MONETARY TURBULENCE & THE SUPPLY OF LIQUIDITY

ROBERT Z. ALIBER
INSIGHTS FROM MEMOIRS

• KING— THE ALCHEMY OF FINANCE
• DARLING— BACK FROM THE BRINK
• GREENSPAN— THE AGE OF TURBULENCE
• PAULSON— ON THE BRINK
• GEITHNER— STRESS TEST
• BERNANKE— COURAGE TO ACT
• WHEN DID EACH AUTHOR REALIZE THE ECONOMY WAS ON THE BRINK OF A CRISIS??
THREE KEY IDEAS

• A BANKING CRISIS IS A PREDICTABLE EVENT—WITH UNCERTAIN TIMING
• EVERY BANKING CRISIS SINCE 1980 HAS THE SAME FORMAT
• THE FLOATING CURRENCY ARRANGEMENT IS INHERENTLY UNSTABLE
OVERVIEW

- FEATURES - MONETARY TURBULENCE
- CASE STUDY—ICELAND
- CAUSE OF A CRISIS VS TRIGGER
- CASE FOR FLOATING CURRENCIES REVIEWED
- WHY THE CASE FOR FLEXIBLE EXCHANGE RATES IS INTELLECTUALLY BANKRUPT
FEATURES OF MONETARY TURBULENCE

- LARGE CHANGES IN CROSS BORDER INVESTMENT INFLOWS
- LARGE CHANGES IN CURRENCY PRICES
- LARGE CHANGES IN SECURITY PRICES
- FOUR WAVES OF BANKING AND CURRENCY CRISSES
THE STYLIZED FACTS

- EACH COUNTRY THAT HAS HAD A BANKING CRISIS PREVIOUSLY HAD A BOOM
- EACH COUNTRY EX JAPAN HAD AN INCREASE IN INVESTMENT INFLOWS
- JAPAN--INVESTMENT OUTFLOWS DECLINED
- INCREASE IN CROSS BORDER INFLOWS LED TO SURGE IN DOMESTIC CREDIT
- EXTERNAL INDEBTEDNESS INCREASED TOO RAPIDLY TO BE SUSTAINED
A CRISIS-”CAUSE” VS “TRIGGER”

- CAUSE—TOO-RAPID INCREASE IN CROSS- BORDER INVESTMENT INFLOWS
- TRIGGER—AN EVENT THAT SLOWED INFLOWS
MONETARY TURBULENCE IN ICELAND 2003-2008

• ICELAND BANKS SOLD IOU’S IN FOREIGN CENTERS
• ICELAND’S CAPITAL ACCOUNT SURPLUS SURGED—BUT ITS CURRENT ACCOUNT DEFICIT INCREASED AT THE SAME TIME
• PRICE OF ICELANDIC SECURITIES INCREASED TENFOLD
• PRICE OF KRONA INCREASED
• HOUSEHOLD WEALTH INCREASED SHARPLY HIGHER CONSUMPTION SPENDING AND IMPORTS SURGED
WHEN DID AN ICELANDIC CRISIS BECOME “INEVITABLE”?

• NECESSARY CONDITION - SHARP INCREASE IN EXTERNAL INDEBTEDNESS/GDP
• SUFFICIENT CONDITION — HIGH RATIO OF EXTERNAL INDEBTEDNESS/GDP
• AS TIME PASSES BOTH RATIOS INCREASED
• WHEN DID ICELAND CROSS THE “DATE OF NO RETURN”
FOUR U.S. DOLLAR CYCLES

- U.S. CAPITAL ACCOUNT SURPLUS INCREASES IN EXPANSIVE PHASE
- PRICE OF SECURITIES INCREASE
- THE U.S. CURRENT ACCOUNT DEFICIT INCREASES
- PRICE OF U.S. DOLLAR INCREASES
- WHAT HAPPENS IN CONTRACTIVE PHASE?
THE TRANSFER PROBLEM—WHEN A CRISIS IS INEVITABLE

KEYNES’ TRANSFER PROBLEM
EXTERNAL INDEBTEDNESS INCREASES MUCH MORE RAPIDLY THAN GDP
SECURITY PRICES MUST INCREASE TO CLEAR THE CURRENCY MARKET
INCREASE IN EXTERNAL INDEBTEDNESS MUST SLOW AND PRICES OF SECURITIES DECLINE
SOURCE OF MARKET FAILURE

- CURRENCY MARKET—PROLONGED ADJUSTMENT MKT IS INEFFICIENT
- SECURITIES MARKET—DEPENDENT ON INVESTMENT INFLOWS
- WHEN INVESTMENT INFLOWS SLOW, PRICES OF CURRENCY AND SECURITIES DECLINE
FLOATING RATE SYSTEM—OBJECTIVES AND CLAIMS

• NORMATIVE OBJECTIVES
  • MINIMAL WEDGES AT NATIONAL BORDERS
  • CENTRAL BANK MONETARY INDEPENDENCE
  • MARKET PRICE OF CURRENCY MOVES TO LONG RUN EQUILIBRIUM PRICE

• POSITIVE CLAIMS
  • SMALLER DEVIATIONS
  • GREATER INSULATION EXTERNAL SHOCKS
  • GRADUAL CHANGES IN CURRENCY PRICES
  • FEWER CURRENCY CRISES
  • SMALLER DEMAND FOR FX RESERVES
SCORECARD—POSITIVE CLAIMS ON FLOATING RATES

• LARGER DEVIATIONS OF MARKET PRICES OF CURRENCIES

• COUNTRIES IMPORT SHOCKS—BOOM AND BUST CYCLE

• MASSIVE DECLINES IN CURRENCY PRICES

• MORE BANKING/CURRENCY CRISES

• SURGE IN DEMAND FOR INTERNATIONAL RESERVE ASSETS
SCORECARD-NORMATIVE OBJECTIVES

• DEVIATIONS OF MARKET RATES FROM LONG RUN AVERAGE RATES HAS BEEN LARGER THAN WHEN CURRENCIES WERE PEGGED

• MONETARY INDEPENDENCE MONETARY POLICY CONSTRAINED BY HIGHLY VARIABLE MARKET PRICE
WHY THE PROPONENTS GOT IT WRONG

• PROONENTS --ONLY GOODS MARKET SHOCKS

• NO MONEY MARKET SHOCKS—

• HOW LIKELY IS IT WE CAN HAVE MONETARY INDEPENDENCE AND NOT HAVE MONEY MARKET SHOCKS
IMPLICATIONS FOR LIQUIDITY

• FLOATING RATES PROVIDE AN ABUNDANCE OF SHOCKS

• THE DEMAND FOR LIQUIDITY INCREASES SHARPLY

• THE SUPPLY OF LIQUIDITY DECLINES
CONCLUSION-THREE KEY IDEAS

• EVERY BANKING CRISIS SINCE 1980 HAS THE SAME FEATURES
• INTERNATIONAL MONETARY ARRANGEMENT IS INHERENTLY UNSTABLE
• CASE FOR FLOATING IS INTELLECUTUALY BANKRUPT