PGDM- IB IV; Trim 2017-19

International Finance

(End- Trimester Examination)

Part B – Two cases

Case 1

Currency Turmoil in the 1990s

Attacks on the Mexican peso and Thai baht and their spill over effects on other currencies

For periods of time, world currency markets can be quite peaceful; with only modest changes in exchange rates. But with the ability to move vast sums of money very rapidly from one part of the world to another and from one currency to another, speculators can suddenly turn this relatively peaceful world into one of extreme turmoil. In this case study we examine two periods over just three years when such turmoil occurred.

1995

It may well have seemed in March 1995 that the currency crisis that had hit the European exchange rate Mechanism (ERM) in September 1992 was returning with a vengeance. Only this time the currency turmoil extended way beyond Europe, involving as it did the US dollar, the yen and many other currencies, such as the Mexican peso.

On 6 March the dollar reached post-war lows against the German mark and the yen, standing at 1.386 marks and ¥92.40 respectively. The fall in value against the yen represented a 32 per cent depreciation since 1992.

In Europe, the knock-on effect of the strong mark was felt in some measure by all the currencies, especially those within the ERM. The Spanish peseta, under pressure prior to the mark's rise, was devalued by 7 per cent, and the Portuguese escudo by 3.5 per cent. Both the French and Swedish governments, with their currencies reaching record lows against the mark, were forced to put up interest rates to prevent further depreciation.

The high yen and mark proved to be equally problematic for the Japanese and German governments. The Japanese economy, which is highly dependent on the US economy for its export earnings (over a third of its foreign sales go to the USA, amounting to 15 per cent of its GDP), found its competitive position significantly eroded. On top of this, a surge in cheap imports reduced many Japanese companies' share of their home market and subsequently stifled the recovery of business growth. Such growth was also being undermined by the sustained high value of the yen, which was encouraging many Japanese businesses to shift production facilities overseas, reducing domestic investment still further.

In Germany, too, concern was being expressed about the high exchange rate and its impact upon the economy's faltering economic recovery. It was suggested that if the 13 per cent appreciation of the mark since December 1994 were not reversed, economic growth could be reduced by as much as 1 per cent.

But why had there been such a large appreciation of the mark and yen? The speculative pressure on the dollar began in late December following an economic crisis in Mexico. Not only did the USA quickly arrange a $20 billion aid package, but more significantly, the prospect of a large decline in Mexican imports was seen by many speculators as a severe blow to the USA's export recovery. On top of this, market analysts were predicting that US interest rates, which had previously been rising, would now fall as US economic growth slowed. In contrast, interest rates in Germany looked set to rise, as the German authorities faced growing inflationary pressures. Faced by all this, many investors moved out of dollars and into the more stable mark. This merely intensified a process that had been occurring throughout 1994, whereby US and Asian investors, seeking to diversify their portfolios and invest in non-US equities and bonds, sold dollars.

The US Federal Reserve seemed unconcerned about the falling dollar and took no steps to support it. This expression of total indifference led speculators to believe that the dollar's fall was not yet over, encouraging yet further selling of dollar balances.

Such was the strength of the speculative wave driving the dollar down that many investment banks began to argue that the dollar had significantly overshot its long-term equilibrium value. By early March the investment bank Goldman Sachs estimated that the real value of the dollar against the yen and mark, using purchasing-power parities, was anywhere between 40 and 50 per cent undervalued.
Blame for the volatility in currency markets was squarely levelled at the USA for being far too slow to raise domestic interest rates to halt the dollar's slide. Both France and Japan (the one keen to push its currency up, the other down) argued that greater international co-operation was vital if the dollar's slide was to be halted and currency speculation stabilised.

However, critics were quick to point out that co-ordinated action between central banks, to buy the dollar and prevent its slide, was only a short-term solution. What was needed was greater international harmonisation in domestic fiscal and monetary policy in order to create exchange rate stability. Countries were, however, far from unanimous in their desire to enter into such an integrated strategy of exchange rate co-ordination, and no agreement was reached.

1997

In the summer of 1997, the Thai baht collapsed. It had been pegged to the US dollar and, with strong economic growth in Thailand, this had encouraged large-scale inward investment. But with a slowing economy in 1997 and a widening trade deficit, investors began to question whether the pegged rate could be maintained. There was massive speculative selling of the currency, and hence the collapse.

The huge depreciation of the baht acted as a catalyst, plunging the whole of south-east Asia into financial turmoil. The shock waves, as one currency after another came under speculative attack, spread outwards from the region. Brazil, Argentina, Mexico, Russia and the Ukraine all saw their currencies come under speculative pressure. All were forced to raise interest rates in an attempt to prevent further depreciation of their exchange rates.

As short-term financial flows increase and currency markets become freer, as the growth in information technology and the process of globalisation make the world's financial markets more integrated, and as fear and rumour seem increasingly able to spread like a bush fire around the world's financial capitals, so the greater is the potential for financial volatility and economic crisis.

Questions

1. If in 1995 the Japanese yen was already above its long-term equilibrium exchange rate, and was therefore likely to depreciate sometime in the future, why did speculators still continue to buy yen?
2. During the year 2013- 2014 Indian rupee suffered huge volatility. Explain the reasons for volatility and RBI measures to handle the volatility?
3. Explain the reasons for current volatility in Indian rupee dollar exchange rate.

Case II

Balance of Payments

"Government of India closely watching rise in the FOREX reserves."

"BOP situation for India worsens over last few months due to bird flu scare."
"RBI considering possible hike in CRR, thereby signaling possible tight monetary policy."
"Political parties demanding compensation in dollar terms, for farmers for chickens culled."
These words were some of the headlines screaming for your attention before the annual board meeting. You – the CEO of a mega property developing corporation – call up the chief economist to take her views into consideration. Your company has heavily invested in many mega projects and you are planning to ride the retail boom. The organization has ambitious plans to make foray into airport and seaport privatization process. This will mean hand holding with international agencies and taking loans and, possibly, equity partnership. These inflows will have the usual condition of repayment of interest and minimum guaranteed dividends in dollar terms.

Your phone rings and chief economist explains, "On one hand, India has a promising future in retail market as it is evident from the shopping malls boom in all metros and mini metros. Therefore, our investments are well protected. GDP is projected to grow about 8% over next five year. This will mean a much larger foreign trade component, giving fillip to requirement of airport and seaport infrastructure. In such a scenario, we should be able to establish our self in this sector as well. However, on the other hand, there is a definite possibility that in case this GDP growth is not achieved, unemployment will rear its head once again, causing supply side shortages and unabated demand in some sectors- thereby meaning inflation will soar, and, in turn, interest rates will go up; and finally this will put downward pressure on rupee against all major currencies. This will erode our credibility and profitability in the market. The signs of impact could be visible in six months from now and among the first indicators of this shift looming over the horizon will be change in India's BOP account." You listen to her silently on your intercom.

You give a sigh of relief as soon as her prognosis is over. You call up your treasurer for a small chat. After all, he is the person who deals in foreign exchange market on minute-to-minute basis.

He has a different story to tell, "Well, even if worst case scenario emerges, we stand to gain. See, hardening of interest rates with devaluation of currency will not have any material impact on us. In fact, with this India will become a preferred destination for further foreign investment. Our exports will become more competitive in the international market and it will give a boost for indigenous production of many things. This means more imports of plant and machinery and of course, raw materials." He signs off by saying, "I see no reason for worry even if BOP situation worsens, we are well covered in currency and interest rate futures market." He adds further with smile, "We can actually make money on the basis of this forecast, subject to the permission from our board to take positions in option market."

You sit back in your chair and try to figure out what your presentation is going to be in front of the board.

Questions:

1. What are the reasons for disequilibrium in India's balance of payments?
2. Suggest measures to correct the imbalance in India's BOP
3. How does BOP position affects country's risk profile?
4. Briefly discuss the current BOP situation of Indian economy.

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