

# International Transmission of the Subprime Crisis

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# Outline

- A fable
- Causes of the Subprime Crisis
- Immediate Transmission through the asset market, then the market of flows
- Adjustment process viewed from a portfolio model of exchange rate determination
- A Tale of Two Cities, Bangkok and New York
- Policy Choices for Japan: Avoiding a one lung flight neglecting the asset market or the role of monetary policy
- Misconception of monetary policy coordination
- Fostering self-fulfilling expectations: A lesson from President Obama
- A new era for macroeconomics?

# A Tale of Grasshoppers and Ants

- What do they do if grasshoppers know that they are spending on the missing wealth?
- What can ants do?
- What can theory do? Portfolio Approach to the exchange rate determination (Pentti Kouri, Branson and Henderson) tells the answer.
- Jumping exchange rates, current account adjustments (return to the equilibrium)
- Below is a theoretical overview.

# Causes of Misconception

- Asymmetric information
- How can lenders know how able borrowers can repay.
- The market of lemons, insurance and credit.
- This disrupts all the network of financial and accordingly economic transactions.

# Miscellaneous considerations or caveats

- Situations are more serious because of the large indebtedness of the United States.
- Determinants of International Debt: different preference (朝三暮四), growth rates, asymmetric information. The subprime is a typical case of the asymmetric information.
- 猿蟹合戦 (Monkey and Crab) The valuation of the American debt. Can China blame the US about the declining dollar?
- Original sin and conflicted virtue (McKinnon, Eichengreen etc.)

# Prices of Prices and Prices of Flows

- Volatile asset prices and fixed existing stock, vs. sluggish flow prices and quantity movements.
- Price increases invite price increase expectations and actual price increases in the market of stock. Intrinsic instability in the asset market.

# Transmission of asset price shocks

- Tokyo, New York and Shanghai
- Figures (Exl), In terms of the single currency.

# Asian Crises, Jusen and Subprime

- The portfolio approach to exchange rates (Branson and Henderson) is a useful tool to see the macroeconomic picture. In most countries, currency depreciation was followed by gradual improvements in the current account. Asian crises (Hamada and Takeda, JER)
- Jumping characteristic of Dornbusch model is carried over to this model.
- Expectations for rising prices of real estates are important for sustaining bubbles. Japan's lost decade--- 1990 on--- was complicated by mishandling of the monetary policy. In the large, the loss by Jusen (Residential special financial) is very similar to the case of subprime.

# Scenes from the East and the West (interlude)

- The United States: Highly securitized economy:
- My retirement fund (cref) shrinking while watching television.
- Yalies still throng around the Wall Street for jobs.
- Entitlement of the fruits of the “Greed.” Bonus etc>
  
- Japan: Very warm society for the less privileged.
- Many social agenda to be filled in this occasion.
- Natural reactions of politicians in democracy.

## Hard reality of inexistence of conceived wealth (again)

- Grasshoppers must tighten the belt.
- Ants must do so as well because exports to the East of the Pacific were reduced
- The total world must suffer because the total wealth is lost.
- If these processes go smoothly, then we do not need to worry about.
- Almost all the financial links are disrupted.

# Graphical Representation of the Portfolio Model

- Asset equilibrium: the more expensive the dollar is, the less willing is the world to hold assets in the United States.
- Flow Equilibrium, the more expensive the dollar is, the current account equilibrium can sustain with more expensive dollar. (FIG1.2)
- Monetary expansion of the US will shift the curve above.

FIG 1

# The Portfolio Model of Exchange Rate Determination

Price of the Dollar

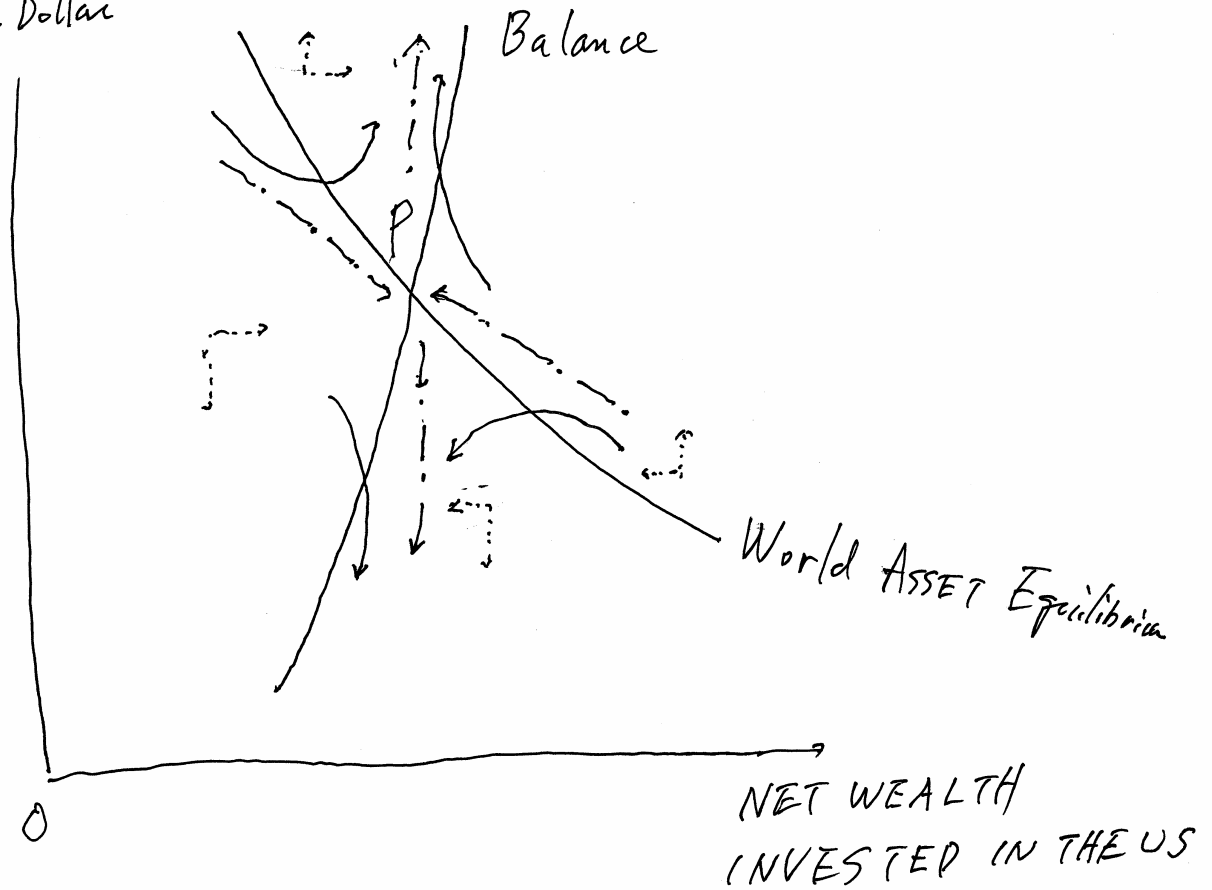
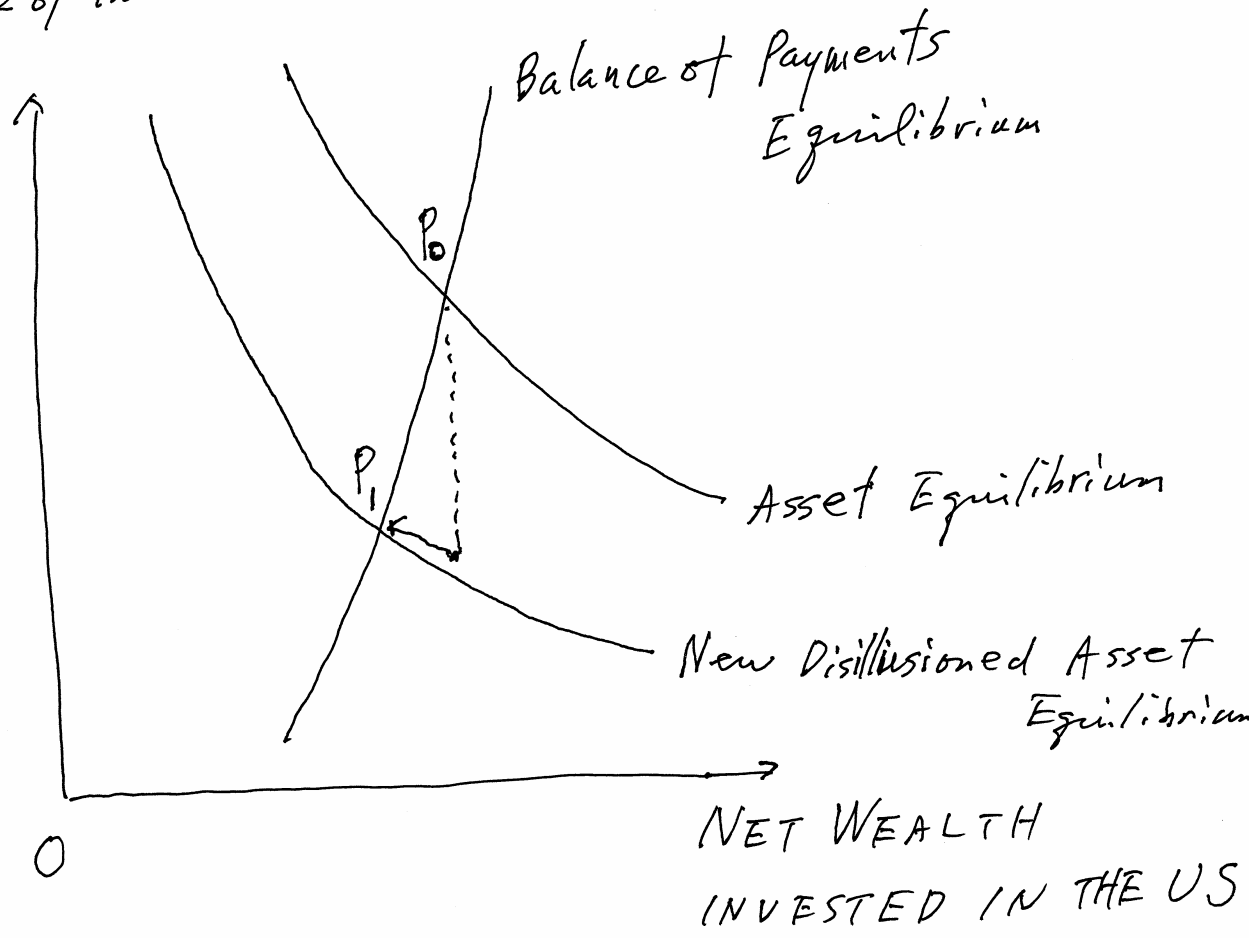


FIG 2 Sudden Exchange Rate Depreciation and the Balance of Payments Recovery (Adjustment)

Price of the US dollar



You can substitute "Thai" for the U.S. to explain the Asian Crisis

# A Tale of Two Cities: Bangkok and New York

- The Sudden Depreciation of the Dollar and the recovery (adjustment) of the current account.
- The world has been equipped with sluggish flow and flow price adjustment.
- Information related contents of crisis --- asymmetric information and moral hazard--- are complex, but the macroeconomics is rather simple. (Figs. 1, 2)

# Alternatives of what they can do?

- (0) Do the structural policies to improve the efficiency.
- (1) Do nothing in terms of macro policy until the adjustment process complete. Prudent bankers and disciplined government. --- System may not survive the hard shocks of asset prices and exchange rates.
- (2) Return to Keynes and do discretionary fiscal policy--- may not be so effective under flexible rates with capital mobility.

# Misunderstanding of the policy coordination process

- Monetary expansion is not a response for policy coordination to the United States.
- Beggar-thy-neighbor linkage of monetary policy under the flexible rate.
- ECB and BOJ are helping the US now by their conservative monetary policy.
- Mundell-Fleming is ba—ack!

# Role of Expectations

- The subprime crisis let us realize the absence of wealth. But wasn't it overdone?
- Underestimation of our capacity is another type of error.
- Price/(Book value) Ratio  $P/B$ , or PBR much below unity.
- Who designates the sun-spot and make the public follow? The great failure of Irving Fisher.
- The condition for a leader is to create positive expectations.

# The Neglect of Asset Market and the Monetary Policy in the large.

- In Japan, cabinet members concentrate on government expenditure policies.
- They neglect, or they are ignorant of, the role of asset management policy, notably the monetary policy in a broader sense.
- A kind of a one lung flight !--- full fiscal policy and little monetary policy. The nation suffers.

# Monetary Policy under the Zero Interest Rate

- The monetary policy is ineffective unless money is exchanged with the asset that is of the least degree of substitutability.
- Long term government bonds, commercial papers, debentures, stocks?
- Costs of unconventional measures.

# Very, or Too Prudent ECB and BOJ

- If the economy does not suffer and survive, the policy might be desirable. Can the economic system sustain itself? Otherwise, the incidence of deflation and income loss will be great!
- See the Figures.
- The BOJ concentrates itself on buying short terms securities. In order to protect the monetary order, it tries to use the least effective instrument --- the instrument with the least side effects.

# Self-fulfilling Expectations

- Importance of creating expectations. One of the conditions for policy makers and politicians is to foster credible expectations.
- Look at Price/Book-value Ratio.

# Fire sparks are from the US

- Is there no possibility of keeping fire burning in Japan even after fire in the epicenter has been extinguished?

# Whither will macroeconomics go?

- 1936 The General Theory
- 1972 or around: The rational expectations revolution
- 2008 Subprime shocks to macroeconomics, in particular to RBC.
- Old wine in a new sack?
- New Keynesian is a little short of revolutionizing.
- Attention should be focused on the relationship the equilibrium of stock and flow variables, a tradition from Wicksell, Keynes, and Tobin? Disruptions to these nominal as well as real shocks are most important subjects to study.
- What will be the innovative energy? Behavioral, psychological, neuro, experimental or ---?