The International Monetary System: Living with Asymmetry

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Main Themes

• The crisis laid bare global stresses related to the two classic coordination problems the IMF was originally designed to address:

  -- Global liquidity needs

  -- Exchange rates and external imbalances

• Today’s incarnations of these problems differ from those of the Bretton Woods era, pre-1973
Floating Exchange Rates Did Not Fix Everything

- Demand for international reserves still high; Triffin problem still present in modified form
- No rapid return to nearly balanced current accounts
- Distributional and allocative effects – not simply changing the clocks, as Milton Friedman argued
- Worse for EMEs – an *asymmetry* (there are several between AEs and EMEs that motivate my title)
- Every bilateral exchange rate is (still) shared by two countries and external adjustment imperatives remain unequal – another asymmetry
- Successes too … the glass is half full
Financial Globalization a Major Change

- There are benefits, but greater risks
- Inflated gross asset positions imply globally interdependent risks
- Risks of currency mismatch
- Financial risks, if socialized, become sovereign risks (Ireland and others)
- Ease of larger current account imbalances also carries risks (Greece and others)
Financial Globalization: Lane/Milesi-Ferretti Data on Gross Foreign Asset, Liability Positions

Gross external positions as a multiple of GDP, 1970-2007

Switzerland  United Kingdom  Euro Zone  United States  Japan  China
Ireland: Gross External Assets and Liabilities

Ratio to GDP

- **Assets**
- **Liabilities**
- **Net Position**


Graph showing the ratio of assets, liabilities, and net position over time.
Need for International Liquidity

There are two basic issues:

• Heightened *sovereign debt* risks for richer countries
  -- Until recently, viewed as emerging-market issue

• Need for ILLR support in *multiple currencies* to safeguard *financial stability* – and for rich countries too (especially?)
  -- Until recently, *domestic* LLR seemed sufficient
Financial-System Lenders of Last Resort

Example

• European banks holding dollar ABCP in special conduits subject to liquidity (not credit) enhancement
• Or AAA-rated tranches of CDOs
• Enabled reduction in regulatory capital
• Purchases funded by short-term credit from money-market mutual funds
• Currency risk supposedly “hedged;” but what happened when dollar credit dried up?
The International Policy Response

- Central banks such as ECB held small dollar reserves, could not comfortably borrow from markets
- Fed made dollars directly available to foreign banks; also set up swap line, under which ECB, SNB, etc., bore the credit risk
- Other central banks followed suit, setting up swaps
- Eventually Fed lines to ECB, SNB, BOE, BOJ, were uncapped
- Unlike Dillon-Roosa swaps of 1960s, not mainly for b. of p. support
Reserve Demand by Emerging Markets

• Emerging markets have sought *unconditional* liquidity in the form of FX reserves

• For some (Asia), this in part reflects unpleasant past experience with IMF

• The volumes are huge (China now sits on $3.2 trillion of which 2/3 believed to be US dollars)
Systemic Problems from Self Insurance

- Reallocation of outside liquidity, not creation
- Asset-price effects (exchange, interest rates), especially as we near multiple reserve system
- Some reserves don’t materially enhance financial stability
- My neighbor’s reserves may decrease the utility of mine; fear of losing reserves
- Reserve accumulation *may* (but need not) be deflationary at the global level: global imbalances
Reserve Adequacy: Triffin Redux

• Classic Triffin issue was mainly fiscal
• There is a modern-day *Triffin paradox*
• Clear recent statement by Farhi, Gourinchas, Rey (*Reforming the International Monetary System*, CEPR e-book, September 2011).

• If reserve demanders prefer safe government debt (they may not), gross debt may have to rise beyond fiscally prudent levels – making it risky!

• “Internal contradiction” is due to AE/EME asymmetries in economic growth rates, creditworthiness (though the latter may change!)
Uneven Growth: EM/Developing Economies in World GDP

Output shares of advanced and emerging/developing economies (at PPP)

Source: WEO database; projections after 2010
Better Ways to Meet Market Liquidity Needs

• Codify central bank swaps, perhaps run through IMF or BIS directly to qualifying central banks

• Requires higher surveillance of financial stability, partly as a brake on moral hazard; how best to do?

• Need for international coordination, politically independent assessments; perhaps utilize internationally representative committees of independent central bankers, as in BIS working groups

• Need to plan better for national and cross-border resolution of SIFIs (living wills for the latter?)
Meeting Market Liquidity Needs (cont’d)

• Outright reserve pooling superior to transactions involving SDRs and currency transformation

• Credit lines in multiple currencies diminish dollar’s singular role as reserve currency (but not as vehicle currency, where it is by far dominant)

• A larger scale of global LLR operations raises in a major way the issue of *fiscal backup* by member governments – as in the European context

• Participation fees for credit line network?
Sovereign Liquidity Crises

- Crises in Iceland and euro zone (now including Spain, Italy)
- Even countries that print own currencies can get into trouble
- A global, not just euro zone issue
- But euro zone needs more fiscal centralization – otherwise “exit risk” too high
- Example of Russia’s $3.4 billion loan to Cyprus (at 4.5 rather than 14 percent)
- Regional lending useful but may not suffice; is IMF lending ideally a complement or substitute in such cases?
Sovereign Liquidity Crises (cont’ d)

• Expanded IMF resources, flexibility to meet needs of governments in crisis (FCL, PCL, GSM?)
• How to make these attractive relative to reserves?
  -- Low/no ex post conditionality
  -- Stigma
• SDRs?
  -- Merely claims on a reserve pool
  -- Substitution account would require fiscal backup
• Under insolvency (rather than illiquidity) need orderly sovereign debt resolution procedures
• Market participants must recognize threat of default
• *Threat not credible if regulators do not ensure that financial institutions can withstand defaults*
Monitoring Exchange Rates and Imbalances

- Large imbalances can be benign, but often they reflect deeper hazards; cases of U.S., Iceland ….
- Can be harmful even for surplus countries – e.g., banks in Germany funded deficits elsewhere
- Apart from this and protection threat, surplus economies face very limited pressure to adjust
- But that may promote global deflation
- Fund is an obvious referee – what governance reforms would allow it credibly to hand out yellow cards, if not red ones? Needed for lending role too
- Over/undervaluations remain hard to call
- Nor are the best policy responses always clear
- But someone must ask how the pieces fit together
Can the IMF (or Anyone Else) Predict Crises?

- There certainly exist key macro variables that can signal higher probabilities of crises, e.g. domestic credit booms, as documented in Gourinchas and Obstfeld (2011):

![Graph showing trends](image)
Living with the Open-Economy Trilemma

- Exchange rate flexibility remains useful, if no panacea; *asymmetrically difficult for EMEs*
- The trilemma of monetary policy in open economies
- Countries, especially EMEs, may need a small toolkit of standardized, transparent, price-based financial-account levers, triggered by agreed rules
- Such tools could also play a macro-prudential role
- At least better than trade restrictions; but open to abuse and evasion and rarely a first-best response
- EMEs could pursue cooperation *among themselves* to limit damage of currency wars; and that would benefit the U.S. and Europe too
Moderating “Currency Wars”

• Countries dislike inflation and appreciation in response to demand for their currencies
• But if they intervene, creating money to prevent appreciation, they get inflation – later
• Payoff to effective nominal appreciation is –1; payoff to inflation is –0.9 (since it is delayed)
• If Brazil appreciates while China does too, its appreciation loss is only 1 - α. Why?

\[ e_{R}^{\text{eff}} = e_{R}/$ + \alpha e_{$/Y} \]
\[ e_{Y}^{\text{eff}} = e_{Y}/$ + \alpha e_{$/R} \]
IMF staff has a role to play in quantifying and advertising such cooperation gains, bringing US into the bargain.
Deeper Moral of All This

• What is the main challenge at the regional (e.g., eurozone) and global levels?

  National sovereignty and self-interest – as expressed through democratic political processes – are not inherently friendly to globalization

  To support the expanded globalization of markets, the globalization of governance institutions must expand as well