Lecture 18 – International Economics
The International Financial System and the Global Financial Crises

Preview

- Introduction to the current system of international governance
- The International Monetary Fund and its policies
- International financial markets
- Financial globalization and financial crises
- Lessons to be learnt from crise

The International Economic Governance

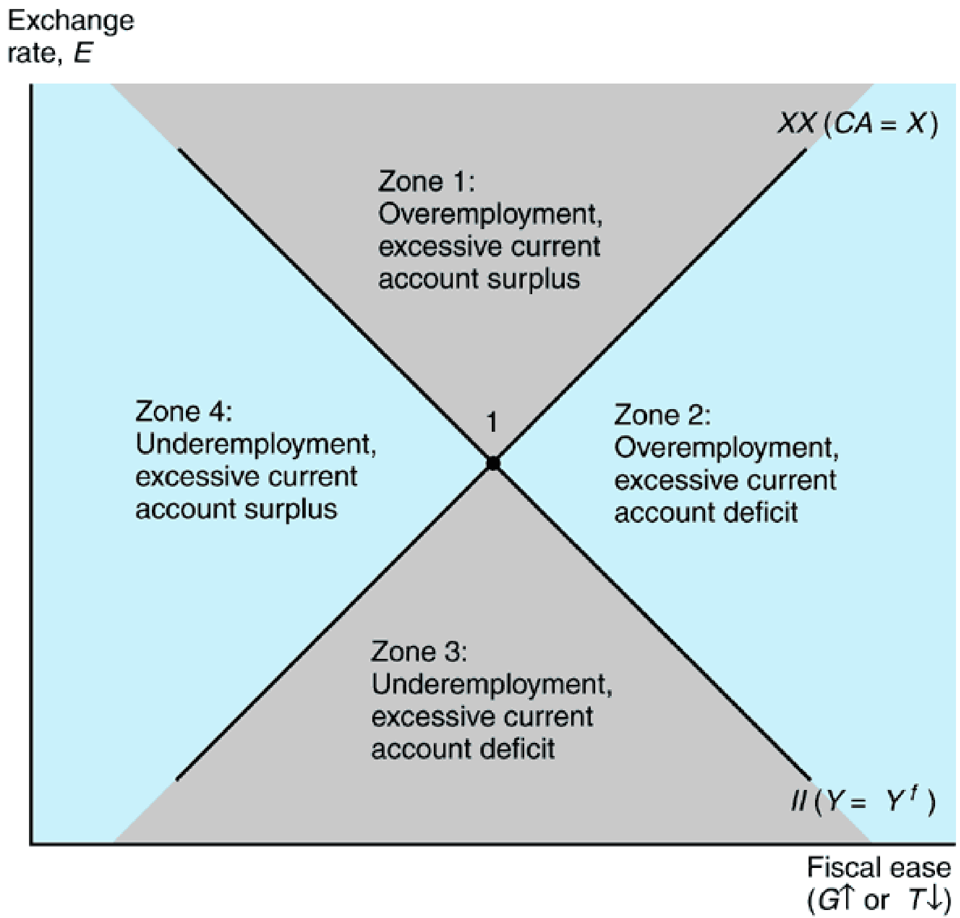
- The present global governance of international economics stem from the **Breton Woods** treaty (1944)
- The architecture is due to J.M. Keynes and is based on three major institutions: the **IMF** (to attain financial stability), the **IBRD** (to coordinate development strategies) and the **WTO** (to manage international trade).
- Only the IMF and IBRD were born in Bretton Woods, while the WTO was only founded in 1994, with the Marrakech Treaty.
- Originally, the IMF set up a system of fixed exchange rates:
  - All currencies had fixed exchange rates against the USD and an unvarying dollar price of gold ($35 an ounce).
  - It intended to provide lending to countries with current account deficits, for stabilization purposes
  - It called for currency convertibility.

The IMF: Goals and Policies

- The IMF Agreement tried to incorporate sufficient flexibility to allow countries to attain external balance without sacrificing internal objectives or fixed exchange rates.
- Two major features of the IMF Articles of Agreement helped promote this flexibility in external adjustment:
  - IMF lending facilities are based on **IMF conditionality:** the surveillance over the policies of member counties that borrow Fund resources.
  - Adjustable parities
- The IMF functioning adapted to the post-1973 system of flexible exchange rates, although subject to strong criticism by countries, social movements and critical economists

Policies Options in a Flexible Exchange Rate Regime

Internal Balance (*II*), External Balance (*XX*), and the "Four Zones of Economic Discomfort"



The IMF: Goals and Policies (2)

Goals

- To promote international cooperation through the coordination of exchange rate policies
- To enhance international trade
- To build a multilateral system of payments
- To help attain trade balance and eliminate public budget deficits

Functions

- To monitor the international financial system and the policies of individual countries
- To provide financial assistance
- To provide technical assistance

Policy structure

- The IMF is basically a bank, and control depends on the majority of shares
- G8 + EU: 56% of the shares. US alone has 18% of the shares (strong veto power according to IMF rules)

The IMF: Goals and Policies (3)

Goals

- The IMF is lending conditional to the implementation of economic reforms (the recipe needed, according to the IMF, to solve macro imbalances)
- The lending is requested when there are imbalances in the BoP, when there is a debt crisis, when there are pressures on the exchange rate
- It is not financing development;
- More or less, lending is subject to the current market conditions.

The *conditionalities*

- Spending review to stabilize debt and to provide macroeconomic conditions to growth
- Restrictive monetary policies to stop inflation and stabilize the currency
- Structural reforms to modernize the country
- Liberalize the markets to trigger efficiency in the allocation of resources
- Privatize, to trigger efficiency, diminish corruption and the public debt.

International Capital Markets

- International capital markets are markets trading different types of financial and physical assets (capital): stocks, bonds (government and private sector), deposits denominated in different currencies, commodities (like petroleum, wheat, bauxite, gold), forward contracts, futures contracts, swaps, options contracts, real estate and land, factories and equipment, derivatives.
- Buyers and sellers can trade:
  - goods or services for other goods or services (the theory of **comparative advantage** describes the gains from trade of goods and services for other goods and services)
  - goods or services for assets (the theory of **intertemporal trade** describes the gains from this type of trade between today's assets and tomorrow level of consumptio.
  - assets for assets (theory or just speculation?)

Portfolio Diversification

- The theory of **portfolio diversification** describes the gains from trade of assets with one type of risk for assets with another type of risk.
  - Investing in a diverse set, or portfolio, of assets is a way for investors to avoid or reduce risk.
  - People usually display **risk aversion**.
  - If value is created through the exchange of assets, mutual advantages appear.
  - However, value quickly disappear, particularly when derivative products are traded and in high-frequency trading.
  - There is a thin line between value creation and speculation, in a changing world where regulation and control over banks is less and less effective

Financial Speculation

- Generally, investment can take two forms:
  - **Real Investment**: the goal is profit and its distribution to shareholders
  - **Financial Investment**: the goal is the **capital gain** (increase in the value of the asset).
  - While the capital gain is value creation for the financial firm, it is commonly defined speculation.
  - Non financial firms are increasing their interest in financial investment, implying a radical change in the management strategy: the **investment horizon** shifts from the long term (profit) to the short term (*capital gain*).
- **Consequences:**
  - Instability and economic unsustainability if the growth rate of financial markets is larger than real economic growth rate
  - Strong volatility, financial bubbles and panic crises.

Trader 1 - I've got a stock here that could really excel...
Others - Really Excel? Excel? Sell? Sell! Sell!

Trader 2 - This is madness! I can't take it anymore. Good Bye!
Others - Good Bye? Bye? Buy? Buy! Buy!!

Trader 3 - I've got a stock here...

Kal, The Economist, 1 Novembre 1997.

Financial Crisis as a “Perfect Storm”

- Financial crises periodically happen when a **certain mix** of macroeconomic imbalances, economic policies and financial disequilibrium appear.
- They become more frequent and deeper since international financial integration between markets (**quicker international contagion**).
- A general framework to explain crises:

  1. Evolution of financial markets:

     1.1 Financial innovation

     1.2 Insufficient or uneffective (de)regulation and lack of a coordinated vigilance authority

  2. Macroeconomic external and internal imbalances

  3. Ineffective or contradictory macroeconomic policies and reforms.

Financial Innovation

- Research in Finance and the development of ICT allowed:
  - Strong development of **derivative products**: financial assets which value depends on the trend of a fundamental asset.
  - **Securitization:** creation of assets through selection and aggregation of other assets.
  - Exponential growth of **over-the-counter** transactions in real-time.
  - Development of **offshore banking** and other ways to avoid taxes and regulation.
- **Consequences:**
  - From investment to speculation to betting.
  - Regulators are always one step behind than financial markets.
  - Dangerous interconnection between finance and criminality.

Deregulation of Financial Markets

- **Free capital movement** is one of the main characteristcs of the globalization process:
  - Since the 1970s: abolition of fixed commissions on transactions.
  - Since the 1980s: Reduction and elimination of limits and controls on capital transfers
  - 1999: Abolition of the Glass-Steagall Act, which was separating commercial and investment banks.

- **Consequences:**
  - **Increasing market concentration** (JP Morgan Chase, Morgan Stanley, Citygroup, Bank of America, Goldman Sachs, UBS, Lehman Brothers)
  - Increasing returns mainly stemming from increasing risk.
  - *Race to the bottom* and **moral hazard** behaviour (**too big too fail**)
  - Quick international contagion and difficult interventions (**too big to save**)

Deregulation of Financial Markets (2)

- Policies have been partially reversed after the crisis:
- **Dodd-Frank Act** in the **U.S.** (2010)
  - It allows the government to regulate "systemically important" nonbank financial institutions and to take them over in case of failure.
  - It prohibits commercial banks from making certain types of speculative investments (**Volcker rule**).
- **EU**: new financial supervision architecture (2011)
  - European Systemic Risk Board (ESRB) for macro-prudential oversight of the financial system
  - European Banking Authority, European Insurance and Occupational Pensions Authority, and European Securities and Markets Authority.
  - Bank surveillance is unified under the ECB, rather than national Cbs.
- Measures are subject to strong political pressure and might be changed

Macroeconomic Internal and External Imbalances

- Policies are effective in the short run, but they create / worsen **macroeconomic imbalances** if they become permanent:
  - Government budget / Sovereign debt crisis
  - Current Account / Reserve crisis
  - Inflationary pressure / Exchange rate crisis
  - These imbalances often develop together, worsening the situation
- **Consequences:**
  - Foreign capitals are first attracted, because of higher returns stemming from increasing risk
  - However they know that stabilization policies will have to be implemented, or changes in the economic fundamentals will appear
  - **Hit-and-run** sort of behaviour, which is connected with bank run and **financial panic**.
  - The financial crisis will eventually happen, although it is almost impossible to predict when.

Macroeconomic Internal and External Imbalances (2)

- Many recent example:
  - The cumulate **deficit in the US current account** between 1999 and 2007 is 4600 USD mld (¼ of the GDP); In those years, the external debt of the US was multiplied by 4, becoming 13400 USD mld.
  - Symmetrically, the **Chinese Trade Surplus** is 10% of the GDP and China has foreign assets equal to 2800 USD mld.
  - Latin American imbalances in the 1908s: inflation, public and external debt.
  - East-Asian crisis of 1997, mainly due to **moral hazard** and insufficient bank regulation and monitoring
  - Russia crisis of 1998: too much government spending, **weak institutions** and regulations.

Cumulative Current Account Balances, 1973–2009 (billions of dollars)

TABLE 22-3 **Cumulative Current Account Balances of Major Oil Exporters, Other Developing Countries, and Advanced Countries, 1973–2009 (billions of dollars)**

	Major Oil Exporters	Other Developing Countries	Advanced Countries
1973–1981	363.8	–410.0	7.3
1982–1989	–135.3	–159.2	–361.1
1990–1998	–106.1	–684.2	51.1
1999–2009	2,647.9	984.7	–3,134.7

Source: International Monetary Fund, *World Economic Outlook*, various issues and online database. Global current accounts generally do not sum to zero because of errors, omissions, and the exclusion of some countries. Numbers for 1999–2009 are authors' estimates based on the preceding sources.

Ineffective and Contradictory Macroeconomic Policies

- Most of the crises have been fuelled by contradictory or short-sighted economic policies:
  - Greenspan doctrine of "**great moderation**": continuous increase in money supply to finance the US **twin deficit** and to back financial markets (but help creating financial bubbles)
  - **Inability to keep fiscal policy under control** (for many Latin American countries) which led to inflationary policies, aggravated by the impact of external shocks and by the "**original sin**".
    - When low and middle-income countries borrow in international financial markets, their debts are denominated in USD, yen, or Euro:
    - When a depreciation/devaluation of domestic currency occurs, the value of their liabilities (debt) rises, implying a decrease in net foreign wealth.
  - Contradiction / unsustainability of f**ixed exchange rate policies** (such as currency boards or dollarization.

Currency Boards and Dollarization

- A **currency board** is a system where the money supply is entirely backed by foreign currency, and where the central bank is prevented from holding domestic assets.
  - The central bank may not increase the domestic money supply by buying government bonds, **stopping inflation and government deficit**.
  - A currency board is more restrictive than a regular fixed exchange rate system, since it does not allow the Central Bank to act as lender of last resort to domestic banks during a financial crisis.
- **Dollarization** is a monetary policy that replaces the domestic currency in circulation with U.S. dollars: control of domestic money supply, interest rates, and inflation is given to the Federal Reserve System.
- These policies are effective iif the macroeconomic fundamentals of the two countries are aligned. Otherwise a devaluation is expected, triggering a financial crisis (e.g. Argentina).

Lessons of Crises

- Countries face **tradeoffs** when trying to achieve the following goals: 1. exchange rate stability; 2. financial mobility; 3. autonomous monetary policy devoted to internal balance.
- The **open economy trilemma**: generally, countries can attain only 2 of the 3 goals.
- As financial assets have become more mobile, maintaining a fixed exchange with an autonomous monetary policy has been difficult.
- Fixing the exchange rate has risks: high interest rates and too restrictive economic policies (high unemployment).
- An autonomous monetary policy (to support government deficit or aggregate demand) results in inflation and pressure for devaluation.
- A fixed currency may encourage banks and firms to borrow in foreign currencies, but a devaluation will cause an increase in the burden of this debt and may lead to a **banking crisis and bankruptcy**.

Lessons of Crises (2)

- **Weak enforcement of financial regulation** can lead to risky investments and a banking crisis when a currency crisis erupts or when a fall in output, income, and employment occurs.
- Liberalizing financial flows without implementing a sound financial regulation can lead to **capital flight**.
- The importance of expectations: even healthy economies are vulnerable to crises when **expectations change**. Expectations about an economy often change when other economies suffer from adverse events.
- International crises may result from **contagion**: an adverse event in one country leads to a similar event in other countries.
- The importance of having **adequate official international reserves**: Official international reserves are needed not just for a current account deficit, but more importantly to protect against capital flight due to speculation and expectations about financial crises.