We've been considering the role that government plays in the open economy and one of our questions is “How does government policy influence the important economic indicators?” Now we’re going to consider how the government can influence the interest rate and the exchange rate in a country by the attitude and the policies that it adopts towards investment in that country.

You'll remember this diagram, in which we explained the interest rate as the price that’s set in the market where loanable funds are supplied by savers and demanded by people who are investing in businesses. The interaction of demand and supply determines the equilibrium interest rate and the quantity of funds lent. Now, think about the position of the people who are lending money in this economy. They're interested in a return, a return that comes from the profits of the businesses they invest in. Now, one of the things that can influence the profitability of business is the attitude that the government takes. We've talked about the government’s taxes of business and government’s regulation of business, but now let’s talk about something a little more dramatic.

What about the role that the government plays in maintaining a stable political climate? A stable political climate is good for the economy, but if political instability threatens the profitability of business, then lenders are going to be concerned that their money is not safe in this economy. Owning stocks and bonds in this economy is risky, because things could happen to their investments that would not allow the people who have borrowed the money to repay it with interest, as they've expected. Let’s think for a moment about things that can go wrong whenever you've invested in a foreign country.

One thing that could happen is that political instability could lead to vandalism and your factory may be destroyed by an act of vandals. And the government may choose, or not be able, to protect your property. Another thing that could happen is, if the political climate becomes unstable, labor may go on strike and your factory may be chained up or sidelined and not produce any profits for you. Another thing that can happen is that the government may change its attitude toward foreign investment. You’ve invested in a foreign country, hoping to get profits from that business, but then the government decides that, once the factory is built, it wants to have it as its own revenue-producing device. Therefore, it seizes the factory or nationalizes it and all of the revenue becomes profit of the government. If any of these things happen, vandalism, the inability or unwillingness of the government to protect property rights, government seizure of capital or labor strikes, then all of a sudden your investment is no longer as profitable as you expected and may, in fact, be worthless.

So when the risk rises that political instability could reduce the profitability of investment in an economy, the rational response of lenders is to reduce the quantity of funds they supply at any given interest rate. We show this in the diagram as an inward shift in the supply curve for loanable funds. Now, there are two ways to interpret this inward shift; at any give interest rate now, lenders are willing to supply a smaller quantity of funds for fear of losing their investments. Another way of thinking of this is, to get any given quantity of loanable funds, lenders have to receive a higher interest rate to compensate them for the risks that they are taking. Now, when the supply curve for loanable funds moves inward at the original interest rate, we have an excess demand for loanable funds, a smaller quantity supply that is demanded at the going interest rate. What happens then is the bidding mechanism pushes the interest rate up, causing some borrowers to be unable to get funds at interest rates that are profitable for them and causing them to no longer undertake investment projects. So borrowers drop out of the market and the higher interest rate compensates some lenders, leading them to stay in even in spite of the political instability. The end result is that the equilibrium interest rate in this market rises from \( i_0 \) to \( i_1 \), and the overall quantity of funds lent shrinks from \( L_0 \) to the smaller quantity, \( L_1 \). So when there's political instability, interest rate will rise in a country and the capital markets will shrink. In the extreme case, everyone takes their money out of this market and there's no money available for borrowers at any interest rate. So that's the consequence in the market for loanable funds.

Let’s think now about what happens in the market for foreign exchange. People in this economy – suppose that this is a country in Central America and its currency is the peso, and this exchange rate here is pesos per dollar, and we’re talking about the market in which dollars are exchanged for pesos. Now suppose political instability develops in this country and people are concerned that their investments may lose value. What happens then is that the demand for dollars increases as the residents of this country try to shift their money from peso denominated investments to a safe
haven, dollar denominated investments in the United States. The demand curve shifts outward, meaning that, at any given exchange rate, the residents of this foreign country want to get more dollars to protect their investments. So the outward shift in the demand curve represents an increase demand for dollars. On the other hand, we now have a reduction in the supply of dollars as people are less interested in buying these pesos, because they don’t want to invest in this country for fear of political instability. The fear of political instability reduces the quantity of pesos demanded, which, as you remember, is the same thing as the quantity of dollars supplied in this market. The supply curve shifts inward, meaning that, at any given exchange rate, traders will supply a smaller quantity of dollars, because of their fear of risk. Well, what’s going to happen in this case, at the original exchange rate, look we’ve got a huge excess demand for dollars. Everybody wants to get into dollars to protect their assets. Well, what’s going to happen, to eliminate the excess demand, is the bidding mechanism kicks in and causes the price of dollars to rise. The dollar appreciates and the peso depreciates until a new equilibrium is established with an exchange rate $e_1$. Remember this is pesos per dollar, so $e_1$ represents more pesos per dollar than before. The peso depreciates.

Now imagine if you had investments in pesos and you saw everyone heading for the exits. Everyone is dumping their pesos, the peso is depreciating, the price of the peso is falling, so any investments you’re holding in pesos are depreciating or losing value before your eyes. You’re fear that this process will continue would lead you then, too, to do the same thing. You try to get your dollars out of this economy before it’s too late, before everything completely collapses. And as everyone acts on this psychology, the peso continues to depreciate. People continue to sell and a frenzy develops, in which psychology takes over and leads the currency to irrationally depreciated levels.

Now, how can you reverse this process? How do you stop the process whereby political instability creates very high interest rates in a country and depreciation of that country’s currency? How do you get people, once again, to be willing to hold capital denominated in this country’s currency and to make investments in the economy? Well, think about the problems that caused the capital flight to begin with. Think about what caused people to want to get out. If the government can reestablish law and order – I mean, that’s certainly going to be helpful, because that creates a good climate for business. So as long as there is political instability that threatens the value of property, you can expect this process to continue. Another thing is that the government needs to establish a reputation for respect for the property rights in that country. It’s not so bad that a government choose to own factories. The problem is when there is uncertainty about whether your investments will remain your property or whether they could be confiscated. As long as this risk is present, people are going to ask for a premium on their investments to protect them against this possibility. And finally, to the extent that workers are content with the way in which labor and management relations are allowing them to supply their factor of production in the process, they’re going to be willing to work for their wages. On the other hand, whenever workers are feeling unfairly treated or whenever strikes become a political tool to achieve other objectives, then your productivity of your factories is at risk. So everything that creates political stability, as a rule, tends to add to the value of investments in an economy and make lenders willing to supply funds at lower interest rates and allows people to be willing to hold the currency of that country as part of their investment strategy.

So there you have it. Political instability means high interest rates and depreciating currency for a country, as people begin to take their money out of the country for fear of having their investments confiscated or seeing them lose value. Political stability, on the other hand, has the opposite results: interest rates remain lower and the currency remains stronger.