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Economic Policy 2023

View of Rovaniemi (Finland)

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Foreign Exchange Market

- **Foreign Exchange market:**
  Market where different currencies are traded, one for another.
- The exchange rate enables people in one country to translate the prices of foreign goods into units of their own currency.
  - An ***appreciation*** of a nation's currency will make foreign goods cheaper.
  - A ***depreciation*** of a nation's currency will make foreign goods more expensive.

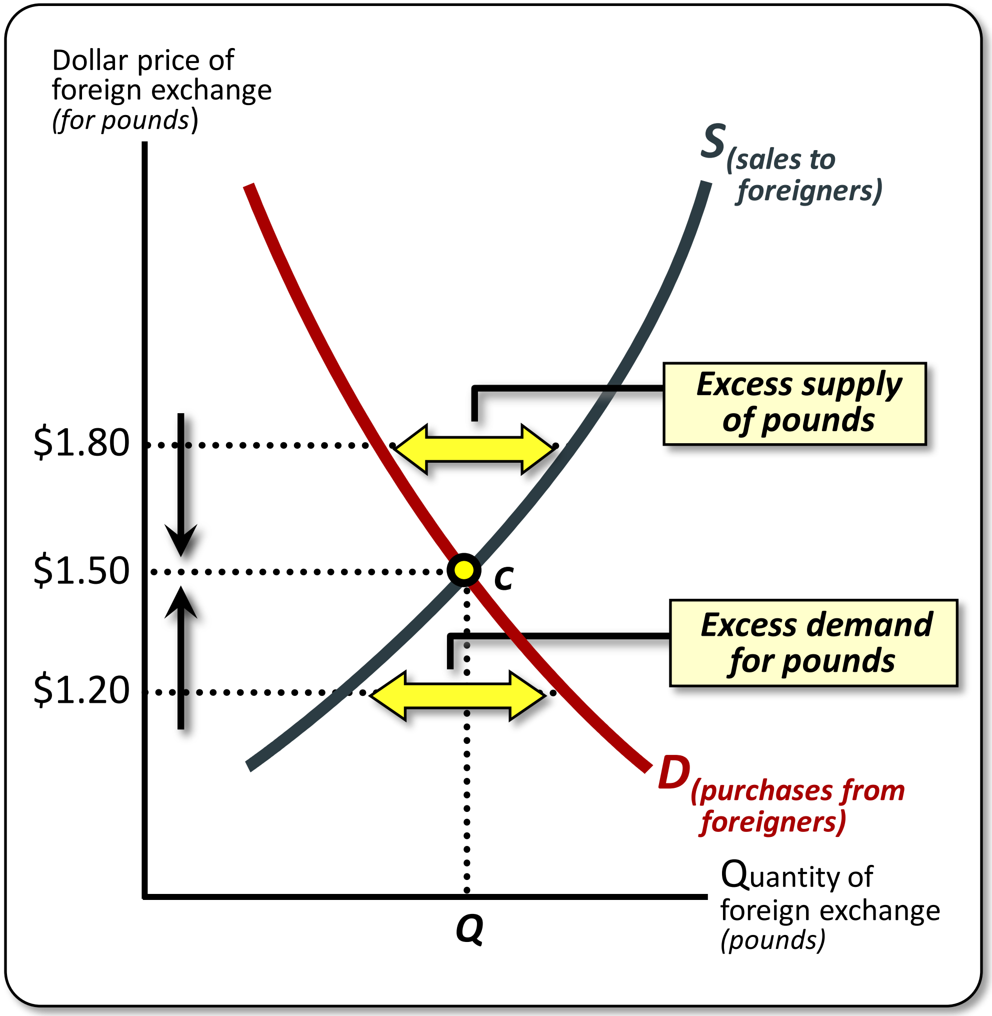
Determinants of the Exchange Rate

Determinants of the Exchange Rate

- Under a ***flexible rate system***, the exchange rate is determined by supply and demand.
  - The ***dollar demand for foreign exchange*** originates from U.S. purchases for foreign goods, services, and assets (real and financial).
  - The ***supply of foreign exchange*** originates from sales of goods, services, and assets from Americans to foreigners.
  - The foreign exchange market brings the quantity demanded and quantity supplied into balance.
    - Also brings the purchases of Americans from foreigners into equality with the sales of Americans to foreigners.

Foreign Exchange Market Equilibrium

- The dollar price of the English pound is measured on the vertical axis. The horizontal axis indicates the flow of pounds in exchange for dollars.
- The demand and supply of pounds are in equilibrium at the exchange rate of \$1.50 = 1 English pound.
- At this price, quantity ***demanded*** equals quantity ***supplied***.
- A higher price of pounds (like \$1.80 = 1 pound), leads to an ***excess supply of pounds*** ... causing the dollar price of the pound to fall (***depreciate***).
- A lower price of pounds (like \$1.20 = 1 pound), leads to an ***excess demand for pounds*** ... causing the dollar price of pounds to rise (***appreciate***).



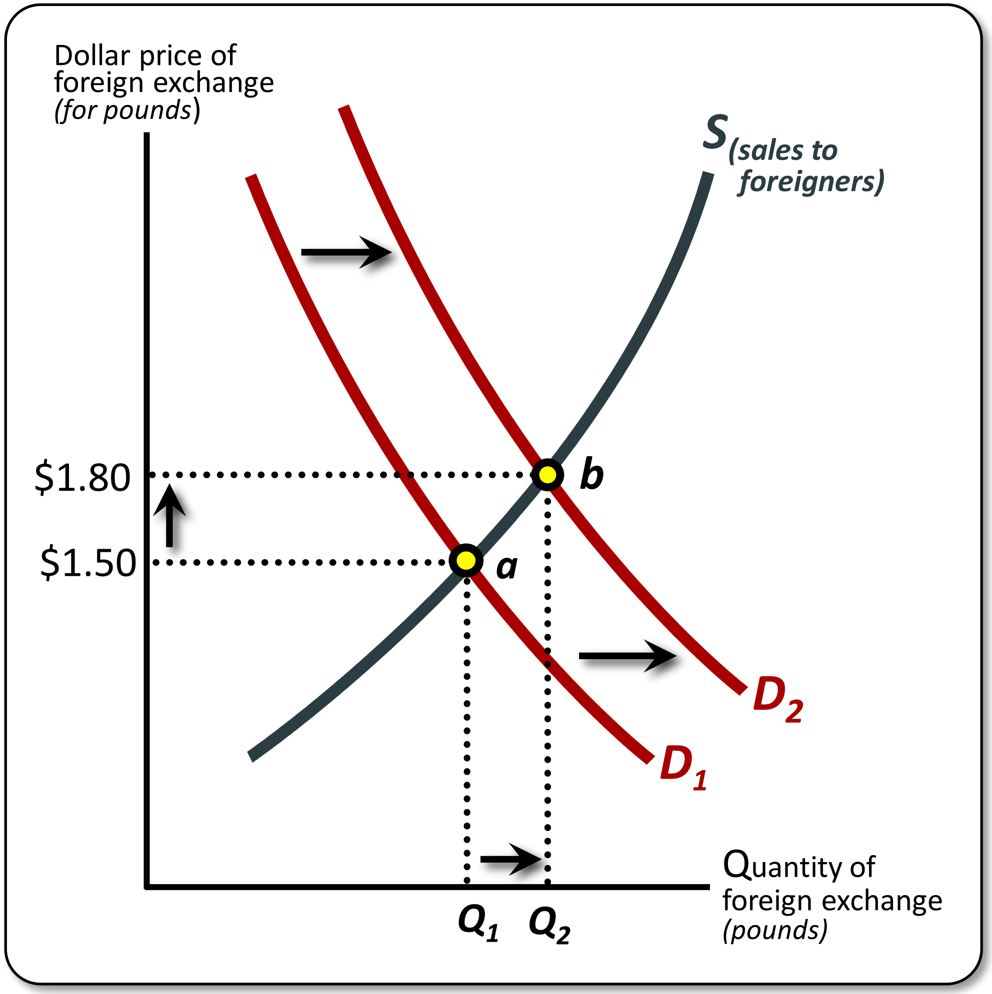
Why Do Exchange Rates Change?

Changes in the Exchange Rate

- Factors that cause a currency to depreciate:
  - a rapid growth of income (relative to trading partners)
    that stimulates imports relative to exports
  - a higher rate of inflation than one's trading partners
  - a reduction in domestic real interest rates (relative to rates abroad)
  - a reduction in the attractiveness of the domestic investment environment that leads to an outflow of capital

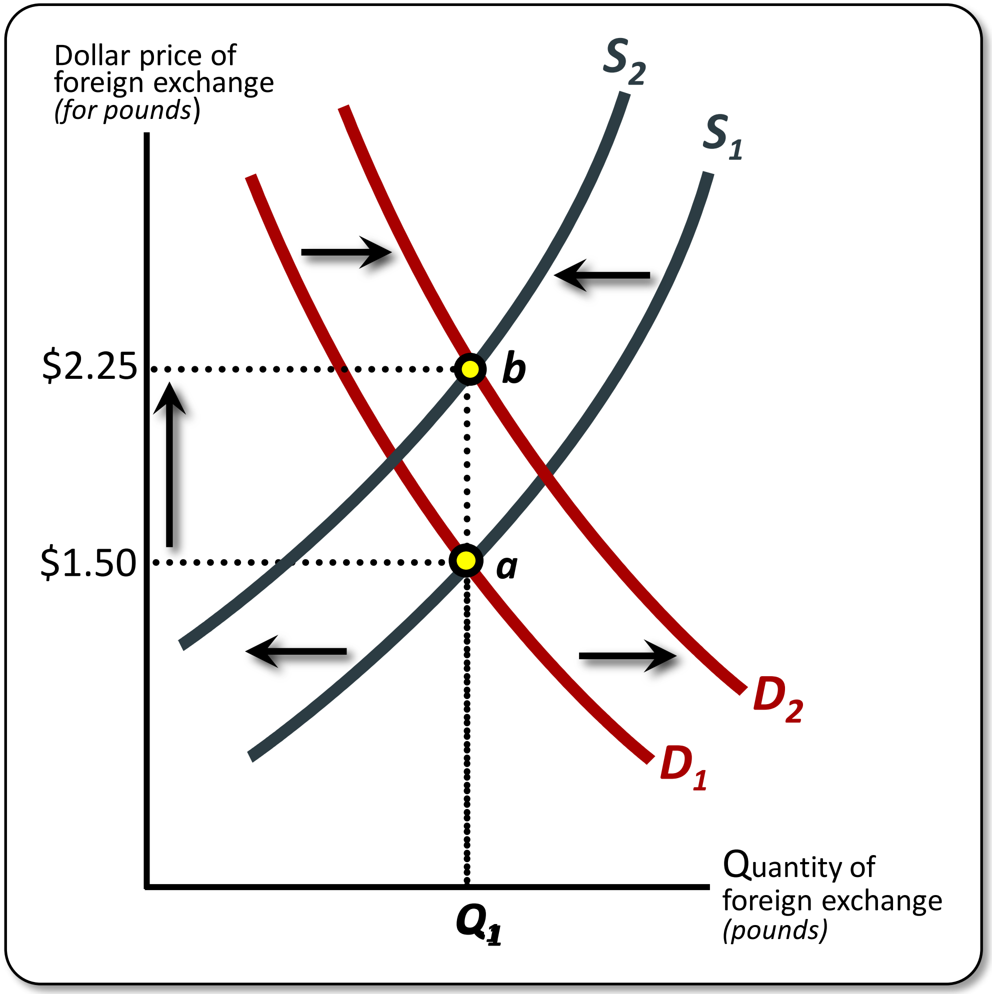
Foreign Exchange Market Equilibrium

- Other things constant, if incomes increase in the United States, U.S. imports of foreign goods and services will grow.
- The increase in imports will increase the ***demand*** for pounds (in the foreign exchange market) causing the dollar price of the pound to increase from $1.50 to $1.80.



Inflation with Flexible Exchange Rates

- If prices were stable in England while the price level in the U.S. increased by 50% … the U.S. demand for British goods (and pounds) would increase … as U.S. exports to Britain would be relatively more expensive they would decline and thereby cause the ***supply*** of pounds to fall.
- These forces would cause the dollar to ***depreciate*** relative to the pound.



Changes in the Exchange Rate

- Factors that cause a currency to appreciate:
  - a slower growth rate relative to one’s trading partners
  - a lower inflation rate than one's trading partners
  - an increase in domestic real interest rates *(relative to rates abroad)*
  - an improvement in the attractiveness of the domestic investment environment that leads to an inflow of capital ()

International Finance and Alternative Exchange Rate Regimes

Three Major Types of Exchange Rate Regimes

Task 1. Please choose the country and share which Exchange rate regime it uses.

- There are three major types of exchange rate regimes:
  - flexible rates;
  - fixed-rate, unified currency; and,
  - pegged exchange rates.

We have listened to 13 presentations.

Task 2. Try to determine the year patterns for the currency exchange rate changes by comparing the data. Are there some months when the currency is getting stronger/weaker? Can you suggest the reasons for it?

Three Major Types of Exchange Rate Regimes

Task 1. Please choose the country and share which Exchange rate regime it uses.

- There are three major types of exchange rate regimes:
  - flexible rates;
  - fixed-rate, unified currency; and,
  - pegged exchange rates.
- We have discussed flexible exchange rate regimes extensively.
- We will now explain the nature and operation of the other two major regimes.

Three Major Types of Exchange Rate Regimes

- The exchange rate regime is the way a country manages its currency in relation to other currencies and the foreign exchange market. There are different types of exchange rate regimes, ranging from fixed to floating, and each one has its advantages and disadvantages. In this report we will analyze what exchange rate regime Russia uses and how it affects its economic policy.

- Russia has adopted a managed floating exchange rate regime since 2005, which means that the central bank intervenes in the foreign exchange market to influence the value of the ruble, but does not fix it to a specific level or basket of currencies. The central bank uses a dual-currency band, which is a range of values for the ruble against a basket of US dollar and euro, and adjusts it periodically according to macroeconomic conditions and market trends. The main objectives of this regime are to maintain price stability, reduce external vulnerability, and increase monetary policy autonomy.

Three Major Types of Exchange Rate Regimes

- The exchange rate regime of China is a complex topic in the field of economic policy. China does not have a fixed or a floating exchange rate system, but rather a hybrid one that combines elements of both. The Chinese yuan (CNY) is officially pegged to a basket of currencies, which includes the US dollar (USD), the euro (EUR), the Japanese yen (JPY), and others. However, the composition and the weights of the basket are not disclosed by the authorities, and the CNY is allowed to fluctuate within a narrow band around the central parity rate determined by the People's Bank of China (PBOC). The PBOC also intervenes in the foreign exchange market to manage the supply and demand of the CNY and to influence its value. The main objectives of this exchange rate regime are to maintain macroeconomic stability, to promote export competitiveness, and to avoid external shocks.

Fixed Rate, Unified Currency Regime

- ***Fixed rate, unified currency regime***:
  a system where currencies are linked to each other at a fixed rate.
  - A single central bank conducts the monetary policy that influences the value of the unified currency relative to other world currencies.
- The linkage may be either through the use of the same currency or through a currency board that agrees to trade the currencies, one for another, at a fixed rate.

Pegged Exchange Rate Regimes

- ***Pegged exchange rate system***:
  a system where the country commits to using monetary & fiscal policy to maintain the exchange-rate value of the domestic currency at a fixed rate or within a narrow band relative to another currency (or bundle of currencies).
- Unlike the case of a currency board, however, countries with a pegged exchange rate continue to conduct monetary policy.

When Pegged Regimes Lead to Problems

- A nation ***can*** either:
  - follow an independent monetary policy, allowing its exchange rate to fluctuate, or,
  - tie its monetary policy to the maintenance of the fixed exchange rate.
- It ***cannot***, however:
  - maintain currency convertibility at a fixed exchange rate while following a monetary policy more expansionary than that of the country to which its currency is tied.

When Pegged Regimes Lead to Problems

Attempts to peg rates and follow a monetary policy that is too expansionary have led to several financial crises —a situation where falling foreign reserves eventually force the country to forego the pegged rate.

The experiences of Mexico in 1989-1994 and of Brazil, Thailand, South Korea, Indonesia, and Malaysia in 1997-1998 illustrate this point very clearly.

Questions for Thought:

1. Can a nation fix its exchange rate to another currency such as the dollar and at the same time follow an independent monetary policy? Why or why not?

Questions for Thought:

2. If a country operates under a currency board regime,
the country commits itself to …

(b) issuing its currency at a fixed rate in exchange for an
equivalent amount of another designated currency
and investing the funds in bonds and liquid assets
which provide 100% backing for the currency units

- *Balance of Payments*

Balance of Payments

- ***Balance of payments***:
  accounts that summarize the transactions of a country's citizens, businesses, and governments with foreigners
- Any transaction that creates a demand for foreign currency
  (and a supply of the domestic currency) in the foreign exchange market is recorded as a *debit item*.

Example: Imports

- Transactions that create a supply of foreign currency (and demand for the domestic currency) on the foreign exchange market are recorded as a *credit item*.

Example: Exports

Balance of Payments

- Under a ***pure flexible rate system***, the foreign exchange market will bring the quantity demanded and the quantity supplied into balance, and as a result, it will also bring the total debits into balance with the total credits.

Balance of Payments

- ***Current account transactions***:
  all payments (and gifts) related to the purchase or sale
  of goods and services and income flows during the
  current period
- <u>Four categories</u> of current account transactions:
  - Merchandise trade *(import and export of goods)*
  - Service trade *(import and export of services)*
  - Income from investments
  - Unilateral transfers *(gifts to and from foreigners)*

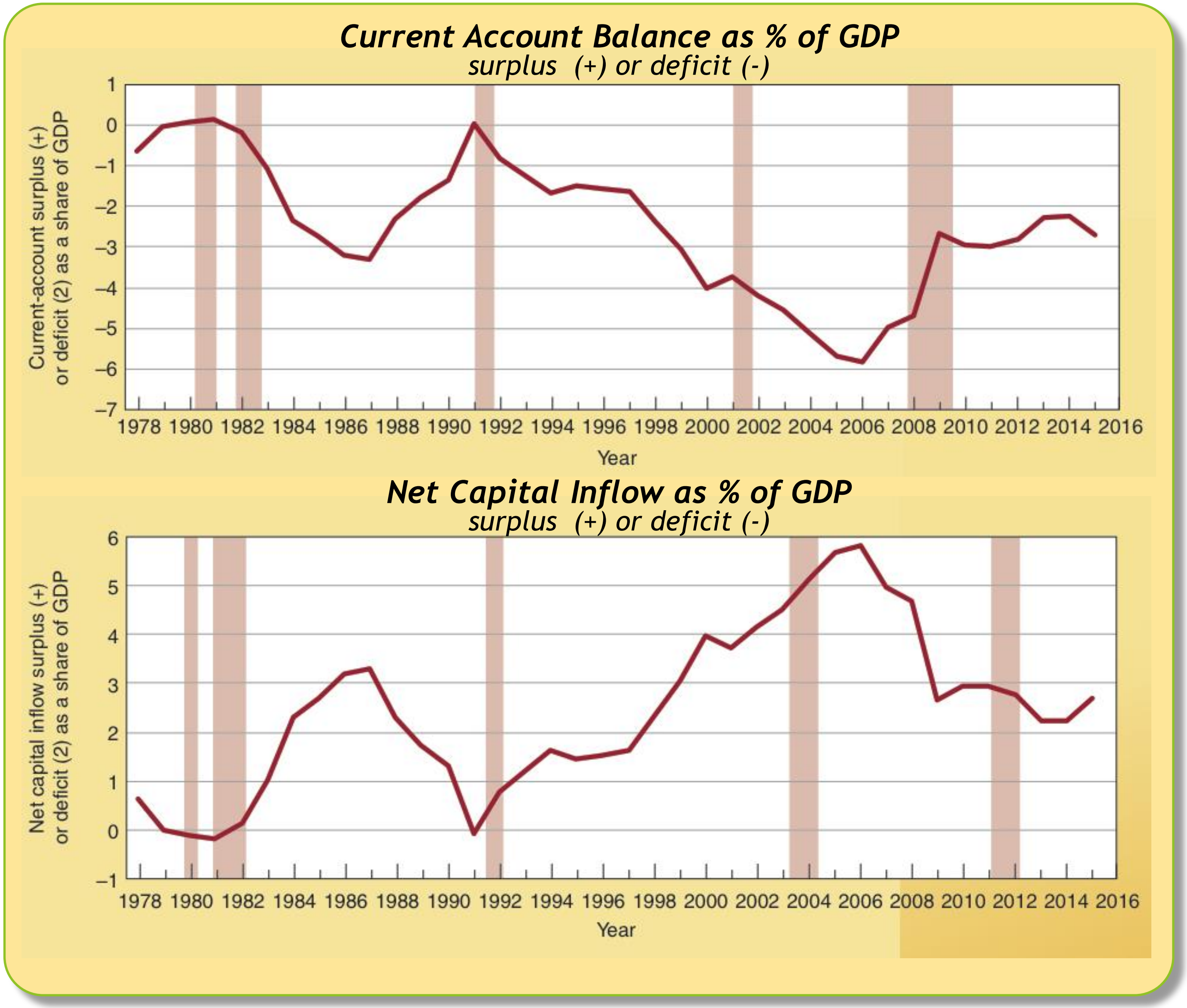
Balance of Payments

- ***Capital account transactions***: transactions that involve changes in the ownership of real and financial assets
- The *capital account* includes both
  - direct investments by foreigners in the United States and by Americans abroad, and,
  - loans to and from foreigners.
- Under a pure flexible-rate system, official reserve transactions are zero; therefore:
  - a current-account deficit implies a capital-account surplus.
  - a current-account surplus implies a capital-account deficit.

Exchange Rates, Current Account Balance, and Capital Inflow

Current-Account Balance and Net Foreign Investment

- As the these figures for the United States indicate, under a flexible exchange rate system, the inflow and outflow of capital exert a major impact on current account balances.



Are Trade Deficits Good or Bad?

- With flexible exchange rates, an inflow of capital implies a ***trade*** (current account) ***deficit***.
- If a nation's investment environment is attractive, it is likely to result in a net inflow of capital and trade deficit.
  - ***When*** this inflow of capital is channeled into productive investments, *this is a positive development*.
- However, ***if*** the inflow of capital is used to finance current consumption or for the finance of unproductive projects,
  it will exert an adverse impact on future income.
  - In recent years a substantial share of the U.S. trade deficits have arisen from this source.

Should Trade Between Countries Balance?

- Political leaders often imply that U.S. exports to a country, China or Japan for example, should be approximately equal to our imports from that country.
  - ***This is a fallacious view.***
- Under a flexible exchange rate system, overall purchases from foreigners will balance with overall sales to foreigners, but there is no reason why bilateral trade between any two countries will balance.

Should Trade Between Countries Balance?

- Rather than balance, economics indicates that a country will tend to experience …
  - *trade surpluses* with trading partners that buy a lot of goods that it supplies at a low cost, and,
  - *trade deficits* with trading partners that are economical suppliers of goods that can be produced domestically only at a high cost.

Thank you