Chaos In The Currency Markets : Currency Crisis Of The EMS Essay, Research Paper

Chaos in The Currency Markets : Currency Crisis of The EMS

1. What does the crisis of September 1992 tell you about the relative abilities

of currency markets and national governments to influence exchange rates?

The currency markets and national governments both have abilities to

influence exchange rates. Like other financial markets, foreign exchange markets

react to any news that may have a future effect. Speculators are the part of the

currency markets that take currency positions based on anticipated interest rate

movements in various countries. Day-to-day speculation on future exchange rate

movements is commonly driven by signals of future interest rate movements. By

using the signal, speculators usually take the position before the things

actually occurred. Sometime, if high power enough, the speculators position can

influence the exchange rate movement. The government controls is one of the

factors affecting exchange rate. The government can influence the equilibrium

exchange rate in many way, including direct intervening (buying and selling

currencies) in the foreign exchange markets and indirect intervening by

affecting macro variables such as interest rates.

2. What does the crisis of September 1992 tell you about the weakness of fixed

exchange rate regimes?

From European currency crisis of September 1992, it shows us that there

are weakness of the fixed exchange rate system. When exchange rate are tied, a

high interest rate in one country has a strong influence on interest rates in

the other countries. Funds will flow to the country with a more attractive

interest rate, which reduces the supply of fund in the other countries and

places upward pressure on their interest rates. The flow of fund would continue

until the interest rate differential has been eliminated or reduced. This

process would not necessarily apply to countries outside ERM that do not in the

fixed exchange rate system, because the exchange rate risk may discourage the

flow of funds to the countries with relatively high interest rate. However,

since the ERM requires central banks to maintain the exchange rates between

currencies within specified boundaries, investors moving funds among the

participating European countries are less concerned about exchange rate risk.

3. Assess the impact of the events of September 1992 on the EU ’s ability to

establish a common currency by 1999.

A major concern of a common currency is based on the concept of a single

European monetary policy. Each country’s government may prefer to implement its

own monetary policy. It would have to adapt to a system in which it had only

partial input to the European monetary policy that would be implemented in all

European countries, including its own. The system would be alike to that used in

the U.S., where there is a single currency across states. Just as the monetary

policy in the U.S. cannot be separated across different states, European

monetary policy with a single European currency could not be separated across

European countries. While country governments may disagree on the ideal monetary

policy to enhance their local economies, they would all have to agree on a

single European monetary policy. Any given policy used in a particular period

may enhance some countries and adversely affect others.

There are some other concerns that could prevent the implementation of a

single currency. For example, at what exchange rate would all currencies be cash

in to be exchanged for the common currency to be used? (think about the trouble

after reunification of Germany). It would be difficult to reach agreement on

this question for each European country’s home currency. Also, some economists

believe that changing exchange rates serve as a stabilizer for international

trade. Thus, the lack of an exchange rate mechanism could possibly cause greater

trade imbalances between countries.

4. The crisis of September 1992 occurred because the ERM system was too

inflexible. Discuss.

The inflexible system was not the main reason. The main reason is

because there are too different monetary policies among the member of ERM. The

German government was more concern about inflation and less concerned about

unemployment because its economy was relatively strong. On the other hand, other

European governments were more concerned about stimulating their economies to

reduce their high unemployment levels. This argument was proved at the end of

the crisis when Germany and France ?s government joined forces to defend the

franc against speculative pressure. If all the member joined forces early the

crisis may not occur.

5. If you were an executive for a company that engages in substantial intra-EU

trade, how would you react to the events of September 1992?

Because the company engages in substantial intra-EU trade, the exchange

rate risk is not the major issue-under fixed exchange rate system the exchange

rate will fluctuate narrowly. A major concern is the interest rate movement.

High interest rate results in high cost of capital to the company and slow

growth economic. The problem will even more serious if the company have to pay

floated rate liabilities in foreign currencies. The company should consider

hedging against interest rate risk such as using interest rate swap or using

fixed rate liabilities.