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

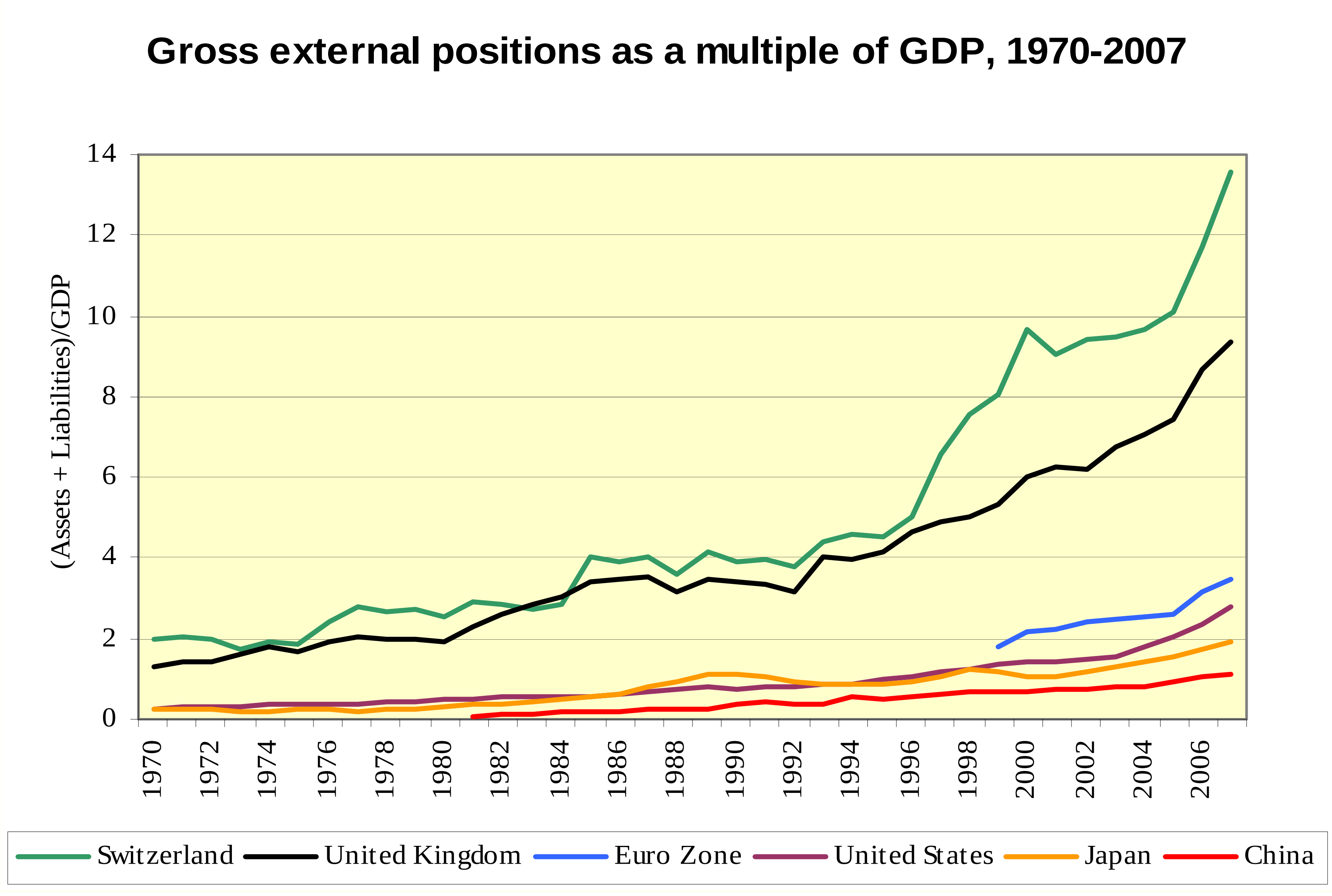
Floating Exchange Rates Did Not Fix Everything

- 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

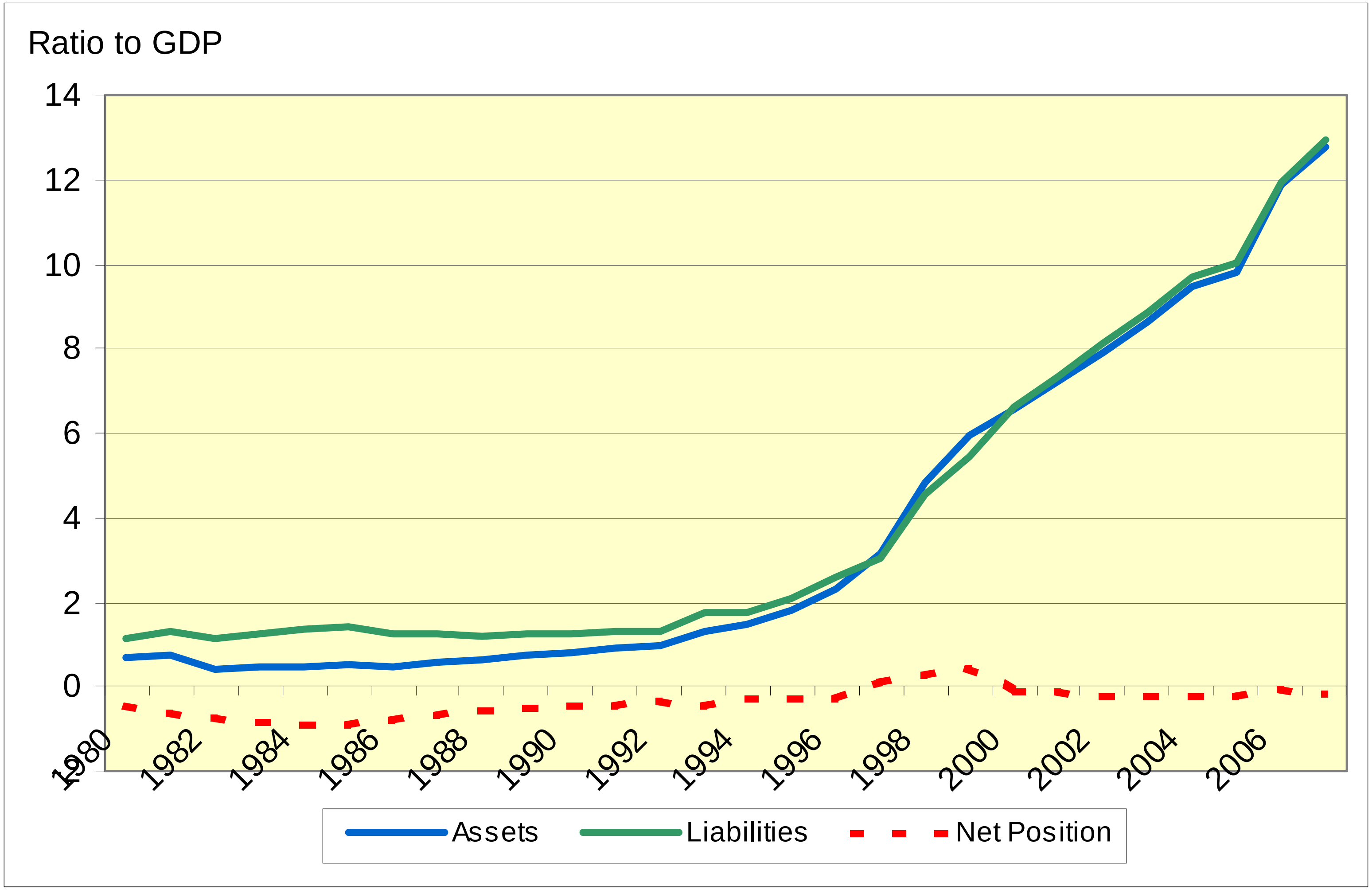
Financial Globalization a Major Change

- 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



Ireland: Gross External Assets and Liabilities



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

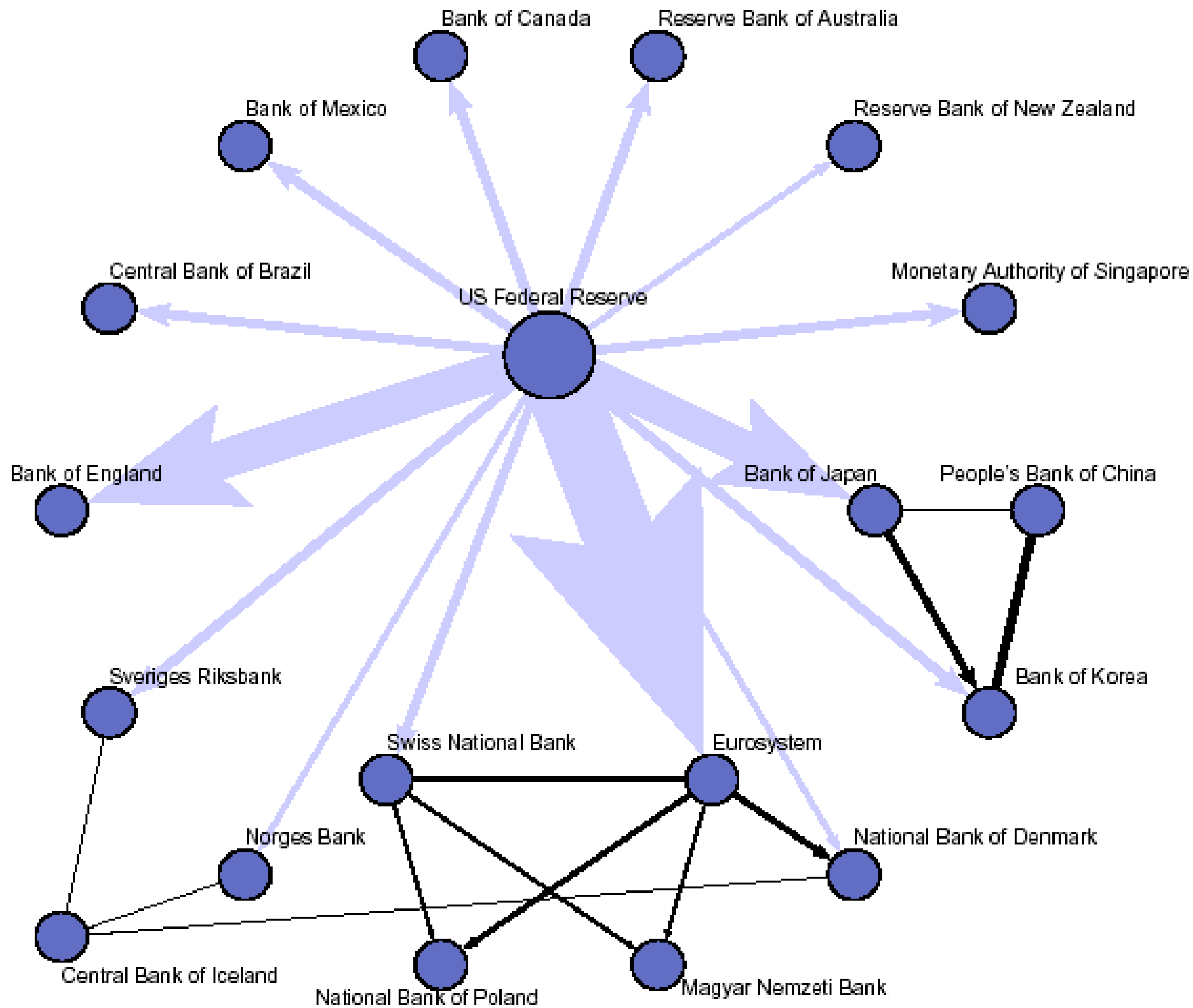
Financial-System Lenders of Last Resort

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

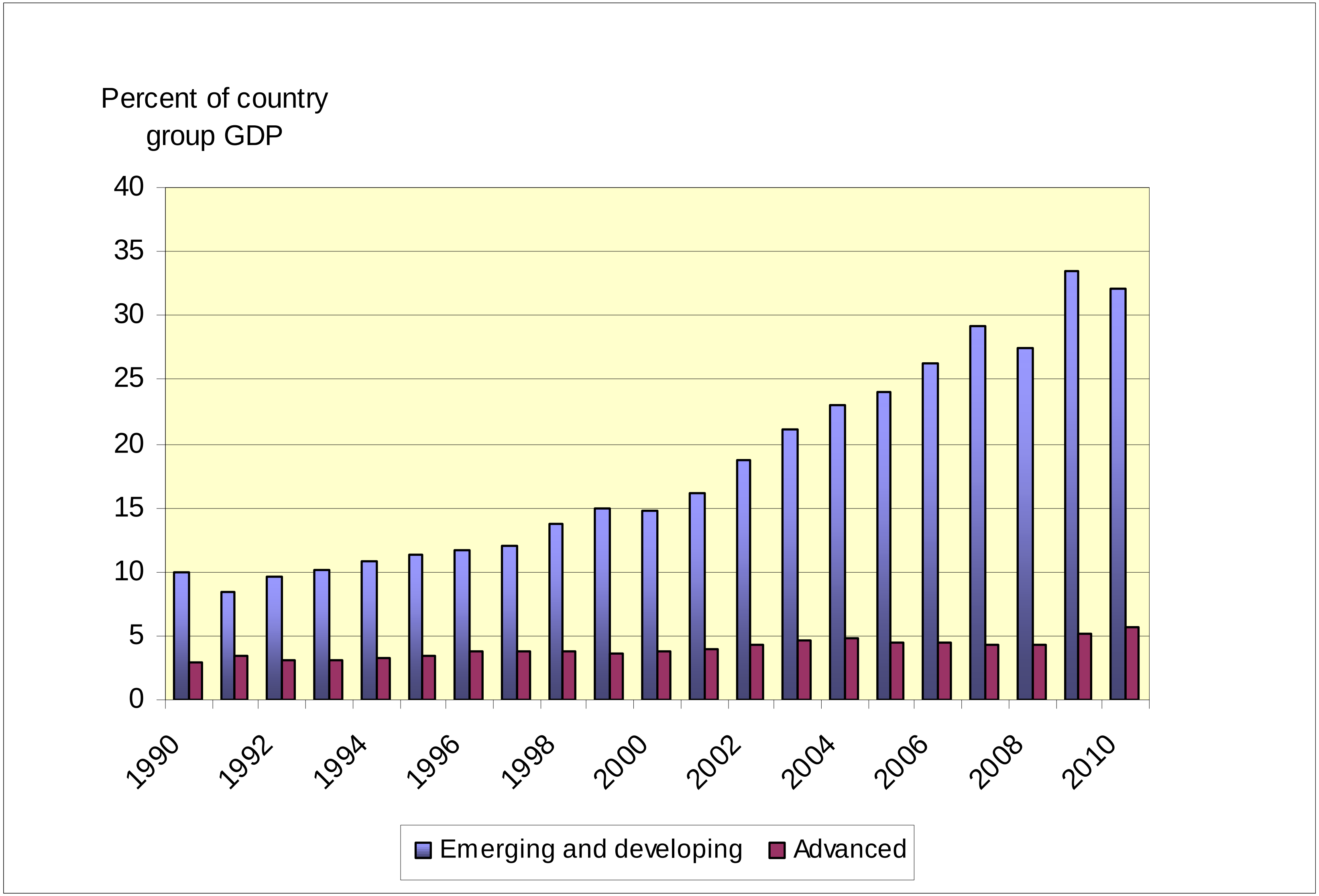


Source: Patrick McGuire and Goetz von Peter, "The US Dollar Shortage in Global Banking and the International Policy Response," BIS Working Papers No. 291, October 2009, at http://www.bis.org. Light arrows are USD, dark arrows other currencies. Arrows show direction of flow (if known).

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)

Global Foreign Reserves



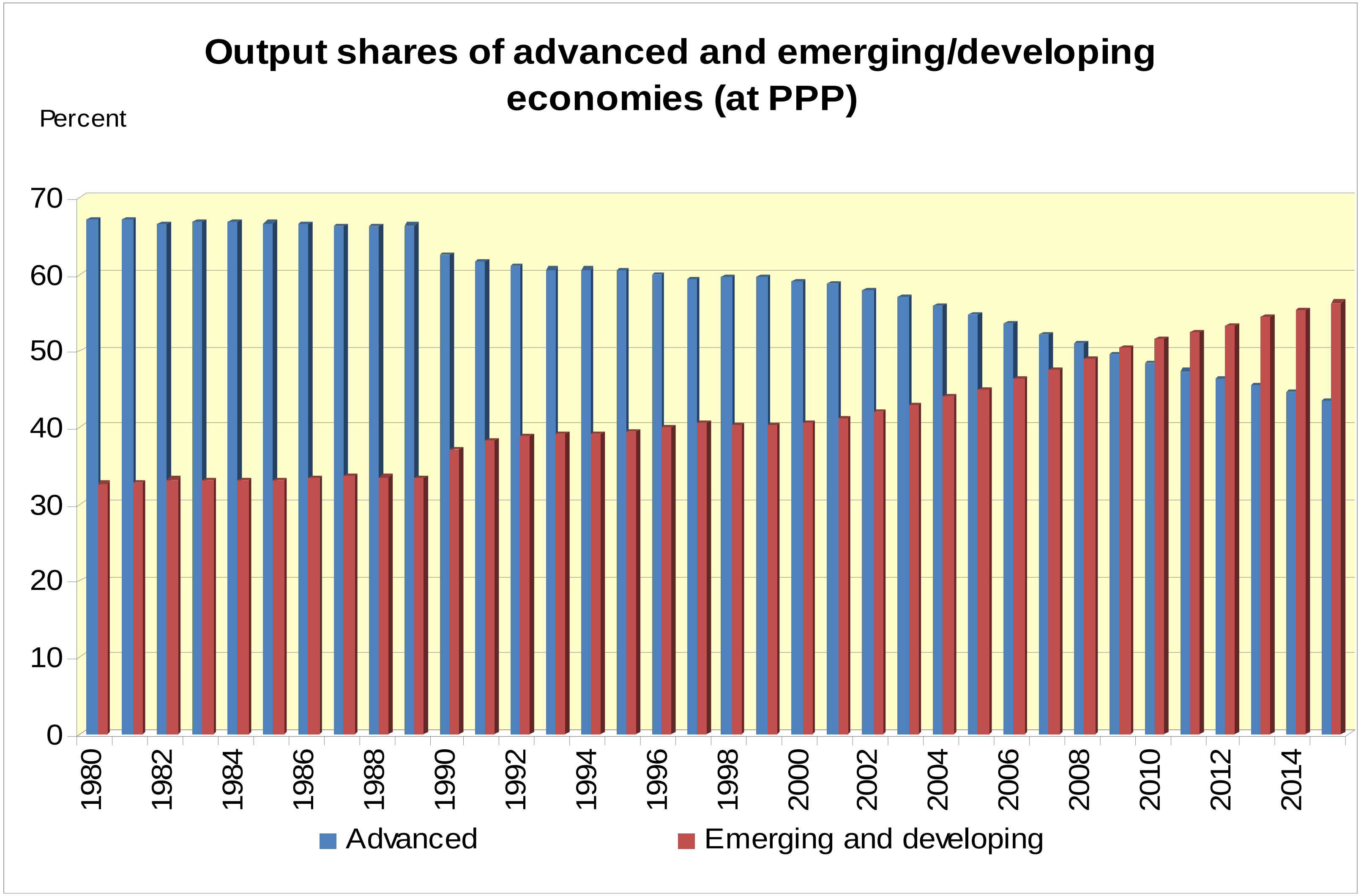
Systemic Problems from Self Insurance

- 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



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 <u>moral hazard</u>; 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

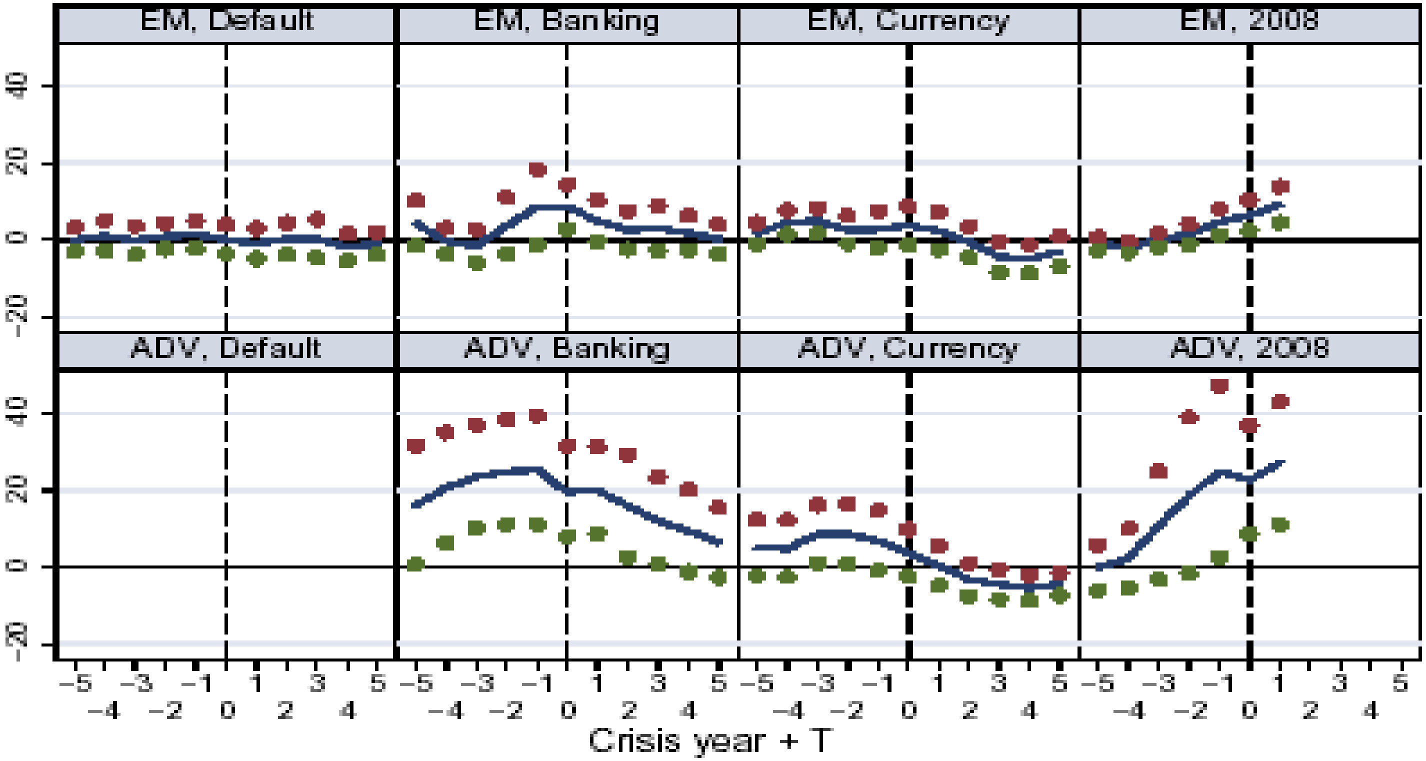
  -- Substitution account would require fiscal backup
- Under insolvency (rather than illiquidity) need orderly sovereign debt resolution procedures
- Market participants must recognize threat of default
- *Threat not credible if regulators do not ensure that financial institutions can withstand defaults*

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):



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?

$$e_R^{eff} = e_{R/\$} + \alpha e_{\$/Y},$$

$$e_Y^{eff} = e_{Y/\$} + \alpha e_{\$/R}.$$

		China	
		Fix	*Appreciate*
Brazil	*Fix*	$-.9, -.9$	$-(.9-\alpha), -1$
	Appreciate	$-1, -(.9-\alpha)$	$-(1-\alpha), -(1-\alpha)$

Figure 11: Coordination Failure in an Intervention Game

• 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