

# Challenges and Risks in the International Monetary System: An Overview

Georgios P. Kouretas · Athanasios P. Papadopoulos

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## 1 Introduction

Since 1997, the Department of Economics of the University of Crete has organized annual international conferences on Macroeconomic Analysis and International Finance. The articles included in this special issue are refereed versions of papers presented at the 16th International Conference on Macroeconomic Analysis and International Finance held at the University Campus, Rethymno 24–26 May 2012 in collaboration with *Open Economies Review*. The central theme of this conference was Challenges and Risks in the International Monetary System. We open this Special Issue of *Open Economies Review* with an overview of these papers.

In “Systematic and Liquidity Risk in Subprime-Mortgage Backed Securities”, Dungey, Dwyer and Flavin argue that the misevaluation of risk in securitized financial products is central to understanding the financial crisis of 2007–2008. They analyze the evolution of a number of factors that have been shown to have affected collateralized debt obligations (CDOs) based on subprime mortgages. The authors build on a theoretical pricing model under which CDOs can be represented as a three factor model, with common shocks, credit-rating shocks and idiosyncratic shocks. They introduce a fourth factor, the vintage factor, which reflects risks associated with the dates during which securities were created. The authors argue that a key feature of subprime-mortgage backed indices is that they are distinct in their vintage of issuance. Using a latent-factor framework, the authors find that the behavior of subprime-mortgage backed securities was influenced by these four main factors. In 2006, each

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G. P. Kouretas (✉)  
Department of Business Administration, Athens University of Economics and Business,  
GR-10434 Athens, Greece  
e-mail: kouretas@aueb.gr

A. P. Papadopoulos  
Department of Economics, University of Crete, GR-74100 Rethymno, Greece  
e-mail: appapa@econ.soc.uoc.gr

of those factors has a discernible role in asset returns. The common factor (i.e. a common shock to all markets) becomes more important when the financial turmoil begins; it is found to have a larger effect on AAA tranches than in the pre-crisis period. Dungey, Dwyer and Flavin further examine the common factor's relationship with observable factors, including real estate prices, the Implied Volatility on the S&P 500 (VIX) index and interest-rate spreads which reflect the financial crisis, and they find that liquidity and counterparty risk, as represented by the spread between the London Interbank Offer Rate (LIBOR) and the Overnight Index Swap (OIS) rate, is sufficient to describe the relationship between the common factor and the financial crisis as reflected in interest rate spreads. Moreover, they undertake a counterfactual analysis of the evolution of the common factor under the assumption that the LIBOR-OIS spread had remained at pre-crisis levels throughout. Their estimation leads to the conclusion that the common factor is 20 % lower at the end of 2009 than it would have been if LIBOR-OIS had not been elevated during the financial crisis. Likewise, their estimations show that the actual value of the Real Estate Investment Trust (REIT) index is about 40 % lower and VIX some 50 % higher than in the simulated model with a stable interest-rate spread. The decreases in the common factor, decreases in the REIT index and increases of VIX are the estimated effects of the elevated values of LIBOR-OIS during the crisis, not effects of lower housing prices.

In "U.S. Monetary Policy: A View from Macro Theory", Gavin and Keen address two questions about U.S. monetary policy; First, can monetary policy elevate output when it is below potential? and second, is the zero lower bound on interest rates a trap? They employ a dynamic stochastic general equilibrium model to answer these two questions. With respect to the first question, their estimates lead them to conclude that monetary policy can increase output when it is below potential, but this effect is only temporary and probably not welfare-enhancing. The answer to the second question is more complicated because it depends on the type of policy adopted by the Federal Reserve. In addition, the authors argue that the outcome also depends on whether the inflation rate or the real interest rate adjusts over the longer run if the policy interest rate is held near zero for an extended period. Finally, they use the Fisher equation to analyze possible outcomes for situations in which the central bank has promised to keep the interest rate near zero for an extended period.

Serletis, Istiak and Gogas, in their paper, "Interest Rates, Leverage and Money", criticize the mainstream approach to the conduct of monetary policy which is based on the New Keynesian model and is expressed in terms of a short-term nominal interest, such as the Federal Funds rate in the United States. The authors argue that the New Keynesian model ignores the role of leverage and downplays the role of money in basic monetary theory and monetary-policy analysis. However, as the Federal Funds rate has now reached the zero lower bound and the Federal Reserve appears to be facing a liquidity trap, the issue of whether there is a useful role of leverage and monetary aggregates in monetary policy and business cycle analysis arises. The authors conclude that there is a need of financial-stability policies to manage the leverage cycle and reduce the procyclicality of the financial system. An additional argument made by the authors is that, in the aftermath of the global financial crisis and Great Contraction, there is a need to move from the New Keynesian framework and return to the quantity-theory approach to monetary policy, based on properly measured monetary aggregates,

including the approach involving the Divisia-monetary aggregate recently adopted by the new Center for Financial Stability.

In “Discretionary Government Consumption, Private Domestic Demand, and Crisis Episodes”, Agnello, Furceri and Sousa analyze the dynamic impact of *discretionary* government consumption purchases on private demand. These authors deal with three issues. First, they analyze the impact of government consumption shocks on output, consumption and investment in both the short and the medium terms. Second, they present empirical evidence pertaining to those shocks in a large set of advanced and developing economies. Third, they assess the changes in the response of output, consumption and investment to fiscal shocks during periods of crises relative to those responses in non-crisis periods. Their empirical strategy consists of a two-step approach. Using a panel of 132 countries from 1960 to 2008, the authors show that discretionary changes in government consumption lead to crowding-in effects in the short run. However, crowding-out effects take over in the medium run although the crowding-out is never strong enough to offset the overall expansionary impact of government consumption completely. The authors also show that, regardless the type of crisis, crowding-in effects are magnified once the authors control for the extreme events caused by a crisis, and dominate during the first years of the crises. Overall, the results lead to the conclusion that there is a potential trade-off between the short- and medium-term effects of discretionary changes in government consumption during periods of crises.

Barnett, Liu, Mattson and van den Noort, in “The New CFS Divisia Monetary Aggregates: Design, Construction, and Data Sources”, extend previous analysis on the design and construction of new Divisia monetary aggregates and the development of the field of aggregation-theoretic monetary aggregation. The authors provide evidence that the components of the Divisia monetary aggregates developed by the authors in association with the CFS—Center for Financial Stability—for the United States closely reflect those of the current and former simple-sum monetary aggregates provided by the Federal Reserve. The first five levels, M1, M2, M2M, MZM, and ALL, are composed of currency, deposit accounts, and money market accounts. The liquid asset extensions to M3, M4-, and M4 resemble (in spirit) the discontinued M3 and L (which is a broadly-defined liquidity monetary-aggregate measure) aggregates, which include repurchase agreements, large denomination time deposits, commercial paper, and Treasury bills. Furthermore, when the Federal Reserve stopped publishing M3 and L, the U.S. monetary authority also stopped providing the consolidated, seasonally-adjusted components of M3 and L. In addition, the Fed no longer provides the interest rates on the components of M3 and L. Therefore, the authors argue that because of the lack of the component quantity and interest-rate data, choosing data for the construction of the CFS aggregates has not been easy and has sometimes required regression interpolation. The authors document the current decisions of the CFS regarding United States data sources with particular emphasis on Divisia M3 and M4.

In “What Drives Clarity of Central Bank Communication about Inflation?”, Bulir, Cihak and Jansen examine whether the clarity of central bank communication about inflation varies with the economic environment. The analysis is based on the use of readability statistics and content analysis. The authors study the clarity of communication on the inflation outlook for seven central banks across three continents during the past 10 years. The main finding is that there exist significant and persistent

differences in clarity over time and across countries. However, they do not succeed in identifying any determinants of clarity that are robustly-relevant across the sample of central banks. Overall, the findings of the analysis suggest that a single model for clarity of central bank communication is not appropriate and, therefore, in studying clarity of communication, country-specific and institution-specific factors are highly relevant and should be employed.

In't Veld, Larch and Vendeweyer, in their paper "Automatic Fiscal Stabilizers: What They Are and What They Do", provide a new look at the debate about the size and effectiveness of automatic fiscal stabilizers in light of the recent global financial crisis. In particular, in the euro area, where monetary policy is centralised and discretionary fiscal policy making is constrained by the EU fiscal rules, knowing the size and the effectiveness of automatic stabilisers is crucial for the making and execution of fiscal policy. While automatic stabilisers are a fairly established concept in the fiscal policy literature, there is still no consensus about their actual nature and their effectiveness. The authors argue that differences in opinion mirror a deeper disagreement over the way the government budget would be constructed if the automatic stabilizers did not exist. The author address this issue by adopting two alternative counterfactual budgets, which give rise to two different conclusions about the extent of automatic stabilisation. The simulation of a structural model provides strong evidence that the degree of smoothing is conditional on the specification of the counterfactual budget.

In the final paper of this Special Issue, Vogel, Roeger and Herz, in "The Performance of Simple Fiscal Policy Rules in Monetary Union", investigate the stabilising potential of simple fiscal-policy rules for a small open economy in monetary union in a two-region DSGE model with nominal and real rigidities. The authors consider a set of simple fiscal instrument rules for government purchases, transfers, and consumption, labor and capital taxes analogous to interest-rate rules employed in the conduct of monetary policy. The main finding of the paper is that a dichotomy exists in the welfare effects of fiscal policy for liquidity-constrained and intertemporally-optimising households, i.e. policies that enhance the welfare of one group tend to reduce the welfare of the other. Furthermore, the moderate average welfare gains from optimal policy contrast with potentially large welfare losses from non-optimal policy. In addition, fiscal policy rules that respond to employment fluctuations may be preferred to fiscal rules responding to indicators of price competitiveness. The authors' simulations also give emphasis to the crucial impact of the budgetary closure rule on the welfare consequences of fiscal business-cycle stabilisation.

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