Lesson Plan Week 7
3/25/08 to 3/27/08

Plan

1. Banking crises: then and now
   - Krugman
   - Bear Sterns
2. Bretton Woods
   - Design
   - Problems and adjustment
   - Decline and fall
3. Currency decisions in the post-BW era
4. Take-home exam info

Pre-class

Put on board:
- Plan

Interesting fact: www.gmap-pedometer.com
- Walking up Bascom from Park St: 73 ft elevation gain, .1558 miles
- Compared to climbing Everest:
  - Total altitude (29,029 ft): 398 times
  - Elevation gain (12,000-15,300 ft): 164-210 times

Intro

Plan

Questions

Banking Crises: Then Now

Krugman

What did you think?

What are some of the basic points he makes? What is he warning us about, and what is he suggesting?

- Situation now is very similar to late 1920s/early 1930s, we can learn what to avoid by looking at that situation
- Great Depression would have been an 'ordinary recession' but became huge because of bank runs across America in the early 1930s (Detroit examples in the New Yorker article, letting major banks fail led to contagion)
- Purpose of banks: provide clearinghouse to bring together savers (who want quick access to their money) and borrowers (no unexpected demands for quick repayment).
- Runs can happen when people lose confidence, and can go through the modest cash reserves banks hold. These can be contagious and multiply on themselves.

How is the financial system (and the international financial context) similar or different now as compared to the 1920s?

- 1920s had few regulations, which made banks vulnerable to the crisis of confidence
- Current banking system has lots of regulations about how much cash banks have to hold on hand and their lending practices, guarantees that back savings up to a certain amount (federally insured deposits), etc that both make runs less likely and less costly
- But complicated investment vehicles get around that back to essentially unregulated markets that offer better rates. Much like the old banking system, no safety net.

Do the comparisons/parallels he draws seem reasonable?

How do the lessons of the events leading up to the Great Depression guide policy today?

- Maybe should have more regulation of this shadow banking system
- Maybe government should step in to bail out financial institutions to prevent collapse?
    - Might help avoid a crisis, some banks are hugely important to the economy, failing would be devastating to lots of investors and could be contagious to more
    - But also creates moral hazard problems (encouraging risky/irresponsible behavior), and can be very expensive
- How do you weigh those factors against each other?

Bear Sterns

What's been going on with Bear Sterns?

- Major investment bank, collapsing with lots of bad loans & risky assets
- Federal Reserve stepped in to help coordinate and guarantee sale to JP Morgan Chase. Negotiates terms, gives it a financing loan to cover the risky assets
- Fed seems to perhaps be assuming the role of regulator that Krugman wants it to

Bretton Woods – Design (Lessons from the Interwar Years)

What major problems was Bretton Woods (1944) designed to address? How was this different from the interwar period? What problems from the 1920s/1930s did BW hope to avoid?

- Didn't want a repeat of the hyperinflation that resulted from completely floating exchange rates after WWI
- Also wanted to avoid the rigid constraints of a purely fixed ER that couldn't adjust to new economic conditions
- Waited for other countries to build up enough reserves to credibly commit to the peg.
- International coordination on any changes

What were the details of the BW system? Why were these created/how did they address the problems Bretton Woods needed to overcome?

- Exchange rate flexibility – fixed-but-adjustable system, allowed governments to move the value of the currency around in case of 'fundamental disequilibrium'
- Capital controls – needed to go through the central bank to exchange currency, which controls ability to buy and sell foreign goods/currency and allows the government to regulate flows of capital. Allowed countries some freedom of domestic monetary policy, even with fixed exchange rates, because capital couldn't quickly leave.
- Stabilization fund – shared pool of capital that countries contributed to and then could draw credit from to manage balance of payments deficits.
- International Monetary Fund – international organization to decide when exchange rate adjustments were acceptable and to manage the use of the stabilization fund. Helped coordinate international actions, prevent competitive devaluations, provide a partial regulator of the international financial system.
- (World Bank – development loans)
- (GATT – tariff agreement)
- Major change from previous international economic systems: much more active cooperation, coordination, regulation

Bretton Woods – Problems and Adjustment (scenario Oatley p.234)

How successful was Bretton Woods? What problems did it face?

- Took a long time to implement it, because the European countries didn't have enough dollars/gold at the end of WWII to allow their currencies to be convertible. Didn't go into effect until 1959, almost 15 years after. (by which time US investment, US aid, and dollar's role as the primary asset for international payments/market intervention had increased the amount of dollars in international circulation)
- But this led to a dollar glut – increasingly more and more dollar holdings by foreigners compared to smaller and smaller US gold reserves.
- Meanwhile, Eurodollar markets are creating de-facto currency mobility
- US started to run major balance of payments deficits – too much money flowing out. Declining confidence in the value/convertibility of the dollar. Increasing speculative attacks in the early 1970s, convertibility suspended in summer 1971

- Three options for adjustment:
    - Devalue the dollar against gold. Couldn't fix the problem unilaterally if other countries just did the same, and Europe/Japan didn't want to revalue.
    - Restrain foreign economic activity in the US – slow down economic activity to cut down the BOP deficit. Potential for falling output, rising unemployment, recession.
    - Expand economic activity elsewhere – increase demand for American products. Potential concerns about inflation.

Read and think about Oatley's Bretton Woods adjustment scenario on p.234. Be prepared to answer the questions under 'take a position' and argue for one or the other of the policy options presented. Think about how this scenario helps us understand the broader dynamics of the Bretton Woods era.

Policy Options (quoted from Oatley p.234):

- *The United States should implement the domestic policy changes required to reduce the size of its current account deficit*
- *The United States should pressure Asia to implement the domestic policies required to reduce the size of their current account surpluses*

Take a Position (quoted from Oatley p.234)

- *What policies would the United States need to implement to eliminate its deficit? What would Asia have to do to eliminate its surplus?*
- *Is one of the two policy options less painful for the world economy than the other? If so, which one and why?*

Bretton Woods – Decline and Fall

What ultimately happened? Why did it eventually fall apart?

- US ultimately refused to play its role as the primary exchange currency backed to gold – domestic adjustments were too costly

How was this related to the problems it was trying to avoid in the first place?

- Ultimately, all about this balance between exchange stability and domestic economic autonomy. Maintaining the fixed peg would have mandated specific domestic economic policies in the US or elsewhere (especially Germany), essentially taking away monetary autonomy, and governments were unwilling to do that.

Why was this collapse gentler than that of the interwar gold exchange standard?

Currency decisions in the post-BW era

After you read Oatley's discussion in Chapter 11 about the trade-offs between domestic economic autonomy and exchange rate stability, I'd like you to think about how these issues would apply in a current case. Pick a country (other than the US) and think about its political & economic situation – how significant trade is for the economy, who its major trading partners are, what sort of governmental system it has, what groups might have influence in the policy process, etc (I don't expect a ton of research here – a few minutes on the CIA World Factbook will probably be sufficient). Based on that, define a currency exchange regime choice and be able to defend why your state is willing/likely to make the tradeoffs it involves. If you like, think about whether your choice is the same as the actual currency regime the state has.

What country did you pick?
What is its economic situation?

- How important is foreign trade?
- Who are the major trading partners?

What is its political situation?

- What sort of government does it have?
- What actors/interest groups care about trade policy? (political parties, social/religious groups, economic interests, etc)

Given all this, what sort of an exchange rate regime is best?

- Why are you willing to sacrifice exchange rate stability for domestic economic autonomy, or vice-versa?

Do you know if this is the same as the actual exchange rate regime the country has?

Benefits of floating (keeping domestic economic autonomy):

- Conduct independent monetary policy – raise or lower interest rates for domestic (sometimes political) purposes, which might be different in different countries
- Automatically correct in response to exogenous shocks, doesn't require costly government intervention

Benefits of fixed (exchange rate stability)

- Facilitates economic exchange. Eliminates…
    - Short-term exchange rate volatility (which can cut into profit margins)
    - Longer-term exchange-rate misalignment adjustments (which can hurt the value of long-term investments, or create pressures for protection)

Take-home exam info

Nuts & Bolts:

- Length: 8 pages (**no less than 7, no more than 10**). Don't mess around with fonts & margins & spacing and such, just makes it look unprofessional.
- Handing it in: Hard copy in my mailbox in North Hall (Grad lounge or TA one) by 2:15pm on April 3rd. No emails. Find a way to get me a hard copy, no excuses, if you're worried about last minute printer malfunctions or traffic jams, get it done a few hours early.
- Plagiarism: I shouldn't even have to say this, but don't do it. I don't know the exact university regulations on using others' work, but we'll be checking, and you bet if we find it happening we'll enforce the rules as strictly as possible as far as disciplinary action, failing grades, etc.

Content:

- I know you've all written papers/essays before, but I still flatter myself into thinking I have something useful to say about how to write well academically, so I have this handout. **hand out paper guide**
- Clear organization & structure
- Logical explanations, theoretical support, relevant examples. Explain your points clearly.