International Financial Policy

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Chapter Goals

- Describe the balance of payments and the trade balance, and relate them to the supply and demand for currencies
- Explain four important fundamental determinants of exchange rates
- Discuss how a country influences its exchange rate by using monetary and fiscal policy
- Explain how a country stabilizes or fixes an exchange rate

Chapter Goals

- Discuss purchasing power parity and the real exchange rate
- Differentiate fixed, flexible, and partially flexible exchange rates, and discuss the advantages and disadvantages of each
- Examine the advantages and disadvantages of a common currency

The Balance of Payments

- **Balance of payments** is a country's record of all transactions between its residents and the residents of all foreign nations
- These include a country's buying and selling of goods and services (imports and exports) and interest and profit payments from previous investments, together with all the capital inflows and outflows
- These accounts record all payments made by foreigners to U.S. citizens and all payments made by U.S. citizens to foreigners in those years

The Balance of Payments Account, 2008

		2008 (billions of dollars)
1	**Current account**	
5	Balance of merchandise trade	- 821
9	Balance on services	+ 139
10	Balance on trade	- 682
13	Invest. trans. balance	+ 9
14	**Balance on current account**	**- 673**
15	**Financial and capital account**	
16	Capital balance	- 3
20	Balance on private financial account	+ 660
24	Balance on government financial account	- 113
25	**Balance on financial and capital account**	**+ 544**
26	Statistical discrepancy	+ 129
27	**Total**	0

The Current Account

- The **current account** (lines 1–14) is the part of the balance of payments account in which all short-term flows of payments are listed
- The **balance of merchandise trade** is the difference between the value of goods exported and the value of goods imported
- The **balance of trade** is the difference between the value of goods and services exported and imported

The Current Account, 2008

		2008 (billions of dollars)	
1	**Current account**		
2	Merchandise		
3	Exports	+ 1,291	
4	Imports	- 2,112	
5	Balance of merchandise trade		- 821
6	Services		
7	Exports	+ 544	
8	Imports	- 405	
9	Balance on services		+ 139
10	Balance on trade		- 682
11	Net investment income	+ 128	
12	Net transfers	- 119	
13	Invest. trans. balance		+ 9
14	**Balance on current account**		**- 673**

The Financial and Capital Account

The **financial and capital account** (lines 15–25) is the part of the balance of payments account in which all long-term flows of payments are listed

1. The capital account includes debt forgiveness, migrant's transfers, and transfers related to the sale of fixed assets
2. The financial account includes trade in assets such as business firms, bonds, stocks, and ownership right to real estate

- **Official reserves** are government holdings of foreign currencies

The Financial and Capital Account, 2008

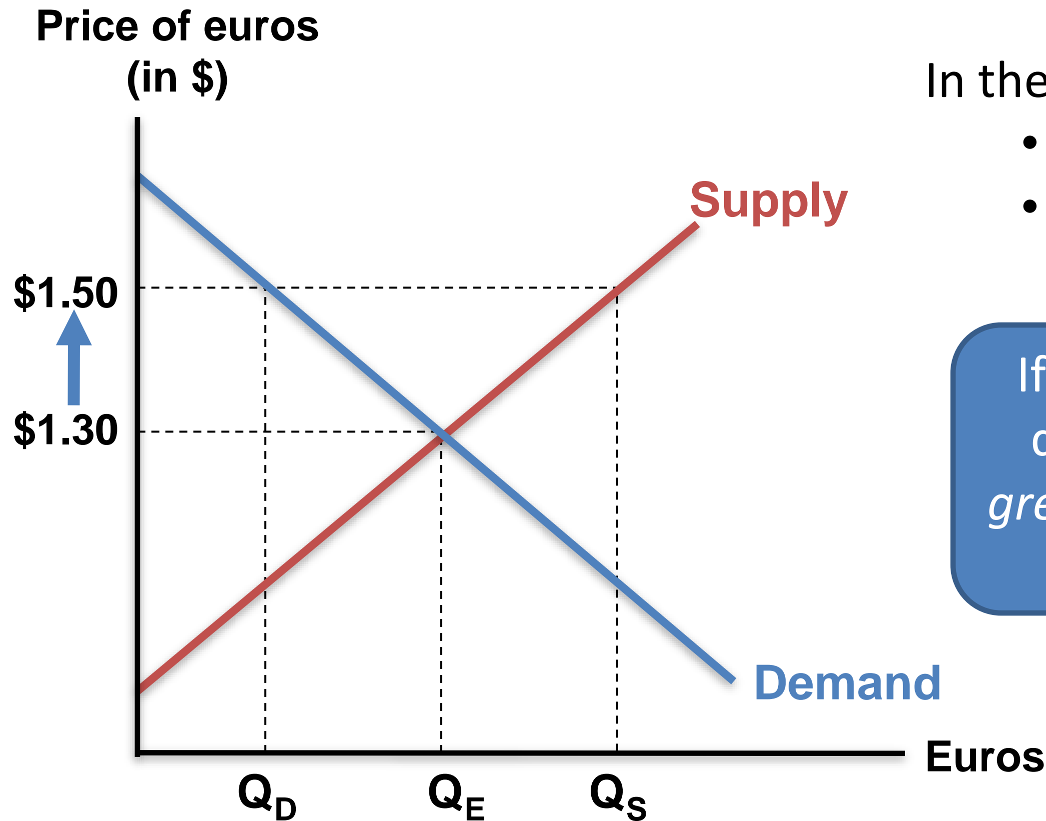
			2008 (billions of dollars)
15	**Financial and capital account**		
16	Capital balance		- 3
17	Private financial account		
18	Foreign-owned assets in the U.S.	+ 178	
19	U.S.-owned assets abroad*	+ 482	
20	Balance on private financial account		+ 660
21	Government financial account		
22	Foreign government financial balance	+ 421	
23	U.S. government financial balance	- 534	
24	Balance on government financial account		- 113
25	**Balance on financial and capital account**		**+ 544**

Note: Line 19 is generally negative. In 2008, however, it is positive due to extraordinary capital withdrawals by U.S. entities from foreign sources as the result of the financial crisis.

Exchange Rates

- An exchange rate is the rate at which one country's currency can be traded for another country's currency
- The exchange rate is determined by demand and supply in the **forex market** (foreign exchange market) where traders buy and sell currencies
- The forex markets are very busy with nearly $2 trillion traded every day

The Supply and Demand for Euros



In the supply of and demand for euros,

- Price is measured in $
- Quantity is in euros

If the price increases to $1.50, the quantity supplied (Q_S) of euros is *greater than* the quantity demanded (Q_D)

Fundamental Forces Determining Exchange Rates

- Fundamental forces determine the demand and supply for currencies and can cause them to shift:
  - A country's income
  - Changes in a country's prices
  - The interest rate in a country
  - A country's trade policy

Indirect Methods of Influencing Exchange Rates

Monetary policy affects exchange rates in three primary ways:

1. Its effect on the interest rate
2. Its effect on income
3. Its effect on price levels and inflation

Changes in Interest Rates

Interest rates in the U.S. **increase**

Demand for U.S. interest-bearing assets **increases**

Demand for dollars to buy U.S. assets **increases**

The increase in the demand for dollars causes the price of dollars to **increase**

Changes in a Country's Income or Prices

Income or prices **increase** in the U.S.

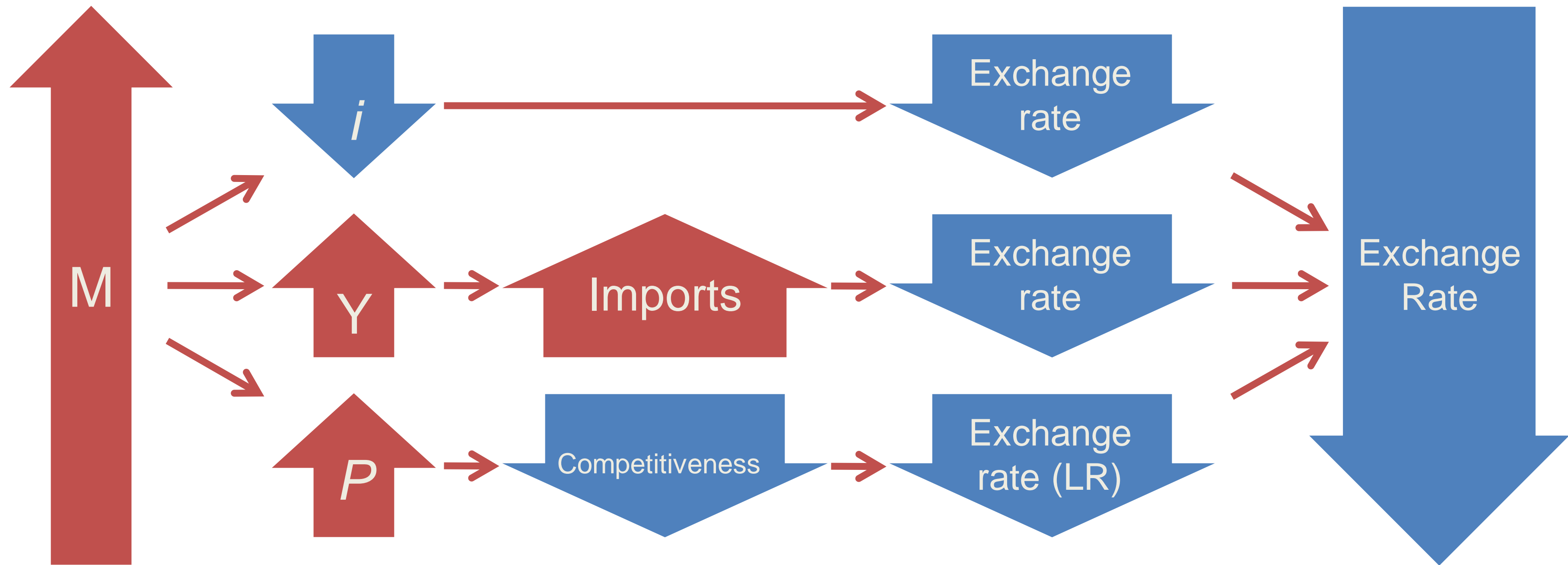
Imports **increase**

Demand for foreign currency to buy imports **increases** which means the supply of the dollar **increases**

The increase in supply of the dollar causes the price of the dollar to **decrease**

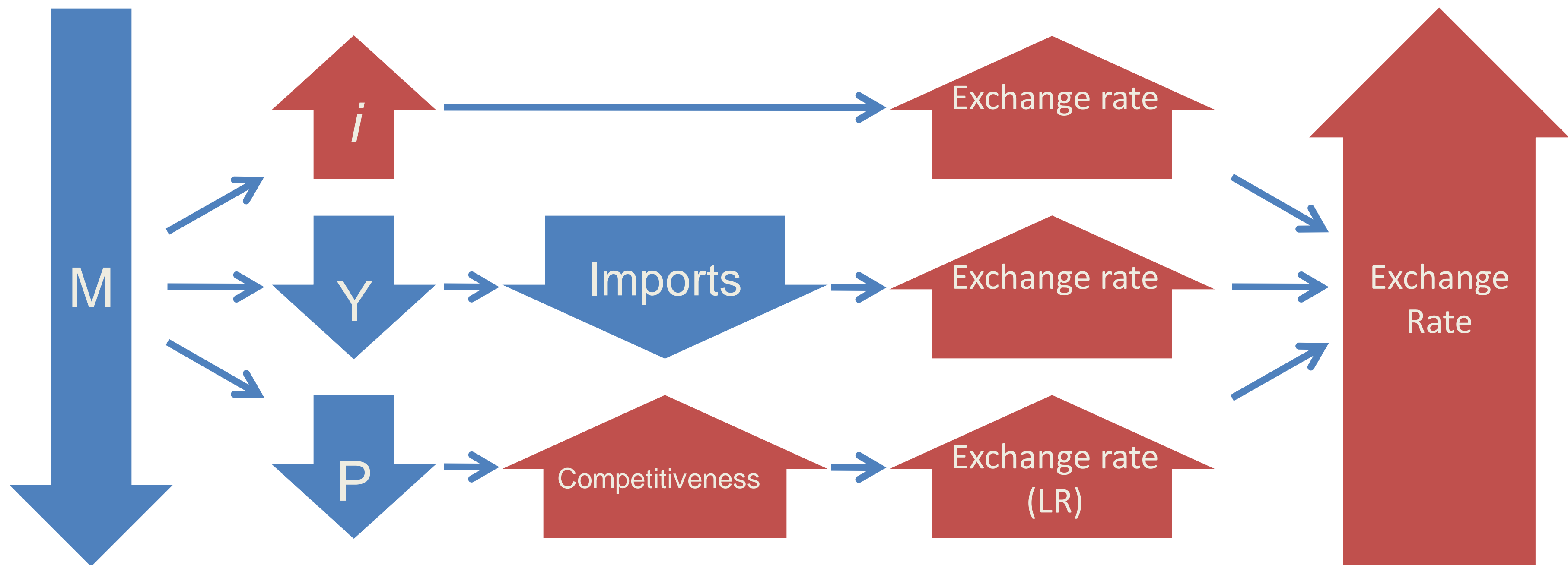
The Net Effect of Monetary Policy on Exchange Rates

- Expansionary monetary policy lowers exchange rates
- It decreases the relative value of a country's currency



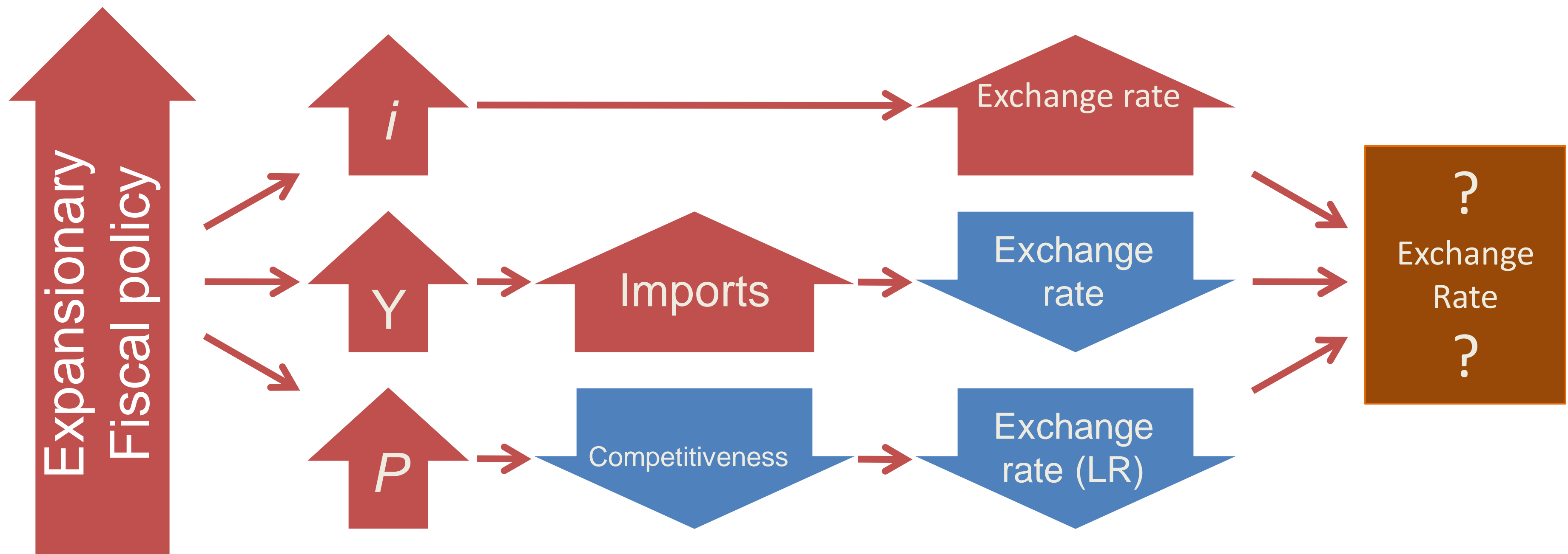
The Net Effect of Monetary Policy on Exchange Rates

- Contractionary monetary policy increases exchange rates
- It increases the relative value of a country’s currency



The Net Effect of Fiscal Policy on Exchange Rates

The effect of expansionary fiscal policy on exchange rates is not so clear



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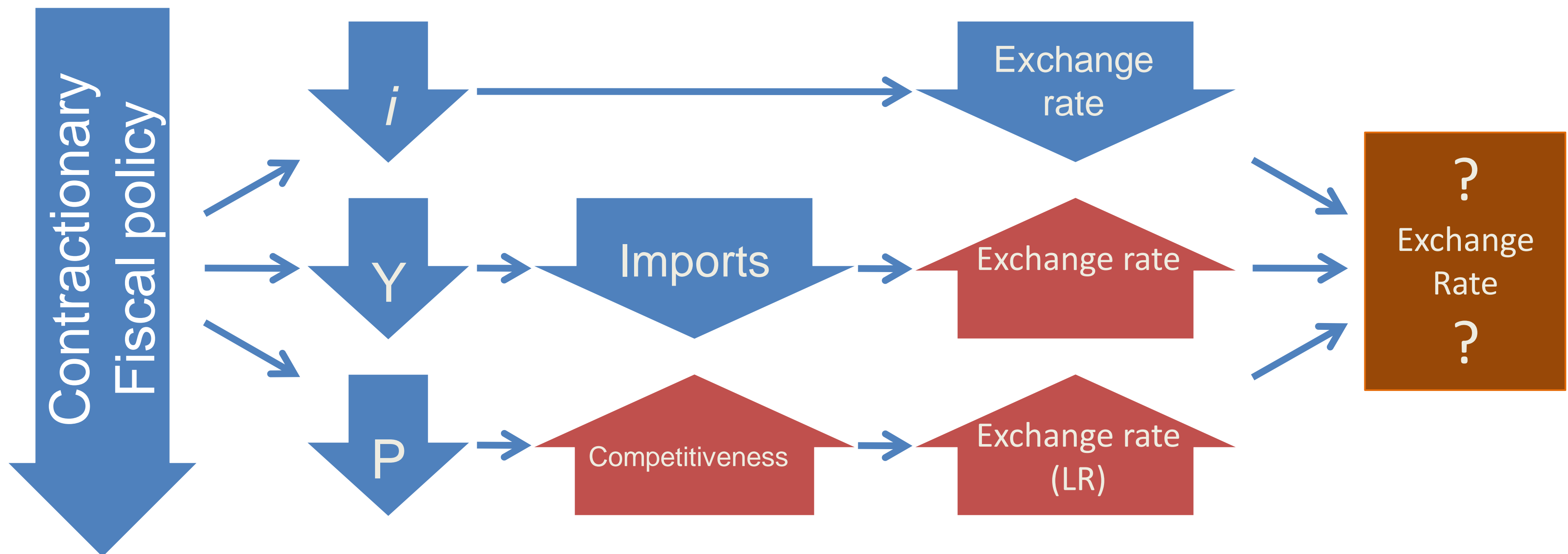
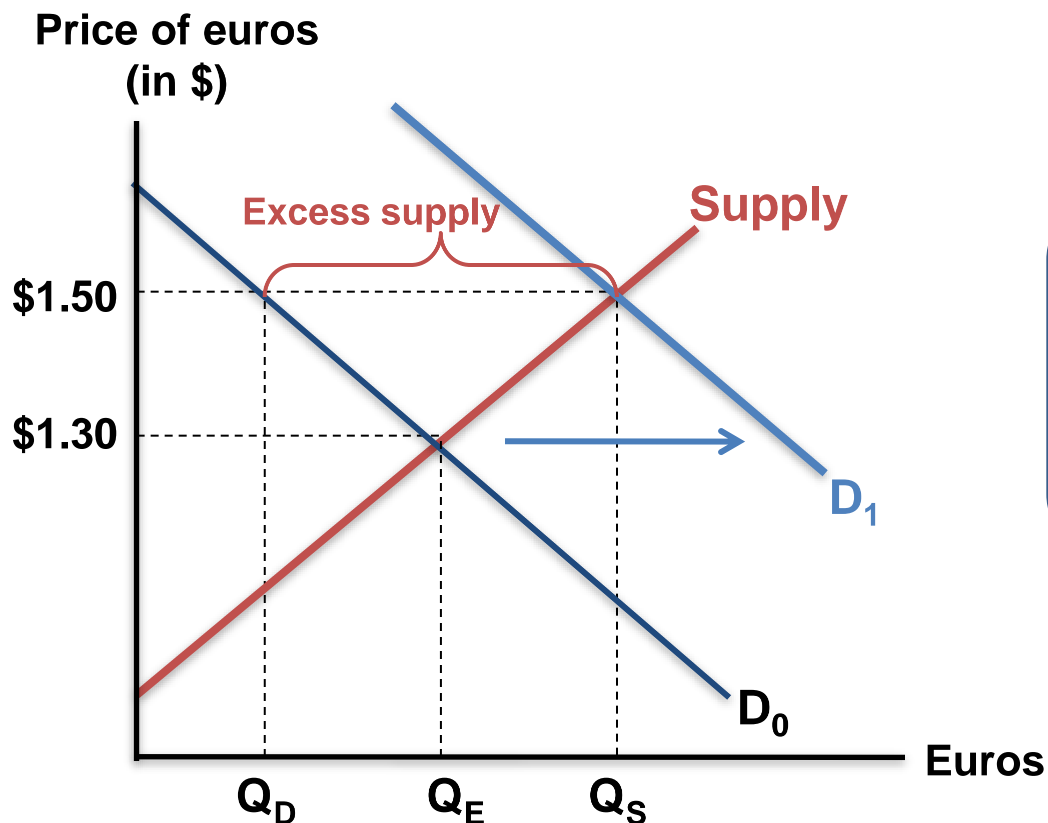


Direct Methods of Influencing Exchange Rates

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

Currency Support

Currency support is the buying of a currency by a government to maintain its value at a level above its long-run equilibrium value



The government purchases this excess (using official reserves) and closes the difference, thus maintaining equilibrium

Currency Stabilization

- A more viable long-run exchange rate policy is **currency stabilization,** which is 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

Purchasing Power Parity and Real Exchange Rates

- **Purchasing power parity (PPP)** is 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 U.S. and ¥1000 in Japan, the exchange rate should be

$1 = 1000/7 = ¥143

- Purchasing power parity exchange rates may or may not be appropriate long-run exchange rates

Actual and Purchasing Power Parity Exchange Rates for 2008

Country	Actual exchange rate	PPP Exchange Rate	+/-
Switzerland	1.0816	1.680	+ 55%
United Kingdom	0.54	0.651	+ 21%
Japan	103.39	117.13	+ 13%
United States	1	1	0%
Brazil	1.8327	1.468	- 20%
Russia	33.523	18.890	- 44%
China	6.9477	3.694	- 47%
Mozambique	26,840	12,579	- 53%
India	43.39	16.142	- 63%
Uganda	2,076	654	- 68%

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 – foreign inflation)

Alternative Exchange Rate Systems

Three exchange rate regimes are:

1. **Fixed exchange rate** where the government chooses an exchange rate and offers to buy and sell currencies at that rate
2. **Flexible exchange rate** where the determination of exchange rates is left totally up to the market
3. **Partially flexible exchange rate** where the government sometimes buys or sells currencies to influence the exchange rate, while at other times letting private market forces operate

Advantages and Disadvantages of **Fixed** Exchange Rate Systems

Advantages

- They provide international monetary stability
- They force governments to make adjustments to meet international problems

Disadvantages

- If they become unfixed, they create monetary instability
- They force governments to make adjustments to meet international problems

Advantages and Disadvantages of **Flexible** Exchange Rate Systems

Advantages

- They provide for orderly incremental adjustment of exchange rates
- They allow government to be flexible in conducting monetary and fiscal policy

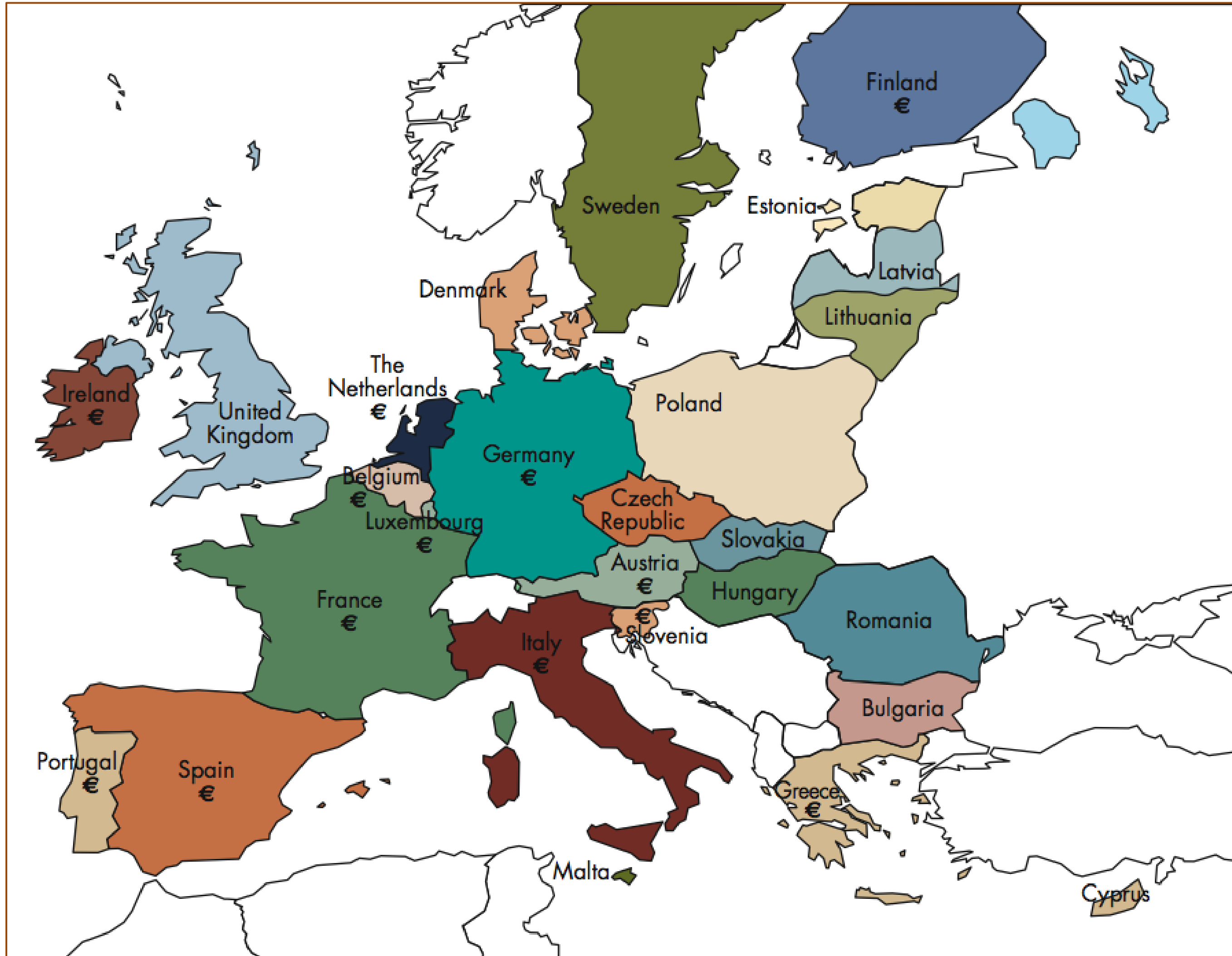
Disadvantages

- They allow speculation to cause large jumps in exchange rates
- They allow government to be flexible in conducting monetary and fiscal policy

Advantages and Disadvantages of **Partially Flexible** Exchange Rate Systems

- Partially flexible exchange rate regimes combine the advantages of both fixed and 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

The Euro: A Common Currency for Europe



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

Chapter Summary

- The balance of payments is made up of the current account and the financial and capital account
- Exchange rates in perfectly flexible systems are determined by the supply of and demand for a currency
- The following increase demand for foreign currencies and depreciate domestic currencies:
  - An increase in domestic income
  - An increase in domestic prices
  - A decrease in domestic interest rates
  - A reduction in trade restrictions on imports

Chapter Summary

- To raise the value of its domestic currency a country can either increase private demand or decrease private supply through contractionary monetary policy
- Expansionary monetary policy, through its effect on interest rates, income, and price level, tends to lower a country's exchange rate
- Fiscal policy has an ambiguous effect on a country's exchange rate

Chapter Summary

- A country can stabilize or fix its exchange rate directly by buying and selling its own currency or indirectly by adjusting its monetary and fiscal policy to achieve its exchange rate goal
- It is easier technically for a country to bring the value of its currency down than it is to support its currency
- The purchasing power parity approach can be used to estimate the long-run equilibrium exchange rate

Chapter Summary

- Fixed exchange rates provide international monetary stability but can create enormous monetary instability if they become unfixed
- Fixed exchange rates force governments to make adjustments to meet their international problems
- Flexible exchange rates allow exchange rates to make incremental changes, but are also subject to large jumps in value as a result of speculation
- Flexible exchange rates give governments flexibility in conducting domestic monetary and fiscal policy

Chapter Summary

- A real exchange rate is an exchange rate adjusted for differences in inflation
- A common currency creates strong political ties, reduces the cost of trade, facilitates price comparisons, and creates a larger single market
- A common currency also makes it impossible to have an independent monetary policy
- The 13 countries that share the euro gave up their own national currencies and gave up independent monetary policies