed exchange rate regimes or is it in effect a sitting duck unless China changes policy?

EU can put tariffs & quotas for imports from China. Why aren't they doing it yet? Not sure. Maybe because this comes at a cost - European consumers will be getting less of the cheap Chinese products, and more of the expensive competitors' products.

Is US economy strong enough to put in control its growing current account deficits?

Yes, it is. In the past couple decades, US has increasing moved out from the production & export of goods to lean more towards provision & export of services. Furthermore, US economy has accumulated substantial intangible assets (like patents, licenses, research in fundamental sciences, know-how, show-how) which will pay handsome dividends in the long run.

**You said: "Greenspan wishes he knew how many dollars were in circulation".
Couldn't he calculate the # of US\$ in circulation from the US mint?**

Sure he could. But, the problem is, there are fake dollars & some bills get damaged overseas. Besides, even if you know how many real dollars are out there, you do not know how many of them are really in circulation. Why do you think that US monetary policy shifted from control of the monetary aggregates (back in the 80s) to control of the interest rates?

Germany's fiscal deficit grew above 60% and this did not cause a currency crisis?

There was a crisis, but its consequences were absorbed by all member countries in EU, that's why the impact was not so pronounced, and it was dubbed "EMS crisis 1992" in the lecture.

How does the IMF police countries that are subject to moral hazard?

Great question. IMF sends missions to the country in need of their assistance quite often and on a regular basis. Thus, they are capable to monitor the way money is spent, and make sure that they do not end up in the pockets of friends of foreign bureaucrats.

During the Bretton Woods years gold was 35 US\$/oz. Were there a market price of gold? How did this system affect it? Was there a potential arbitrage b/n nations who could buy gold w/ their central banks US\$ reserves and then sell it for more on the public market?

There were arbitrage opportunities at the time in buying gold w/ US\$, and then timing the market for gold as a commodity to sell it. However, since US had to stand ready to exchange US\$ for gold, as part of the Bretton Woods arrangement, it was also a major player in the gold commodity market. Besides, central banks are not profit making businesses, so arbitrage there is not the name of the game. And, to ship gold is quite expensive. So arbitrages of that sort (if any) were on small scale. As you can see from the graph (I could not get more data from Datastream...) in the available data period before Bretton Woods breakup, 1968 – 1971, gold price was quite stable.



Source: Datastream.

What is an asset market bubble?

Prices go way above a rational valuation. Back at the end of the 90s, Alan Greenspan called (very diplomatically) “irrational exuberance”.

What exactly happens when you short-sell weak currency and buy strong currency? What is the price impact of that strategy?

Well, this is a momentum strategy – short the losers, long the winners. This would make the weak even weaker, and the strong, even stronger. In words, it would create a lot of volatility in prices.

How do EU-member-to-be countries w/ weak currencies, like Czech republic, cope with the competition from EU companies?

Speaking for the forex side of the question, many Eastern European companies actually benefit from weak exchange rates (why?). However, oftentimes there are no match for their technologically superior rivals from Western Europe. The result: multiple cross-border acquisitions of Eastern Europe companies by Western Europe ones.

If there are so many US\$ around the world wouldn't it be disastrous if the US\$ exchange rate collapses? What are the chances of this happening?

It would be disastrous, US\$ has grown so important, that it can't be allowed to fail. The chances of this happening are very small. The US economy is the world's power engine, for years to come.

Can you elaborate on why the US had to run deficits on the BOP when they were the gold anchor in the Bretton Woods system?

Because they had to provide liquidity to the whole world, in terms of US\$. How can you do that? You have to print dollars, and use them overseas on purchases/ imports of goods & services. Of course, such activity will generate huge deficits in the BOP. And here comes the paradox, described by John Triffin back in the 60s: the more deficits you run, the more likely are you to lose your currency credibility. That was the main flaw of the Bretton Woods arrangement.

Can you explain the impossible trinity again? Why only 2 sides @ a time?

There are three desirable features a currency may have: be convertible (integrated), be stable, & allow independent monetary policy actions. The think is, there is a tradeoff between these. Take the first two (convertibility & stability). This is the case w/ Hong Kong dollar. Can they use monetary policy as they wish, i.e. independently? Nope. If they start printing money, then they will lose stability (why?).

Take convertibility & independence. Well, if you have fully convertible currency, and can take independent monetary policy actions, like the Japanese yen, you (as a central bank) have to stand ready to accept that market forces (like supply & demand of yens) move your exchange rate. Can you try to keep it fix? Sure, but that will create arbitrage opportunities, so speculators will make you pay for it.

Take stability & independence. Well, these two do not go together. If there is monetary independence, no investor will believe that your currency will be stable (you can change your mind for what you want tomorrow, after all that is independent policy). I cannot think of a fixed rate system, where the central bank can exercise freely monetary policy.

Why would a crisis in Mexico have a contagious effect on other Latin American countries?

Because the investors that specialize in investing in Mexico, also look into other related markets, like the one in Argentina, Chile, Brazil, etc. So, when these investors pull out of one market, they might overreact and pull out of the other markets, similar to the Mexican.

What dictates exchange rates b/n floating currency countries?

The supply and demand of each currency determines what is the free-floating exchange rate.