

①

Lecture of April 17, 2012

International monetary & financial
system in historical perspective

— — —

Three phases of globalization (Prof. Help, RPE)

① 1820 - 1913 First phase of globalization

- Starts with the industrial revolution in the UK which spreads all over the world
- London was the financial center of the world & the UK sterling the dominant currency
- Innovations like steam power, sea and rail transports contributed to economic & financial integration and to economic growth

→ Apex in 1870 - 1913 (Gold Standard)

In 1870/71, when Germany adopted gold as the reference metal, historians place the start of the "gold std"

Monetary regimes were based on precious metals, typically silver and gold

The value of money was given by the content of precious metal

US \$ = 23.22 grams of gold
UK pound = 113 grams

→ Exchange rate $113/23.22 = 4.87$

hence needed 4.87 US dollars to obtain 1 pound

Before 1870 there was no clearcut rule. Some countries were on the gold std (UK, Portugal) others on the silver std (Germany, Austria, Netherlands, Russia, Sweden); other adopted bimetallism (US, France, Italy, Belgium).

Banknotes: countries were committed to assure "full convertibility" at any moment of FIAT money

Under the gold std (basically, a system of fixed exchange rates), there was a period of exceptional growth & financial stability (historians are re-visiting this)

→ The 1913 peak in world exports equalled in 1970

② 1914 - 1944 Interwar period

- I WW puts an end to the golden era of the gold standard
- Countries started to rely on beggar-thy-neighbour policies to gain a competitive advantage
- Bilateral agreements prevail on multilateral/regional agreements
- Competitive devaluations become the norm
- Some countries impose banknotes circulation by law without committing to full convertibility
- Widespread use of restrictions on commercial & financial cross-border flows
- Hyperinflation in some countries

③ 1944 The Bretton Woods Conference

In May 1944 the US invite 44 other countries to a conference with the aim to establish a "new economic order"

(Germany, Italy & Japan not invited)

④

The IMF, WB and (later on) the WTO are established.

Currencies are fixed on a "dollar std"
→ so called "Bretton Woods System"
of "fixed but adjustable" ex. rates.

④ 1944 - 1973 II Phase of globalization

- The reconstruction after the war & the BW economic order foster a new era of growth and financial stability
- Inflation is low and is not yet an objective of monetary policies (at least, not for all CBs)
- Trade and financial flows become more open (back to globalization)
- The US \$ becomes the world reference currency

⑤ 1973 - nowadays III Phase of globalization

This is a very extended period that can in principle be subdivided in more subphases. For instance, there is evidence that after 1989 (break of the Berlin wall) world integration has accelerated.

THE CONCEPT OF STABILITY - A DIGRESSION

When we classify historical periods we use the concept of "stability" to determine whether that period was economically good or bad.

But what we mean by "stability"

It is feared around three concepts

① Stability in (domestic) prices
(hence INFLATION)

You want prices to be as stable as possible since this helps domestic transactions

② Stability in exchange rates

You want ex-rates to be stable or even fixed since they also are prices and stability help international transactions

③ Financial stability

Stability in financial markets, mostly the banking system - A "stable" B System

4 TER

is one that is not prone to crisis
(defaults, deposit runs - - -)

The 3 concepts of stability interest
with each other

① & ③ Inflation is relevant
for financial transaction. For
interest it is important a debt in
"real" terms. In fact inflation reduces
the real value of a debt, hence helping
debtors - It is also relevant to
determine nominal/real interest rates

① & ② Domestic prices & the exchange
rate interest in several guises. Devaluation
may be inflationary, but also inflation
spiral may cause devaluations

① & ③ It is relevant to know whether
a debt is denominated in
domestic or foreign currency -
In many financial crises, there was
lot of debt denominated in a
foreign currency (LA & the US \$) -
When the country devalues the value
of the debt explodes -

BRETON WOODS AND ITS LEGACY

When 45 nations gathered in 1944 in BW (New Hampshire, USA) their aim was to establish the foundation for a new economic order.

- ① To re-activate the process of (post-war) growth and employment creation, they were convinced that trade & financial integration was essential.

→ BW can be read as the start of the re-globalization process, the so-called III phase of globalization.

The IMF, WB and GATT/WTO can be seen as all having the same final objective: global integration!

- ② People in BW had in mind the gold standard era, when ex rates were fixed and full convertibility was assured.

→ Hence they tried to replicate the gold standard mechanism with the BW system of fx rates.

⑥

BW system of £ + RAABES

- Par values with the US \$
- 35 US \$ - 1 ounce of gold
- Full convertibility of the US \$ in gold, hence a gold-dollar standard
- GRID system of $\pm 1\%$ around par value

Two devices were added which made the system more "flexible" than the pure gold std.

① Par values were "adjustable" in case of "fundamental disequilibrium in the BOP" (but the Statute of the IMF gave no definition of this). To change the par value, the member would consult the IMF. If $\Delta E < 10\%$ the IMF could not ~~offse~~ ~~offse~~ otherwise the IMF advice was more binding and sanctions were envisaged in ~~the~~ case the member would not abide.

② Capital restrictions were allowed (J.M. Keynes was in favor of capital restrictions that he thought could limit speculative flows)

IMPOSSIBLE TRINITY

You cannot have at the same time:

- free capital movements (cross-border)
- an autonomous monetary policy
- a fixed exchange rate

In the previous lecture I showed how monetary policy is not autonomous in fine-tuning the cycle when there is a peg and capital flows are free to move in and out of the country. In fact monetary policy is "targeted" to the peg.

Therefore, if you want both (i) a fixed exchange rate and (ii) an autonomous m.p., you have to →

→ introduce capital restrictions!

This is what was done in BW: capital restrictions were allowed (although ~~not~~ not recommended) in order to allow members to adjust more freely m.p. to support the economic cycle.

8

FALL OF THE BWR SYSTEM

1971-73

By the end of the '50s and throughout the 60s the system was characterized by wide BOP disequilibria.

The US, also due to the Vietnam war, had a large BOP deficit, whereas Germany and Japan had BOP surpluses.

~~The US~~ As a consequence a huge amount of US\$ began accumulating outside the US:

→ In 1970 ~~total~~ official reserves in \$ (held by non US central banks) had reached \$40 billion, whereas US gold reserves were only \$11 billion.

• In 1971 Nixon declares the unconvertibility of the US dollar

• The dollar is initially devalued by 8% (38\$ per 1 gold ounce)

• By the spring of 1973 the system is definitely over.

CAUSES: Adjustments of par values were rare and thus insufficient to cope with the large and persistent BOP imbalances

GOLD STD

GOLD EXCHANGE STD

110

9

DIFFERENCES BETWEEN GOLD STD & "DOLLAR STANDARD"

- In the GS you have N countries & N exchange rates vis-à-vis gold. No country has a privileged position, hence the system is perfectly symmetric
- In the DS you have $N-1$ ex rates vis-à-vis the reference currency and the ~~one~~ pivot country has no need to intervene
- The US ~~can~~ have seigniorage and a privileged position since their monetary policy is more autonomous

Who determines global monetary conditions?

- In the GS this hinges on gold stocks of reserves owned by the central banks

Disadvantages

- Monetary policy is not autonomous
- The (global) stock of gold varies depending on the discovery of gold mines
- There can be disparities among countries depending on their natural ~~availability~~ endowment of gold

10

• In the IM STD it is the US that determine global monetary conditions

\rightarrow $\text{US} \uparrow \rightarrow \text{Rus} \downarrow$

There will be downward pressures on the US \$ and other currencies will tend to revalue, hence foreign CBs will have to intervene and in the end ~~the~~ R will be lower worldwide -

When the US was providing the international liquidity through its BOP deficits, at the end of the '60s, they were accused of "exporting inflation" abroad (especially by the Germans).

France also was very critical of US policies and accused the US of an "exorbitant privilege" (C. de Gaulle)

ARCHITECTURE OF THE BW SYSTEM

FoI

- Coordination of economic policies
- Financing of BoP for short term
- BW system of E & Rates till 1973
- Remove monetary restrictions on trade

Based on a "quota" system

↓
Can issue bonds but has never done this

WB (IBRD)

- Financing the process of reconstruction after the war

Draws money from the mkt issuing bonds

- Financing (long term) for developing economies

"quotas"

GATT/WTO (1995)

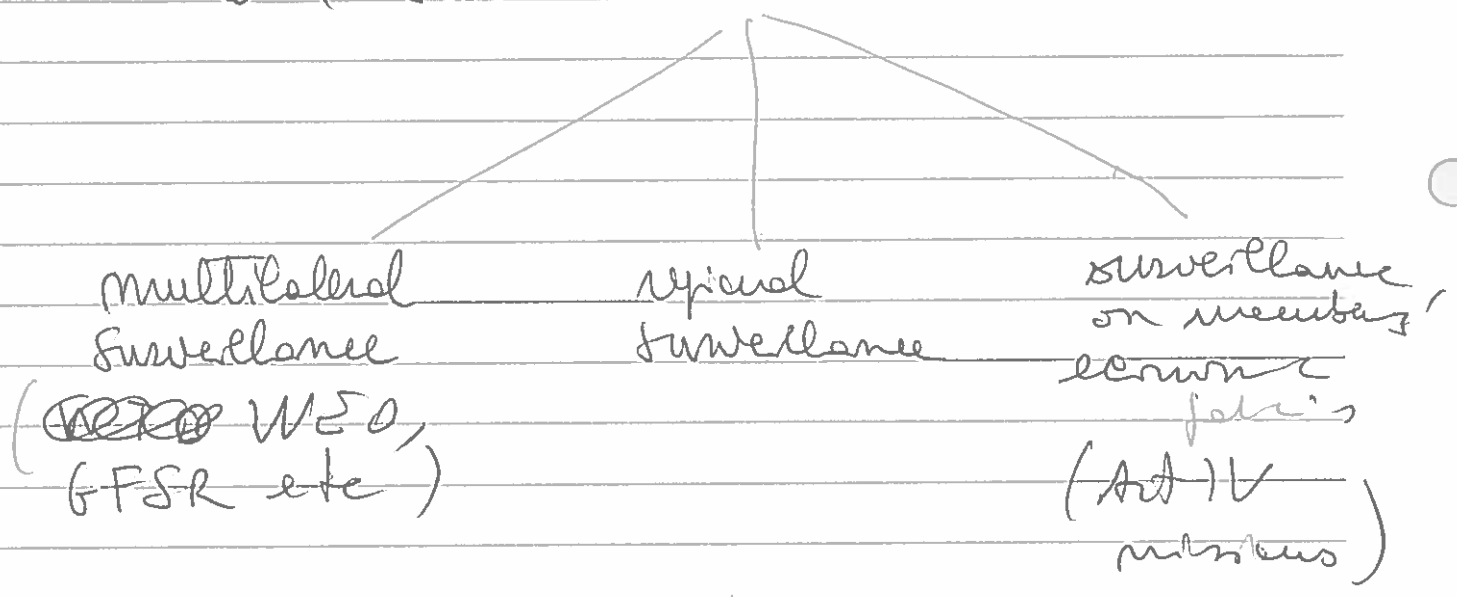
- Remove barriers to trade (no financing)

This difference in the ~~para~~ resource mechanism between IMF and WB was used to justify the fact that the President of the WB had to be an American (and the head of the IMF an European). Since the WB had to tap financial mkt, it was said that an American banker would be preferable and reassure the mkt - indeed the story is much more complex

The IMF

A universal organization of 187 members whose main functions are:

- coordination of economic policies and surveillance



Short-term financing

IMF financing is aimed at correcting policies that have led to a depletion in the BoP or level of reserves/ex rate

They are provided under "CONDITIONALITY" that is under the condition that the economic plan agreed with the authorities is realized.

They are normally absorbed in tranches

so that the IMF can verify each time whether there has been progress in the economic plan, if not, financing can be postponed or even interrupted

Conditionality is quantified through "performance criteria" (for instance: reduce budget deficit to 3% by end year). that may concern macroeconomic policies as well as structural policies

Things to keep in mind

- ① The resources of the Fund are limited (total quotas amount at \$360 billions) thus, although the Fund can rely on extra resources (GAR & NAB, also limited at \$134 billions) it must be used on a "rotative basis" as in cooperative system
- ② The interest rate payed on IMF loans is an average of mkt rates but it is normally lower than the rate that the country would pay on the mkt
- ③ IMF financing ^(normally) cover only 9-15% of a country's financing need. Their role is more in terms of a "catalytic" role for other public and private financing.

MAIN FINANCING FACILITIES

① Stand-by Arrangement (SBA)

The traditional IMF financing tool for temporary problems that lasts normally 1-2 years (repayments within 5 years)

* Normally up to 200% of a member's quota and not more than 600% cumulatively

② Flexible facility/arrangement

Aimed at supporting programs to solve longer-term, structural problems (repayments within 10 years)

* Same as SBA

③ Flexible Credit Line & Precautionary Credit Line

Used on a precautionary basis to avoid domino effects
No formal limits and no conditionality

Special facilities (ad hoc): oil facility, Y2K facility

Special Drawing Right (SDR)

New liquidity that the Fund can "allocate" to its members in case of global liquidity needs
It's only 3% of global reserves -

GOVERNANCE OF THE IMF

Board of Governors (187) (Assembly)

Approves decisions concerning membership, quotas, SDR allocations - 3



International Monetary & Financial Committee (24)

"
" Analytical & decisional body of the Fund

Organized around 24 constituencies



Board of Directors (24)

Discharges the daily business meeting 2-3 times a week

Ex. Directors are employees of the Fund & reside in Wash, D.C.



Managing Director (C. Lagarde)

The MD is the de fact most important element in the IMF governance and the one who sets the "direction" of IMF policies -

16

Quotas & Fund Resources

The liquidity available to the IMF is made up by the "quotas" that the members pay to Fund.

Quotas are proportional to each member economic size (GDP, export-import flows, stock of intn. reserves ---). They are revised every 5 years.

The last quota revision (2008) brought the "FOND" to \$360 billions. Note that this is only 1.5% of world trade, when in 1950 total quotas were around 6.5% of WT. So, in real terms, the size of the Fund has shrunked.

The Fund can count on extra resources made available by members on a voluntary basis. Through the NAB & GAB it can draw another \$500 billions (up to). Other liquidity can be made available by countries on a bilateral basis (e.g. Japan).

Not all the FOND is really available for financing purposes since:

- it serves also to cover the costs for the ordinary functioning of the organization;
- not all currencies are usable for financing.

Quotas determine also the relative (voting) power of each member. The formula is

$$250 \text{ basic votes} + 1 \text{ vote for each } 100,000 \text{ SDR}$$

Under the last reform basic votes will rise to 750, in order to give more voice to the small countries.

Main quotas

US	=	17.67%
Japan	=	6.56%
Germany	=	6.11%
FR & UK	=	4.50%
Italy	=	3.31%
China	=	4.00%
India	=	2.44%

