

CURRENCY TURBULENCE AND BANKING CRISES

THE POST-1970 INTERNATIONAL
MONETARY ARRANGEMENT
IS DYSFUNCTIONAL

PRESENTATION OVERVIEW

THE POST-1970 INTERNATIONAL MONETARY CONSTITUTION

THE AGE OF TURBULENCE

THE SOURCE OF TURBULENCE:

STRUCTURAL SHOCKS OR MONETARY SHOCKS?

STYLIZED NARRATIVE—A SHOCK TO THE CAPITAL ACCOUNT

KEYNES' TRANSFER PROBLEM REVISITED

PRIMARY DEFICITS AND BANKING CRISES

THE LINK FROM ONE BANKING CRISIS TO THE NEXT

TEN KEY IDEAS

WHAT REMAINS OF THE CASE FOR FLOATING CURRENCIES?

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”

THE CLAIMS OF THE PROONENTS

GREATER MONETARY INDEPENDENCE

SMALLER DEVIATIONS FROM PPP

MORE GRADUAL CHANGES IN PRICES OF CURRENCIES

GREATER INSULATION FROM FOREIGN SHOCKS

NO SIGNIFICANT MONETARY SHOCKS

CHANGES IN THE PRICES OF CURRENCIES WOULD

BE DE-POLITICIZED

THE AGE OF TURBULENCE

MUCH LARGER VARIATIONS IN MARKET PRICES OF
COMMODITES, 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

INCREASE DECREASE

CHANGE IN PRICE OF ICELANDIC KRONA	INCREASE	MONSHOCK	STRSHOCK
	DECREASE	STRSHOCK	MONSHOCK

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 CRISES

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

PRI DEF SEC DEF

CHANGE IN PAYMENTS POSITION OF ICELANDIC HOUSEHOLDS

PRI DEF	SEC DEF
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PRI DEF=PRIMARY DEFICIT SEC DEF=SECONDARY DEFICIT

MOST COUNTRY OBSERVATIONS IN THE NORTHWEST CELL

THE LINK BETWEEN SUCCESSIVE BANKING CRISES

1970S—POST CAMP DAVID "RUN ON THE US DOLLAR"

OCT 1979—CONTRACTIVE FED POLICY LEADS TO "SUPER DOLLAR"

MID-1985—PRICE OF US DOLLAR DECLINES 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 CRISES

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 CRISES HAVE BEEN “IMPORTED”

ACCELERATOR LEADS TO “OVERSHOOTING” OF PRICES OF CURRENCIES

BANKING CRISES ARE PREDICTABLE EVENTS

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

CURRENCY CRISES INTENSIFY BANKING CRISES

MONETARY SHOCKS SERIALLY RELATED

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

EVERY CLAIM OF THE PROONENTS 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