Finance and US Foreign Policy II

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What is the Trifflin dilemma? What are its implications for the U.S. economy? What are its security implications?

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What are exchange rates? How does the differential in exchange rates between countries affect trade (the price of imports and exports)? Understand the example of the U.S. and the Japanese yen in the 2010s that was offered in lecture. What are the implications of differential exchange rates for U.S.-China relations?

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Explain how the mobility of capital has increased the discipline of global capital (bond) markets. What happens when foreign capital holders lose confidence in a government

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s monetary policy? What are some recent examples of this?

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How does this discipline from the global capital markets affect democratic politics? If bond markets constrain national monetary policy because of the threat that capital will move to a different market then do elected officials have the ability to respond to voters’ demands?

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What is the International Monetary Fund? What are its main functions? What is the main source of its influence in the international economy? What is conditionality and how does the IMF use it to promote economic reforms within countries? Why does the U.S. have so much influence within the IMF?

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What is the Bretton Woods economic order? What were the main forces that served as an impetus for the U.S. to construct the Bretton Woods order? What are the main organizations that emerged from Bretton Woods?

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Discuss the 2008 financial crisis and the role that the United States played in sparking the crisis. How did the U.S. respond to the crisis and why did the U.S. government bail out the banks? What were the political challenges associated with the bailout and what are some of the consequences for the international economic order for the bailout?

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According to the Farrell reading (his interview with Thomas Oatley), how did the Iraq war contribute to the 2008 financial crisis?

The $$$ at the center of the international monetary system

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Extremely deep markets for US Treasury bonds and mortgage backed securities in US

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Serve as source of reserves for banks all over the world (because treated like cash) AND central banks around the world

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Helps make dollar a key reserve currency

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Example: Chinese central bank has about $3.9 trillion in reserves, maybe 2/3 of that in $$$

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This excess demand for $$$ allows US government to run big deficits because world needs a currency that can be trusted and the dollar is it

The dollar at the center of the international monetary system (ctd)

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Trifflin dilemma: as it grows, global economy needs more expansion of money supply ($) to facilitate transations; however, get this expansion via great US government debt

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How long sustainable? Cannot run deficits indefinitely just like credit card company eventually cuts you

off

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Ultimately, inflationary which drives the value of the dollar down

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But can sustain as long as people still willing to lend money to Treasury: can measure this appetite

through yields (interest rates) in Treasury markets

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This why controlling budget deficits so important after recovery began

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Example: China pressure on Obama about Obamacare because worried about what do to deficit

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Security implications

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Will China sell $$$? Ask yourself about their incentives to do so

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Rest of world subsidizing US military leadership post-9/11? US runs huge budget deficits, yet interest

rates go down. This tells us world still willing to lend us money.

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Currencies valued in relative terms: dollar denominated investments still safer than others

Exchange rates

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Reflect differences in value of respective currencies; price of one currency in terms of another

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As $ appreciates, it can buy MORE units of a foreign currency

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As $ depreciates, it buys FEWER units of a foreign currency

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Example

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September of 2011, $ bought 77 yen

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November of 2014, $ buys 115 yen

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Dollar has appreciated RELATIVE TO YEN since 2011

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Price function of two key variables

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Interest rates

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Important: As interest rates in an economy go up, the value of its currency will go up as well

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Expected change in currency’s exchange rate against other currencies (forward exchange rate)

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Future interest rate differentials, inflation differentials, budget changes (new deficits)

Why exchange rates important?

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Shape the relative price of conducting international transactions

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TRADE EXAMPLE

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September 2011: Honda dealer in central TX buys CRV for 1,540,000 yen ($20,000\*77¥)

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November 2014: CRV price in yen stays the same, but now only costs dealer 1,540,000¥/115 or $13,391

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IMPORTANT: When dollar appreciates, imports go up because they are cheaper

Exchange rates and US-China relations

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Implications for US-China relations:

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China has long sought to stimulate exports to US

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How? Push dollar up to increase purchasing power of American consumer

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How push dollar up? Buy dollar assets like US Treasuries and mortgages

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Ask: do they really want to sell those dollars?

The discipline of global capital (bond) markets

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Current era of capital mobility: costs of moving financial assets from one country to another extremely low or nonexistent

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Competitive pressures unleashed by US in mid-1970’s

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If taxes on capital too high, it invests in another economy

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Empowers the Electronic Herd: When foreign capital holders lose confidence in a government’s monetary policy, they tend to sell assets denominated in that currency

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Currency depreciates

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Government can reassure investors (or bring them back) by offering higher returns i.e. push interest rates up

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But...raising interest rates steeply pushes domestic economy into recession

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Example: Greece, Spain, Ireland, Portugal, Cyprus, Italy in the Euro crisis

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Real policy implications: international capital markets can sharply constrain country’s monetary policy; limiting discretion of elected officials and forcing them to push it into recession to reassure creditors

Bretton Woods economic order

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Emerges in final stages of World War II (1944): US supports creation of international organizations to ensure economic growth through international trade

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Impetus from:

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Great Depression

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Emerging battle against Communism

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Increasing support for free trade in US

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Key organizations emerging from:

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General Agreement on Tariffs and Trade (GATT that would become WTO)

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International Monetary Fund

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International Bank for Reconstruction and Development (would become World Bank)

International Monetary Fund

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Pool of capital created by member countries

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Set up to provide international liquidity (didn’t work as world relied on $)

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Limit exchange rate fluctuations (prevent currency wars from Depression that interrupted trade)

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Lender of last resort: Help governments in exchange rate crisis stabilize reserves with loans

The power of the IMF

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Conditionality: demands conditions that change economic conditions in country and enhance long term ability to repay

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IMF loans as multiple disbursements: get partial money, then must implement reforms before get more

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Often imposes real pain: cut tariff barriers, cut budget deficits i.e. raise taxes and cut spending

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Power of IMF stems from its willingness to lend when no one else will

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Good housekeeping seal of approval necessary for private capital to come back in

The US and the IMF

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Voting power not equal in IMF, set by relative contribution to Fund

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US biggest shareholder, therefore lots of influence on terms of emergency loans i.e. bailouts

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Charged with promoting Wall Street agenda in 1990’s: used bailouts to open up markets to American financial sector

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US often relaxes conditions for strategic reasons (e.g. Pakistan)

The 2008 financial crisis

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Why?

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How US respond?

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Why bail out the banks?

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What are political challenges associated with bailouts?

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What are some of the larger international political consequences of this crisis?

The dollar, the Iraq War, and the 2008 crisis

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Oatley on the links between war and financial crisis

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Political challenges to financing war lead to reliance on debt

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Unique position of dollar allows US to finance wars with capital inflows from abroad

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Capital inflows push dollar up, hurt exports, facilitated investment in sector protected from international competition (housing)

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Important: not about limited regulation of financial sector but war