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:

- 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.