The Mises-Hayek Business Cycle Theory, Fiat Currencies and Open Economies

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Introduction

- The canonical version of the Mises-Hayek business cycle theory assumes gold standard.
- An updated version of the theory should account for fiat currencies rather than gold standard. (Wagner, 1999)

- Recent work that considers open economies:
  - Cowen (1997), Ritchie (2005), Hoffmann (2010), Hoffmann & Schnabl (2011)

Introduction

- If we assume fiat currencies, then:
  - Why can’t a central bank inflate for ever? What mechanism replaces adverse clearing of reserves?
  - There is more than one currency:
    - How feedback mechanism among central banks affect the unsustainable boom?
    - What role do foreign exchange rates play?

Paper Outline

- The international monetary regime and open economies.
  - Interaction between central banks.
  - Domestic versus international monetary policy.
- The effects on the small open economies.
  - The foreign exchange channel and the capital structure.
- Are business cycles more or less severe in the context of fiat currencies and open economies?

Findings

- The international monetary regime and open economies.
  – Interaction between central banks can mislead monetary policy and extend in time the expansionary monetary policy..
- The effects on the small open economies.
  – Capital structure gets distorted not only on its length, but also on the allocation of capital goods between tradable and non-tradable industries.

The International Monetary Regime

- Let major advanced economies be the ‘center’ economies.
  - For example: United States, Euro Area, Japan.
- Let the closely linked small open economies be the ‘periphery’ of the center.
  - For example: Southeast Asia to Japan or Eastern and European Countries to the Euro Area.

The International Monetary Regime

- Two problems with fiat currencies:
  - Without adverse clearing of reserves, a substitute indicator needs to be chosen.
    - Which one? How is it going to be measure? How is going to be interpreted?
    - Monetary nationalism.
  - Since there is more than one currency, the behavior of each bank affects the decisions of other central banks.

The International Monetary Regime

- The periphery absorbs reserves and stabilizes the foreign exchange rate.
  - In the center, consumption gap is satisfied with imports and inflation is postponed; especially if there is an output gap (i.e. China and regions of Asia).
  - There are no signs of currency appreciation or depreciation if there is a policy of foreign exchange rate stability.
- Then, the expansive monetary policy can continue for a longer time.
  - (Eichengreen 2004, Leijonhufvud 2007, Taylor 2009, W. White 2006).

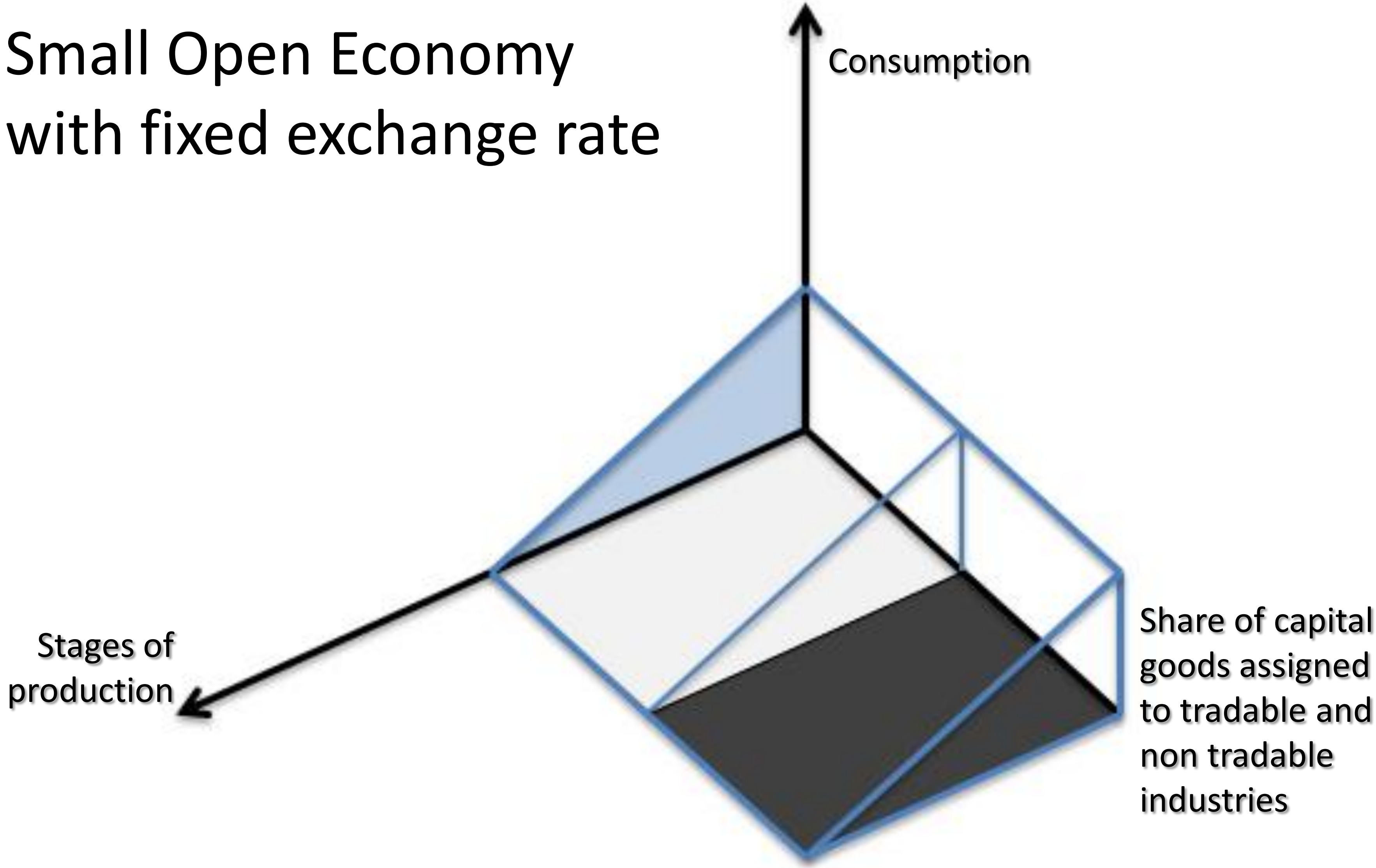
The Effects on Small Open Economies

- Import/export industries (fixed exchange rates)
  - From the point of view of the center:
    - Imports increase.
    - Price of non-tradable goods increase *before* prices of tradable goods (i.e. housing).
    - Resources are reallocated from production of tradable goods to production of non-tradable goods.
  - From the point of view of the periphery:
    - Exports increase.
    - Price of non-tradable goods increase *before* prices of tradable goods (i.e. housing).
    - Resources are reallocated from production of tradable goods to production of non-tradable goods.

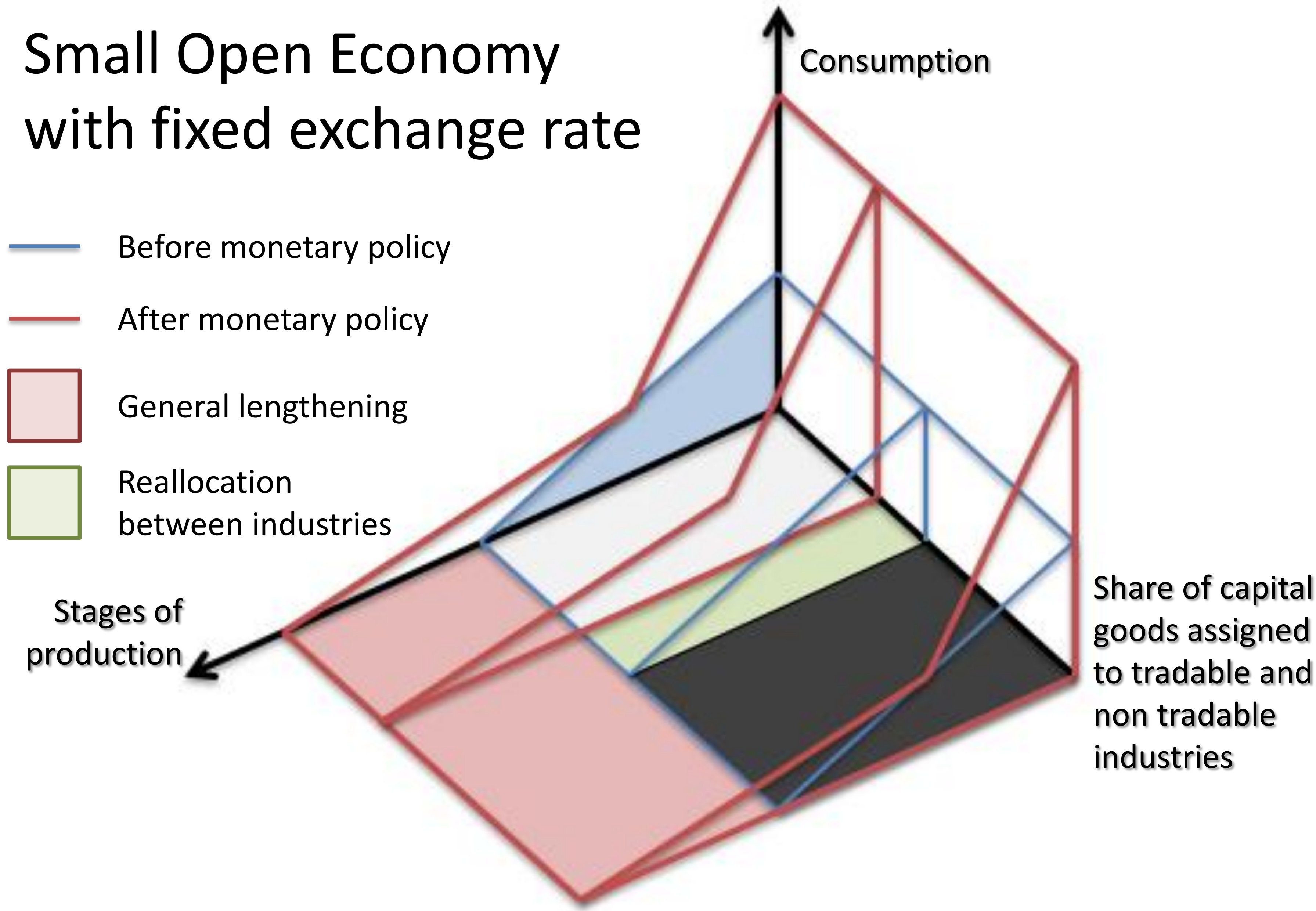
The Effects on Small Open Economies

- The capital structure is affected in *two* dimensions:
  - Length/roundaboutness.
  - Share of capital goods allocated to tradable and non-tradable industries.

Small Open Economy with fixed exchange rate



Small Open Economy with fixed exchange rate



The Effects on Small Open Economies

- The ABCT and alternative business cycle theories in small open economies.
  - If the center follows an expansionary monetary policy, then the liquidity shock is not the *cause* of the crisis, but one of its *effects*.
  - The two distortions in the capital structure *before* the liquidity shock contribute to the explanation of the crisis in the small economy.
  - This point of view can explain contradictions between business cycles and “conventional wisdom” (Canova, 2005).

The Effects on Small Open Economies

- Empirical example:
  - Colombia: floating exchange rate
  - Panama: dollarized economy

	Colombia		**Panama**	
	More roundabout	**Less roundabout**	**More roundabout**	**Less roundabout**
2002-2007 (Accumulated)	31.03%	22.79%	96.40%	46.73%
2002-2007 (Yearly)	5.55%	4.19%	14.45%	7.97%

- Thanks for your time.

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