Chapter 15

Review questions

1. What are the benefits of a global financial market?

There are several clear advantages to engaging with an international financial market, including facilitating international trade, portfolio diversification, promoting an efficient allocation of resources, and serving as a disciplining device on policymaking.

There are welfare gains from international trade and international capital mobility can benefit trade in two ways. Firstly, when exchange controls are imposed, trade is restrained as there is only a limited access to foreign currency. Secondly, and perhaps more importantly, access to the international financial market enables countries to live with trade deficits. Current account deficits can be offset in the balance of payments by encouraging capital inflows and generating capital account surpluses.

Portfolio diversification is a way of diversifying risks by investing in a range of different assets. This will limit the exposure of the investor to the poor performance of any particular asset. In an international financial market, the opportunities for doing this are much greater.

An international financial market also enables savers and borrowers to invest anywhere in the world. As a result, investors will move their funds in order to achieve the highest return possible, wherever that is in the world. The projects offering the highest returns will be those that are undertaken, meaning that world output will increase. Competition in international financial markets can also have strong dynamic effects. In order to achieve the highest rate of return, firms will be encouraged to minimise costs and only undertake investment projects that yield positive returns.

Finally, in the same way that international capital markets encourage firms to behave efficiently, they can have a similar disciplining device on policy makers. Poor policy is likely to be punished with capital outflows, e.g., poor policy produces an interest rate penalty for the economy.

2. Are currency crises self-fulfilling?

In second generation models, a crisis can become a self-fulfilling event. In such a situation, strong coordination among speculators is required for pessimism to become self confirming. The situation in which a crisis could happen, but need not presents speculators with a one way bet. They will reap a huge capital gain by selling currency if the exchange rate regime collapses, but will make no losses (apart from transaction costs) if the collapse fails to materialise. If self-fulfilling crises are a possibility, then what can create the coordination dynamics that can set them off? An explanation is herding behaviour, which is the simple idea that speculators will all move in the same direction because the behaviour of one will influence the behaviour of others in the same direction.

3. Why are emerging market economies particularly vulnerable to currency crises?
Emerging economies are vulnerable to crises as they tend to exhibit the conditions under which a currency likely to come under attack. Namely, these include a balance of payments crisis when reserves are limited, being prone to inflation whilst in a fixed exchange rate regime which can erode competitiveness, and finally, a government with a substantial debt may produce some inflation (seigniorage revenues) to reduce the real value of its debt which leads to the likelihood of the first two conditions.

More advanced problems
4. "Exchange rate volatility is the symptom of poor domestic macroeconomic policies." Discuss
The internationalisation of financial markets suggests that there is increasing volatility in currency and capital markets globally. Exchange rate volatility, which reflects buying and selling pressure in currency markets, can be a product of the growth in international capital flows. However, there are also instances such as the first generation models of currency crises where the macroeconomic policies of a country leading to a balance of payments crisis, inflation and high levels of debt generate conditions which make a currency attack more likely. However, second generation and third generation models suggest that inconsistent policy objectives and underdeveloped financial markets can cause a currency to come under attack even when domestic macroeconomic policies are otherwise not clearly poor or imprudent.

5. Capital controls give policy makers an extra degree of freedom. Is this a decisive argument in favour of their implementation? What other policies can policy makers use to prevent currency crises?
Capital controls can prevent features of a currency crisis, such as contagion from taking hold. However, they also deprive economies of the benefits of international financial markets and are their effectiveness are increasingly eroded because of the growth of offshore banking which has been a reason for the demise of the use of capital controls. Therefore, on the pro side, obviously capital controls will prevent instability brought on by hot money flows. It will also give policy makers more influence over their domestic monetary policy, and a greater ability to set interest rates. However, on the con side, interrupting the flow of international capital could result in problems and inefficiencies. Policy makers would find it harder to deal with balance of payments problems brought on by current account shocks, if offsetting capital account transactions are limited. Secondly, it is argued that capital flows act as a good disciplining device on policy making; bad policies resulting in current account deficits, inflation or fiscal deficits will be punished by outflows of capital. Finally, capital should be free to move to where it can achieve the highest possible return, imposing such limits on its mobility may well result in a sub-optimal worldwide allocation of capital. One alternative policy is a Tobin tax, which is a tax on any short-term international transactions. This would discourage active speculation against a currency. However, there are problems with its implementation, which has led many to believe that it could never work in practice. As a fixed exchange rate regime is regarded by many as being ultimately unsustainable because speculators are offered a one-way bet and thus an attack is always an eventual outcome. In this respect, there are two alternatives for policy makers which is to either

adopt a floating exchange rate regime or a monetary union. Banking regulation is another policy alternative, which can address the latest set of currency crises but also raises questions about the difficulties of regulating international banking in a global system.

6. Should a small country print its own money or adopt that of a large established economy? How might the relative political stability of the two countries play a role in this decision?

This issue tends to be discussed in the context of the decision of the Latin American countries to adopt dollarization. The reasons for doing this are partly similar to those that underlie the adoption of a single currency in Europe. We have seen that fixed exchange rate regimes have a tendency to eventually breakdown. This is usually when speculators believe that commitment to the fixed parity is no longer credible and that domestic policy objectives will override it. This was certainly the case with the ERM and pointed to full monetary union as the only long term way of sustaining fixed exchange rates. There are many reasons why emerging market economies may wish to adopt a fixed rate against the U.S. dollar. If the fixed rate is credible, then it can encourage low domestic inflation. In addition, stable exchange rates and prices would encourage capital inflows and trade – all potentially valuable things for a nation looking to promote long run growth. However, if commitment to the fixed rate requires the imposition of painful domestic policies, then speculators may only be too willing to test the resolve of governments. Dollarization is therefore an attempt to introduce extra credibility into a nation's monetary and exchange rate policy. Dollarization is an ultimate form of a fixed exchange rate. It should thus reduce the pressures for devaluation and thus a currency crisis. From Mexico's experience in 1994-95, the civil unrest which generated pressures for a devaluation suggests that political stability will play a role in the expectations of a devaluation of a currency even if it is fixed to the dollar. The general principle behind attacks seems to be the inconsistency in policy making and that ultimately governments are prepared to forsake long term political or inflation credibility for a short run economic expansion. Therefore, adopting the currency of a stable, large economy should be beneficial in reducing the likelihood of an attack, but the political risks and pressures in a developing country can still lead to a currency crisis.