Module 20

Finance and US Foreign Policy I

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What is the puzzle of the international bond market? Why is it so strong and has such great influence of the financial policies of states?

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What are three important functions of money? What is the relationship between money and interest rates? How do interest rates affect economic activity? What are the political

implications of this relationship?

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What is the Federal Reserve? How is it different from commercial banks? What are its main functions and policy goals? What are the three key policy instruments of the Fed?

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What is inflation? What are its negative consequences? What is deflation and why is it also bad? How do you choke off inflation? How are interest rates, the control of inflation, and the reelection of politicians interrelated? What is the monetary version of the fundamental problem of politics and how does having an independent central bank help to prevent this problem?

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What is quantitative easing and how did it play a big role in resolving the 2008 economic crisis?

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What is a bond and what are its key traits? How do extremely deep markets in U.S. treasury bonds and mortgage-backed securities help make the U.S. dollar a key reserve currency? How does this situation allow the U.S. to run big deficits?

The political power of finance...Why?

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You mean to tell me that the success of my program and my reelection hinges on the Federal Reserve and a bunch of f\*\*\*ing bond traders

”

“

I used to think if there was reincarnation, I wanted to come back as the president or the pope or a .400 baseball hitter. But now I want to come back as the bond market. You can intimidate everybody.

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Even if constraining domestically...

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Might be empowering for the US internationally

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Dollar as a reserve currency helps US government run bigger debts

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Support internationalist policy that domestic public unwilling to pay for?

Global capital markets, the dollar, and American financial power

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Main questions

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How do capital markets constrain by governments to set (independently) their economic policies?

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How does the global demand for dollars (and American debt) strengthen America’s political influence?

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Subsidiary questions

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What is money? What is monetary policy?

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What is inflation? Its policy challenges?

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What is quantitative easing?

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What role does the dollar play in the international monetary system?

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What are exchange rates? How do they influence trade flows?

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What is the IMF?

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What caused the 2008 financial crisis?

Money fundamentals

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Money has three important functions

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Medium of exchange: facilitates trade and specialization

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Whew...Rob doesn’t have to trade lectures on the Cold War to his banker to pay his mortgage

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Unit of account: means to measure value of things and compare different goods and services

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Store of value: allows wealth/value to be held over time

Money and interest rates

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Price of money reflected in interest rates

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Cost of borrowing capital

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As costs down, economic activity tends to go up (easier to borrow and buy)

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As costs up, economic activity tends to slow (GDP growth slows or negative)

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Policy implication: governments can stimulate economic activity by pushing interest rates down

What is monetary policy?

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Monetary policy as government efforts to influence monetary outcomes liked inflation, interest rates, the

money supply, and exchange rates

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Federal Reserve (Fed) key government agency tasked with implementing monetary policy

Three key policy instruments of the Fed

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Reserve requirements: set how much cash (reserves) banks must hold, which simultaneously sets how much capital they can lend (Remember: loans their key source of profits)

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Higher reserve ratios limit money supply

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Discount rates: interest rate Fed charges big banks

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Open market operations: purchase/sale of financial assets like bonds

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Important example: Quantitative Easing

Another version of the fundamental problem of politics

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A monetary version...

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Society needs government to issue currency (money)

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Can abuse that power by printing new money to pay its debts...but this inflationary

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How prevent this?

Monetary policy and inflation

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Inflation is just rising prices

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Measured by CPI and PPI, which track price movements over time in bundle of goods

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Bad because erodes value of...

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Savings as reduces its purchasing power

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25 cents bought a candy bar in 1979, but not in 2014

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Creditors’ assets (loans)

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Financial sector strong interests in low inflation

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But deflation bad too

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If people think prices falling (e.g. houses in 2008-11), then wait to buy; if everyone waits, then economic activity collapses and firms go bankrupt and/or lay people off

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Optimum: moderate price growth of around 2%

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How choke off inflation? Slow economic activity by raising interest rates

Solving the fundamental problem of monetary politics...

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How limit inflation, or political incentives to print money or borrow money before an election (to get reelected)?

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Delegate responsibility to an unelected bureaucratic official like the Chairperson of the Federal Reserve (an independent central bank)

The Federal Reserve

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Central bank of the United States

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Regulates banking sector

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Lender of last resort to banks

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Banks’ bank but different bank because not tasked with earning profits

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Policy goals of employment and limit inflation

he Federal Reserve and QE

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Last three leaders: Greenspan, Bernanke, Yellen

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Influence short term interest rates (loans with terms in days and months) through discount (lending) rate

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Influence long term interest rates with open market operations

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Quantitative easing (QE): Fed purchase of US Treasury Bonds (Fed Gov IOUs) and mortgage backed securities (bundles of loans backed by home mortgages) to push down long term interest rates (e.g. 30 year mortgage)

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Key role in responding to 2008 financial crisis

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Federal reserve balance sheet (total assets and liabilities) went from $900 billion in September 2008 to $4.5 trillion in November 2014

Bond markets

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Bond as a loan (an IOU)

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Promise to repay a fixed amount of money in fixed period of time (time to maturity)

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Payment often in two forms (principals and coupons)

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Investors/creditors buy IOUs

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Debtors offer IOUs

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Key Traits

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Price: price that creditor pays to debtor to buy IOU

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Example: might pay $94.34 for a promise (IOU) to get repaid $100 in a year

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Price=$100/(1+i) or 94.34=(1+.06)

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Yield (interest rate)

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In the example above, the yield would be 6%

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Coupon

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Quality of debt: score by credit agency that makes guess about ability of debtor to repay, helps to influence interest rates