What is an exchange rate?

- The price of a currency expressed in terms of other currencies or gold.
What the International Monetary System Has to Do

• Assure currency **convertibility**
• Maintain sufficient availability of currencies for trading and capital flows (**liquidity**)
• Maximize **stability** of exchange rates given changes in demand and supply
• Allow balances of payments to equilibrate over time via changes in exchange rates
Definitions

• **Balance of Trade**
  – Exports minus Imports

• **Balance of Payments**
  – trade balance minus net financial flows

• **Budgetary Balance**
  – govt. revenues minus govt. expenditures

“surplus” means balance is positive
“deficit” means balance is negative
Figure 2-12. U.S. Balance of Trade in Goods and Services and Balance of Payments on Current Account, 1946-2006, in Billions of Current Dollars

U.S. Balance of Trade, 2008-2009

United States Balance of Trade

Balance of Trade (Billion USD)

source: U.S. Census Bureau

www.tradingeconomics.com
Structural Imbalance

• When a trade or balance of payments deficit or surplus persists over a relatively long period of time, it is called a “structural imbalance.”

• If a country has a structural deficit, it needs to import less and export more, especially after it can no longer borrow funds to “finance” its deficit.
What is a Key Currency?

• Currency used in international trade settlement, or as a reference currency in setting exchange rates. The current key currency is the U.S. Dollar. Central banks hold a portion of their reserves in a key currency.
Figure 2-6. The Dollar as Percent of Total Official Foreign Currency Holdings, 1978, 1986, 1996, and 2007

Source: International Monetary Fund, Annual Reports, various years.
Special Status of Key Currency Country

• A key currency country does not have to worry as much as others about dealing with a structural deficit, since its currency is needed for international transactions.

• A key currency country can “export its inflation” to other countries by keeping domestic demand high during a period of structural deficits.
Structural Surplus Countries

- Germany and Japan maintained structural surpluses from late 1960s on.
- They refused to upwardly revalue their currencies so that their payments would come into balance.
- They did this because the growth of their economies depended heavily on exports.
Figure 2.14. US-China and US-Japan Bilateral Trade Deficits, in Billions of Dollars, 1991-2006

Figure 2-10. Balance of Payments in the G-5 Countries, 1970-2007, in Billions of Current Dollars

The Nixon Shock of 1971

• August 1971, US has a small balance of payments deficit (first for many years)

• Nixon and Treasury Secretary John Connally agree on new policy:
  – dollar no longer tied to gold
  – import surcharge of 10 percent on all imports
  – US will withdraw surcharge if surplus countries (Germany and Japan) agree to revalue currencies
Nixon, Connally, and the Smithsonian Agreement
Figure 2-6. Volatility in Deutsche Mark (DM) and Yen Exchange Rates with the U.S. Dollar, 1965-1979, Percentage Changes from the Previous Month

Plaza Accord

Agreement signed on September 22, 1985 at the Plaza Hotel in New York City by 5 nations - France, West Germany, Japan, the United States and the United Kingdom. The five agreed to, amongst others, depreciate the US dollar in relation to the Japanese yen and German Deutsche Mark by intervening in currency markets.

Year

Yen per Dollar

DM per Dollar

0 0.5 1 1.5 2 2.5 3 3.5 4 4.5


Plaza Accords

Nixon Shock

Yen-Dollar DM-Dollar
Figure 2-13. DM-Dollar, Yen-Dollar, and Euro-Dollar Exchange Rates, 1985-2007

## Shift in the Monetary Regime After 1971

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Predictions of Doom

• End of fixed exchange rates would lead to “competitive devaluations” -- as in the 1930s -- which could lead to another Great Depression.

• End of U.S. hegemony would result in an unstable world economy.
Flexible exchange rates came just in time to deal with the shock created by the OPEC price increases of the 1970s.

Although there would be greater volatility in exchange rates, there would be fewer crises brought on by delayed devaluations.

Many countries would continue to peg their currencies against the dollar.
Financial Crises

• Often begin with structural deficit problem accentuated by a severe downturn in the domestic economy
• Country may default on its international obligations (loans, other foreign investments)
• All this occurs in a general atmosphere of panic, currency value may fall rapidly
The Peso Crisis of 1994

- Mexico admitted to OECD in May 1994
- Huge balance of payments deficit financed by Tesobonos (bonds denominated in dollars)
- Zedillo replaces Salinas as President
- Sudden devaluation of the peso in December 1994
- GDP contracted by 7 percent in 1995
The Asia Crisis of 1997-98

- **Frontline video of origins**
- Starts with collapse of Thai currency, the baht
- Crisis spreads to Indonesia, South Korea, and other East Asian countries
- IMF criticized for bad advice/pressure during the crisis
Russian Crisis of 1998

- Delayed impact of Asia Crisis
- Oil prices on the decline, government unable to collect taxes
- Use of dollar-denominated GKO bonds to finance budget deficits
- Ruble suddenly devalued in August 1998
- Economy recovered quickly when oil prices increased
Global Financial Crisis 2008

• Led by bursting of housing bubble in the US

• Made worse by near collapse of US financial markets connected with mortgage-backed securities and credit default swaps

• Response revives Keynesian approach to preventing deep recessions
House Prices in the UK 1975-2005

Real House Prices
Source: Nationwide Building Society

Base: 2005 Q4
Trend from 1975 Q1 to 2006
Trend = c2.4% per annum