THE UNBALANCED IMS, THE DOLLAR CYCLES AND THE SYSTEMIC CRISIS OF GLOBAL FINANCE

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The semi-dollar standard: ineffective adjustments

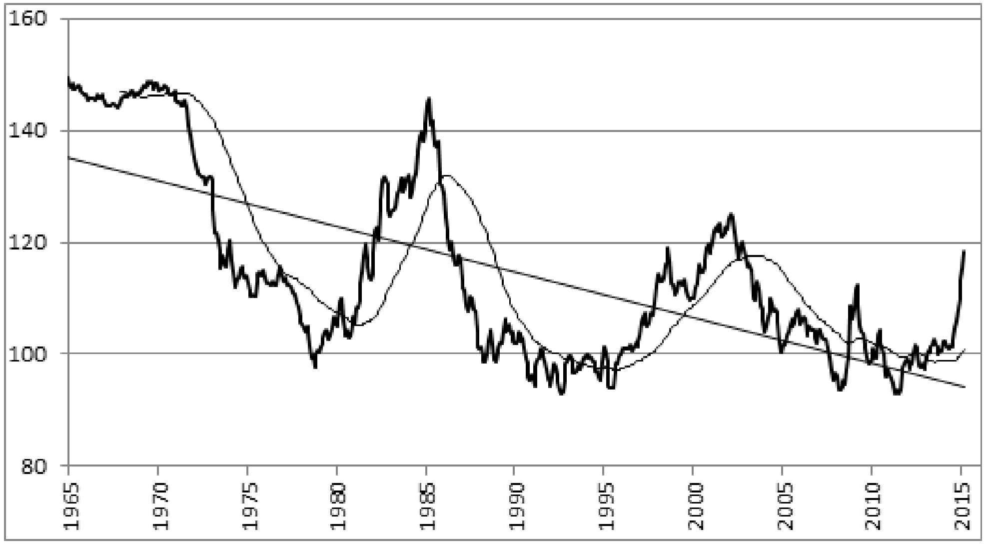
Since 1973 the IMS has been a semi-dollar standard

- **An hybrid system**:
  - Total lack of rules (Jamaica agreement, 1976)
  - A small number of fully convertible currencies with flexible exchange rates and open capital markets. Exchange rates vary partly with fundamentals, partly with momentum-driven financial strategies.
  - A large number of partially convertible currencies with capital controls and +- loose anchoring on the dollar. They can be currencies of primary commodity producer countries or of export-driven countries.

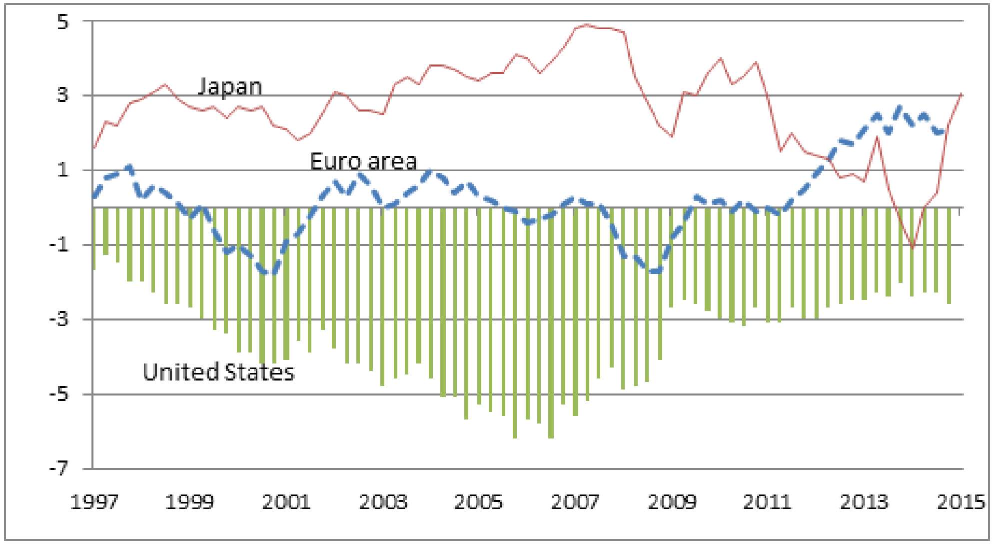
- **Failing international adjustment: twin disequilibria**
  - *Dollar cycles* against other convertible currencies distort relative prices, impeding international adjustment.
  - *Polarization of international liquidity on the dollar whose global supply is uniquely determined by domestic monetary policy*→ accumulation of financial imbalances leading to the expansion of FX reserves and world liquidity.
  - The *dollar carry trade* is a process that triggers vicious circles: FX rates appreciate the most in countries where levered asset prices ↑ the most, leading to sharp reversals

The twin disequilibria as failure of international adjustment

- The dollar cycles and the falling trend (real effective exchange rate)

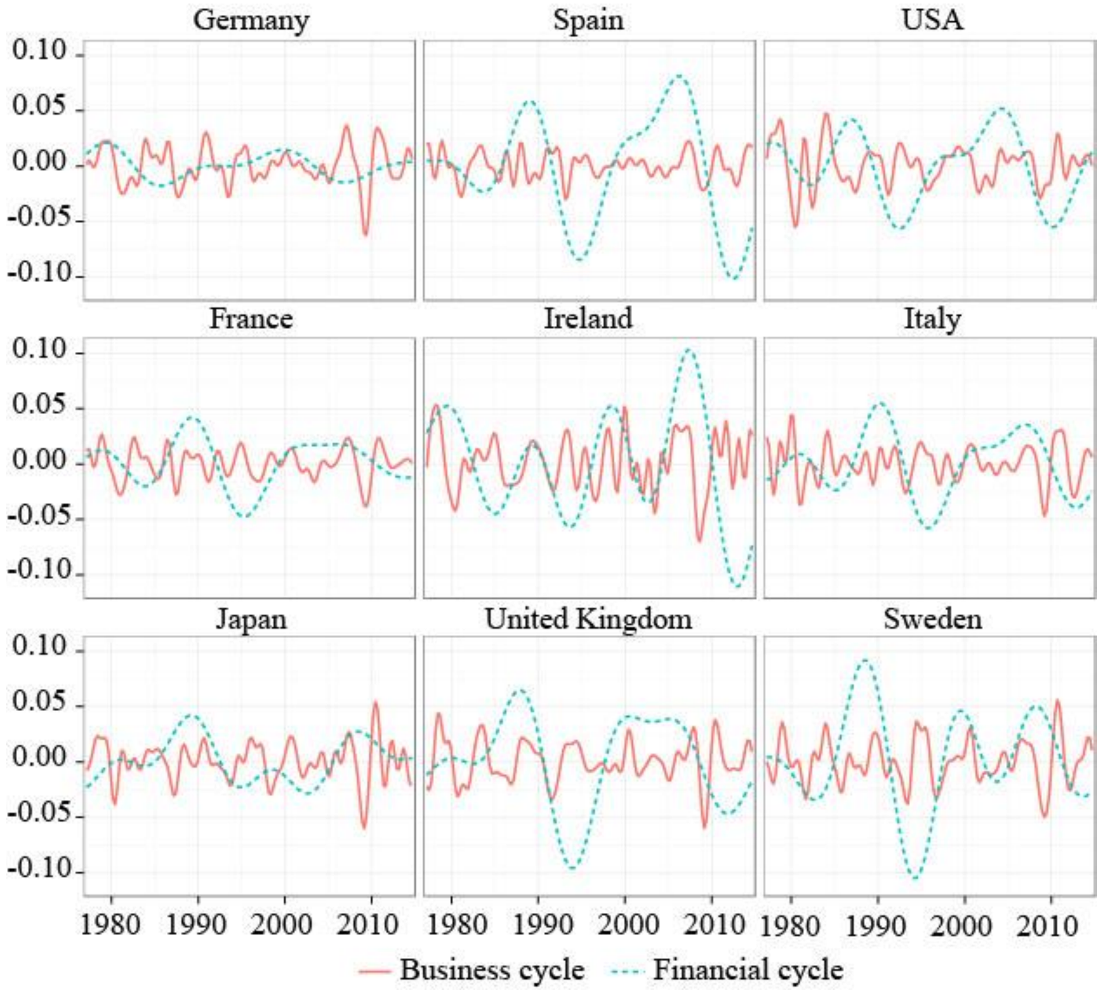


- Polarization in current account balances between US and other developed countries



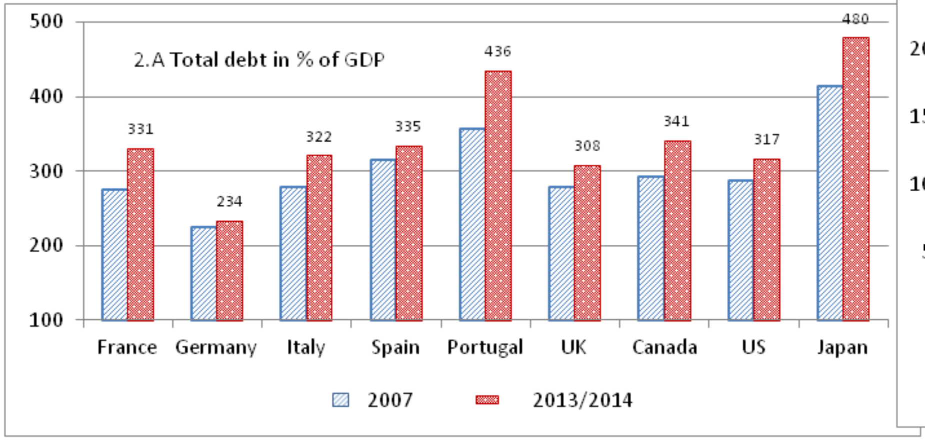
The dollar cycle belongs to a more general financial cycle

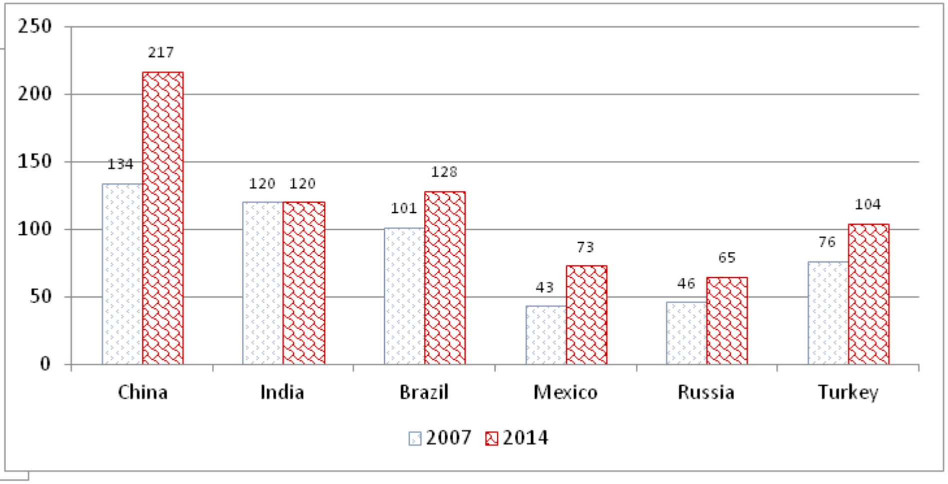
- The financial cycle is measured as an average of 3 financial variables deflated, detrended and filtered: total credit of the private non-financial sector (in log), share of private credit in GDP (in %), real estate price (in log)



The present dollar momentum is arising in a fragile financial environment:

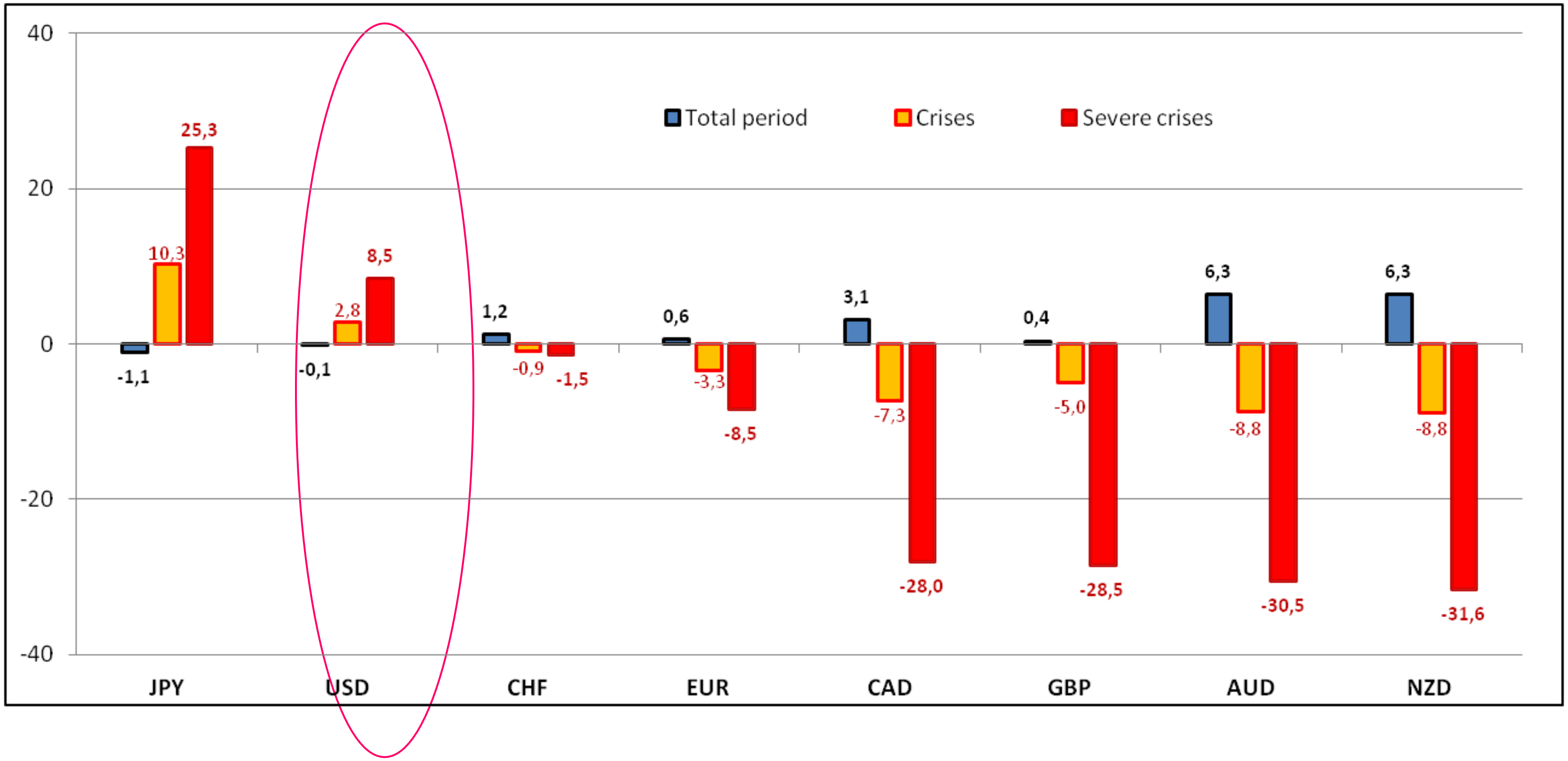
debt has been rising everywhere since the early days of the financial crisis, spurred by massive liquidity injections of central banks





The dollar: safe haven in stressful time

Excess currency return against SDR during crises (VIX>30) and severe crises (VIX>40) /average on 1999-2013 (in %).



The foundations of the semi-dollar standard are eroding

Divergence between declining US economic weight in the world economy and persistent financial dominance

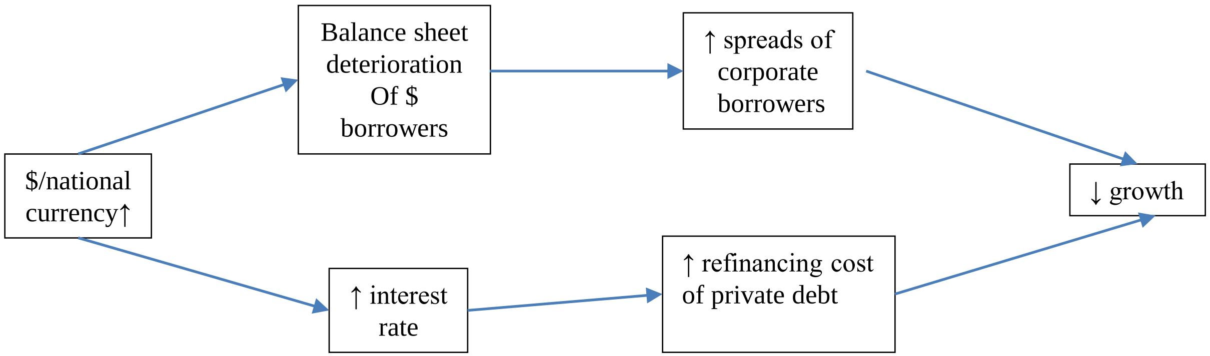
- **Indicator of global economic weight**: (Subramanian, 2013): average (in % of world total) of shares in GDP + in international trade + in net export of capital:
  - 1973: US (18%), Germany (7%), Japan (7%)
  - 2010: US (14%), Japan (6%), China (12%)
  - 2020f): US (14%), Japan (5%), China (15%)
- **Monetary and financial dominance of the dollar persist**:
  - 60% of world GDP is still dollar-linked because the control of the international $ payment system gives a huge extraterritorial power
  - The size of cross-border capital flows has ominously swelled since pre-crisis time: 20% of world GDP in 2007, 40% in 2014
  - Those flows have no relation with current account imbalances. They are not driven by fundamentals but by the trn$ of liquidity injection and are hypersensitive to changes of financial conditions in the wholesale $ money market.
- **Consequence: turmoil in global financial markets**
  - The US is no longer the single bell weather in the world economy, but the influence of large EMEs is obscure for market participants.
  - Standard strategies of portfolio diversification are breaking down with ultra-low yields of safe assets and high correlation between market indices→ *renewed instability in asset markets.*

Present symptoms of vulnerability

- "*Déjà vu":* disruptive financial dynamics spread to EMEs:
  - Fed QE injected \$4trns liquidity→ cascade of leverages via carry trade= 7trns to finance EME corporate (bank credit + bonds) from 2009 onwards
  - Total debt in EMEs> debt of advanced countries before the 2008 crisis. ≈ \$3trns over indebtedness (IMF estimate); Alarming because return ↓ with over capacities and deflation in production prices→ excess supply in Asia and lack of demand in Europe give rise to *secular stagnation*.
- *Deterioration in credit conditions*:
  - Maturity mismatch when initial lenders withdraw funds with \$↑→ sudden stops and chain of counterparty risks because assets expected to be liquid no longer are
  - Outflows→ deterioration in costs and conditions of credit →↓ currencies/\$ →↑ interest rates on domestic currency debt and ↑ in domestic value of \$ debts.
- *Instability in asset markets*:
  - High correlation in global asset markets between US/Europe/EMEs: 70% correlation against 35% average on 1997-2007 and 80% at the apex of crisis
  - *Fragile market structures since the crisis*: concentration and interconnection in asset management, lack of market making (withdrawal of investment banks) and immoderate use of complex derivatives

EMEs: new weak links in the world economy

- Indebted EMEs are vulnerable to the dollar cycle whatever the currency denomination of their debts:



- Differenciation between groups of countries:
  - *Asia (but India):*heavy corporate borrowing→ govts want to avoid bankruptcies→ rollover loans→ prolonged over indebtedness and zombie firms→ capital trapped in non-performing sectors due to former misallocation.
  - *macro fragile countries (Brazil, Turkey, South Africa):* highly dependent on $ financing with their CA deficits : exchange rate↓ → inflation ↑ → interest rate↑. Those countries are at risk of an open financial crisis.
  - *Countries with limited private indebtedness (India, Mexico, Argentina, Russia)* where consumer markets are underdeveloped. SOEs can absorb losses on junk debt in restructuring with the State help.

Which LT evolution for the IMS?

- Organizing regional currency areas

-Two competing concepts of global finance

-A SDR-based IMS

Organizing regional currency areas

- Benefits of regional currency areas:
  - They are compatible with competing international currencies
  - They can be open, flexible and apt to multiple forms of cooperation: ex. In East Asia, decoupling from the dollar may resort to effective real exchange rate objectives that keep consistency to the Yuan
  - They apply a principle of subsidiarity: a number of shocks may be absorbed within currency areas without global spillover.

- Regional currency areas linked to one another through capital markets with flexible exchange rates do not make a global public good:
  - Dissenting monetary policies between leading convertible currencies nurture carry trade financing of asset price momentum→ nothing guarantees improvement in BoP adjustments.
  - Replacing key currency by asymmetric competing currencies leaves unresolved the pb of the *ultimate reserve asset* and *the global anchor of world prices*.

Competing concepts of global finance: can they be combined via proper regulation?

Washington Consensus +US$ as key currency

- Financialization of corporations (shareholder value) expanded worldwide
- Free capital flows linking all asset markets all over the world
- Intermediation by market making under the dominance of systemic investment banks
- Internl LOLR performed by the US swap network granted exclusively to countries fulfilling political criteria of US Treasury
- Most developing countries forced to accumulate $ reserves for self-assurance
- Major drawback: not suited to finance LT real investments

China's view of integration through infrastructure financing + SDR as multilateral currency

- LT investment as growth driver
- Finance restructuring to mobilize ≈of trillions of dollars of investment every year
- Globalization deepening via the production of global public goods, common goods and positive externalities
- Intermediation by national, regional and multilateral development banks
- Major drawback: risk of political conflicts in the definition, monitoring and exploitation of investment projects

Reforming the IMF for international monetary cooperation

- The IMF should return to its original mission: institutionalized monetary coordination and be granted executive power for collective action
  - *In multilateral surveillance*: monitoring credit development and macro policies, organizing regular confrontations at high political level to strike compromises
  - *In LOLR function*: supplying equitable credit facilities to countries with insufficient financial resources under global stress
  - *In SDR issuance*: widening the supply of SDR in making it functionally linked to the counter-cyclical needs of ultimate liquidity to guarantee symmetrical settlement between central banks. The US balance of payment would no longer be financed by an unlimited amount of $liabilities to ROW countries.

- The powers inside the IMF must be reshaped and its capacity of political decision enhanced:
  - Adequacy between voting rights and economic weight of member countries
  - Merging quotas of EA countries with common representation
  - Repealing veto privilege of a single country
  - Strengthening the power of the executive policy

The SDR in IMS reform

- The SDR offers several advantages for a gradual reform of the IMS:
  - As a reserve asset it is not the direct liability of any single economy
  - As a store of value it is an international standard by construction
  - As a unit of account it has less volatility of valuation and greater market stability than any currency

- Changing the rules to make the SDR the single vehicle of IMF credits
  - Merging the general department and the SDR department, so that non-used SDRs become deposits to the IMF, as such a base of IMF credits
  - Creating a substitution account for conversion of excess dollar reserves
  - Evolving to quota suppression towards IMF financing entirely through SDR issuance

- International money regulation via SDRs:
  - Contra-cyclical issues/ needs of international liquidity
  - Substitution account allows an off market reserve diversification → dampening FX volatility
  - Opportunity for the IMF to mobilize non-used SDRs (deposits on the liability side of the SDR account) to buy bonds issued by multilateral development banks or to capitalize the world Green Fund.