EE 460: Monetary Policy II International perspective

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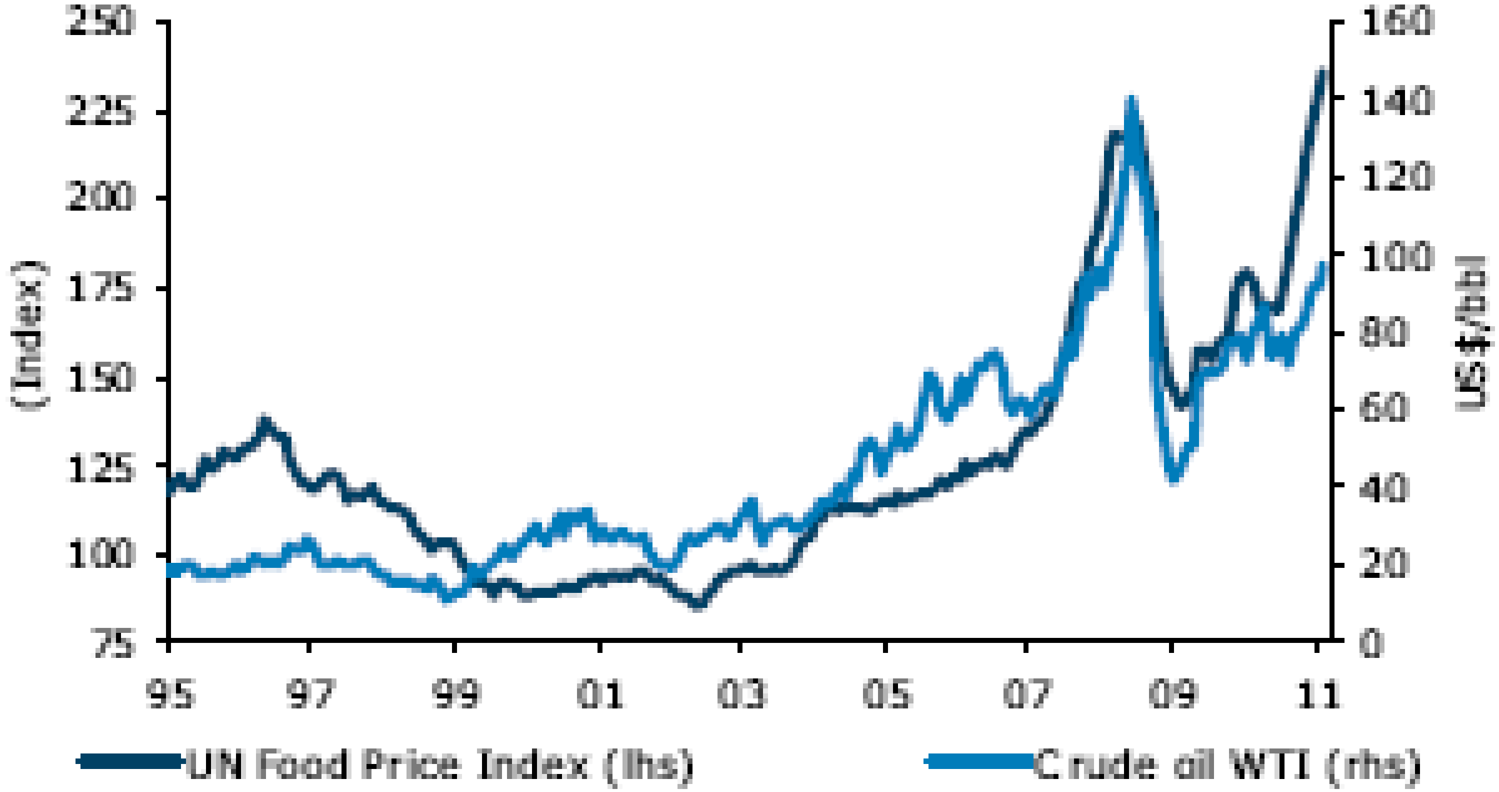
Lecture 26B

Outline

- The recent oil price shock
- The bail-out and the budget
- Australia’s Dutch disease
- The Phillips curve revisited
- Inflation targeting
- Asset price bubbles
- Ponzi finance
- QEII

FIGURE 1. FOOD AND OIL PRICES SURGING IN 2011



Source: Bloomberg

- The price of oil jumped to a fresh 30-month high, above $108 a barrel Monday as fighting in Libya and unrest in the Middle East continued to raise doubts about future supplies.
- In London, Brent crude rose $2.25 to settle at $120.66 a barrel on the ICE Futures exchange. Libya shipped about 1.6 million barrels a day or about 2 percent of the world's oil supplies. Most of it went to refineries in Europe.

Monetary Normalization

- Monetary tightening is needed to ward off “second-round” effect of rising commodity prices, whereby wages and prices respond to an initial upward jolt by spiraling higher.
- With unemployment as long as 1%, and core inflation, which exclude more volatile goods like energy and food, have rising, an imminent rate rise is expected at the MPC meeting.

FIGURE 2. INFLATION AND ITS MOMENTUM

	y/y	3m/3m saar
Vietnam	12.3	25.3
India	8.2	13.7
Indonesia	6.8	9.7
Singapore	5.5	7.0
China	4.9	9.4
Korea	4.5	5.7
Hong Kong	3.6	7.2
Philippines	4.3	9.7
Thailand	2.9	6.3
Malaysia	2.4	9.7
Taiwan	1.3	4.7

Sources: CEIC, ANZ

From the Phillips curve

$$\pi_t = E_{t-1}\pi_t + \phi(Y_t - \overline{Y}_t) + \nu_t$$

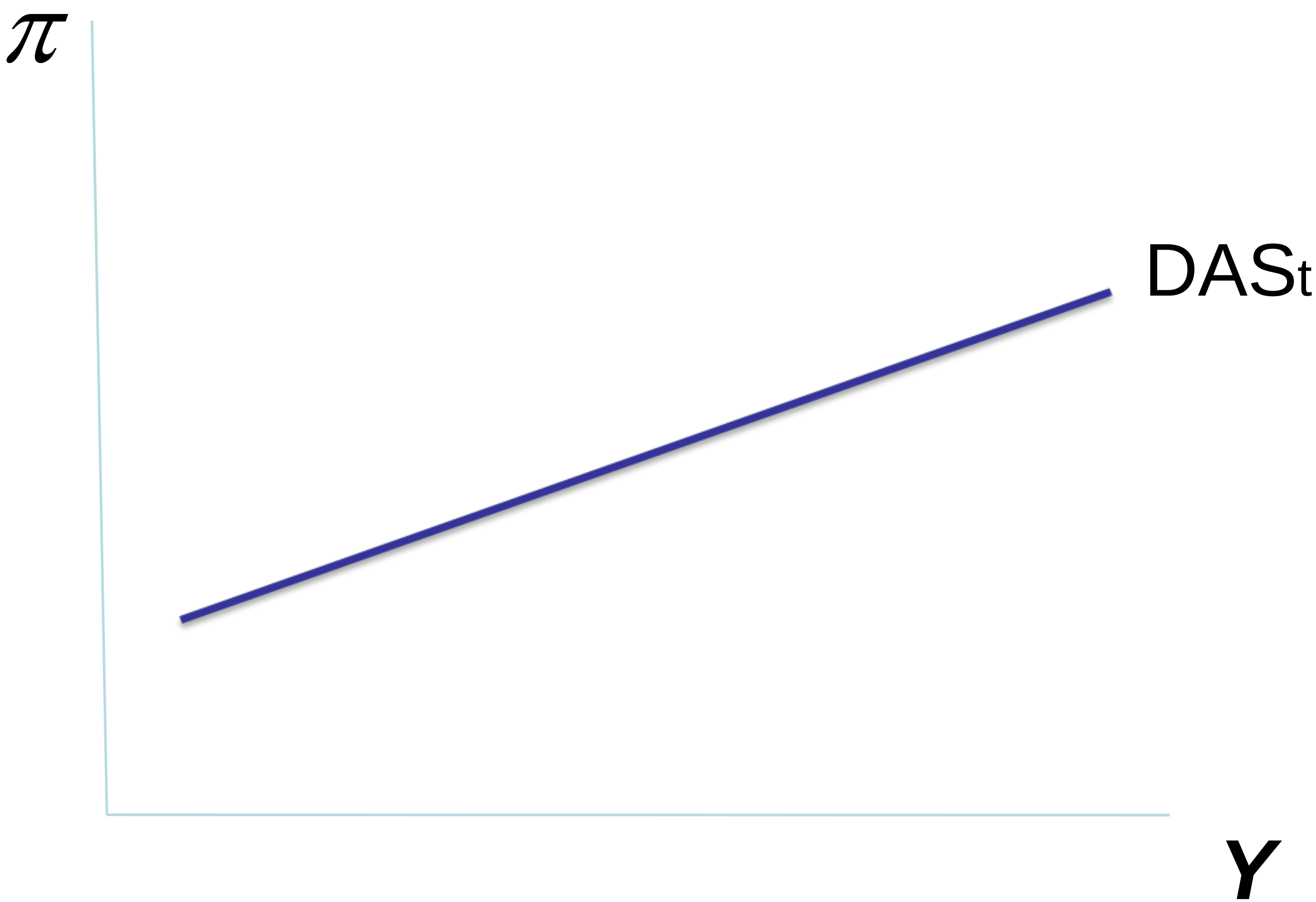
With Adaptive expectation,

$$E_{t-1}\pi_t = \pi_{t-1}$$

$$\pi_t = \pi_{t-1} + \phi(Y_t - \overline{Y}_t) + \nu_t \qquad (DAS)$$

The importance of the parameter ϕ

Dynamic Aggregate Supply Curve



$$\pi_t = \pi_{t-1} + \phi(Y_t - \overline{Y}_t) + \nu_t \qquad (DAS)$$

$$U = -\lambda(Y_t - \overline{Y}_t), \quad \lambda > 0$$

$$\pi_t = \pi_{t-1} - \eta U + \nu_t \,; \eta \equiv \phi / \lambda$$

Speculative (Ponzi) Finance

- Speculative finance: refinancing to acquire illiquid assets results in *net increase in debt* and reduce *safety margins.*
- The margin of safety consists of (1) the difference between cash receipts and payments commitments, (2) the excess of value of assets over liabilities, and (3) holding of *cash* and other *liquid* assets.
- Hedge finance, unlike speculative finance, does not require some rollover of debt for contracts to be fulfilled.

When the bubble bursts

- Investors with **speculative finance** have negative margins of errors.
- Rising interest rates and currency depreciation raise the cash payment commitment.
- A collapse in property and stock prices led to negative net worth.
- Holding large illiquid assets led to distress selling, further depressing the asset values.

Banking trouble in Ireland

- The stress-tests results unveiled by Ireland's central bank require that four banks must raise an extra €24 billion of capital to meet a minimum core Tier-1 capital ratio of 6% under the tests' worst-case assumptions.
- Two other banks, Anglo Irish and Irish Nationwide, have already been nationalised and are being wound down.
- The tests did not reveal the need for more money to be poured into the maw of Anglo Irish, which today announced a loss of €17.7 billion for 2010, the largest in Irish corporate history.

The Economist April 2, 2011

- The stress-test results do not represent a credible upper limit on the cost of Ireland’s banking disaster.
- They look pretty conservative: loan-loss projections were provided by a third party; officials talk of robust discussions over the size of banks’ forecast pre-provision earnings; and really, how much more is it even possible for the banks lose?
- But stress tests are inherently arbitrary. Ireland’s property losses are fast migrating from commercial real estate to residential property, for instance, and the impact of euro-zone interest rates is hard to predict. Working out a reasonable price for asset sales is also difficult when markets are illiquid.

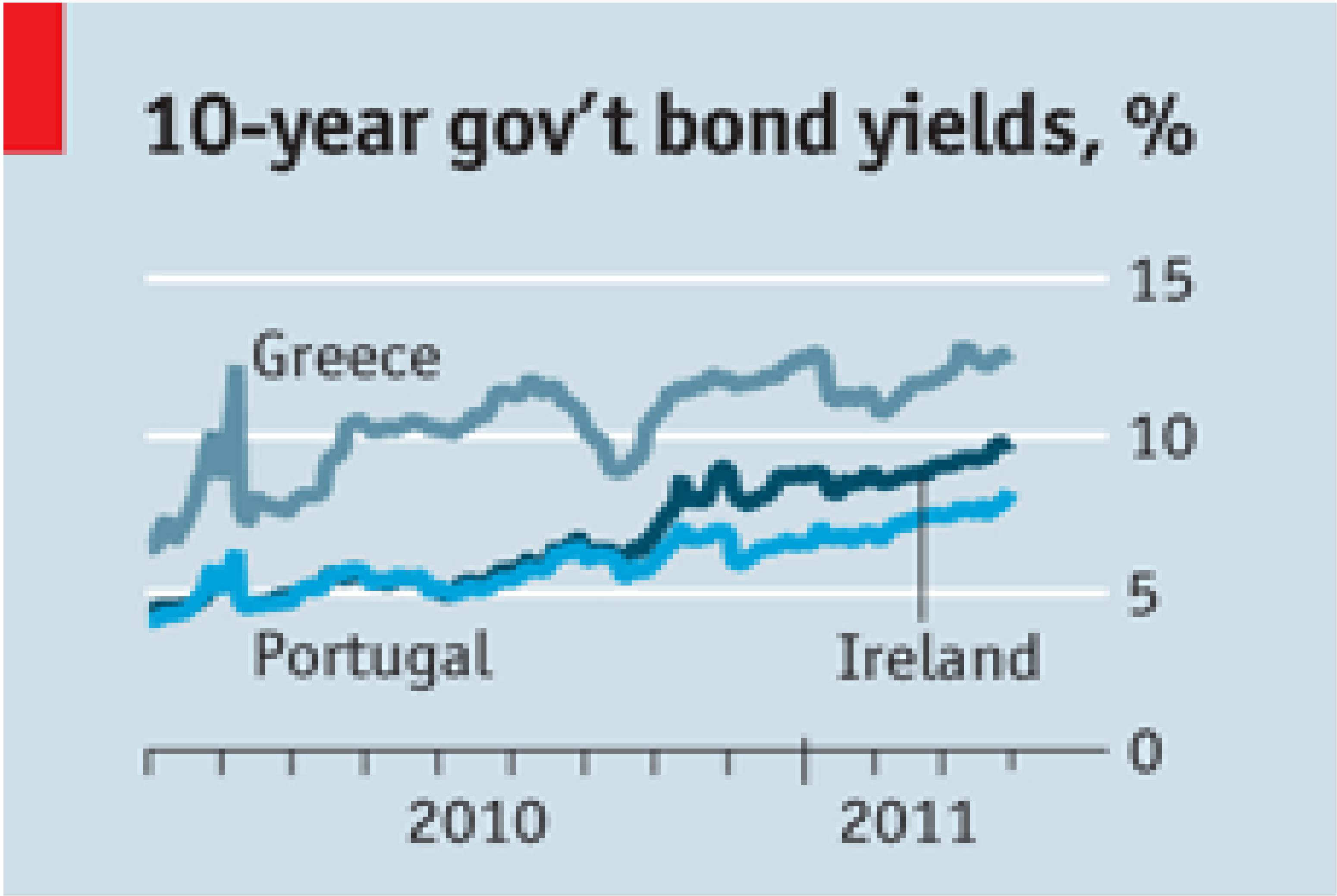
The bail-out and the budget

- An analysis by the central bank in February showed that the amount of unguaranteed, unsecured senior debt in Irish banks totalled €16.4 billion; imposing a 50% haircut, say, on that debt would have a material impact on the banks' capital hole.
- Since the banks are the primary cause of Ireland's sovereign-debt worries, reducing the bail-out bill might even help the government's finances, too.
- But that is not the view elsewhere in Europe, where officials fret that hitting bank bondholders will serve only to spook creditors in other euro-zone economies.

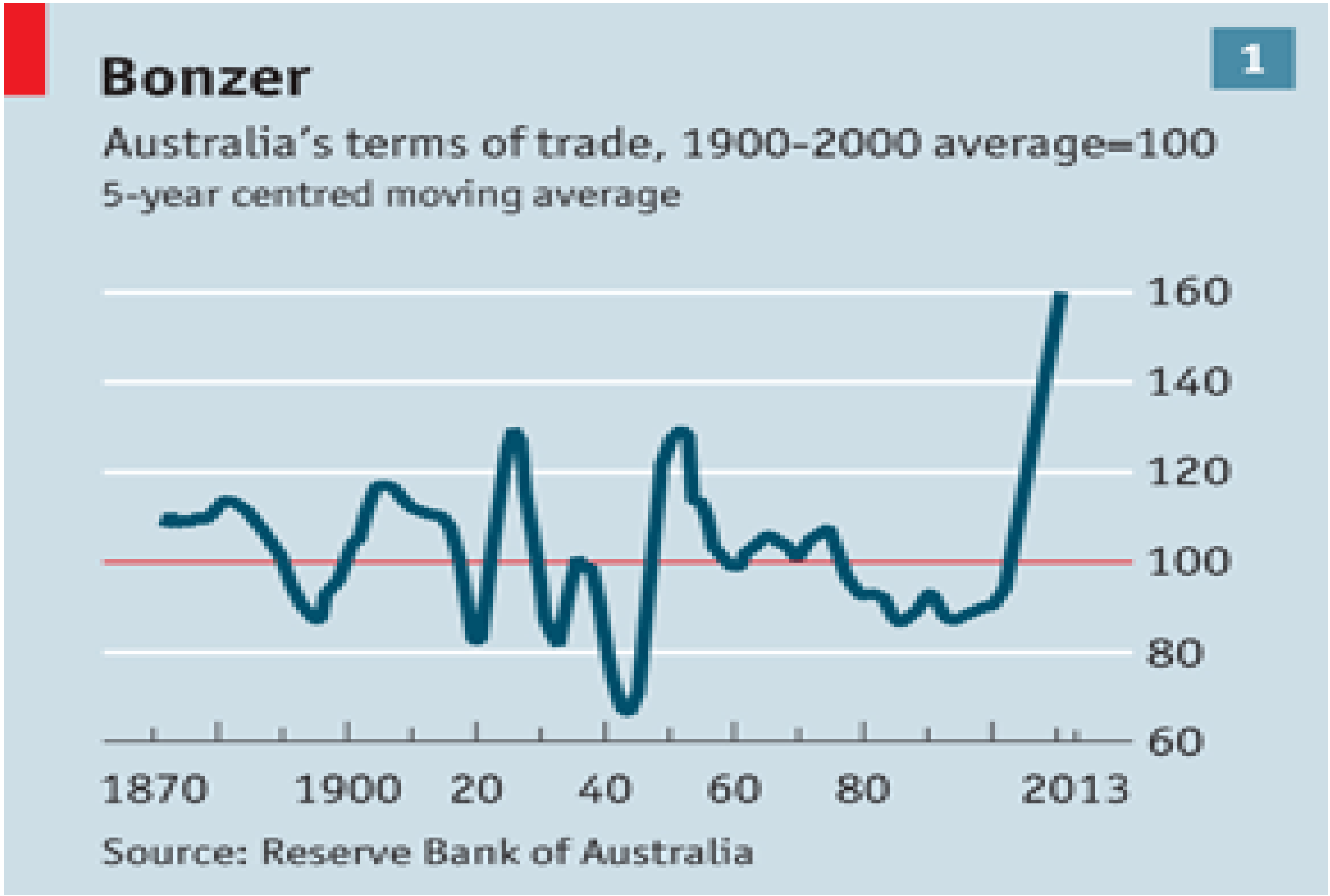
When debts are relatively high

- Countries that accumulated a large amount of debts are likely to suffer a **more prolonged recession** than countries that were less burdened by debt.
- Crisis-hit countries have priority to slash their budget deficits regardless of the consequences on growth.
- But austerity drags down output.
- Public debt to GDP is expected to peak at 160% for Greece, 125% for Ireland, and 100% for Portugal—look ever more unplayable.

At the peripherals



Australia's Dutch disease



- Five years ago a shipload of iron ore bought 2,200 flatscreen TVs, says Glenn Stevens, governor of the Reserve Bank of Australia (RBA).
- Now it buys 22,000. The terms of Australia’s trade—the price of its exports, relative to the cost of its imports—have improved by 42% since 2004.
- Commodity booms have come and gone in Australia’s history but no boom this strong has lasted this long

- “There is no shortage of coal and iron ore around the world”.
- With prices so high, miners will eventually unearth it. “All the more reason to make hay while the sun shines.”
- As Australia rushes to make hay, some worry that it will forget how to make everything else—an antipodean version of “Dutch disease”, in which a natural-resources boom boosts currencies and hurts manufacturing exports

In a February survey of manufacturing chief executives, 93% said their exports cannot compete when the Australian dollar buys more than $1. On March 31st, it bought $1.033

- A strong currency is, however, necessary to keep inflation in check. As prices rise quickly in Australia's booming industries and regions, the RBA can meet its inflation target only if prices elsewhere fall.
- Over the past 18 months the RBA has raised its key interest rate by 1.75 percentage points.
- These hikes have no effect on the mining industries, which sell and borrow abroad.
- Higher rates and a stronger currency do, however, hurt firms in manufacturing and construction.

- One reason may be that Australia is close to full employment. The jobless rate is 5% and projected to fall. In the past firms would import labour.
- But Australia’s economic recovery has coincided with an ill-timed tightening of immigration policy: it admitted 36% fewer net newcomers in the year to September 2010 compared with the previous year.
- If the country is fully employed, its boom industries cannot grow unless other industries shrink.

- No tinkering with monetary policy will change that
- Australia could bring some relief to squeezed exporters by saving, not spending, the proceeds of the boom.
- That would reduce the inflationary pressure at home, resulting in lower interest rates and a cheaper exchange rate.

- Households are doing their bit, saving 9.7% of their disposable income compared with less than zero in 2004.
- The government is also tightening its belt, albeit more gingerly.
- Having run a budget deficit of 4.4% of GDP in the last fiscal year, it expects a surplus in the fiscal year ending on June 30th 2013, including the proceeds from a mining tax.

Should it tighten its belt faster?

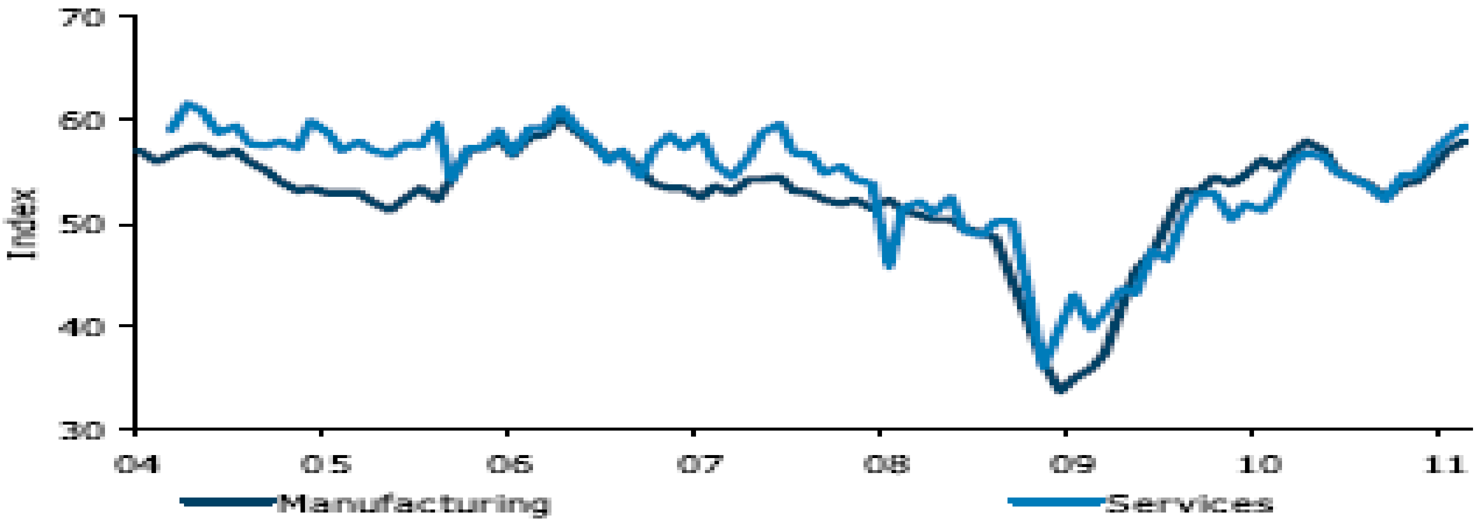
- In Chile a fiscal law obliges the government to run budget surpluses whenever the economy is at full employment and the copper price is above its long-run equilibrium, as estimated by an independent panel.
- A similar rule in Australia would imply a budget surplus of 2% this year
- Should the government do more than get out of the way of the boom?
- One traditional fix is tariffs and subsidies, which can offset an uncompetitive exchange rate.
- The government recently imposed fresh anti-dumping duties on Chinese imports of sodium bicarbonate

Productivity is the key

- Rather than seek government help, firms are encouraged to raise productivity and improve quality.
- At Penrice’s plant in Osborne, for example, the workforce has shrunk even as their qualifications have risen.
- The plant’s 200 workers must now be computer-literate, although their collars are not yet entirely white.
- Imports, especially of capital goods, also play their part in Australia’s exporting success.

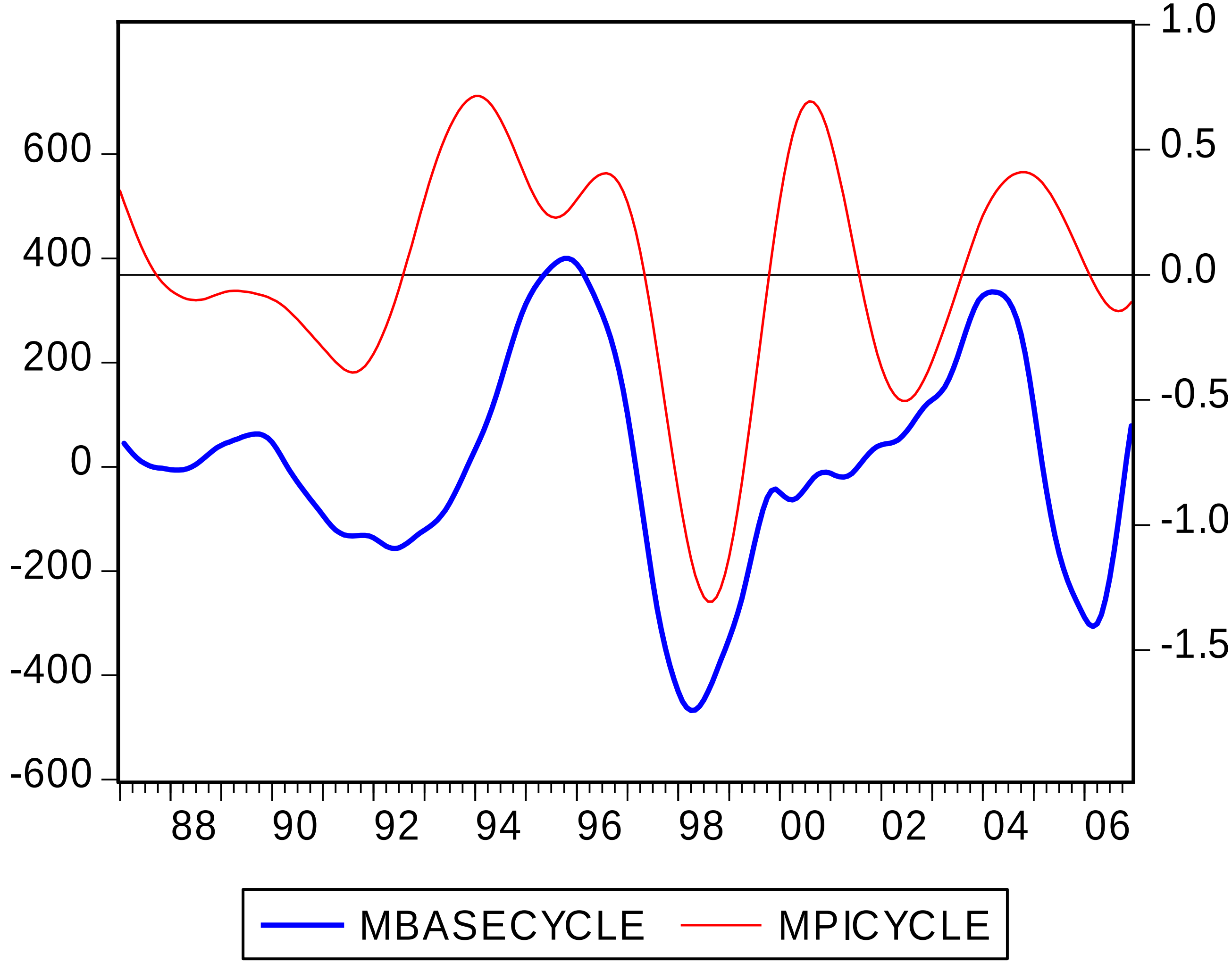
Since economic recovery needs credit to finance capital stock building, it takes longer for banks to clean their huge amount of non-performing loans and to recapitalize their equity.

FIGURE 2. GLOBAL GROWTH IN RECOVERY



Source: ANZ

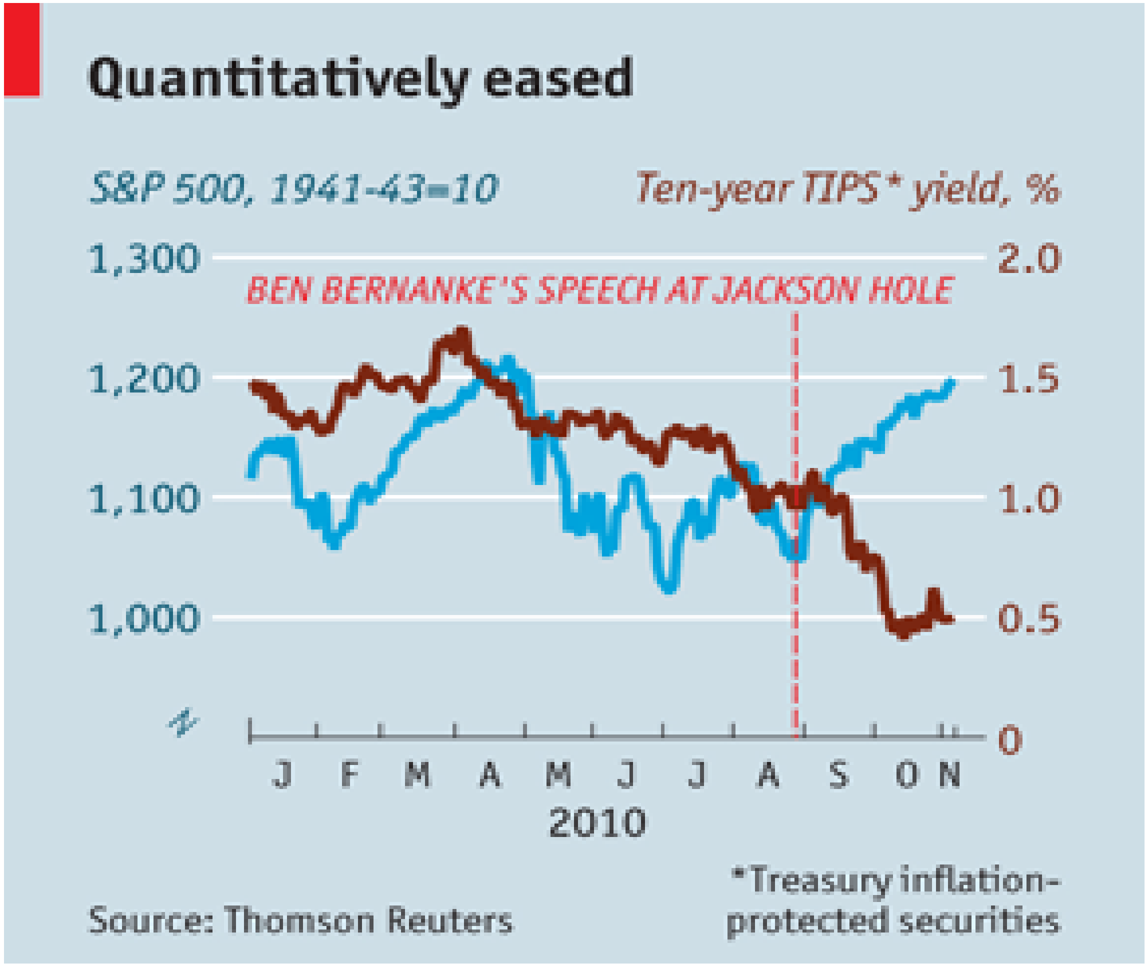
Monetary and output cycles



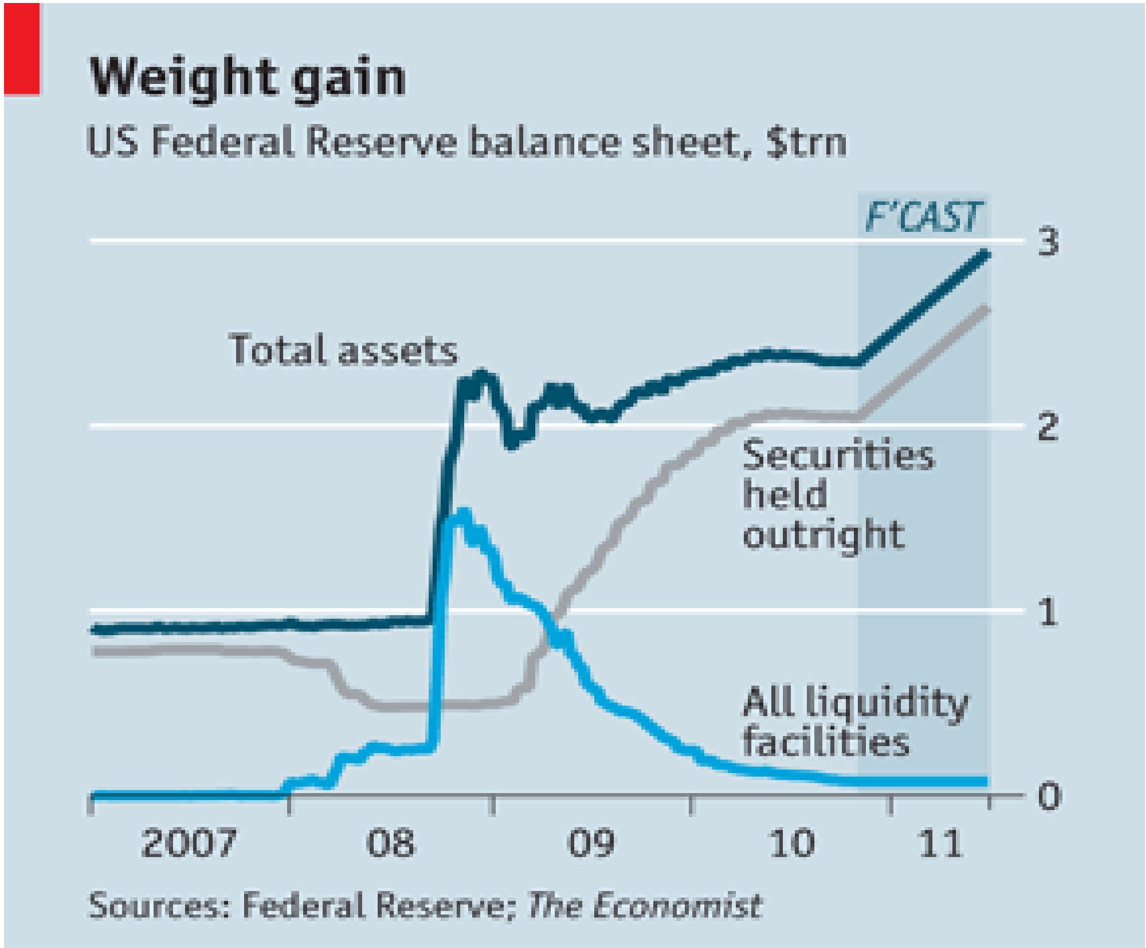
Quantitative Easing

- An ugly name for a simple idea
- Central banks buy long-term government bonds with newly printed money.
- It raises the bonds’ prices, lower their yields and provide a helpful boost to growth when central banks; main tool, the short-term interest rate, is close to zero.

Under QE the Fed buys long-term bonds with newly created money, lowering long-term yields and chases investors into riskier, alternative investments.



Other countries complain that QE is merely bringing them overvalued currencies and bubbly asset markets by pushing investors to seek higher returns elsewhere.



Conclusion

- The bubble in the stock market preceded the bubble in the real estates markets.
- It is desirable and possible to prick the bubble by using tight credit policy to curb excessive credit growth.
- If monetary policy can produce sustainable growth with price stability, there would be favorable consequences on other development issues such as poverty reduction, employment, income distribution, and urban migration.