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2604697 Financial Markets, Institutions and Instruments

Homework #2 (Due 6th Nov 2023 (FT) and 11th Nov 2023 (FLEX))

(Write your answer in the provided space only. Do not exceed the line limit.)

Q.1: Both the currency board (i.e., Hong Kong) and dollarization (i.e., Ecuador) are considered fixed exchange rate regimes. What are the differences between the two approaches? What are the main drawbacks of these systems? *[1 point]*

With currency board, a country still use its own currency but it has to maintain fixed exchange rate with foreign currency. In other words, Hong Kong can print its home currency if it has foreign reserve asset. In contrast, with dollarization, a country uses foreign currency, instead of its own home currency, for legal tender in its country. The main drawbacks of both exchange rates regimes is that they have to give up the independence of monetary policy.

Q.2: Explain why, in the modern world of financial markets, a financial crisis in one country can quickly transmit to other countries' **financial markets** and **real sectors**. For example, the U.S. Subprime Crisis affected both financial markets and real economic activities of other countries around the world. Another example is how Greece's Sovereign Debt Crisis affected financial and real sectors in other Eurozone countries. *[3 point]*

The main reason behind the quick transmission of effect of the financial crisis in one country to others is the globalization. In other words, one country can trade or invest with or in another countries easier compared to the past. This creates financial and trade linkages throughout the world. To illustrate, during subprime crisis, European banks and mutual funds invest in US mortgage-back securities in a large amount. Thus, the collapse of MBS due to shrinked US housing market also negatively affected Europe's financial market during that time. In addition, other countries also received indirect effect through their real sector from sub-prime crisis. For example, the sub-prime crisis indirectly affected Thailand as US people became poorer and consume less. Besides, as the US is the largest import market and its size of economy is large, the financial crisis in US also affects its trade partners through real sector.

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Q.3: From the last slide of Topic 11, students could see that countries like Japan and China have largely been running continuous current account surplus. What would be the consequence of the continuous current account surpluses on the country's net foreign investment position? Is it always desirable to have a current account surplus? *[1 point]*

Japan and China have always been running current account surpluses, meaning that they are net lenders of capital to the rest of the world. This also means that Japan and China have more claim on foreign assets. However, having continuous current account surplus is not always desirable as it can lead to too strong home currencies against foreign currency. Consequencely, central banks of these countries have to intevene their exchange rates to remain their export competitiveness.

========== END ==========

Q1

1 Under currency board, the role of CB is divided between "lender of the last resort" and "monetary authority".
The currecy board is appointed to manage and run "monetary authority" function.
The objective is to keep the amount of monetary base (MB) in line with foreign reserve assets at a fixed exchange rate.
That means any unit of the domestic monetary base is backed up by a fixed amount of foreign reserve asset.
This is supposed to give market participants confidence about the value of the domestic currency.
Under dollarization, a foreing currency (usually a hard currency) is adopted as a legal tender for domestic transactions.
Usually, both the domestic and foreign currencies are allowed for domestic transactions.

The drawback of these systems is that the central bank will have less or no power to influence domestic monetary base and, therefore, money supply. That means, the country will lose out the independence of its domestic monetary policy.

Q2

3

Transmission to other financial markets: Financial markets are intertwined both in terms of ownership on financial assets and sentiment.
1. Due to holding of foreign financial assets of financial institutions, when crisis strikes one countries it will cause finanical institutions in other countries to incur losses depressing equity value of these institutions. This will cause losses of confidence in other countries.
2. Crisis in one country may cause risk aversion of investors in other countries to increase. Investors may reassess their risk and adjust investment strategies. This may cause value of financial assets in other countries to drop.

Transmission to real sectors:
1. As value of fincial drops, investors become less wealthy. They may reduce their consumption and firms reduce their investment. This will cause the economic activities to slow down. In the U.S. case, this also implies the U.S. will import less from other countries.
2. Due to loss of confidence, financial market becomes less liquid and cost of capital higher. This makes it more expensive for household and firms to raise fund. Therefore, reducing economic activities.

Q3

1 The surpluses in current account balances of these countries imply that their net foreign investment has increased.
However, CA surplus may not be desirable some times. For example, due to slow economic growth and high private saving rate in Japan, the country has expereinced current accout surplus.