POLI 150: International Finance and Monetary Policy

Daniel Gustafson

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Today's Class

- International Investment & Risk
- Monetary Policy

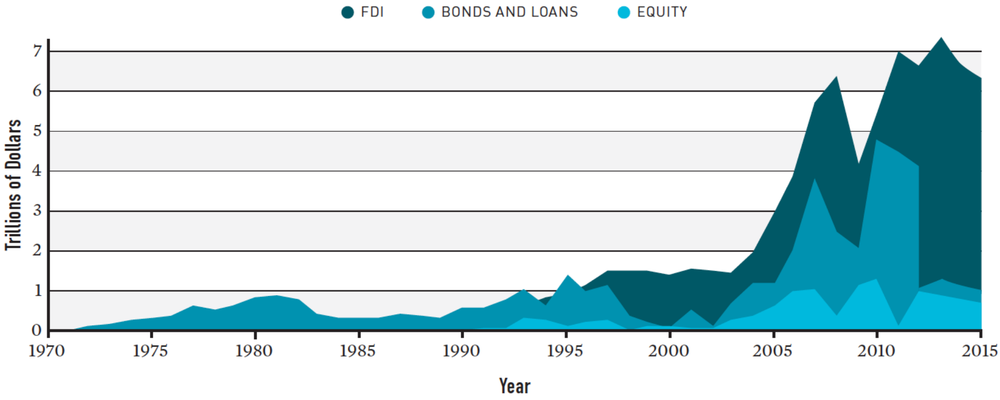
Puzzles of Investment

- Why is so much money invested internationally?
- Where is investment occurring?
- Why is international investment controversial?

Types of Investment

- **Portfolio Investment**: investment in other countries with no role in managing the investment (i.e. loans, stocks, bonds)
- A big part of portfolio investment is *sovereign lending*, or loans from private financial institutions to states
- **Foreign Direct Investment (FDI)**: investment in a country that involves acquisition or establishment of a facility in which investors maintain management

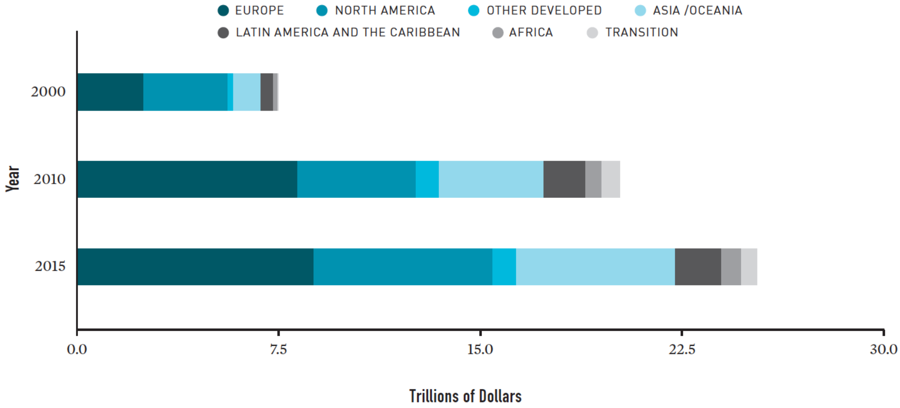
Types of Investment



Why Invest/Borrow Abroad?

- Actors participate in international financial markets to make money
- Goal is to move capital to areas where profits are higher
- For capital, its value is in the interest rate
- Where are interest rates the highest?
- The Hecksher-Ohlin theory would suggest that it's more valued where it is scarce (i.e. developing countries)

FDI by Area



EUROPE
NORTH AMERICA
OTHER DEVELOPED
ASIA /OCEANIA
LATIN AMERICA AND THE CARIBBEAN
AFRICA
TRANSITION
Year
2000
2010
2015
0.0
7.5
15.0
22.5
30.0
Trillions of Dollars

Investment and Risk

- Investors must take into account risk
- In international investment, risk is that a foreign government can reduce the value of the investment
- For loans, they may not pay all or some back
- For FDI, they can devalue the investment up to taking it over

Problems with International Investment

- Once loans are made, debtors have incentives to not pay debts in full
- Loan repayments can require raising taxes, reducing spending, and otherwise angering population
- Lending nations can also face angry domestic citizens

International Investment Controversies

- Governments, especially developing ones are eager to borrow abroad
- Repaying these loans becomes very costly, leading to austerity measures and potential recession
- Can lead governments to default
- Default can lead to greater economic crisis, so lenders often offer more loans (i.e. bail-outs)

Puzzles of Monetary Policy

- What is monetary policy?
- Why does it matter which system countries choose?
- What does it mean to be a currency manipulator?

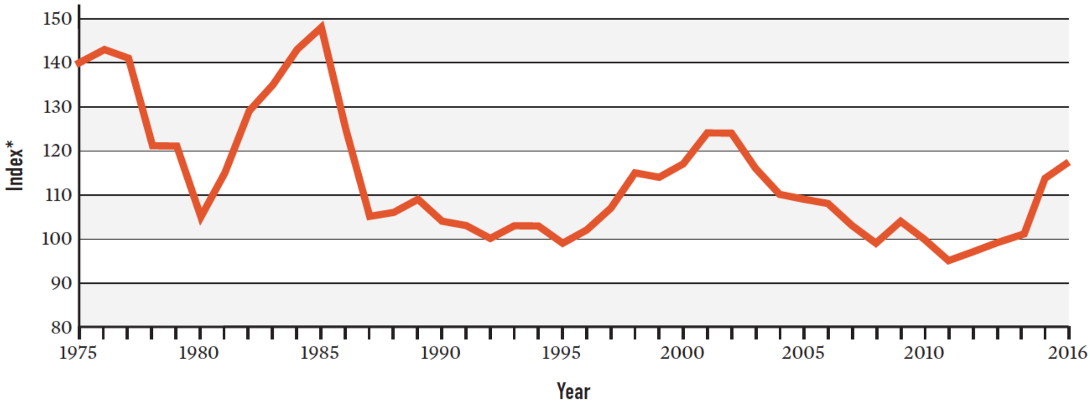
Monetary Systems

- Governments provide the public good of a monetary system: supplying, controlling, and instilling trust in currency
- Most governments have their own currency (i.e. USD, CAD, etc.)
- Common currency arrangements exist such as the Euro
- Other countries choose to use the currency of another state (i.e. some Central American countries use the USD)

Exchange Rates

- **Exchange Rate**: the price at which one currency is exchanged with another
- When one currency's value relative to another goes *up*, we say it has *appreciated*
- When one currency's value relative to another goes *down*, we say it has *depreciated* or is *devalued*
- The exchange rate between states determines how much a consumer from one state can purchase from a producer in another state

USD Value Over Time



Changing Currency Values

- Exchange rates are subject to supply and demand
- High interest rates in a country lead investors to invest more, increasing demand for currency, and increasing its value
- The interest rate within a state is one of the key levers of monetary policy, which is usually controlled by a central bank

Interest Rates

- $\uparrow$ interest rates, $\uparrow$ investment, $\uparrow$ currency value
- $\downarrow$ interest rates, $\uparrow$ borrowing, $\uparrow$ economic activity
- $\downarrow$ interest rates, $\downarrow$ currency value, $\uparrow$ demand for products
- $\downarrow$ interest rates, $\uparrow$ prices, $\uparrow$ inflation

Exchange Rate Regimes

- One of the most powerful decisions a country can make concerns what kind of exchange rate it will use
- **Fixed Exchange Rate**: state commits to take actions to keep its currency value tied to some other currency or commodity
- **Floating Exchange Rate**: state allows currency to be traded on the open market without control
- These are the two extremes; there are shades of grey that some states opt to use

Why Does the Government Care?

- Fixed exchanges rates allow for stability, facilitating trade
- However, governments on fixed exchange rates have committed themselves to a specific value, *even if manipulating it would improve the economy*
- Countries on fixed exchange rates give up control of their monetary policy
- In a recession, a common practice is to lower interest rates; fixed exchange rates prevent governments from doing this

Weak or Strong?

- Stronger exchange rates improve national purchasing power
- They also make domestic goods more expensive on the international market, making exporting more difficult
- 1981-1985: USD appreciated by more than 50% $\rightarrow$ greater prosperity for consumers $\rightarrow$ 1.5 million manufacturing jobs lost

Domestic Politics & Exchange Rates

- Fixed exchange rates allow for more predictability at the loss of monetary policy
- Domestic interests largely determine what states will do
- If the economy is heavily reliant on exports, there will be pressure to keep exchange rate fixed

Currency Manipulation

- Some states purposely keep their currencies weak to stimulate exports
- China post-1979 weakened the renminbi $\rightarrow$ benefits exporters and international consumers, effectively taxes domestic consumers
- Also causes huge friction with international trading partners who face backlash from their own domestic producers
- Widely discussed in the run-up to the 2016 US Presidential election
- Should states punish currency manipulators?

Review

- A nice review of some of these concepts