CURRENCY TURBULENCE AND BANKING CRISSES

THE POST-1970 INTERNATIONAL MONETARY ARRANGEMENT IS DYSFUNCTIONAL
PRESENTATION OVERVIEW

THE POST-1970 INTERNATIONAL MONETARY CONSTITUTION
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THE SOURCE OF TURBULENCE:
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STYLED NARRATIVE—A SHOCK TO THE CAPITAL ACCOUNT
KEYNES’ TRANSFER PROBLEM REVISITED
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WHY THE POST-1970 MONETARY CONSTITUTION IS DYSFUNCTIONAL?
THE POST-1970 MONETARY CONSTITUTION

“RULES OF THE GAME” FOR A FLOATING CURRENCY WORLD

“BETTER TO ALLOW THE PRICE OF A CURRENCY TO ADJUST THAN ADJUST PRICES AND INCOMES TO RETAIN A PARITY”

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GREATERT MONETARY INDEPENDENCE
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THE AGE OF TURBULENCE

MUCH LARGER VARIATIONS IN MARKET PRICES OF COMMODITIES, SECURITIES, REAL ESTATE, AND CURRENCIES RELATIVE TO LONG RUN AVERAGE PRICES

BANKING CRISES AND CURRENCY CRISES “TWINNED”

BANKING CRISES MORE FREQUENT AND MORE SEVERE

BANKING CRISES LEAD TO “GREAT RECESSIONS”

FORTY YEARS OF FLOATING CURRENCIES—DO WE HAVE FLOATING CURRENCIES BECAUSE WE HAVE MORE STRUCTURAL SHOCKS, OR DO WE HAVE MORE SHOCKS BECAUSE WE HAVE FLOATING CURRENCIES? THAT IS THE QUESTION!!!!!!!!
WHERE DOES TURBULENCE COME FROM?

“ACTS OF GOD”
STRUCTURAL SHOCKS
   CHANGES IN OIL SUPPLIES
   BAD HARVESTS
MONETARY SHOCKS
   CHANGES IN CENTRAL BANK MONETARY POLICIES
   CHANGES IN INVESTOR DEMAND FOR FOREIGN SECURITIES

DID ICELAND EXPERIENCE A STRUCTURAL SHOCK OR A MONETARY SHOCK?

CHANGE IN ICELAND’S TRADE DEFICIT

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<th>INCREASE</th>
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<th>CHANGE IN PRICE OF ICELANDIC KRONA</th>
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ICELAND HAD A MONETARY SHOCK—THE NORTH WEST CELL
SIMILARLY MOST OF THE SHOCKS THAT HAVE LED TO LARGE CHANGES IN THE PRICES OF CURRENCIES HAVE BEEN MONETARY
STYLIZED NARRATIVE

SHOCK--AN INCREASE IN THE FOREIGN DEMAND FOR ICELANDIC SECURITIES--ITS CAPITAL ACCOUNT SURPLUS INCREASES

ICELAND’S CURRENT ACCOUNT DEFICIT MUST INCREASE TO CORRESPOND WITH THE INCREASE IN ITS CAPITAL ACCOUNT SURPLUS

THE PRICE OF THE ICELANDIC KRONA INCREASES
THE PRICE OF ICELANDIC SECURITIES INCREASES
ICELANDIC HOUSEHOLD WEALTH SURGES
CONSUMPTION SPENDING SURGES

THE SURGE IN HOUSEHOLD WEALTH IS AN INTEGRAL RESPONSE TO THE INCREASE IN ICELAND’S CAPITAL ACCOUNT SURPLUS

WHEN FOREIGN DEMAND FOR ICELANDIC SECURITIES SLACKENS, THE PRICE OF THE KRONA DECLINES, AND THE BOOM MORPHS INTO A BANKING CRISIS
TRANSFER PROBLEM REVISITED

WHAT IS THE TRANSFER PROBLEM?

HOW DOES AN ECONOMY ADJUST TO AN INCREASE IN THE FOREIGN DEMAND FOR ITS SECURITIES?
   -- WHEN ITS CURRENCY IS FLOATING
   -- WHEN ITS CURRENCY IS PEGGED

WHAT INDUCES THE INCREASE IN THE CURRENT ACCOUNT DEFICIT?
   -- HIGHER PRICE FOR ITS CURRENCY (EXPENDITURE SWITCHING)
   -- HIGHER PRICES FOR SECURITIES

WHY DO THE PRICES OF SECURITIES INCREASE?
   -- INCREASE IN FOREIGN DEMAND
   -- INCREASE IN DOMESTIC GDP AND DEMAND

THE “ACCELERATOR”—WHY DOES THE COUNTRY’S CAPITAL ACCOUNT SURPLUS INCREASE AS THE CURRENCY BECOMES MORE OVERVALUED?
   -- INCREASE IN THE ANTICIPATED RATES OF RETURN
   -- MOMENTUM TRADES IN CURRENCIES
PRIMARY DEFICITS AND BANKING CRISSES

WHAT IS A PRIMARY DEFICIT?

DOMESTIC IMPACT OF A PRIMARY DEFICIT IN INTERNATIONAL PAYMENTS ACCOUNTS

EVERY BANKING CRISIS (EX JAPAN’S) HAS BEEN PRECEDED BY A PRIMARY DEFICIT IN INTERNATIONAL PAYMENTS ACCOUNTS

PRIMARY DEFICITS CANNOT BE SUSTAINED
# A Scorecard on Primary Deficits and Banking Crises

## Change in Iceland’s International Payments Position

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<tr>
<th>CHANGE IN PAYMENTS POSITION OF ICELANDIC HOUSEHOLDS</th>
<th>PRI DEF</th>
<th>SEC DEF</th>
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**PRI DEF** = Primary Deficit  
**SEC DEF** = Secondary Deficit

Most country observations in the northwest cell.
THE LINK BETWEEN SUCCESSIVE BANKING CRISIS

1970S—POST CAMP DAVID “RUN ON THE US DOLLAR”

OCT 1979—CONTRACTIVE FED POLICY LEADS TO “SUPER DOLLAR”

MID-1985—PRICE OF US DOLLAR DECLARES AS US INTEREST RATES DECLINE—(SURGE IN PRICE OF JAPANESE YEN)

EARLY 1990S—PRICES OF CURRENCIES OF EMERGING MARKET COUNTRIES INCREASE

JULY 1987—SURGE IN PRICE OF US DOLLAR AS ASIAN COUNTRIES EXPERIENCE BANKING CRISIS

A SUCCESSION OF OVERSHOOTING EPISODES—EACH OF THE NEWLY INDEBTED COUNTRIES HAS A PRIMARY DEFICIT
WHAT REMAINS OF THE CASE FOR FLOATING CURRENCIES?

NATIONAL ADJUSTMENTS IN PRICES AND INCOMES TO CHANGES IN THE REAL PRICES OF CURRENCIES ARE LARGER THAN IF CURRENCIES WERE ANCHORED TO PARITIES

SHOCKS THAT HAVE LED TO THE LARGE CHANGES IN PRICES OF CURRENCIES HAVE BEEN MONETARY

LARGER DEVIATIONS FROM PPP

VARIABILITY IN CROSS BORDER INVESTMENT FLOWS LEAD TO SURGES IN PRICES OF SECURITIES—ECONOMIC BOOMS MORPH INTO BANKING CRISES
KEY IDEAS

SHOCKS THAT HAVE LED TO CHANGES IN THE PRICES OF CURRENCIES HAVE BEEN MONETARY

SHOCKS THAT HAVE LED TO LARGE CHANGES IN PRICES OF SECURITIES HAVE BEEN MONETARY

BOOMS THAT PRECEDED BANKING CRISSES HAVE BEEN “IMPORTED”

ACCELERATOR LEADS TO “OVERSHOOTING” OF PRICES OF CURRENCIES

BANKING CRISSES ARE PREDICTABLE EVENTS

BANKING CRISSES AND CURRENCY CRISSES ARE MANIFESTATIONS OF SAME SHOCK IN DIFFERENT MARKETS

CURRENCY CRISSES INTENSIFY BANKING CRISSES

MONETARY SHOCKS SERIALLY RELATED

BANKING CRISSES OCCUR UNDER VARIOUS CURRENCY ARRANGEMENTS, BUT ARE MORE SEVERE AND MORE FREQUENT WHEN CURRENCIES FLOAT

EVERY CLAIM OF THE PROPONENTS OF FLOATING CURRENCIES SERIOUSLY CHALLENGED BY THE DATA
WHY THE POST-1970 INTERNATIONAL MONETARY ARRANGEMENT IS DYSFUNCTIONAL?

MANY MORE MONETARY SHOCKS THAN STRUCTURAL SHOCKS

MONETARY SHOCKS MORE SEVERE THAN STRUCTURAL SHOCKS

VARIABILITY IN CROSS BORDER INVESTMENT FLOWS DESTABILIZE DOMESTIC ECONOMIES

MONETARY SHOCKS ARE SERIALLY RELATED