The End of QE and EMs
A Panel

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Attention!!

- Effects are not Causes.
- Liquidity Trap, Excess Aggregate Supply are effects of financial crises.
- 20^{th} macroeconomics, as well as current policy debate, have, on the whole, treated them as causes.
- My favorite (proximate) cause is Liquidity Crunch.

Liquidity in Macro Theory

- Liquidity is a nuisance for macro theory,
- Because economists are <u>addicted to Walras</u> (Lite Walras, rather).
- Conventional macro models treat <u>liquidity</u> (just *money* in most cases) <u>as an afterthought</u>.
- TFP shocks are crowd-pleasers, to the detriment of liquidity shocks.
- Labor market inflexibility (e.g., nominal wage rigidity) takes the center stage, to the detriment of financial inflexibilities (e.g., incomplete markets).

Putting Liquidity First

- Assume that trades can only be executed by employing primitive Media of Exchange, MOE.
- Cash is the classical example.
- Collateral is a MOE for intertemporal trade, or credit (a more interesting example)
  - collateral is "liquidity in advance" for credit.
- A key problem with liquidity is that it can evaporate in the blink of an eye, and give rise to Liquidity Crunch.
- The Lehman episode run on repos is a salient example.

Not All Liquidities are Born Equal

- Some liquidities are more resilient than others.
- Liquidity Crunch could hit liquid assets differentially.
- ABS proved to be fragile while the US dollar showed incredible resilience.
- In contrast, EM currencies melt down in financial crisis.
  – Just think about the impact of the non-tapering episode, and last week's good employment news in the US.
- The Price Theory of Money, PTM, offers an interesting, albeit incomplete, insight on these issues.

Price Theory of Money (PTM)

"[...] ***the fact that contracts are fixed, and wages are usually somewhat stable in terms of money, unquestionably plays a large part in attracting to money so high a liquidity-premium***"
Keynes (GT, Chapter 17, p. 236)

Price Theory of Money: Sticky Prices

- Price setting entails a <u>ground-up commitment</u> to make fiat money valuable in terms of output.
- Under staggered prices, agents are more willing to accept fiat money in exchange for their goods, because most prices will not be modified in the short run.
- PTM could also be labeled "Price in Advance Theory": the *sustainability* of the output value of money *follows* from setting prices in advance.

Endogenous Liquidity

- Financial innovation. Examples:
  - Mortgage-backed securities and “shadow banking.”
  - According to the FT, Collateralized Loan Obligations are coming back big way.
- Incentives for liquidity creation are enhanced by **low global interest rates**, as now.
- Capital inflows in EMs could enhance liquidity of EM liabilities: **“Inverse Bank Run”**.
  - <u>But an increase in US interest rates could quickly generate liquidity crunch</u>.

Liquidity Crunch $\Rightarrow$ Sudden Stop

- Liquidity crunch destroys collateral and, hence, has a negative impact on credit flows.
- How likely and how big is the impact depends on *fundamentals*.
- For example, Calvo, Izquierdo, Mejia (2008 NBER WP 14026) shows that Current Account Deficit and Domestic Liability Dollarization are major risk factor.
  – Recent Non-Tapering episode appears to confirm these results.

QE and All That

A Twenty-Year Anniversary

- Calvo, Leiderman and Reinhart (*Staff Papers*, March 1993) claimed that US short-term interest rates had a big impact on LAC's capital inflows.
- We found this result somewhat puzzling because most people at the time expected, e.g., 10 year bonds, to be more relevant.
- However, Putting Liquidity First helps to rationalize this effect.
- Moreover, the result had a successful trial by fire during the Tequila crisis.

Will it Happen Again?

- DM easing has given incentives for the creation of liquid assets in EM.
- Its duration is unprecedented and current accounts have deteriorated; thus, it is to be expected that the sums involved are substantial.
- This helps to explain the high sensitivity of EM to threats of monetary tightening in DM.

- Some observers take LAC’s resilience during Lehman as an indication that the region is strong to withstand Tapering.
- This ignores that the region’s CAD and Fiscal Deficits have sharply widened, and that DM central banks are less likely to come to EM’s rescue through, e.g., currency swaps.

The EM Policy Front

- International reserves and IMF credit lines have proven effective instruments to smooth out credit Sudden Stop.
- It is important, though, that these resources do not simply feed capital flight.
- The latter is much easier saying than doing. So, my strong advice is to carry out “Fire Drills” to prepare the central bank and the government to act quickly and effectively.

Exchange Rate Flexibility

- Some EM are well-suited to use the exchange rate as a shock absorber.
- However, large changes in the rate of exchange could destabilize even strong economies.
- Moreover, large devaluation can push inflation far above inflation targets.
- Thus, the greater preparedness of several EM to let the exchange rate do some of the work, compared to 1998, say, should not fool us to believing that exchange rate flexibility is a silver bullet.

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