

# CURRENCY TURBULENCE AND BANKING CRISES

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# 2008 CRISIS--THE US POLICY ESTABLISHMENT VIEW

THE US BANKING CRISIS WAS DUE TO “BAD ACTORS”--  
LEHMAN AND MOZILLO, CREDIT RATING AGENCIES, ETC

WHY OTHER COUNTRIES HAD SIMILAR CRISES AT THE SAME  
TIME?

THIS VIEW CONFUSES THE SYMPTONS THAT DEVELOP DURING  
A CREDIT BOOM WITH THE CAUSE OF THE BOOM

THE CHALLENGE—GIVEN THE INCREASE IN THE FOREIGN  
DEMAND FOR US DOLLAR SECURITIES, THE UNITED STATES  
WOULD HAVE HAD A BANKING CRISIS EVEN IF MOTHER  
THERESA HAD BEEN CHAIR OF THE FED, AND THE SISTERS  
OF MERCY HAD BEEN IN CHARGE OF BANK REGULATION

# KEY QUESTIONS

WHY HAS THERE BEEN SO MUCH TURBULENCE IN  
FINANCIAL MARKETS IN THE LAST FORTY YEARS?

WHY HAVE THERE BEEN SO MANY BANKING CRISES?

WHY DO THESE CRISES FOLLOW REAL ESTATE BOOMS?

WHY DO THESE CRISES COME IN WAVES?

ARE THE SUCCESSIVE WAVES INDEPENDENT EVENTS?

WHAT IS THE SOURCE OF TURBULENCE?

# FEATURES OF TURBULENCE

LARGE CHANGES IN MARKET PRICES OF  
CURRENCIES RELATIVE TO LONG RUN AVERAGES

REAL ESTATE PRICES SURGE AND COLLAPSE

STOCK PRICES SURGE AND COLLAPSE

BANKING CRISES TWINNED WITH CURRENCY CRISES

BOOM AND BUST GDP CYCLES

# THE SOURCE OF TURBULENCE

IS A BANKING CRISIS AN “ACT OF GOD”?

DOES A BANKING CRISIS HAVE A PREDICTABLE  
CAUSE?

A STRUCTURAL SHOCK

OR

A MONETARY SHOCK

# CENTRAL QUESTION

IS A FLOATING CURRENCY ARRANGEMENT  
NECESSARY TO COPE WITH LARGE CHANGES IN  
THE PRICES OF SECURITIES AND OF REAL ESTATE  
THAT FOLLOW FROM STRUCTURAL SHOCKS?

OR

ARE THE LARGE CHANGES IN THE PRICES OF  
SECURITIES AND OF REAL ESTATE AND OF  
CURRENCES A RESULT OF CHANGES IN  
INVESTOR DEMAND FOR FOREIGN SECURITIES?

# THE CASE FOR FLEXIBLE CURRENCIES REVISITED

## THE CLAIMS OF THE PROPONENTS

SMALLER DEVIATIONS BETWEEN MARKET PRICES OF  
CURRENCIES AND LONG RUN AVERAGE PRICES

CHANGES IN PRICES OF CURRENCIES WOULD BE GRADUAL

FEWER CURRENCY CRISES

GREATER INSULATION FROM EXTERNAL SHOCKS

SMALLER DEMAND FOR INTERNATIONAL RESERVE ASSETS

EACH CLAIM IS CHALLENGED BY DATA OF THE LAST 40 YEARS

# THE ICELANDIC EXPERIENCE

INVESTMENT INFLOWS LED TO SURGE IN DOMESTIC DEBT

	12/02	12/03	12/04	12/05	12/06	12/07	12/08
ISK/US\$	80.6	70.9	61.0	62.9	71.6	61.8	120.6
CAB/GDP	1.5	-4.6	-9.4	-15.5	-23.1	-15.5	-23.6
EXDBT*/GDP		109	173	286	443	568	971

“DATE OF NO RETURN” AFTER WHICH A CRISIS WAS INEVITABLE



# STYLIZED FACTS

EVERY BANKING CRISIS HAS FOLLOWED AN ECONOMIC BOOM

EACH BOOM FOLLOWED INCREASE IN CROSS BORDER INFLOWS

INVESTMENT INFLOWS LED TO SURGE IN DOMESTIC CREDIT

INVESTMENT INFLOWS LED TO HIGHER SECURITY PRICES

INVESTMENT INFLOWS ACCELERATED AS CURRENCIES OVERSHOT

INCREASE IN INDEBTEDNESS WAS TOO RAPID TO BE SUSTAINED

EACH BOOM MORPHED INTO CRISIS WHEN INFLOWS SLOWED

# THE MODEL OF ADJUSTMENT WHEN CURRENCIES FLOAT

A SHOCK LEADS TO AN INCREASE IN INVESTMENT INFLOWS—THE  
CONTRY'S CAPITAL ACCOUNT SURPLUS INCREASES

ADJUSTMENTS MUST ENSURE THAT THERE IS AN CORRESPONDING  
INDUCED INCREASE IN ITS CURRENT ACCOUNT DEFICIT

PRICE OF SECURITIES INCREASE--HOUSEHOLD WEALTH SURGES

IMPORTS INCREASE IN RESPONSE TO CONSUMPTION BOOM

BOOM INDUCES MORE RAPID INVESTMENT INFLOWS

LENDERS BECOME MORE CAUTIOUS WHEN THEY REALIZE  
BORROWERS ARE TOO EXTENSIVLEY INDEBTED

A BOOM MORPHS INTO A CRISIS WHEN INFLOWS SURGE

# FOUR ANALYTIC STATEMENTS

#1-A SHOCK LEADS TO A PROLONGED CROSS BORDER INVESTMENT INFLOWS

#2-INCREASE IN THE PRICE OF SECURITIES IS AN INTEGRAL PART OF ADJUSTMENT PROCESS

#3-THE INCREASES IN INDEBTEDNESS (BOTH EXTERNAL AND DOMESTIC) INVOLVE NON-SUSTAINABLE PRIMARY DEFICITS

#4-THE CORRECTION OF ONE IMBALANCE OFTEN HAS LED TO THE NEXT IMBALANCE

# #1-ADJUSTMENT IN THE GLOBAL MONEY MARKET

PURPOSE—TO SHOW THAT ADJUSTMENT TO A SHOCK LEADS  
TO A PROLONGED CROSS BORDER INVESTMENT INFLOW

FISHER OPEN—AN EQUILIBRIUM CONDITION  $(R_d - R_f) = (S_t^* - S_t) / S_t$

A SHOCK DISRUPTS THE EQUILIBRIUM --DISEQUILIBRIUM LEADS  
TO CROSS BORDER INVESTMENT INFLOWS

DISEQUILIBRIUM PERSISTS FOR SEVERAL YEARS BECAUSE

- CROSS BORDER INFLOWS ARE SMALL RELATIVE TO STOCKS  
OF SECURITIES
- CROSS BORDER FLOWS LIMITED BY ABILITY TO GENERATE  
LARGER TRADE DEFICITS

CROSS BORDER INFLOWS ACCELERATE OVER TIME

# #2-DOMESTIC ADJUSTMENTSTO LARGER INVESTMENT INFLOWS

OBJECTIVE—TO SHOW THAT THE INCREASE INVESTMENT INFLOWS  
LEADS TO INCREASE IN PRICES OF SECURITIES & WEALTH

KEYNES' TRANSFER PROBLEM PROCESS

$C+K=0$  THE SHOCK—AN AUTONOMOUS INCREASE IN  $K$  MUST LEAD  
TO AN INDUCED INCREASE IN  $C$  (IF  $K$  IS POSITIVE,  $C$  IS NEGATIVE)

WHY THE CURRENT ACCOUNT DEFICIT INCREASES?

RELATIVE PRICE ARGUMENT

RELATIVE INCOME ARGUMENT (SURGE IN WEALTH)

COUNTRY EXAMPLES

# #3-PRIMARY DEFICITS IN INTERNATIONAL PAYMENTS

OBJECTIVE—TO SHOW THAT A BANKING CRISES IS A PREDICTABLE EVENT

WHAT IS A PRIMARY DEFICIT (PD) ? AND WHY IS A PD NON-SUSTAINABLE?

A SCORECARD ON PRIMARY DEFICITS AND BANKING CRISES

		INTERNATIONAL PAYMENTS	
		PD	SD
DOMESTIC PAYMENTS	PD	(1)	(2)
	SD	(3)	(4)

NEARLY EVERY BANKING CRISIS IS PRECEDED BY A PRIMARY DEFICIT

CURRENCY CRISIS INTENSIFIES BANKING CRISIS

# #4-SEQUENTIAL OVERSHOOTING

OBJECTIVE—TO SHOW THAT THERE IS SIGNIFICANT  
CONNECTION BETWEEN SUCCESSIVE BANKING CRISES

A METAPHOR—THE PENDULUM ON A GRANDFATHER CLOCK

SEQUENCE OF IMBALANCES-1970S RUN ON THE US DOLLAR

EARLY 1980S RUN TO THE DOLLAR

LATE 1980S RUSH TO THE YEN

EARLY 1990S RUSH TO THE BHAT, PESO ET AL

LATE 1990S RUSH TO THE US DOLLAR

ADJUSTMENT TO ONE IMBALANCE LEADS TO THE NEXT IMBALANCE

# THE BENEFITS AND COSTS OF FLOATING CURRENCIES

## BENEFITS

CHANGES IN PRICES OF CURRENCIES ARE DE-POLITICIZED

## COSTS

MUCH GREATER DEVIATIONS BETWEEN MARKET PRICES  
OF CURRENCIES AND REAL PRICES

MASSIVE SWINGS IN CROSS BORDER PROFIT COMPARISONS

COUNTRIES IMPORT BOOM AND BUST CYCLES

GREATER SCOPE FOR BEGGAR-THY-NEIGHBOR POLICIES

GDP GROWTH RATES HAVE BEEN LOWER



# ANALYTIC CONCLUSION

FLOATING CURRENCY ARRANGEMENT IS DYSFUNCTIONAL

CROSS BORDER INVESTMENT INFLOWS ARE SELF JUSTIFYING  
UNTIL LENDERS REALIZE BORROWERS ARE OVER INDEBTED

SOURCES OF “INEFFICIENCY”

--PROLONGED CROSS BORDER INVESTMENT INFLOWS

--THE ACCELERATOR, INFLOWS LEAD TO MORE RAPID  
GDP GROWTH

--LENDERS ARE MYOPIC ABOUT THE “END GAME”

# CONCLUSION—ANSWERS TO FIVE KEY QUESTIONS

SHARP VARIABILITY IN CROSS BORDER INFLOWS LED TO  
TURBULENCE

EACH REAL ESTATE BOOM FOLLOWED INCREASE IN INFLOWS.

BANKING CRISES FOLLOWED SLOWDOWN IN INFLOWS

CORRECTION OF ONE IMBALANCE LEADS TO ANOTHER

A FLAWED INTERNATIONAL MONETARY CONSTITUTION