Sample essay on currency crisis avoidance or reversion

Economics, Currency

Essay Questions

- NAFTA and the EU

NAFTA (North America Free Trade Agreement) was established on January 1st, 1994 between the United States, Mexico and Canada. All quantitative restrictions and duties were eradicated as planned on January 1, 2008. NAFTA established the largest free trade area of the World that currently links 450 million people producing $ 17 trillion worth of products. On the other hand, EU (European Union) was established in the late 1940s after World War II in an attempt to consolidate the countries of Europe. It is an economic and political union between countries which make its own policies regarding member’s economies, laws, societies and to some degree security. EU came into full action on November 1st, 1993 after the signing of the Maastricht treaty on European Union.

NAFTA and EU are both large regional systems bringing together sovereign nations or states. There is also the removal or reduction of trade barriers such as custom fees in both of them. What is clearer is how these two regional systems are different from one another. Whereas NAFTA is a free trade agreement with some environmental and labor agreements as well, the EU is economic and political entity. NAFTA countries have their own currencies while the members of EU use the Euro as their common currency. The long term goal of NAFTA is to establish a free trade area and aid Mexico’s development whereas the long term goals of the EU are integration and expansion.

- Forward Contracts and Swaps

Forward contracts refer to customized contracts between parties concerned to sell or buy an asset at a particular price on a future date. Forward contracts can be applied for hedging or speculation, even though its non-standardized aspect makes it specifically suitable for hedging. Unlike forward contracts, Swaps are derivatives whereby parties concerned exchange cash flows of one party's financial instrument for those of the other party's financial instrument.

Both forward contracts and swaps are forms of traded derivatives and are also applied in hedging risks by the parties concerned. However, they differ in that forward contracts have a single future payment while swaps involve a series of future payments. Furthermore, forward contracts are usually customized by the parties concerned as opposed to swaps that are usually standardized by the parties concerned.

- Futures Contracts and Option Contracts

Futures contracts refer to contractual agreements, usually made on the basis of futures exchanges, to sell or buy a specific financial instrument or commodity at a pre-determined price in the future. On the other hand, option contracts are contracts that let the holders sell or buy the underlying security at a given price, referred to as the strike price.

Futures contracts and option contracts are both derivative securities for future delivery or receipt and in principal they are very similar since both are applied to attain the same goal of risk management. The main difference between futures contracts and option contracts prevails in the obligations they put on their sellers and buyers. Futures contracts grant the buyer obligation to buy a certain asset, and the seller to sell and deliver that asset at a particular future date whereas option contracts grant the buyer the right, but not the obligation to buy or sell a particular asset at a specific price at any time amid the life of the contract. In addition, the underlying position is much larger for futures contracts, and the obligation to sell or buy a particular amount at a given price makes futures contracts more risky than the option contracts for the inexperienced investor.

- “ Winners” and “ Losers” of a Currency Depreciation

Currency depreciation refers to a decrease in the level of currency in a floating exchange rate system, as a result, of market forces. Currency depreciation can take place because of a number of reasons, for example, economic fundamentals, political instability, interest rate differentials and risk aversion. The “ winners” of currency depreciation are, therefore, the exporters since currency depreciation makes the exports more competitive and thus appear cheaper to foreigners thereby increasing the demand for exports. On the other hand, the “ losers” of currency depreciation are indeed the importers because currency depreciation makes imports become more expensive and thus reduces the demand for imports.

- “ Winners” and “ Losers” of a Currency Appreciation

Currency appreciation is an increase in the level of currency in a floating exchange rate structure, as a result, of market forces. Currency appreciation occurs due to various reasons, for instance, the state of the country’s current account and capital inflows. The “ winners” of currency appreciation are, therefore, the importers since currency depreciation make the importers more competitive and thus appear cheaper thereby increasing the demand for imports. On the contrary, the “ losers” of currency appreciation are the exporters because currency appreciation makes exports become more expensive and thus reduces the demand for exports.

- Benefits of Immigration in the USA

Immigration is the movement of people from different parts of the world into a specific nation or area. Immigration is a hotly-debated political matter in the United States particularly the illegal immigration. Even though, people view immigration from different aspects; immigration does bring various benefits to the United States as follows.

- Availability of Cheap Labor

Many United States immigrants labor in low-paying jobs that most Americans are not ready and willing to work. The result is cheap and affordable labor for many firms that in turn keeps the American economy functioning.

- Benefits to Taxpayers

Illegal immigration usually has a positive impact on the average United State taxpayer. This is because immigrants in U. S. compensate more in taxes than they eat up in social amenities.

- Greater Cultural Diversity

Immigrants come to the U. S. from various parts of the World bringing with them cultural, ethnic and racial diversity, which in turn expose America citizens to a new way of life and new ideas from different parts of the globe.

- Creation of Jobs

Besides being job seekers, many immigrants to the United States are natural entrepreneurs who are very innovative and own various companies, thus creating a number of job opportunities to even the native-born American citizens.

- Factors that can Cause a Currency Crisis

A Currency crisis is, as a result, of a decline in the value of a nation's currency. The following factors can cause it.

- Hyperinflation

Countries with rampant inflation may result to hyperinflation. Hyperinflation causes a currency to lose its value and requires people to use copious amounts of money to buy goods and services thereby resulting to a currency crisis.

- Contagion

Crises in particular nations may cause doubt on the economic stability of other nations and areas. The more a nation is linked with the one that is experiencing a currency crisis, either through the same export structure, or intensive mutual trade, the same language and culture, similar financial market structures, etc. the more vulnerable it is to a currency crisis.

Currency crisis can be avoided or reversed by the following two ways

- Maintaining the Current Fixed Exchange Rate

When faced with the possibility of a currency crisis, central bankers operating in a fixed exchange rate countries may attempt to keep up the current fixed exchange rate by allowing the exchange rate fluctuate, or eating into the foreign reserves of the country.

- Restricting Borrowing by Domestic Banks and Firms

Domestic banks and firms should not be allowed to borrow foreign money without authorization from the government. High foreign indebtedness of domestic firms has been the main factor for the reduction of central banks' exchange reserves in the course of a currency crisis.