Replies to the one minute memos, 9/24

Dear Students,

Thanks a lot for asking these great questions! The answer to my question (*under a fixed exchange regime is the government responsible for ensuring a balance of payments near zero?*) is yes, government is responsible under a fixed exchange rate regime to maintain a BOP near zero.

Please notice the following correction to the sample quiz one answers. Note that if you have chosen to answer in question II part1, the answer that I have given you is not correct (thanks Greg & Irmo for pointing that out!). So I would give you <u>full credit</u> for that question. I apologize for my mistake, and for misleading you, won't happen again O.

Here are the answers to your questions:

In the last memo there was a question at the end about Japanese interest rates. Could we imagine that, if a rumor went that the interest rates would rise in the near future, people would think it is better to borrow now and really start borrowing?

Yes. But if that happens then the interest rate increase becomes a "self-fulfilling" prophecy – the more the people borrow, the more likely is that the price of borrowing – the interest rate, goes up.

Do currency traders use different approaches for short-term and long-term opportunities analysis?

Yes. To determine long-term trends they need to outline the long-term trend, "wave" of the exchange rate. For short-term prediction they base their trading strategy more on asset market approach.

Can you explain how the overshooting comes into effect?

Suppose price in Germany are sticky – they engrave them on the glass door of a café in Cologne O to make sure they do not change. So, suppose next that there is an increase in the money supply of the country (for example, Germany decided to issue more bonds to subsidize with their proceeds the integration of East Germany). Now, this implies that interest rate has to go down. Why? The money supply is up, but the money demand of investors & businesses are the same. So, here is a dilemma:

We know that if you have more money chasing the same amount of goods, soon or later you will have inflation. So, in the long-run, this currency will depreciate as predicted by PPP. However, in the short-run prices are not moving at all. And on top of it, interest rate is down. So, what to do? Would you hold a currency that will depreciate, yet earn a low interest rate? NO! Unless, the currency immediately depreciates by so much more, that after that you can actually start observing the opposite effect – gradual appreciation over the long run. That is what we call overshooting.

Now, in the case of Brasil's 1999 crisis, what happened was a little bit more interesting \textcircled . You see, these guys have a lot of US\$ denominated debt. Now, when real devaluation overshot, what happens with the Brazilian debt? Well, it became so big (in terms of reals) that actually, even if you were solvent before, now you could go insolvent. So, if you become insolvent as a result of that, your creditors step in and try to sell your debt as soon as they can (this is the beginning of a capital flight). By the time they are done the currency is much more devalued (because of the capital flight) and the overshooting devaluation is even larger.

Could you go through your argument for the flow (BOP) approach again, specifically about manipulating interest rates to achieve balance?

The flow (BOP) approach suggests that if you have an imbalance in your BOP, you could fix it w/ a change in domestic interest rates. For example, suppose you have a deficit in BOP. You can raise domestic interest rates, so that you attract "hot money" (e.g. money in search of higher return) in order to achieve a capital account surplus, that will offset the BOP deficit (to a certain degree, depends how much you raised your interest rate O).

I did not quite get all the different approaches in the Asset Market Model.

In general the asset market (stock) model looks at the exchange rate as the price of an asset that can be used to store value (i.e. foreign currency as a store of value – you would be surprise how many countries overseas do look upon the US\$ in this way!). There are in essence two directions in the asset market model. One looks only at foreign and domestic monies as a store of value – <u>the monetary approach</u>. In monetary approach exchange rate is the price of one money in another money, so that the supply and demand for each money would determine the relative price b/n the two monies (the exchange rate). In the other approach – <u>portfolio balance</u> – there are three assets: domestic money, domestic bonds, & foreign bonds. The exchange rate establishes balance in the portfolio of these three assets. How? In essence, <u>the expected excess return on domestic over foreign bonds</u>,

i^{DOMESTIC} - i^{FOREIGN} – Expected depreciation of domestic currency

is what determines portfolio weights. Notice that the above term is not always zero (as Fisher open predicts) since we have imperfect capital substitutability (i.e. home and domestic bonds of same maturity and risk are not similar in terms of borrower's credit worth).

Today you said that managed float regimes raise interest rates to defend their currency. But doesn't Fisher open say that this will depreciate the currency?

Yes it does, but not immediately. Fisher open assumes full arbitrage – sometimes, actually oftentimes, there are many <u>limits to arbitrage</u>, such as capital controls & currency controls.

How does home country current account surplus lead to an appreciation in home currency (the preferred local habitat model)?

A current account surplus implies that the home country is consuming less than usual and it is being rewarded for that with a transfer of financial wealth. Think of Japan – they have a CA surplus, and as a result of that a lot of financial wealth is transferred in Japan in terms of US\$ denominated financial assets. Okey, if financial wealth in the US increases, where will it go, if there is home bias? In US bonds & bills, of course. So the US\$ becomes more desirable, and consequently, appreciates.

In regards to the BOP approach – fixed/ floating, managed float – do they all want BOP as close to zero as possible?

Fixed exchange rate regimes necessitate a "balanced" BOP (i.e. BOP close to zero). For managed float and for floating exchange rate this is not required – in the first case government can use interest rates to offset the effect of deficit/surplus on the BOP, while in the second the change in exchange rate itself could help offset the dis-balance on the BOP.

Is the most ideal to have a currency appreciate or depreciate? For a currency to depreciate seems like it's viewed as a bad thing, but at the same time a currency that depreciates/ devalues leads to more trade and exports to countries w/ an overvalued currency value, which would be a good thing. So what's best and what are specific pro-s and con-s of each?

It depends O. If you want to stimulate an economy that experienced deficits of BOP for many years, devaluation might be a good idea – exporting businesses gain competitive advantage over their peers overseas.

Can fixed exchange rate countries have a positive BOP? Does an "excess" of reserves put pressure on currency or does it only work the other way around?

Sure, for example, Hong Kong (which has a currency board w/ par rate to the US\$) has fixed exchange rate w/ high amount of reserves. Now, just like lack of foreign reserves under a fixed exchange rate regime puts pressure on the currency to devaluate, the excess reserves put pressure on the currency to go into the other direction -- revaluate.

Could you please explain the important aspects of the recent G7 meeting and the recent movement (slide) of the US\$.

The main point discussed at that meeting was the large current account deficit of the US. As an engine of the world wide recovery, the US economy's BOP deficit is a serious concern. Why? CA deficit implies, soon or later, depreciation of the US\$. But that means that other currencies will appreciate/ revalue. In other words, their economies will suffer stifled growth since their exports will be subdued (b/c their currencies appreciate).

How long do you think national banks in India & China will continue to maintain their very high foreign reserves?

First, a few facts. As we have session in the session on the history of exchange rates, China has currently more than 300 billion US\$ in official reserves. Similarly, India has more than 85 billion US\$ in reserve. The most striking fact though, has been the size of increase of foreign exchange reserves in India – 85% since 2001, and more than 25% since January 2003 alone!!! Why is that? Initially, analysts were attributing this to a "precaution fear", or insurance motive. However, both China and India have restrictions on their capital accounts (flows). It is conceivable that when the capital flows (or the "hot money" flows) are liberalized, then these reserves will slide down.

What is the main difference b/n the capital and financial account in BOP?

The capital account tracks down more short-term investment flows, or the "hot money", which can easily flow in and out of a country's market at the slightest change of interest rates. Vice versa, financial account represents long-term investment flows, such as foreign direct investments, and portfolio investments.

An increase in which macroeconomic shocks to foreign exchange will create the greatest impact of depreciation of home currency? An increase in the foreign interest rate?

An increase in the foreign interest rate or a decrease in the domestic interest rate would have more of an immediate impact on a currency – depreciation, according to the asset market approach. Why? Because, when you "balance" your portfolio of

South America had spurts of growth in Brazil and Argentina – is it possible that this was just driven by financing?

Growth comes because of new investments. So, if financing was used for the purposes of investments (such as highways, bridges construction, new enterprises) then this will result in growth.

Can we have 30 minutes for the quiz?

Let's make it 25 minutes [©] for quiz 2, and see how it goes.

How comes that the FOREX trading is more expensive than stock trading?

My take on it, trading into forex is more expensive because the underlying asset is more volatile. This means that if you are a forex trader, you will have higher inventory costs (that is costs associated with keeping inventory of currencies at your offices – these include foregone profit opportunities, incurred losses because of depreciation of currencies, etc).