

Balance of payments crises

Michael Keavane
Dept. of Economics
Santa Clara University
Spring 2003

- Arise from policy 'trilemma'
- Can't have:
 - Fixed exchange rate
 - Free capital flows
 - Independent monetary policy

Why want fixed E?

- Importing anti-inflation commitment
 - Price expectations 'anchor'
 - Credibility
- Promoting trade
 - Less volatility
 - Less political uncertainty

Why have independent monetary policy?

- Suppose have shock to aggregate demand
 - This leads to recession
 - Self-correcting as price level falls, interest rates fall, aggregate demand stimulated
 - But this process takes a long time
 - Expansionary monetary policy could work quickly

Why have free capital flows?

- Developing countries
 - National savings is low because of poverty and weak financial institutions, so borrowing from abroad can be major source of financing of new projects
- Developed countries
 - Markets are more effective institutions for channeling financial flows into new investments, because investors are rewarded by successful projects
 - The bigger the market, the more competition increases effectiveness

Theory of optimum currency areas

- Degree of economic integration determined gains and losses from having common currency without independent monetary policy
- Consider case of country joining 'larger' country or region
- GG schedule traces how gains (from currency union) come with greater integration (reduction in uncertainty)
- LL schedule traces how losses decline with greater integration
- At low levels of integration, losses outweigh gains

Balance of payments crises

- Countries want to 'have it all', but 'trilemma' says they can't, and BP crisis is reality check
- Bretton Woods (Germany and others wanted independent monetary policy from Fed)
- EMS (Britain wanted independent monetary policy from Germany)
- Asian financial crisis (capital controls lifted, exacerbating moral hazard)
- Argentina (Fixed exchange rate at bad level, without provision for change)

Bretton Woods

- Currencies linked to dollar, dollar linked to gold
- Fed is the 'center' and can pursue independent monetary policy
- Fiscal monetary mix of the 1960s- US has expansionary fiscal and monetary
- Other countries will import 'inflation' and accumulate gold
- Triffen – problem of gold reserves and dollars outstanding
- US devaluation could only be accomplished by other currency revaluation – 1971

EMS crisis of 1992

- German reunification given expansionary fiscal with contractionary monetary policy
- UK faced with declining demand from US due to US recession of 1991-92
- Scandinavia faced with declining demand from Russia after collapse of 1989-90
- Germans refused to pursue expansionary monetary policy to preserve exchange rates

Asian financial crisis

- Asian economies growing rapidly through combination of government controls and 'outward orientation' – exports a high % of GDP
- In early 1990s starting liberalizing capital markets, while maintaining fixed E
- Weak financial regulation and implicit public sector guarantees leads to *moral hazard*, 'crony capitalism' - especially severe in Indonesia, Thailand and South Korea, in different ways.
- Prone to speculative attack

Argentina

- Convertibility Law links peso to dollar on one-to-one basis
- But fundamental government fiscal deficit problem not solved
- Argentina 'needs' to have inflation to finance fiscal deficit
- Peso collapses in 2002, capital controls imposed