

# Dissertation chapter



Brazil, Mexico, Paraguay and Uruguay are members of MERCOSUR, is regional trading areas that are trying to become a common market. What issues should they consider before they accept or reject a common currency?

Before accepting a common currency, the countries should look at the benefits and constraints that will accrue to such an endeavor. The three countries being developing nations if they have open capital account especially if their capital markets are small and shaky banking institutions and since they are used to the way the monetary system works, they will be forced to change their policies and adapt those set by the common currency governing body. The economic cost will be the loss of national autonomy in monetary policy.

#### Benefits

Having a common currency will enhance trade and development among the four countries. This is because there will be less transaction charges and they will not have to deal with the unpredictable fluctuations in the exchange rate. Moreover, the common currency facilitates good relationship among the countries especially because they will be constantly communicating with each other thus will be able to exchange economic ideas and share new technological ideas and in so doing, it will enhance the development of the region as there will be increased trade. Moreover communication will foster openness. Another benefit of a common currency is that it can decrease the costs of products sold within the countries and this will be good for the consumers as they will now afford a lot of things that they would otherwise have done away with (Krugman, 1998). Having a common currency ensures flexibility in prices therefore people as it is centrally governed and this will be good for employees who will be assured of job stability.

## Constraints

Before choosing a common currency, they will need to look at how the four economies are structured and how they have progressed over the years. This will be good because problems will arise when certain countries are doing better than others so they will see this idea as an opportunity to use them or exploiting weaker countries. They also need to look at the financial structures and how the common currency will affect various institutions as sometimes not everyone is for the idea of sharing the same currency. Political constraints will also influence such a decision as they determine the policies within their countries and will want to see them work.

Why are crises associated with severe recession? Specifically what happens during an international financial crisis to create a recession in the affected country or countries?

A crisis occurs when suddenly various institutions in an economy lose huge sums of money and some of their assets. This is mainly as a result of stocks prices falling or banks panicking. When such crises continue for a while, businesses start closing down, investments fall drastically and there is a general increase in prices in the economy. This leads to the recession because of the decline in the economy. Recessions last for a short period but when it persists, it becomes severe. Such that even the basic essentials like education and healthcare become very expensive.

An international financial crisis occurs when the international market prices fall and everyone is affected. This will be such that the currency of a country falls; especially those of well developed nations, such that they are not able to import commodities like they used to as they have less money to spend. This negative situation will be furthered by less capital inflows and therefore

the production and growth of the economy is slow. Individual firms will now start feeling the pressure of the tough economic conditions therefore they will lay off some workers to be able to operate within their set budgets. Laying off workers means increased unemployment which further says that people will have less money to spend and with the increase in prices, they will not save or invest. On top of this, the countries will not be able to pay the debts they owe other countries and this will further affect their balance of payments.

When such big economies are affected like this, the developed nations will later start feeling the impact because there will be reduced trade between the countries, furthermore if they were getting aid which maybe inform of funds or grants it will be reduced or cut-off. Big multinational companies will also be affected as trade will be generally slow. Therefore we can see that an international financial crisis spreads across the nations like a wild fire and with it comes recession as individual country's progress declines. A country will know that it is affected when its GDP is negative and it does not show signs of improve.

Look at each of the cases from the point of view of the balance of payments for the United States. Determine the sub category of the current account or financial account that each transaction will be classified in and state if it would enter as a credit or a debit.

The balance of payment refers to the measure used to tell the difference between a country's imports and exports. The current, financial and capital account are used to account for these imports and exports. The current

account is comprised by the goods and services accounts while the financial account records financial assets and liabilities.

- The U. S government sells gold for dollars

When the U. S government sells gold for dollars, it gets money in the form of cash therefore it will be recorded in the financial account as it deals with financial assets. It will be debited because the country will be gaining by increasing its cash reserves

- A migrant worker in California sends \$ 500 home to his village in Mexico

When the migrant worker sends money to Mexico, the country will be losing the \$ 500 and since money is being transacted, it will be entered in the financial account and will be credited as it will be reducing the country's money.

- An American mutual fund manager uses the deposits of his fund investors to buy Brazilian Telecommunication stocks

Since the mutual fund manager is further investing his/her client's money, this benefits that will accrue to the company will be a source of revenue to the country therefore, it will be entered in the financial account and debited.

- A Japanese firm in Tennessee buys car parts from a subsidiary in Malaysia

Since the Japanese company is a foreign company, it means that they are investing in the country therefore by them buying car parts from Malaysia,

they will have spent their money which will not have an influence on the United states accounts therefore it will not be entered in any account.

- As American church donates five tones of rice to the Sudan to help with famine relied

When the church donates the food to Sudan, they are dealing with a tangible commodity therefore it will be entered as a current account and since they have used the countries money to but as well as export the food, it will be credited.

- As American retired couple flies from Seattle to Tokyo on Japan airlines

When the American couple flies using the Japanese airlines, they will be using services being offered by a foreign country other than their own therefore, this will be recorded in the current account and since the country will not earn this money it will be credited.

- The Mexican government sells pesos to the US treasury and buys dollars

When the Mexican government sells the pesos to get the dollars; they will lose a little money because of the differences in the rates of buying and selling. By the Mexican government losing, it means that the American's will gain. Therefore, it will be recorded in the financial account and the entry debited.

Describe the mechanism that leads from a change in fiscal policy to changes in interest rates, the exchange rate and the current: account balance. Do the same for monetary policy.

- Fiscal policy

Fiscal policy refers to the measurers that the government uses to balance and control its revenues and expenses. The government can create changes

in the fiscal policy by either increasing or decreasing the revenues and expenses by the way it spend its money. When the government increases its spending which can be done by cutting down taxes the demand curves will shift to the right, which will increase disposable income. This will cause the new demand to be more than the supply thus increasing the GDP. As the gross domestic product rises, the rate if interest will also increase and with higher interest rates, the country will gain from trade with other countries and this will make will demand for the country's currency thus increasing its value and at the same time decreasing the exchange rate. This will have a positive impact on the current account balance as there will be more returns as opposed to the expenses.

- Monetary policy

Monetary policies are the policies used to control money in the economy. Assuming that the country has a fixed exchange rate, when the aggregate supply curve shifts to the right due to expansionary forces, there will be a decrease in the interest rate. In addition, the disposable income will reduce. Moreover, this decrease will create a shortage of money supply in the country. The government will therefore have less money to spend and they will cut on their expenses. Since trade will be minimal, the exchange rates will increase as their will be less demand of the country's currency. This will affect the current account negatively as they will be spending more on their exports than in the imports they get.

The US is currently running a large current account deficit. If congress and the White House decide to enact policies to reduce or eliminate the deficit, what actions should they take? Describe the set off policy options available for them.

When there is a deficit, the US government will be looking at ways that can increase the revenues it gets from importing and exporting goods and also ways of reducing its operating expenses. The policies that the congress and the white house can use to rectify its current account include;

#### Lowering the exchange rate

This it will do if it adjusts its fiscal and monetary policies so that they ensure that the rate is kept stable at all times and that the banks can have enough money to lend to people so that the economy is kept on check.

#### Export subsidies

They can decide to offer producers as well as manufacturers subsidies such that when they are exporting goods they are exported at a lower price. This will encourage other people to produce more for exports and this will increase the money got from exports thus correcting the current account deficit.

#### Import tariffs

They can establish import tariffs so that imported goods become expensive and this makes people to use locally manufactured goods. Through this they will ensure the progress of their industries which will export the surplus they produce and this will improve the current account.

#### Lowering the rate of inflation

Since the government is the overall decision maker on money issues, they can ensure that the rate of inflation is kept minimal as this will stabilize the



prices of the economy and create a favorable environment for businesses to conduct business.

They can also cut down on their spending especially on luxury goods as they will save more by doing that and this will make their current account better off and they will have a high chance of making profits.

### 1.7 . Explain the moral hazard problems inherent in responding to a crisis

There may be poor asymmetric information which contributes to financial crises. Financial crises lead to bank failure as people will not have confidence in the banking system.

“ When there are no proper channels of getting information which used to be got from clients when banks were operating better, this worsens the moral hazard as well as other adverse selection problems(Reinert, 2009).” The problems with asymmetric information also limit how countries respond to problems.

The moral hazard problem inherent with credit marketers

Borrowers who have little money will not lose much when there is a crisis. Moral hazard becomes an issue for credit marketers when the central bank regulates the amount of loans banking institutions can offer. This is because they will make decisions that banks will have to abide by some of which do not favor the progress of the company. Such problems can lead to banking crisis.

Delivery of aid in the recipient countries

The way aid is distributed also creates a moral hazard problem. This is because donors give aid to countries but once they have finished the transactions and given it to them, then they cannot control how the funds are being used. Some people will end up misusing it or being corrupt such that people it was meant to help never get to use the funds (Reinert, 2009). And due to the differences in public regulations between countries, it makes it difficult to fire such workers.

## References

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