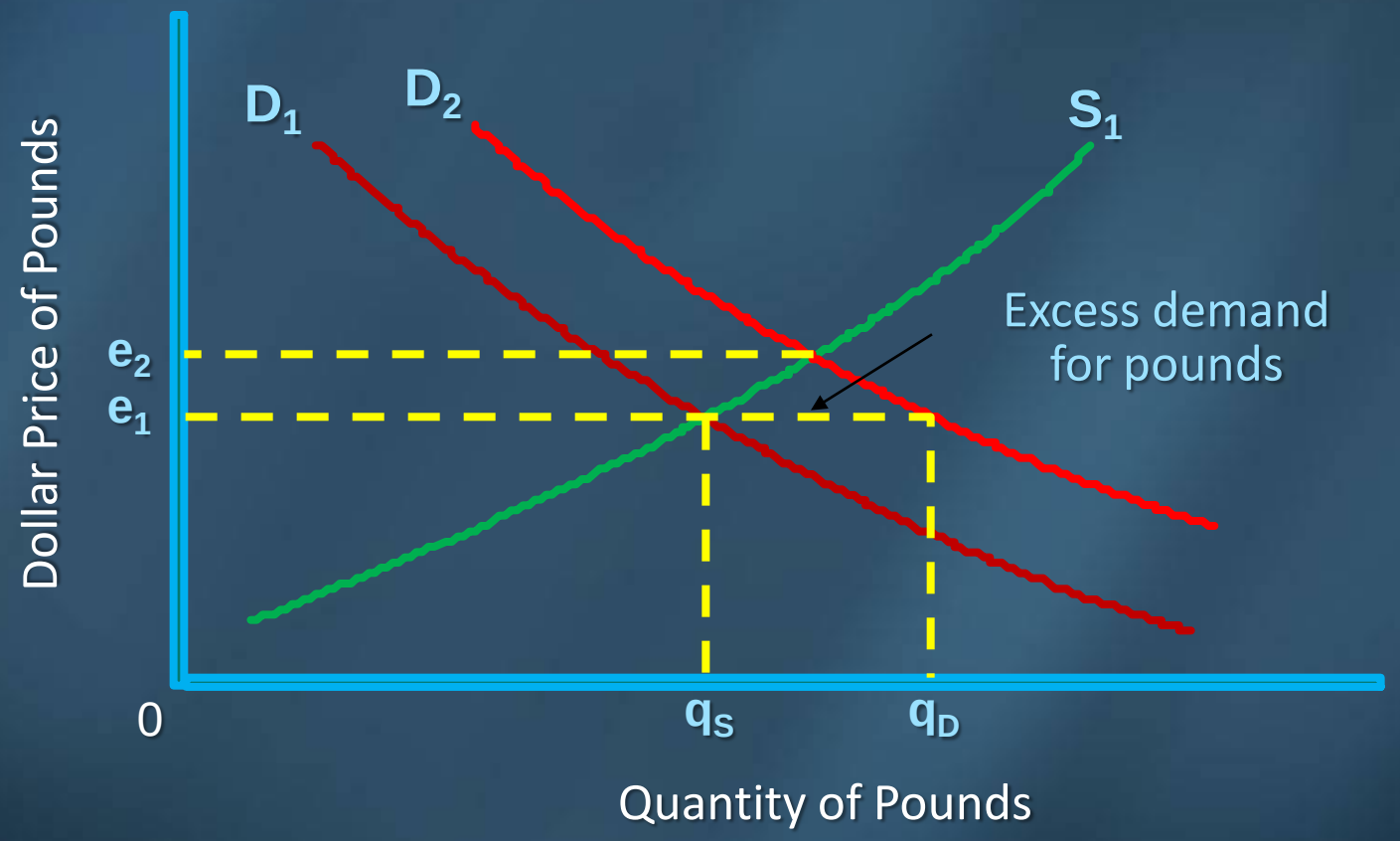
International Finance Part III

Trillions of dollars every day are being exchanged around the world in all of the financial markets.
-Kenneth Lay

Chart: Fixed Rates and Market Imbalance



The Need for Reserves

- The Treasury could help maintain the officially established exchange rate by selling some of its foreign exchange reserves.
- ***Foreign Exchange Reserves*** - holdings of foreign exchange by official government agencies, usually the central bank or treasury

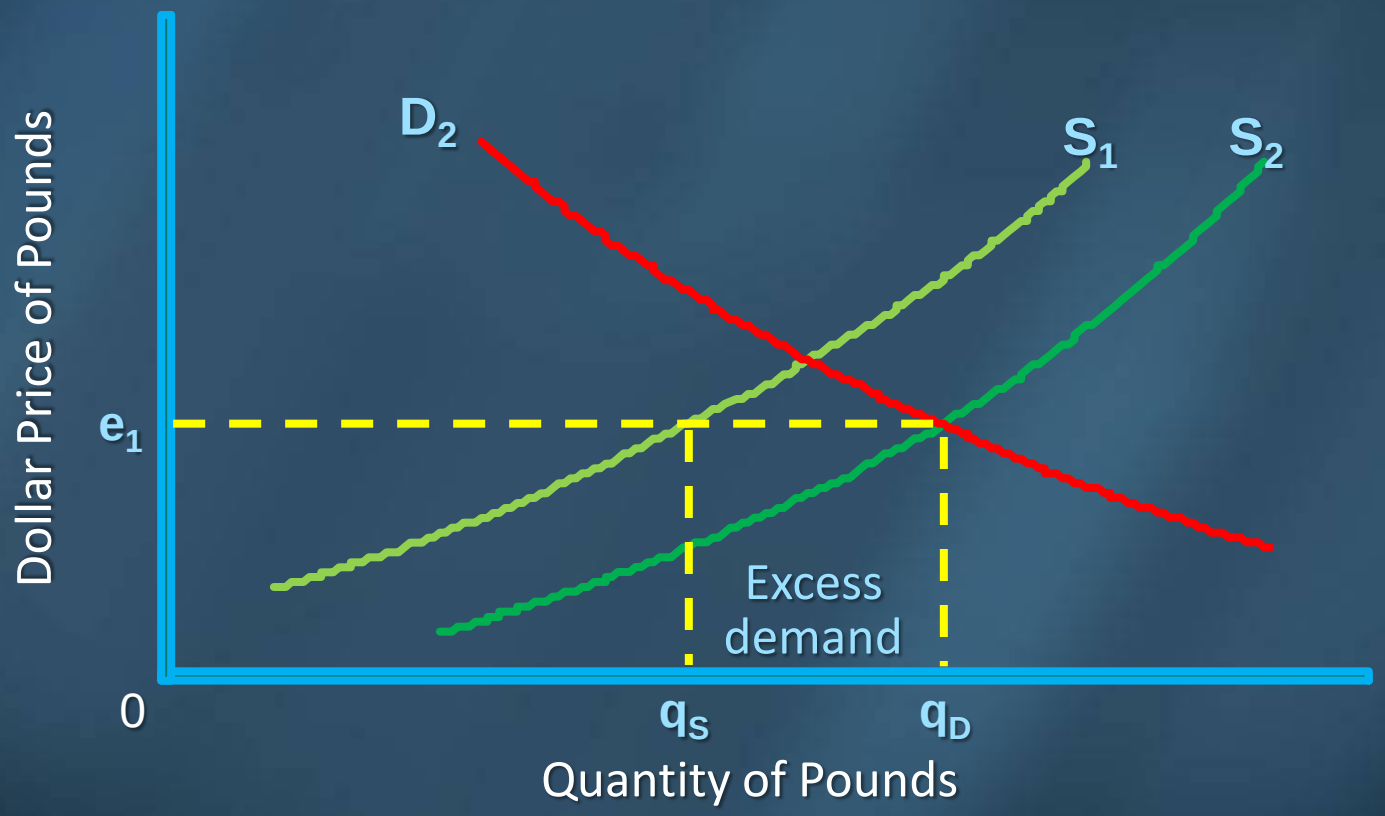
The Need for Reserves

- Foreign exchange reserves may not be adequate to maintain fixed exchange rates.
- The long-term string of US balance-of-payments deficits overwhelmed our stock of foreign exchange reserves.

Exchange Rate Intervention

Governments often intervene in foreign exchange markets to achieve greater exchange rate stability.

Chart: The Impact of Monetary Intervention



The Role of Gold

- Gold reserves are a potential substitute for foreign exchange reserves.
- ***Gold Reserves*** - stocks of gold held by a government to purchase foreign exchange

The Role of Gold

- Continuing US balance-of-payments deficits exceeded the holdings under Fort Knox.
- As a result, US gold reserves lost their credibility as a potential guarantee of fixed exchange rates.

Domestic Adjustments

- Trade protection can be used to prop up fixed exchange rates.
- Deflationary (or restrictive) policies help correct a balance-of-payments deficit by lowering domestic incomes and thus the demand for imports.

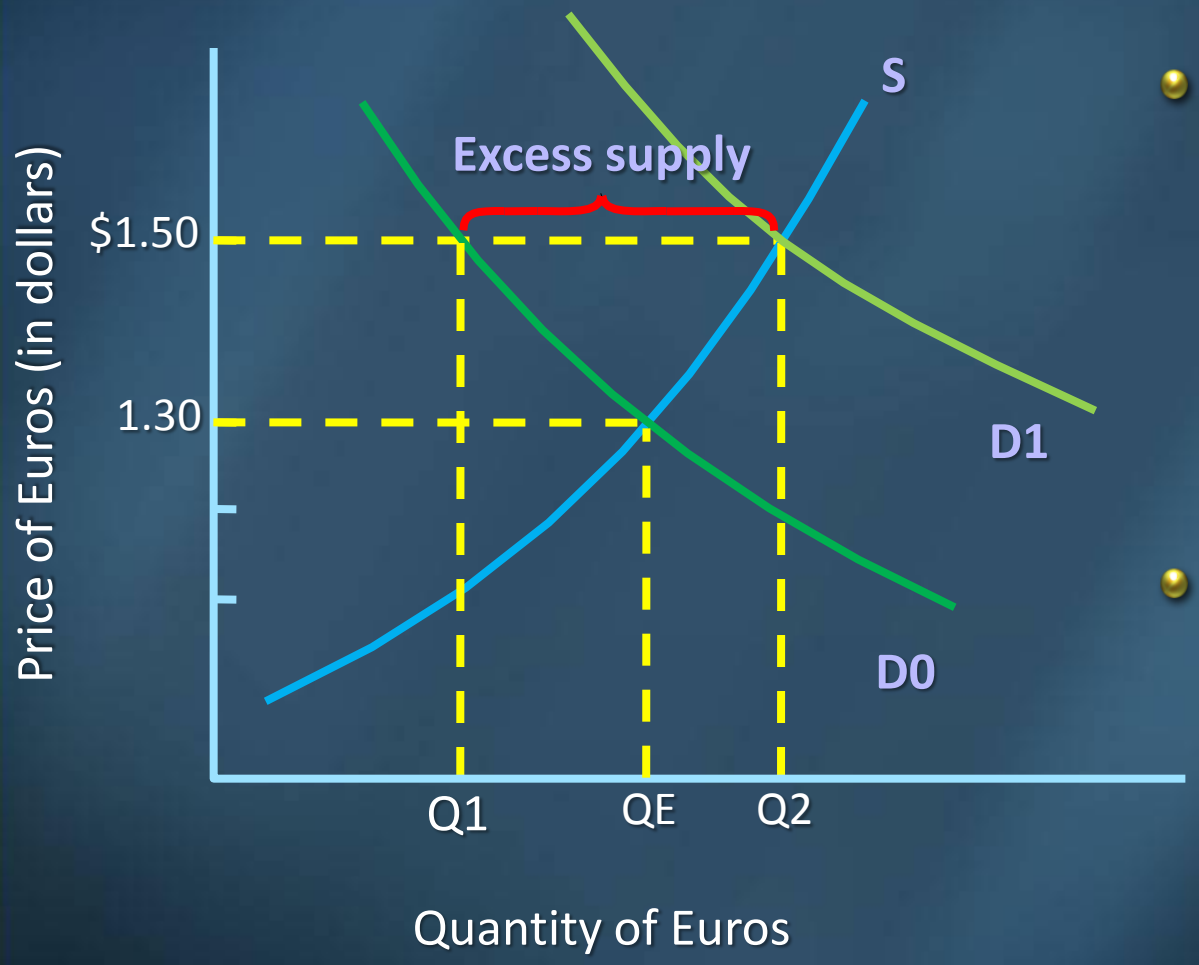
Domestic Adjustments

Domestic adjustments require a deficit country to give up full employment and a surplus country to give up price stability.

Direct Exchange Rate Intervention

- To avoid the problems caused by fluctuating exchange rates, governments sometimes intervene to fix exchange rates by buying and selling currency.
- If a government buys its own currency, it can increase its exchange rate.
- If a government sells its own currency, its value decreases.

Chart: Direct Exchange Rate Intervention

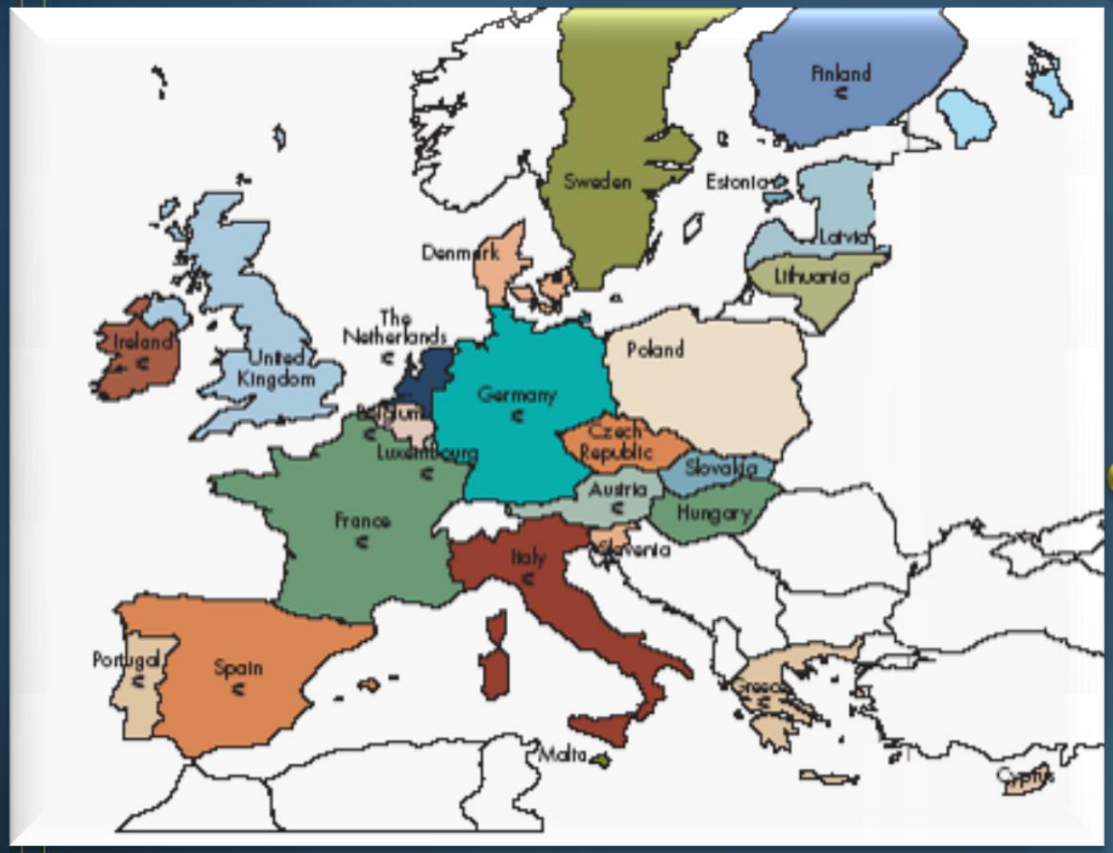


- If the government wishes to hold the exchange rate at $1.50 when the equilibrium is $1.30, there is an excess supply of Q_2-Q_1.
- The government purchases the excess (D_1) to maintain $1.50 as equilibrium.

Currency Stabilization

- A more viable long-run exchange rate policy is ***currency stabilization*** – the buying and selling of a currency by the government to offset temporary fluctuations in supply and demand for currencies
- The government is not trying to change the long-run equilibrium, but is trying to keep the exchange rate at that long-run equilibrium.
- A central issue in exchange rate intervention policy is estimating the long-run equilibrium.

The Euro Fix



- The 12 nations of the European Monetary Union (EMU) fixed their exchange rates in 1999.
- They eliminated their national currencies, making the Euro the common currency of the EU.

The Euro: A Common Currency

- Advantages
  - eliminates the cost of exchanging currencies
  - facilitates price comparisons
  - creates a larger market
- Disadvantages
  - loss of independent monetary policy for member countries
  - loss of some national identity

Estimating Exchange Rates with Purchasing Power Parity

- ***Purchasing Power Parity (PPP)*** – a method of calculating exchange rates that values currencies at rates such that each currency will buy an equal basket of goods
- According to PPP, if a basket of goods costs $7 in the US & ¥1000 in Japan, the exchange rate should be $1 = 1000/7 = ¥143.

Real Exchange Rates

- A ***real exchange rate*** is an exchange rate adjusted for differential inflation or differential changes in the price level.
- A nominal exchange rate is the actual exchange rate used when currencies are exchanged.

%Δ real exchange rate =

%Δ nominal exchange rate –

(domestic inflation – foreign inflation)

Flexible Exchange Rates

- ***Flexible exchange rates*** is a system in which exchange rates are permitted to vary with market supply and demand conditions.
- Also called floating exchange rates.
- With flexible exchange rates, the quantity of foreign exchange demand always equals the quantity supplied.

Flexible Exchange Rates

- Someone is always hurt and someone is always helped by exchange rate movements.
- Exchange rate movements associated with flexible rates alter relative prices and may disrupt import and export flows.

Flexible Exchange Rates

- Advantages
  - provide for orderly incremental adjustment of exchange rates
  - allow government to be flexible in conducting monetary and fiscal policy
- Disadvantages
  - allow speculation to cause large jumps in exchange rates
  - allow government to be flexible in conducting monetary and fiscal policy

Partially Flexible Exchange Rates

- Partially flexible exchange rate regimes combine the advantages of both fixed & flexible exchange rates.
- If policy makers believe there is a fundamental misalignment in a country's exchange rate, they allow market forces to determine it.
- If they believe the currency's value is falling because of speculation, they step in and fix the exchange rate.

Speculation

- Speculators often counteract short-term changes in foreign exchange supply and demand.
- Sometimes, speculators move “with the market” and make swings in the exchange rate even more extreme.

Managed Exchange Rates

- Governments may buy and sell foreign exchange for the purpose of *narrowing* exchange rate movements.
- Such limited intervention in foreign exchange markets is referred to as ***managed exchange rates***.

Managed Exchange Rates

- ***Managed exchange rates*** is a system in which governments intervene in foreign-exchange markets to limit but not eliminate exchange rate fluctuations.
- Sometimes called “dirty floats.”
- The basic objective of exchange rate management is to provide a stabilizing force.

Currency Bailouts

- The world has witnessed a string of currency crises.
  - the Asian crisis of 1997-1998
  - the Brazilian crisis of 1999
  - the recurrent ruble crises in Russia
  - periodic panics in Mexico and South America

Currency Bailouts

In most cases a currency “bailout” was arranged by the International Monetary Fund, joined by the central banks of the strongest economies.

The Case for Bailouts

- The case for currency bailouts typically rests on the domino theory.
- Weakness in one currency can undermine another.
- Industrial countries often offer currency bailout as a form of self-defense.

The Case Against Bailout

- Critics of bailouts argue that such interventions are ultimately self-defeating.
- Once a country knows that currency bailouts will occur, it may not pursue domestic policy adjustments to stabilize its currency.
- A nation can avoid politically unpopular options such as high interest rates, tax hikes or cutbacks in government spending.
- It can also turn a blind eye to trade barriers, monopoly power, lax lending policies and other constraints on productive growth.

Future Bailouts?

To minimize the ill effects of bailouts, the IMF and other institutions typically require the crisis nation to pledge more prudent monetary, fiscal and trade policies.

Future Bailouts?

As long as the crisis nation is confident of an eventual bailout, however, it has a lot of bargaining power to resist policy changes.


The End