Financial cycles, the state and currency hierarchy

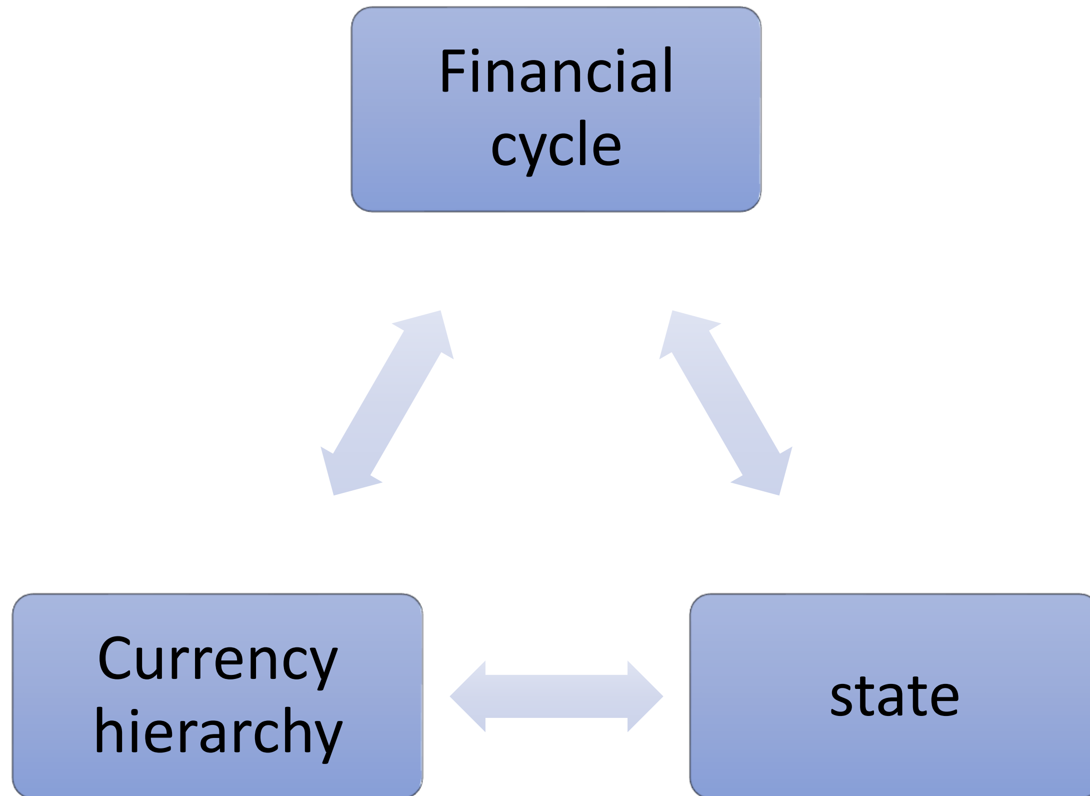
Engelbert Stockhammer, KCL

PKES AWS 2023

The main idea

- Gap in the IPE literature: strange absence of financial crises; focus on top of currency hierarchy
- Q: What do financial cycles imply for currency hierarchy and the state?
- Two ingredients/starting points
  - (liberalized) finance comes with financial cycles
    - Minskyan financial instability hypotheses: endogenous financial cycles
    - In world with different currencies -> currency hierarchy
  - In a financial crisis, there will be pressure on states to act
    - But currency hierarchy will asymmetrically affect state capability
    - This gives rise to structural power along the hierarchy
    - And relational power during a crisis

outline



- Preludes
  - CH in IPE and in PKE
  - Minsky: endogenoug financial cycles
  - Some empirics
- Financial cycle and CH
- Financial cycle and the state
- The state and CH

IPE on currency hierarchy

Mainstream-ish IPE of International Money

- Cohen: Ability to delay adjustment, power to deflect adjustment costs
- Kirshner: Financial power = ability to withhold finance in a discretionary sense (Suez crisis); notes that financial liberalization will increase financial instability, which shifts power to the USA
- Frieden: distributional effects of exchange rate regimes
- Norrlof (2014): power measures monetary capabilities (defense spending, GDP, equity and bonds).

- Overall: Currency hierarchy without (much) financial crisis
- Concern for top currency, less interest in the periphery
- Implicit trade focused (trade surpluses as basis for cap flows) and loanable funds

IPE of international money following Susan Strange

- Strange. Relational and structural power. Emphasises private firms as power players (beyond interstate notion of power)
  - Structural power = to shape structures
  - Power through non-action,
- Helleiner (2006) Ability to shape relevant financial regulations and norms
- Schwartz (2019) Cap flows to USA as expression of power. (1) late developers have structures that suppress domestic demand (export-led growth), they then invest [trade!] surplus in the USA, (2) US firms highly profitable because of IPR, profits from GVC syphoned to US = US asset high returns

- What I do ….
- closest to Strange and parts of Helleiner, Schwartz, Eichengreen
- But put endogenous financial cycles at the centre
- Structural power = asymmetric playing field

PK theory of currency hierarchy

- Largely absent from/ignored by IPE debates on currency hierarchy
- based on Keynesian liquidity preference theory and static (e.g. Herr 2008)
- Countries in lower position in CH need to pay higher interest rates (on financial assets) as their currencies are ‘less world money’
- Implications for economic policy for developing countries (de Paula et al 2017): less policy space
- current debates: more ‘Minskyan’ = emphasise the liability side; but don’t have endogenous cycles (Bonizzi and Kaltenbrunner 2021, Carneiro and de Conti 2022)
- What I do: financial cycles at centre and as endogenous; liquidity preference changes over the cycle

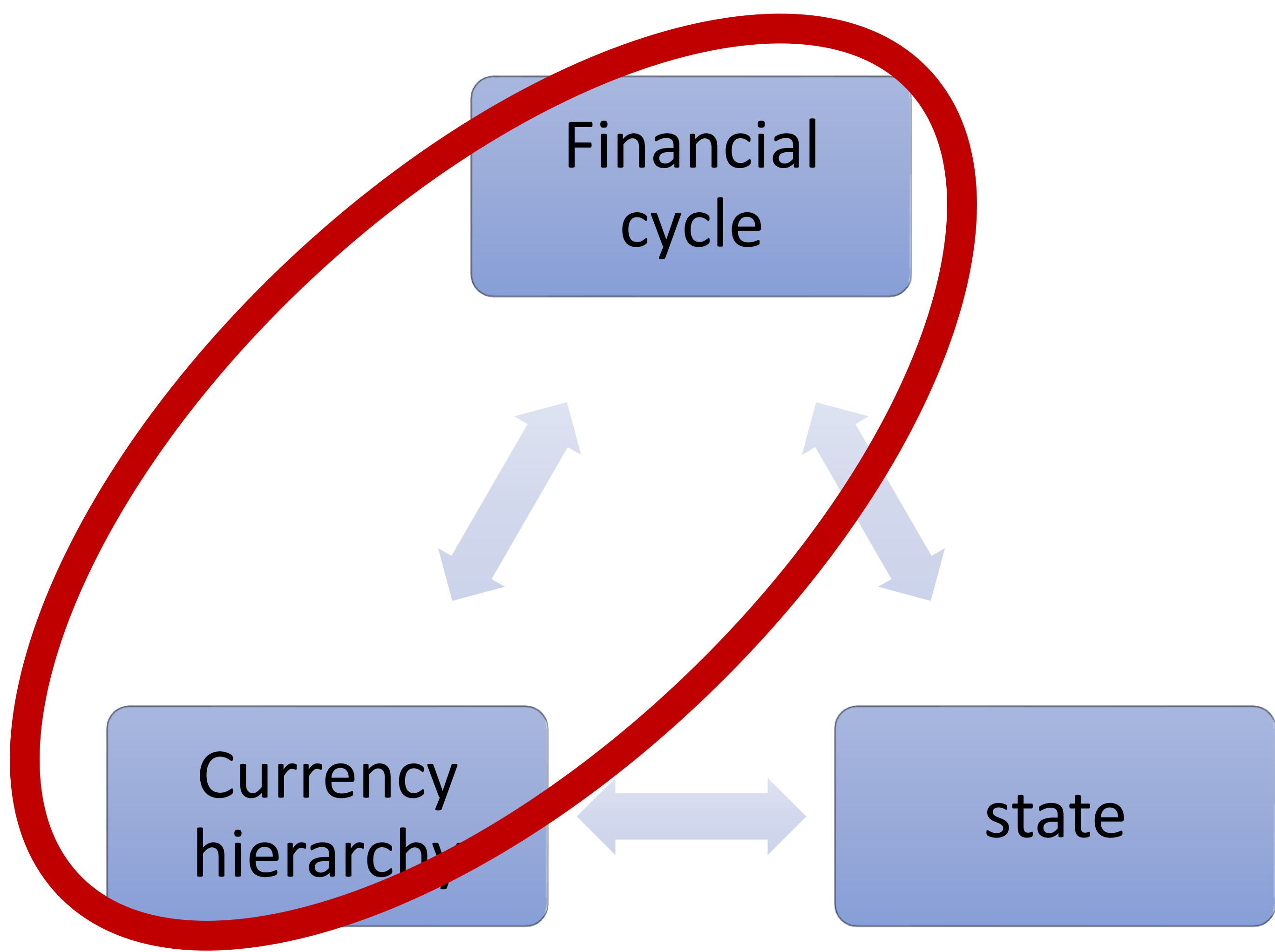
Minsky financial cycles

- Endogenous (systemic) financial cycles: build up of debt during the boom -> economy (firms, banks) become more financially fragile during the boom
- = during boom there is an decline in the liquidity preference = a shift towards riskier assets
- During financial crisis: increase in liquidity preference = flight to safety (in Keynes: money)
- All cycles need (at the minimum) and overshooting and a dampening force that interact
- Real–financial interaction cycles: e.g. overshooting investment, which leads to rising indebtedness, high debt dampens investment
  - That's Minsky's core argument
- Momentum trader models: interaction of two forms of expectation formation overshooting (momentum traders) and dampening (fundamentalists)
  - Elements of that in Keynes and Minsky, elaborate by behavioural finance

Empirical research on financial cycles

- Driven by mainstream-ish research more than by hetecon
- Strong evidence for regular financial cycles (spectral analysis, turning point analysis …)
- Financial cycles (credit, house prices) tend to be longer than 'short' GDP cycles (ca. 15yr rather than 7yrs) (Aikman et al 2015, Drehmann et al 2012)
- Recessions with a financial crises are deeper and more long lasting

- Global financial cycle (short; share prices) vs domestic financial cycle (longer; house prices, credit) (Aldasoro et al 2020)
- Also cycles in commodity prices (even longer) Erten and Ocampo 2013)

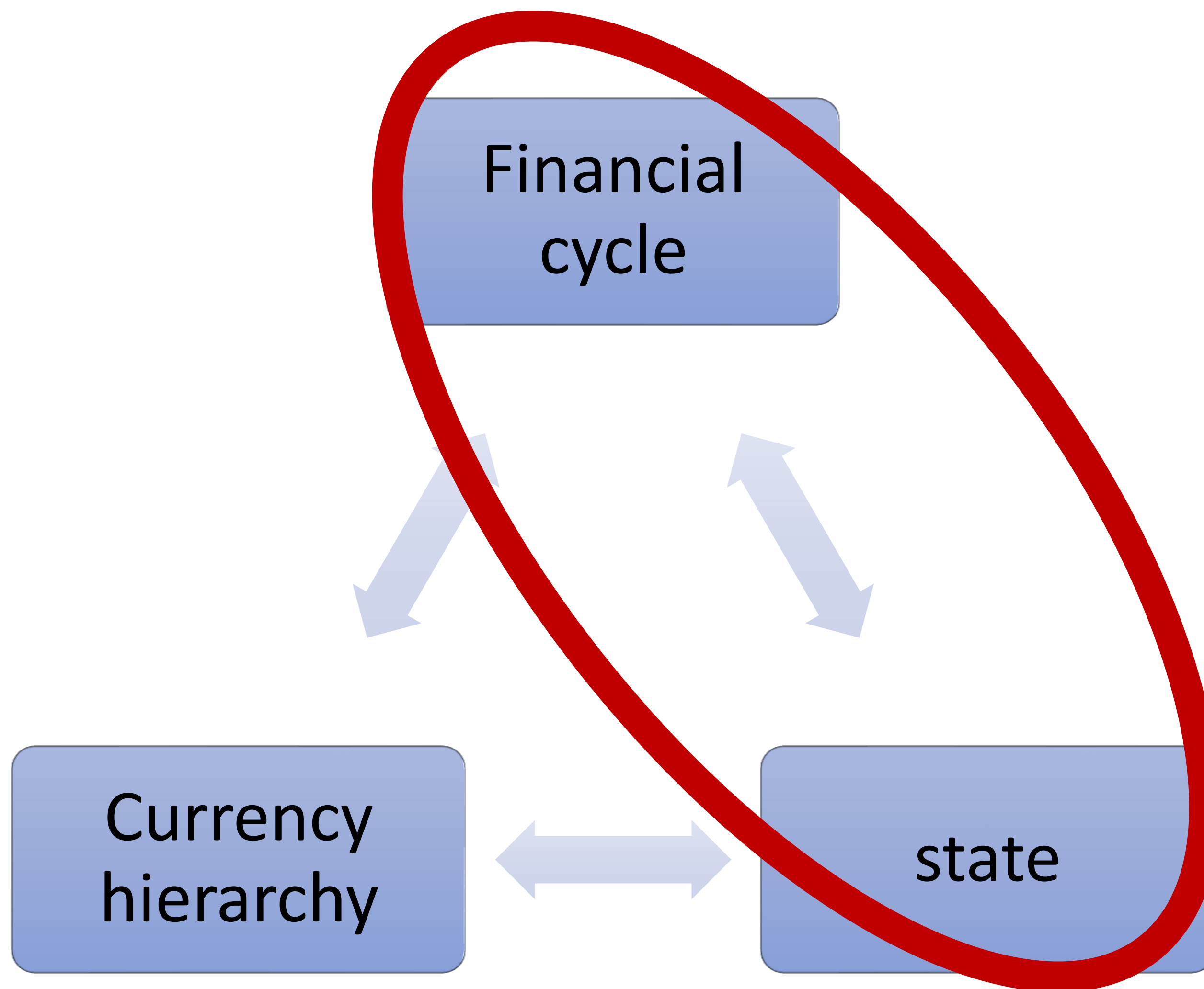

Financial cycle
Currency hierarchy
state

financial cycles and currency hierarchy

- In crisis (increased uncertainty) there is flight to safety = to the central currencies
- In crisis: Outflows from peripheral countries
- Causes recession: financial channel (real debt burden because of FX debt) dominates trade channel (exports more competitive); Akyuz, Ocampo
- => Currency Hierarchy
- countries lower down the pecking order of currency hierarchy (that are ‘less world money’) have higher interest rates

Capital flows and the financial cycle in the periphery

- In developing economies: borrow abroad (lower interest rate b/e of currency hierarchy)
- Borrowing abroad = capital inflow = appreciation
  - Can think of financial variable in terms of inflows or of exchange rate
- Inflows will be pro-cyclical
- But *pro-cyclical with respect to what?*
  - Type 1 crisis: pro-cyclical with respect to financial cycle in top currency; BRICS in 2008
    - Rey 'global financial cycle'; much of PK CH; exogenous shock for developing country
  - Type 2 crisis: pro-cyclical with respect to domestic activity in developing country; domestic boom gets amplified by capital inflows
    - Endogenous financial cycle with international component
  - Aldasoro et al (2020) Two different cycles: 'global financial cycle' vs 'domestic financial cycle' – different periodicities
- Kohler and Stockhammer 2022: evidence for a (domestic) real- (international) financial interaction cycle


Financial cycle
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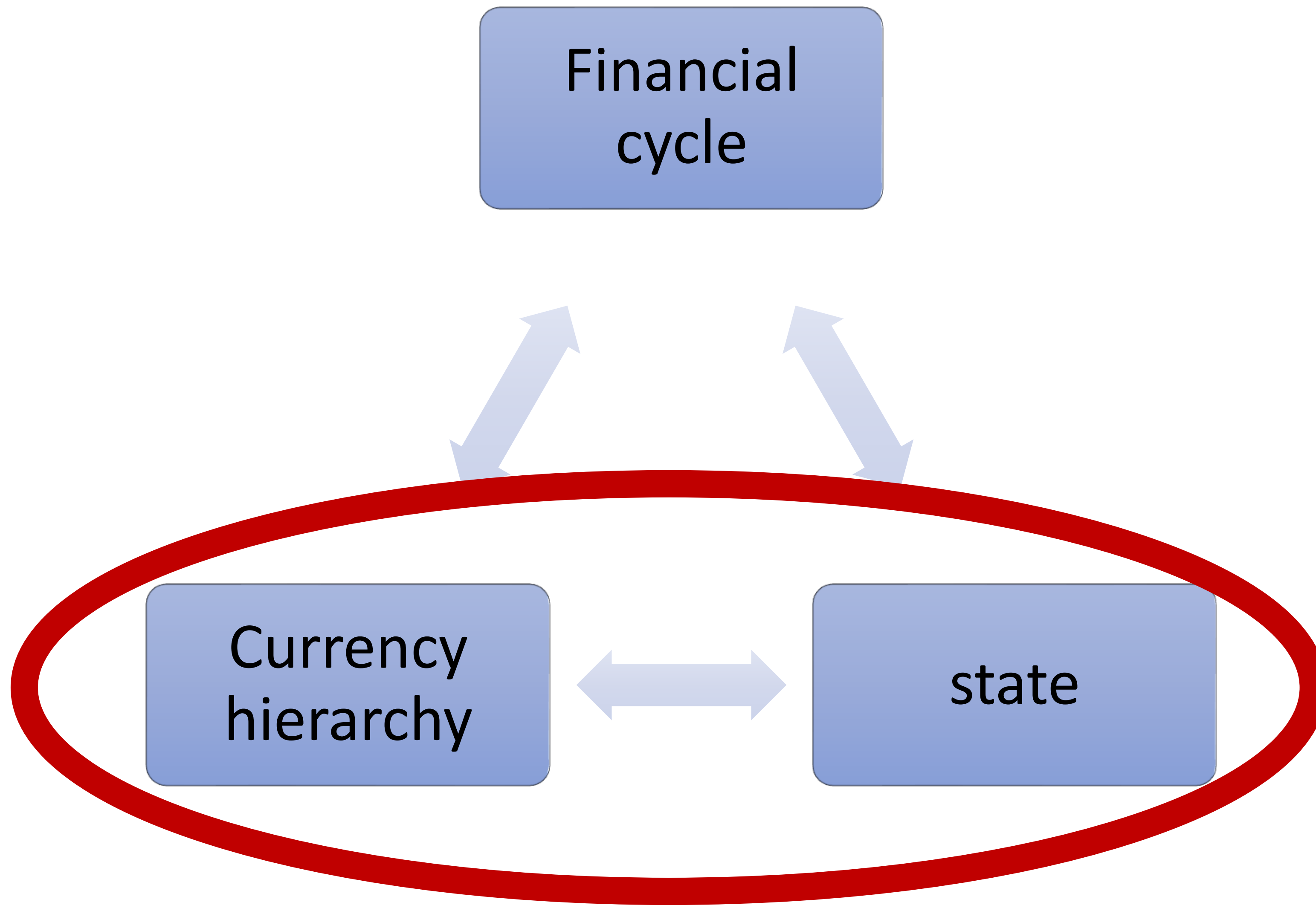
Financial cycles and the state

- Most theoretical Minsky models have symmetric cycles: same mechanism creates boom as well as bust (=endogenous cycles)
- State is missing.
- Minsky super cycles (Palley 2011; Dafermos et al 2022): state financial regulation gets weaker during boom and tighter in response to crises; financial innovation to circumvent regulations
- My point is different: during bust pressure on the state to ‘act’ = stabilizing the financial system and counter-cyclical fiscal policy
- gov’t will intervene more heavily in downturn, *if it has the capacity to do so*.
- Thus expect actual financial cycle to be asymmetric
- Pistor 2013: in crisis power relations become apparent: which financial institutions should be bailed out?
- emp lit find that fin crises are followed by elevated public debt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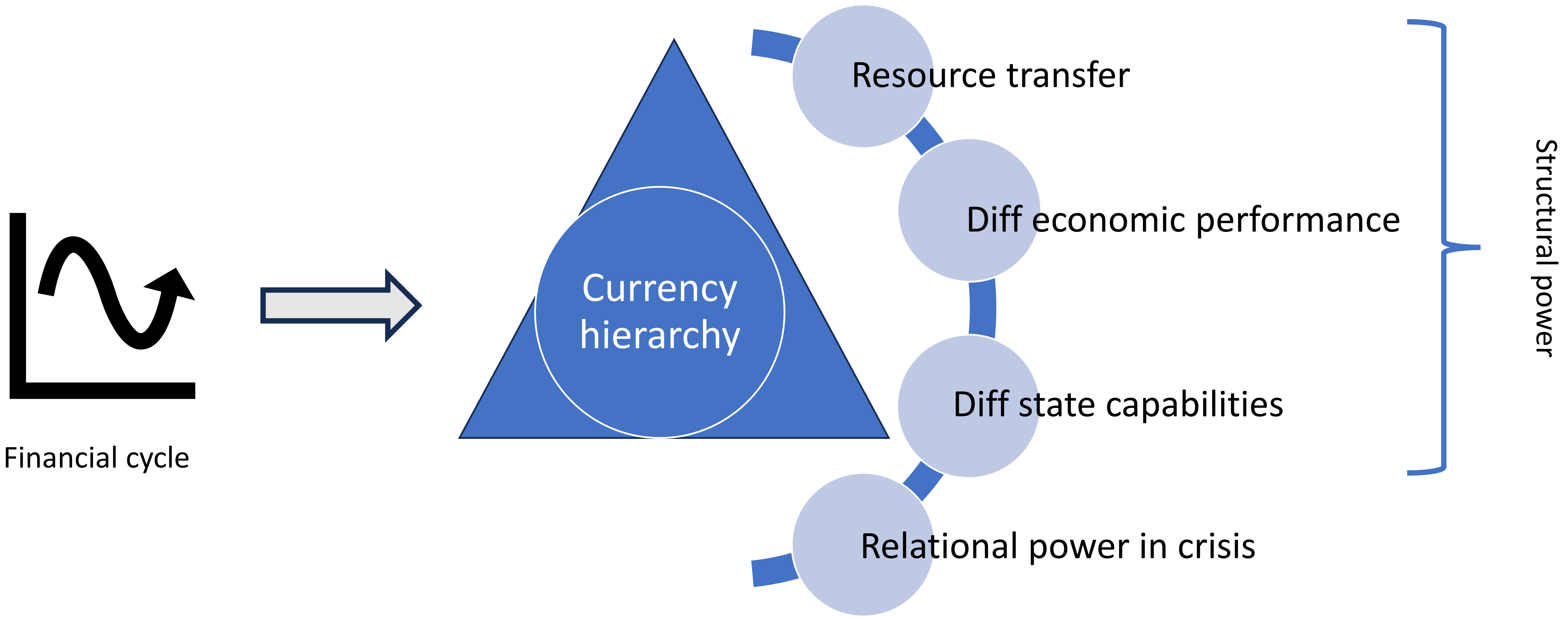
Peripheral states in the crisis

- Capital flight from periphery to centre
- Upward pressure on interest rates in periphery
- Can’t keep interest low as that would lead to devaluation
  - Financial account dominance: in FX indebted countries devaluation is contractionary
- Difficulties of state in borrowing
- There is a financial dimension (or cause?) of state power that differs systematically between centre and periphery
  - Ability to borrow in own currency
  - Ability to borrow counter cyclically
  - Ability to save their banks
- => Economic growth volatility larger in developing economies than advanced (e.g. Pritchett)
- In practice: apply for IMF support; capital controls (Malaysia); after SE Asia crisis: shift to reserve accumulation (via undervaluation)

Core state in the crisis

- One condition for states to remain at the apex of the currency hierarchy is that they offer safe assets => The safety of the asset depends on the position in the currency hierarchy, but also on the policy response during the crisis
  - If in financial crisis CB doesn’t buy govt bonds (e.g. Euro crisis), crisis will escalate and turn into sovereign debt crisis
- => need to manage the crisis (also: Strange 1971)
- Thus not only political pressure to pursue Keynesian policies in the crisis, but also systemic requirement for top currency.
- LOLR is a power position (similar to Pistor); in CH power to CB of top currency during crisis
  - Who does the USA give FX swaps during the crisis? (McDowell 2012)
- Illustration 1: Eichengreen and Flanderau (2009), Chitu et al 2014: USD first replaces £ as main reserve currency first in 1920s, but then looses position in early stage of Great Depression. Policy matters: failure of US to stem banking crisis led to shift out of dollar
- Illustration2 : Euro area vs US during GFC
  - Handling of Euro crisis disqualifies Euro as international currency (Germain and Schwartz 2014)

The main argument



Summary findings

- Endogenous financial cycles: debt build up during boom and flight to safety during crisis
- => leads to emergence of a currency hierarchy (the default during the crisis justifies higher interest rates)
- Distinct form of financial cycle in the periphery (bottom of CH)
  - Pro-cyclical capital flows amplify domestic business cycles
  - FX debt and capital flow reversals during crisis
  - This crisis (like the Asian Financial Crisis) is unique to the periphery
- Currency hierarchy creates asymmetries in structural power between core and periphery of the hierarchy
  - Firms and banks are more vulnerable
  - States' ability to conduct countercyclical policies is limited by FX debt and capital flight
  - Resource transfer: 'exorbitant privilege' (Gourinchas and Rey 2007, Mayer 2021)
- Top of the CH: willingness to manage financial crises is a precondition to maintaining the position of key currency
  - Relational power in crisis: can decide who to extend currency swaps to

conclusion

- Minskyan approach to CH
- Relation to IPE: echos of Strange, structural power in sense of uneven playing field; endogenous (systemic, re-occurring) financial crises
- IPE CH: focus on top (core), strange absence of financial crises
- PK CH: focus on periphery
- State enters during crisis. Asymmetry in state capabilities across CH
- Minskyan theory of financial cycles leads to a theory of asymmetric power relations between states
- Empirical research agenda

The currency hierarchy

Capital flows during crisis	*Interest rate differentials*	*FX debt*	*State capabilities during crisis*	*Label (Cohen)*
Inflows			Enhanced	Top currency
(neutral)	+	No gov't FX debt, but financial sector for international activity	State is fine (does not need bailout), but can't provide FX emergency liquidity to financial sector	Elite/patrician
outflows	++	Has gov't FX debt and/or substantial corporate FX debt	Needs bail out, and can't provide FX liquidity to fin sector	Plebeian
Outflows	+++	FX used for domestic purposes (currency substitution)		Quasi currency

IPE lit groupings

Helleiner and Krishner 2010

- Market-based approaches: mostly economists; confidence, liquidity, and transactional networks
- Instrumental approaches: the role of public authorities in determining the dollar's international role, whether other states use dollar as anchor/peg (political decision)
- Geopolitical approaches: IR scholars (Gilpin) "every international monetary regime rests on a particular international order"
- Later they write about market-based, instrumental and geopolitical determinants

Ly (2012) adds a 4th approach

- Institutionalist approach (Eichengreen): "claims that institutions can enhance the reserve status of a currency by creating liquid markets and by intervening quickly in financial crises" (p. 342)

How, if at all, does my version differ?

- Current PK CH treats liquidity preference as stable
- Treats financial crises as exogenous shocks to developing countries

- This paper: ‘more Minskyan’
- Financial cycles (and associate capital flows) essential for CH
- Financial cycles are endogenous
- Liquidity preference changes endogenously over time (thus the capital flow cycle)