Imbalances and the International Monetary System

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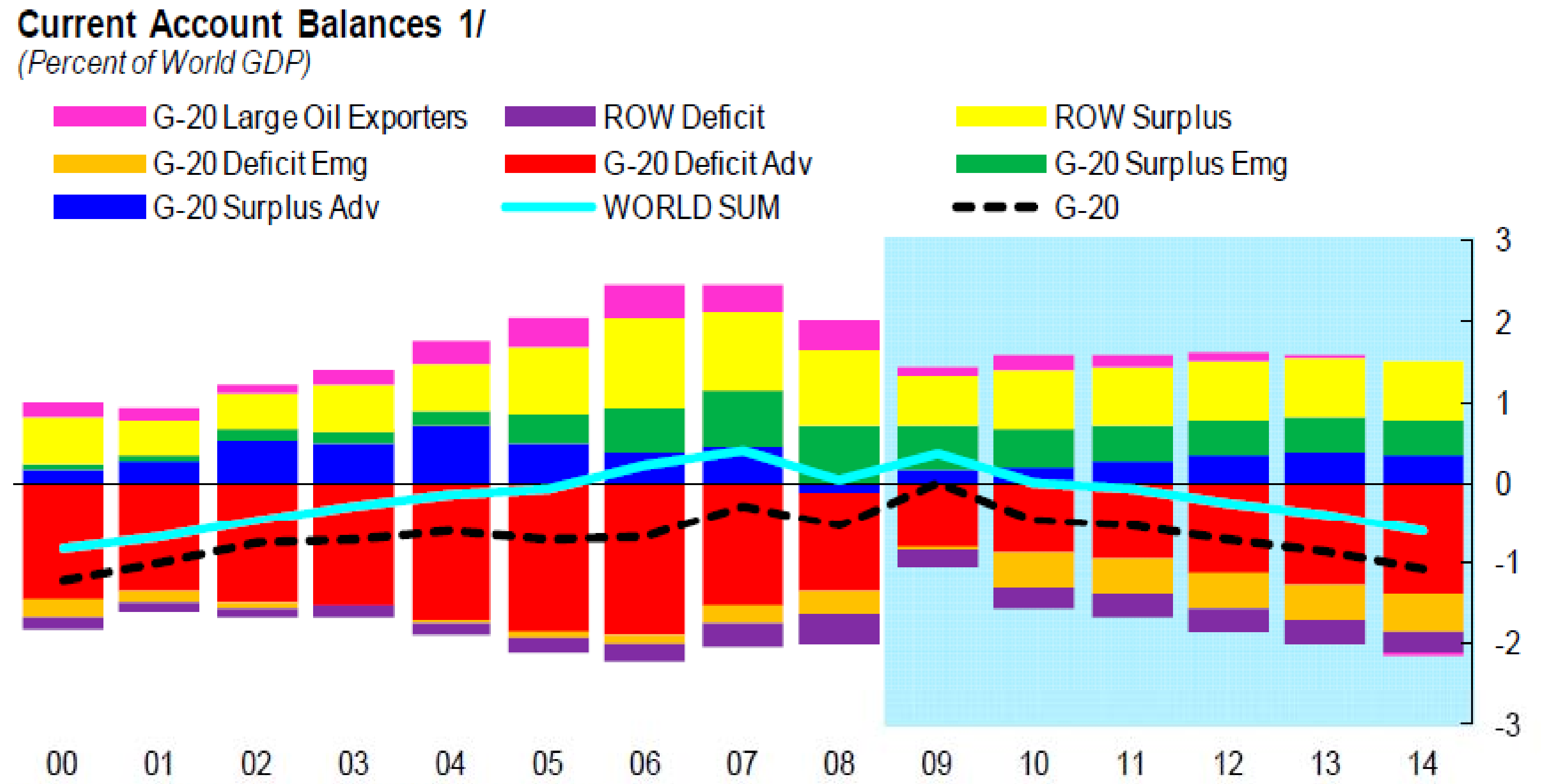
Balance sheet of countries

- Crisis has put centre stage the importance of modelling (monitoring!) carefully balance sheets of financial intermediaries
- Capital flows and external balance sheets of countries equally important
- International Monetary System and balance sheets of countries intimately linked

Facts and projections



Sources: G-20 authorities and IMF staff estimates.
1/ 2000-2008 reflects WEO data; 2009-2014 reflects MAP estimates and projections for G-20 countries and WEO projections for ROW.

Capital flow bonanzas and expansionary monetary policy

- Have put pressure on US financial system
- Mechanics known but US special. Large demand for dollar assets: destination of choice for capital flows (but financial systems in UK, Ireland, Spain, Portugal, Greece, etc... also under pressure)
- Flows have financed US consumption
- Low real interest rate and search for yield
- Regulators asleep, ratings agencies complicit

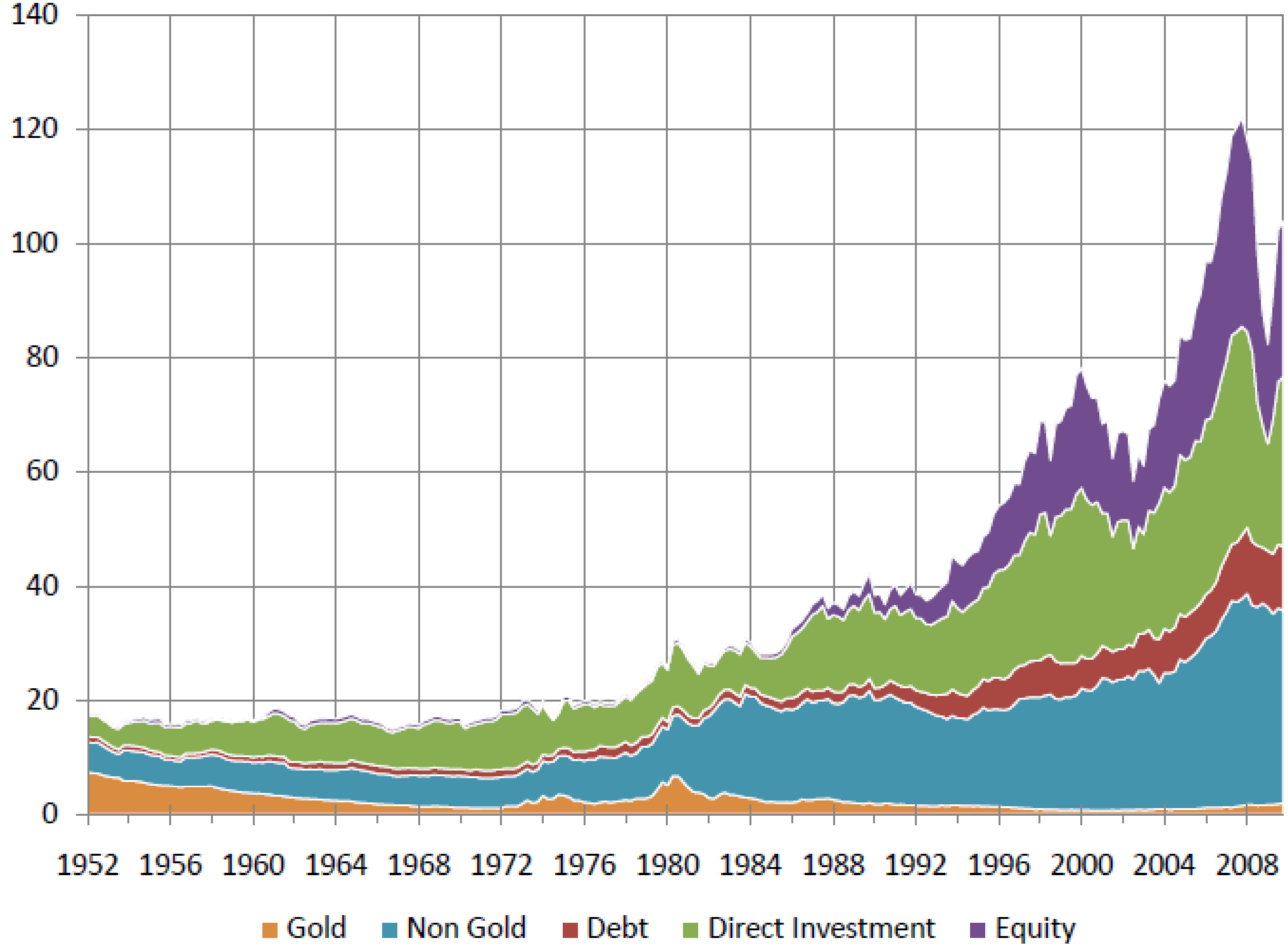
⇒ Excessive risk taking and leverage

Crisis at the core of the international monetary system

- Dollar is the international currency
- Many aspects: vehicle currency on forex, dollar pegs, currency of invoice for trade etc...
- World Banker. US is the issuer of international liquidity. It issues safe liquid liabilities ($ cash, T-Bills, ...) and invests in longer-term riskier assets

Source: Gourinchas, Rey, Govillot (2010)

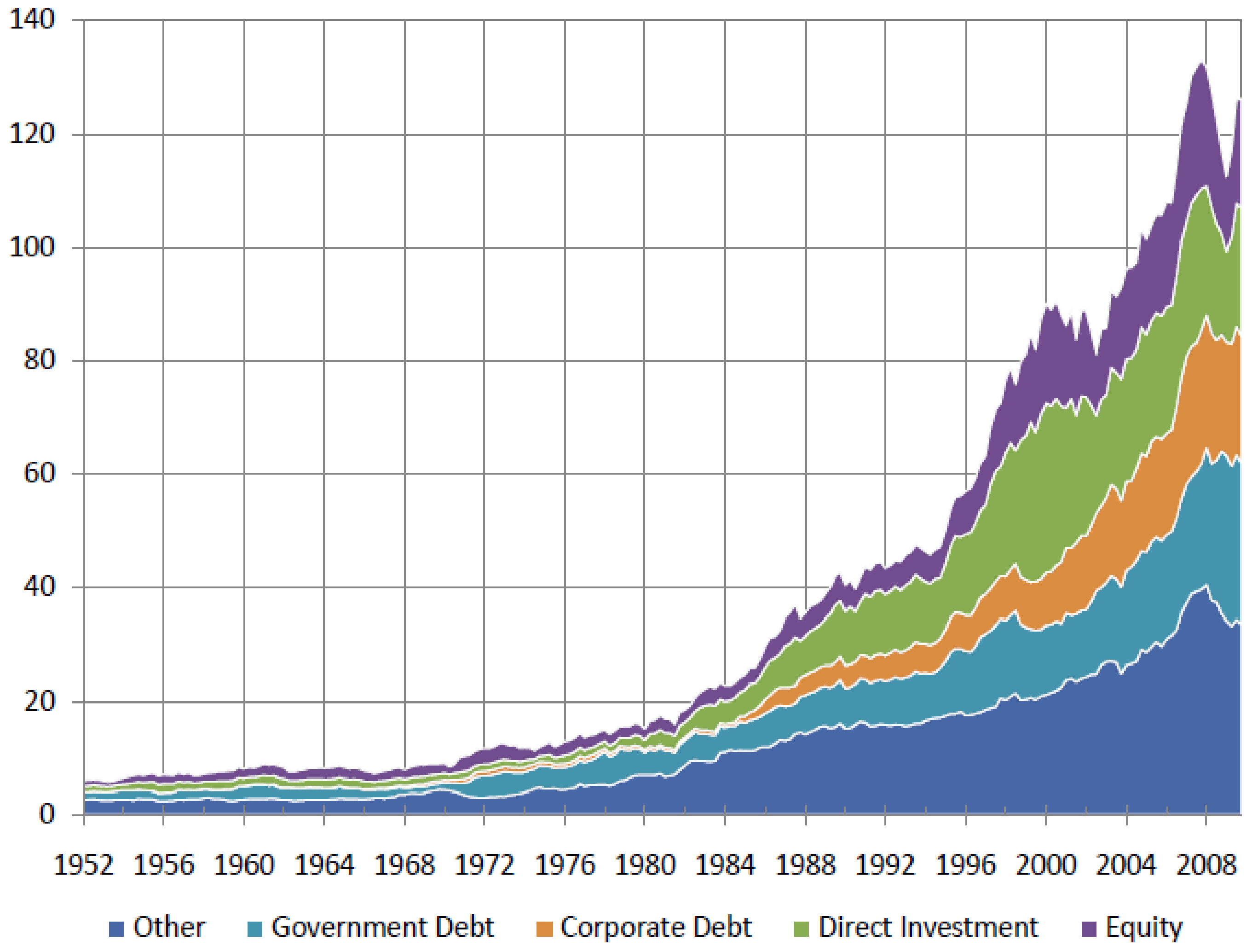
US Gross Asset Position (percent of output)



Source: BEA, SCB, 1941-43 Treasury Surveys, and authors' calculations

Source: Gourinchas, Rey, Govillot (2010)

US Gross Liabilities Position (percent of output)



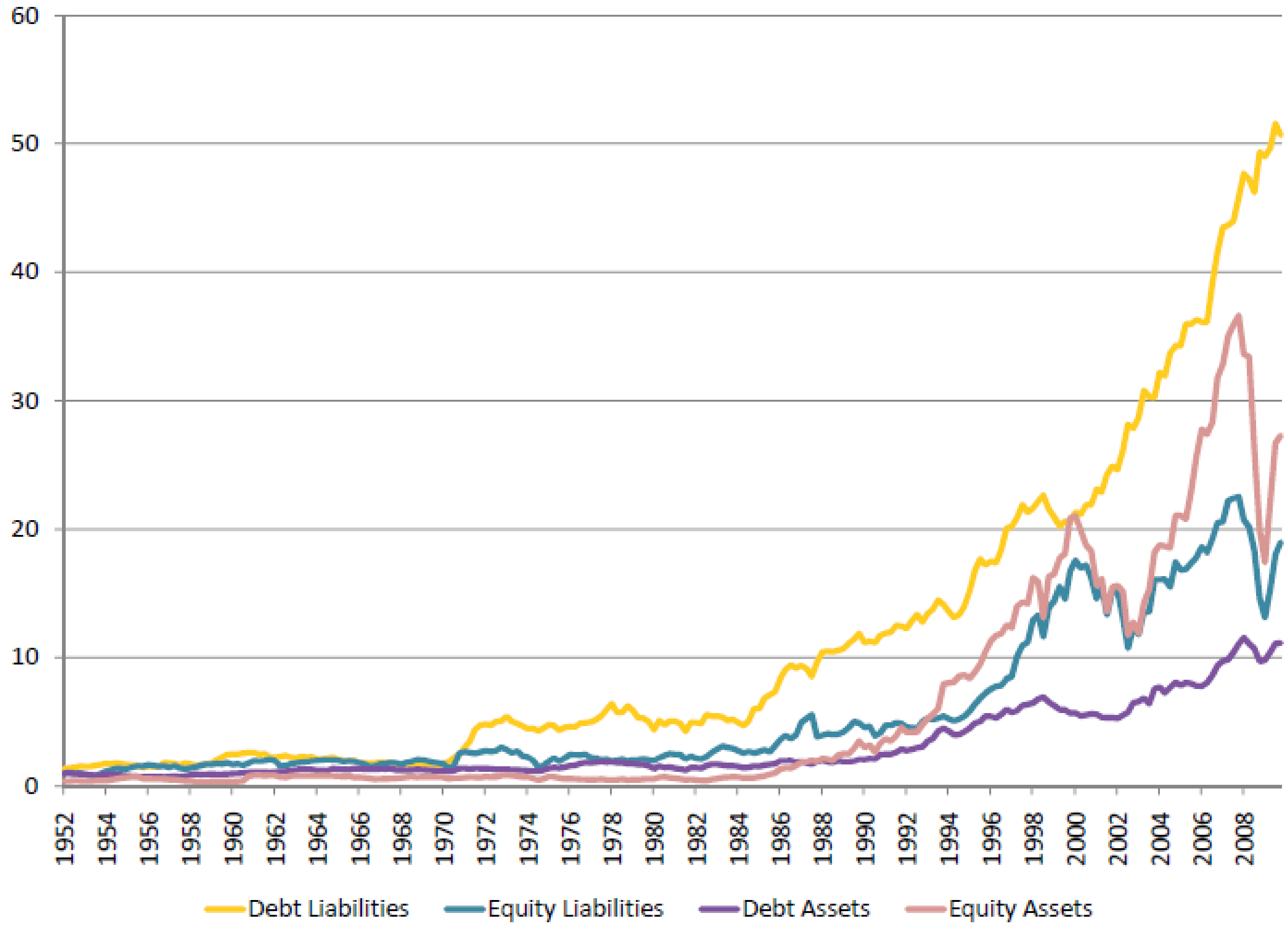
Source: BEA, SCB, 1941-43 Treasury Surveys, and authors' calculations

International currency

- Earns a non trivial excess return on the net foreign asset position
- Safe haven properties
- Coordination of agents on the international currency in crisis time
- Role of US government liabilities (T-bills)

Source: Gourinchas, Rey, Govillot (2010)

U.S. External Debt and Equity, percent of US GDP



Source: BEA, SCB, 1941-43 Treasury Surveys, and authors' calculations

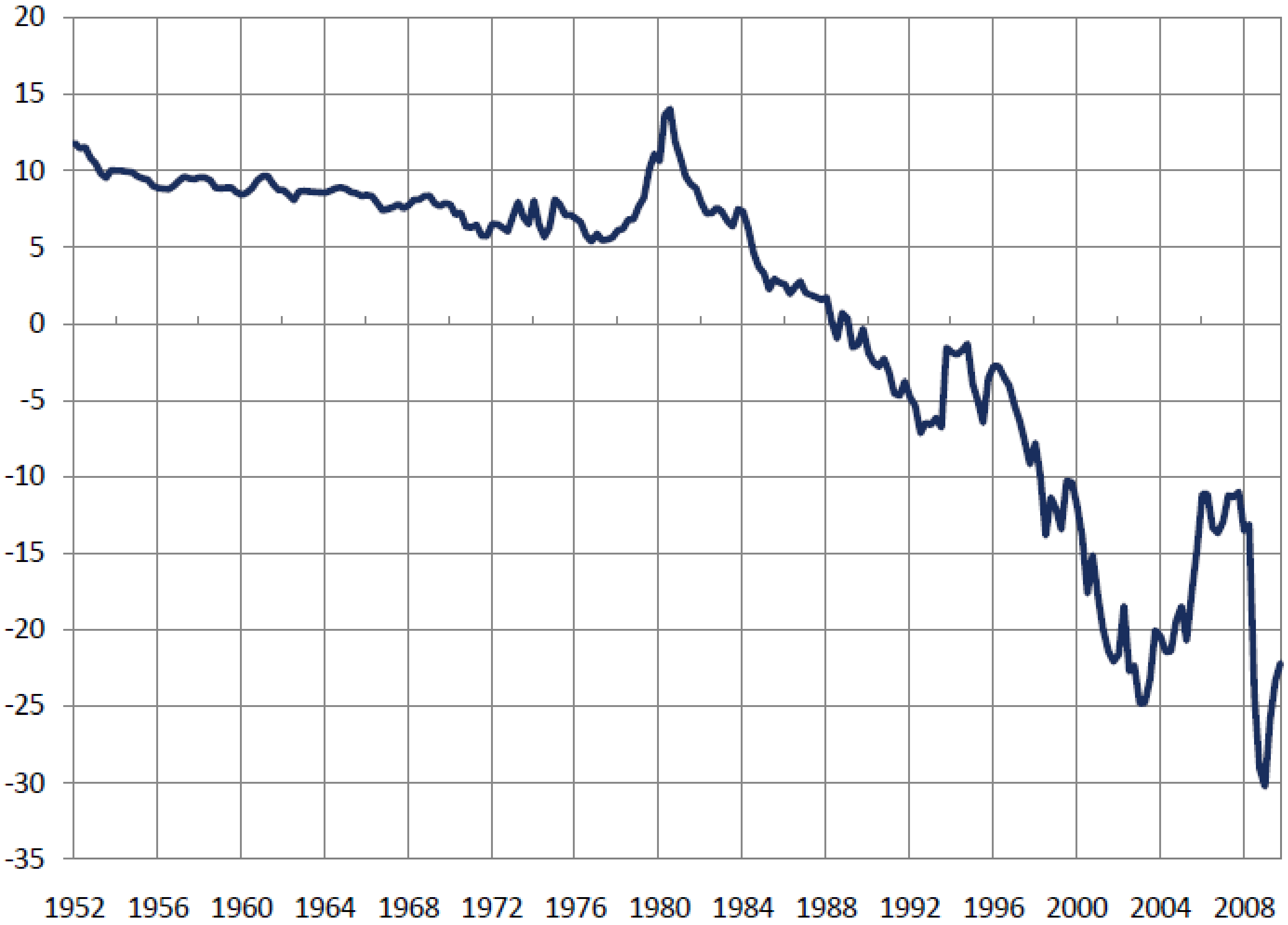
Triffin Dilemma

- In the 1960s: dollar international currency convertible into gold at a fixed rate
- As international liquidity expanded (stocks of dollars held abroad increased), probability of a run on the dollar went up, since US gold reserves finite
- Current account deficits increase probability of a run (gold reserves decrease)

New Triffin Dilemma?

- Country providing international currency issues large amounts of liquid **GROSS** external liabilities (needed for international liquidity)
- Not necessarily current account deficits but very large gross positions

US Net Foreign Asset Position (percent of output)

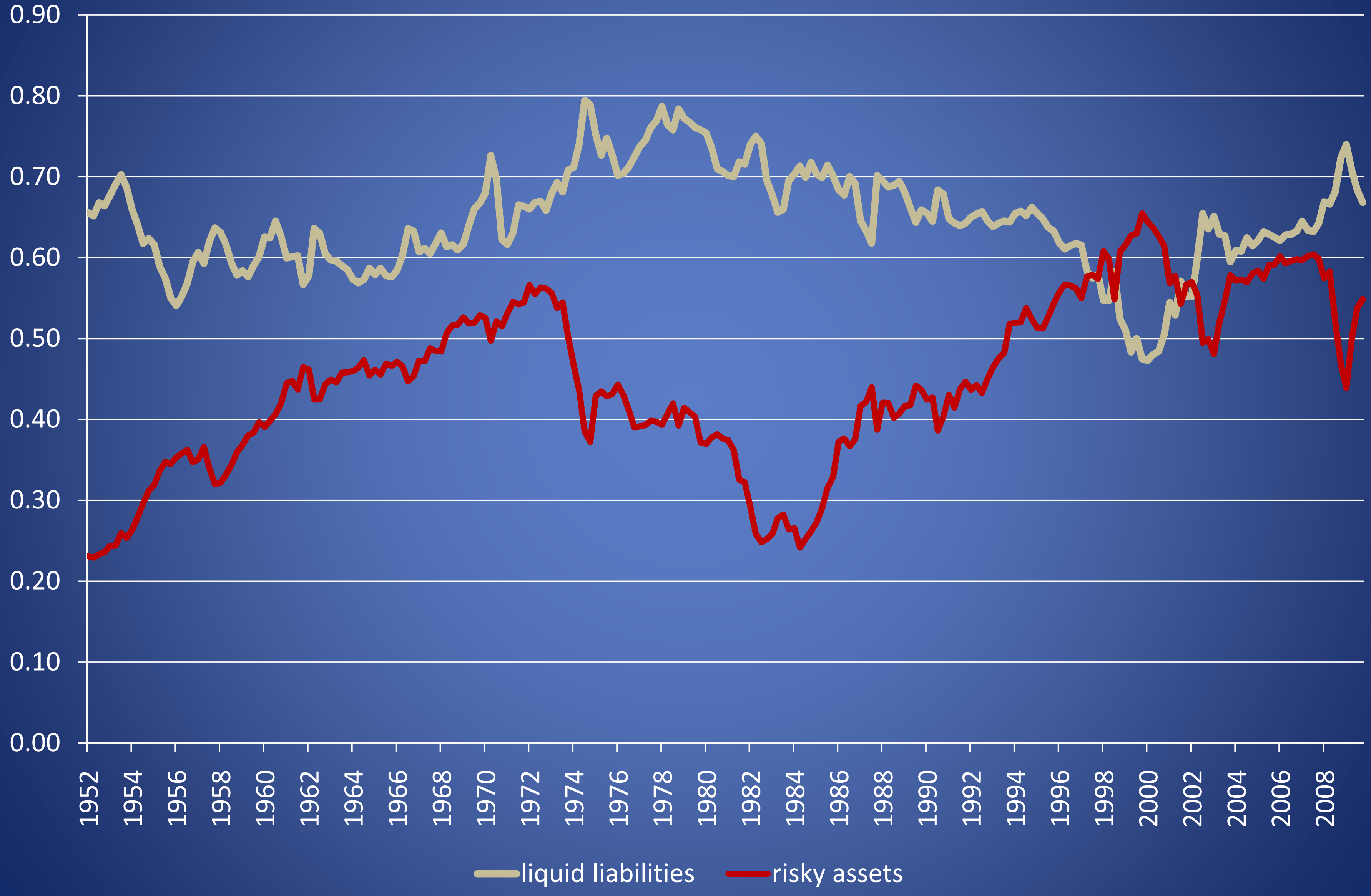


Source: BEA, SCB, 1941-43 Treasury Surveys, and authors' calculations

Two KEY FEATURES: LIQUIDITY. SAFETY.

- Valuation effects important and maturity mismatch: runs on the dollar increasingly possible as net external asset position goes down
- Treasuries safe assets: depends on fiscal capacity of the US

Liquid Liabilities (% of total L) &Risky Assets (% of total A)



Liquid liabilities are debt and bank loans; Risky assets are equity and FDI

Summary: Issues with the organization of the International Monetary System

- Capital flows (saving investment imbalance), low real rate, weak regulation put pressure on financial systems (Portes 2010).
- Fire sale externality (Krugman, Kashyap and Stein,..)
- True for emerging markets or Spain etc..., but worse consequences when in centre country (US) and because of international currency status (longer build up).

Summary: Issues with the organization of the International Monetary System

- New “Triffin dilemma” inherent to centre country status: large amount of gross short term external liabilities for the liquidity providing country. Makes it vulnerable to runs.
- Requires high fiscal capacity of the Centre country.

Implications for macro prudential regulation

- Closer monitoring by regulators of credit booms, need for more indicators
- Particularly important for centre country or country with some international currency status (longer build up)

Implications for international monetary system

- Possible leads for future research:
- Reconsider the desirability of a more multipolar world with several international liquidity providers
- In the past, such a world has been dismissed on the grounds of network externalities in currency use and undesirable instability of portfolios (more substitutability means more portfolio shifts and exchange rate volatility)

Implications for international monetary system

- Eichengreen and Flandreau (2009) historical evidence puts strength of network externalities for reserve currency status into question (interwar switches between dollars and sterling)
- Exchange rate instability due to portfolio shifts may not be so much larger than current one!
- Fiscal capacity constraint may be binding for a country as world economy grows

Implications for international monetary system

- Benefits of the multipolar world could be a sharing of maturity mismatch/leverage risk across centre countries/fiscal capacity
- Benefits could be a better discipline imposed on current accounts
- Benefits could also be a better discipline on financial innovation via competition of financial centres (but we could –and I think we would- also see excessive risk taking to gain market share!)

New candidates for international currencies

- SDR? No lender of last resort in SDRs, no markets
- Yen: debt to GDP an obstacle, yen markets not very internationalised
- Yuan: needs a lot of build up of the financial markets in China (and convertibility). Political will seems there. Takes time.
- Sterling or Swiss Franc: too small

New multipolar system?

- Euro: needs better governance (in particular for crisis)
- Euro T-bill market would help
- Could make one where only some countries would be allowed to issue a fraction of their debt. Fully guaranteed by treasuries of those countries.
- Would act as a “carrot” for euro area countries to be more fiscally responsible
- Better pricing of risk of euro area bonds

Conclusions

- Is it the first order issue?
- G20 new Chair seems to think so