# Lecture of May 22, 2012

## World Economy after 1973

(1) Monetary policy in a FIAT money economy

(2) Recent financial crisis
( 80s, 90s & Argentina's default )

(3) Main causes of financial crises

(4) 2008 - 2012 Economic & Financial crisis

(4.1) Phase I Subprime loans crisis

(4.2) Phase II ( European Sovereign debt crisis )

(5) Consequences of Greece leaving the eurozone.

# Monetary policy in a "fiat money" economy

Once in 1973 gold was definitively abandoned, monetary policy has been in search of an "anchor" ever since.

In fact, if the anchoring to gold was per se contractionary, in a fiat money economy the risk is that monetary policy is inflationary.

One easy solution for a monetary anchor is to chose a fixed ex. rate, which however reduces the autonomy of mon. policy, as was shown.

After 1973, as we know, several countries chose a flexible ex. rate. Under a flexible ex. rate, there are normally two ways to anchor M.P.

① Set a rule for the growth of monetary aggregates

This is the approach that ~~started~~ eventually in the FED under Paul Volcker at the end of 70s. It concentrates on money (M1, M2, M3 --) and credit aggregates

(3)

$$MV = PQ$$

The basic logic is that money & credit (growth) should go hand in hand with real growth. In other words they should accompany the pace of economic activity without being either deflationary or inflationary.

There can be several versions of this approach. For instance, Milton Friedman proposed that a constant, small expansion of money supply was the only wise policy.

For more than a decade CBs in advanced economies and the IMF have followed this approach to regulate money supply.

However during the '90s it became clear that monetary & credit aggregates had become difficult to control due to financial innovation.

(2) Target inflation directly

As monetary aggregates became too unstable to control CBs started to size inflation directly. This means to set their objective/target in terms of consumer price growth or price stability.

For instance you know that the ECB, in its statute, is required to contain inflation (in the eurozone) under 2%.

To set an inflation target does not mean that you forget about money supply & interest rates, but only that these become your "tools" to achieve the required objective in terms of price growth

The FED also states regularly its desired inflation target, that is normally expressed as a range, usually 1.5 - 2%

Clearly the more precise is the inflation target — both in quantitative terms and in terms of the time period required to reach the target — the less autonomy has monetary policy to target other objectives, such as growth & employment.

By contrast, the more discretion you have in setting the inflation target, the more you can be subject to criticism that your policy was inflationary

That's probably why the FED was often accused to be too "accommodative" and the ECB too "restrictive"

# Current issues in monetary policy

As was said, in the current globalized economy, inflation is much less of a problem than in the past. Not only inflation has gone down dramatically but also oil & raw material prices increase are less inflationary than in the past.

Therefore, during an expansionary phase, inflation shows up in asset prices (real estate & stock exchanges) more than in consumer goods.

This new phenomenon has put in difficulty monetary policy based on inflation targeting. CBs (like the FED) are often accused of being late in tightening money supply since the growth in asset prices is proof of an inflationary process.

CBs reply that their target is price inflation and they have no mechanism to size asset prices and that they do not want to be responsible for a stock mkt or house mkt crash

# FINANCIAL CRISES IN THE POST-BW ERA

1971-73 Fall of Bretton Woods System of exchange rates

1973 ... First oil price increase
→ inflation back to the attention of policy-makers

- No way to re-establish a worldwide system of fixed exchange rates

→ the world is set in a "system" of "free" ex. rates (or in a non-system)

- Policy-makers concentrate, especially after II oil shock, on inflation (price stability) more than on ex. rates (stability)

→ In Europe, however, an area of ex. rate stability is created:

1972 - The "snake" (jointly free against the US $)

1979 - ERM
The European Exchange Monetary System

1999 - The Euro

- Several episodes of financial/ex rate instability / BoPs imbalances (with domino effects)

## 1982 LA debt crisis

*similarities with current financial crisis! (Greece)*

- large exposure of industrialized countries' banks to developing nations
- little awareness that governments can default on their obligations

*The trigger /*

- Paul Volcker's change in monetary policy, ~~which "targets" inflation~~ ~~and~~ leading to a substantial rise in (world) interest rates

## 1992 ERM crisis

In September 1992 the British Pound was pushed to abandon the system. It was followed by the Italian lira. A year later the ERM was de facto dead!

- High German interest rates to counteract fiscal expansion after re-unification put the ERM under stress and may have triggered the crisis

## 1994-95 Mexican crisis

- Mexico was under a fixed ex. rate regime with the peso pegged to the US $
- A lax fiscal policy, insufficient $ reserves, and raising lack of confidence in the banking system lead to the abandonment of the peg
- A domino effect onto several emerging mkt could subside only after an IMF led support financial package was agreed

## 1997 - 1999 Asian financial crisis

- A crisis of vast proportions on which there have been spent thousands of pages in the economic literature
- Surprising since it touched the "Asian tigers" which were a "model" of economic growth
- Causes not in sovereign debt but in private debt and badly regulated domestic banking systems

## 2001 Argentina's exchange rate & banking crisis

- Currency board since 1991 to fight inflation
  - fixed exchange rate (peg to US$)
  - "$\Delta M^S = \Delta R$"

- By the end of 2001 - early 2002 the currency board broke down

- Causes are debated: fiscal laxity was one of the reasons but an overvalued currency which contributed to low growth also played a role

- The case of Argentina interesting not for the domino effect (which was very limited), but for demonstrating how difficult it is to defend fixed ex rates

2007 → Current ec. & financial crisis (GREAT CRISIS)
Subject of final lecture

# CAUSES OF FINANCIAL CRISES

Although financial crises differ from one another, economists and economic historians study their common features with the aim to learn from past episodes of instability and avoid the same mistakes in the future

In recent crisis episodes, inflation is less of a problem than in the past since globalization has reduced prices worldwide

So you normally observe a combination of factors affecting the exchange rate, especially when it is fixed, the BoP and/or the level of reserves, and the financial/banking system

In particular, it is recurrent to have a situation in which the banking system is fragile, the BoP has a deficit (initially in the current account) or reserves are limited, the exchange rate is pegged and overvalued and a devaluation is likely. When this situation persists sooner or later speculation will attack

the peg and cause a devaluation, with all its consequences.

Normally, however, the ex rate, the BOP and the financial fragility are symptoms of deeper problems. These may be in lack of competitiveness of the productive system (growth & exports are too low), problems in [illegible] functioning of some mkts (protections and restrictions on transactions are widespread) or "governance" [illegible] in the banking system or corporate system.

Bad economic policies [illegible] are also often the cause of a financial crises, as can be a prolonged lax fiscal policy.

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A note of EX. RATE instability

While in the past flexible ex rate were considered [illegible] source of instability, nowadays it seems that fixed ex rates are the real source for concern.

When the peg is wrong (currency is overvalued) and/or a devaluation is largely expected, this becomes "self-fulfilling" → speculation in the end succeeds in causing the peg to break-down. Paradoxically, it happens that fixed rates are unstable!

# 2008 – 2012 Economic & Financial Crisis

(1) Considered the most severe worldwide crisis since the Great Depression, and in fact it is normally said "the Great Crisis"

(2) Largely unexpected

Although several international institutions had sent warnings since the growth process was accumulating imbalances (especially in BoPs) none had foreseen the crisis. None could foresee that a serious financial crisis could develop in the most advanced system of the world, the U.S. If a crisis could occur – most of us thought – then it would come from emerging mkts or a fall in the $

(3) If in the first years the center of the crisis were the US, in the last 2-3 years it has become Europe (Sovereign debt crisis)

(4) From financial the crisis has rapidly muted in a real crisis, with sharp falls in GDPs (mostly in Europe: in 2009: Ireland (–5%), UK (–2,8%), Germany (–2,3%) etc etc.

## 5 Main features

Although the Great Crisis differs in several respects from past crisis episodes, it seems to replicate the normal/classic pattern:

(a) Imbalances accumulate and spread out in the system during the expansionary phase

(b) Prices/asset values rise exaggeratedly as in a classical boom episode.

(c) Monetary policy tightens, prices & asset values start to fall and imbalances come to the fore causing a break of the system.

As far as (b) is concerned, while in the past it was consumer inflation (that is: inflation in the prices of goods & services) in more recent episodes inflation appears in the forms like

- stock price inflation
- real estate prices
- oil & raw materials valuations

# How the crisis develops

A complete TIMELINE of the Great Crisis can be found in the website of the FED of St. Louis. Here only the main events and factors underlying the crisis –

## 1st PHASE 2007-2009 The (mostly US) subprime loans crisis

- A real estate boom, in quantities & prices of houses, had characterized the years 2004-2006
- Subprime loans (i.e. mortgages to individual with a very poor credit rating) contribute to the boom
- SL were offered at a low rate for the first years, but the rate would rapidly rise subsequently
- Fraudulent behaviour on the part of financial "agents" contributed to the spread of subprime loans
- In 2006 the Federal funds rate reaches 5,25% after a progressive tightening of the monetary stance. Interest rates on subprime loans rise accordingly; loans start not being repaid –

- Serious defaults in the banking system start to occur

  - Northern Rock in the UK (nationalized in feb. 2008)
  - Bear Stearns defaults in march 2008 (merges with JP Morgan)
  - Merryl Lynch merges with Bank of America Sept 2008
  - Lehman Brothers defaults and the panic spreads across the mkts
  - AIG is saved by US financial authorities
  - Authorities around the world have to intervene in support of major financial institutions (Fortis, UBS, Hypo Real Estate, Royal Bank of Scotland, Dexia — )
  - Between Sept & Oct 2008 the S&P 500 falls by 26%
  - The interbank mkt — an essential channel for liquidity through the banking system — is literally frozen due to a widespread lack of confidence in the system

- In 2009 financial mkt stabilize, due to the intervention of the authorities, also ODPs around the world sustain dramatic falls

- End of 1st part of the crisis

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**Things to keep in mind**

- Subprime loans were assembled in packages called CDOs (Collateralized debt obligations) and were sold by one bank to the others in order to diversify risk

- Rating agencies assigned high ratings to CDOs which were supposed to diversify risk

- There is a clear responsibility in US and international supervisory authorities in having overlooked at the risk that was accumulating in the system

- In this respect, the case of US investment banks, which were subject to a lax supervision, is worth mentioning. They are now transformed in commercial banks

## II PHASE 2010-2012 — The (European) Sovereign debt crisis and Greece

- First Eurozone crisis since its creation in 1999

- At the end of 2009 Greece enters into serious economic difficulties, after a period of rapid growth (5.6% in 2006)

  — The new government (Papandreou) reveals that the public deficit in 2009 would be 12.7%, the triple of what claimed by the previous administration

  — GDP falls by 2% and the economy enters into recession

- Serious repercussions across Europe, especially on Spain, Portugal and Italy.
  2010
  → Spreads explode.
  → Ratings on sovereign debt are cut

- May 2010 – Support Plan by 110 billion euros in support of Greece by EU & IMF

- The crisis continues affecting the European banking system. European bank are in fact full of sovereign bonds.

- The easy and massive financing by the ECB is used to buy new sovereign bonds, which aggravates the problem -

- Banks are required to raise more capital and thus reduces credit to the economy. The recession worsens -

- The economic & financial crisis in Europe continues throughout today with an increasing risk of Greece leaving the euro and getting back to the drachma -

## Critical questions

Is the crisis due to:

1. Public finances out of control?
2. structural weaknesses in the banking system &/or in the regulatory framework?
3. Competitiveness gap among European economies (which cannot be adjusted through ex. rates)?

All 3 explanations have played a role, but ③ is probably more important than is normally believed, especially in Greece, Spain, Italy & Portugal -

What is Greece exit the euro zone?

- Getting back to the drachma would allow an ex. rate adjustment that would support exports & growth (it would devalue by 30-50% vis-à-vis the euro)
- However, as Greece's debt is denominated in euro, the cost of the debt would rise dramatically

→ defaulting on the debt will be unavoidable

- Domino effects on other countries are possible and are the reason why European authorities will continue support Greece, if they do not want to put at risk the monetary union.