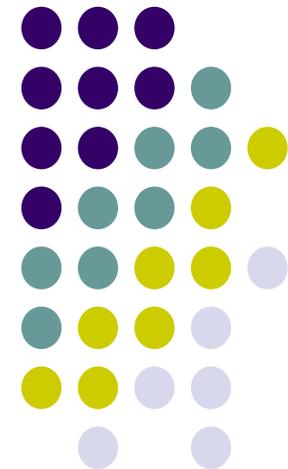


# ***THE DOLLAR TRAP : WHAT ARE THE OPTIONS FOR THE INTERNATIONAL MONETARY SYSTEM?***

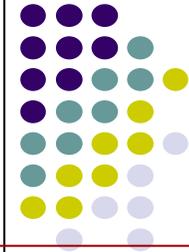
Where is Global Finance heading?  
Status of the International Monetary System  
and the Stake of Emerging  
Economies

July 2009, Cusco, Peru

Joshua Aizenman  
UC Santa Cruz & NBER

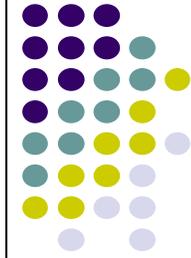


# Observations



- **EMs converged to trilemma's middle ground:**
  - Growing managed ER flexibility and financial integration, while maintaining a degree of monetary control.
  - These trends have been buffered by growing accumulation of IR.
- **International Reserves:**
  - the benefits are higher, and the costs are lower than what most economists had thought.
  - From “The fear of floating” to “the fear of losing IR.”
  - In times of systemic crisis, one needs more ~ swap lines, IFIs, etc...

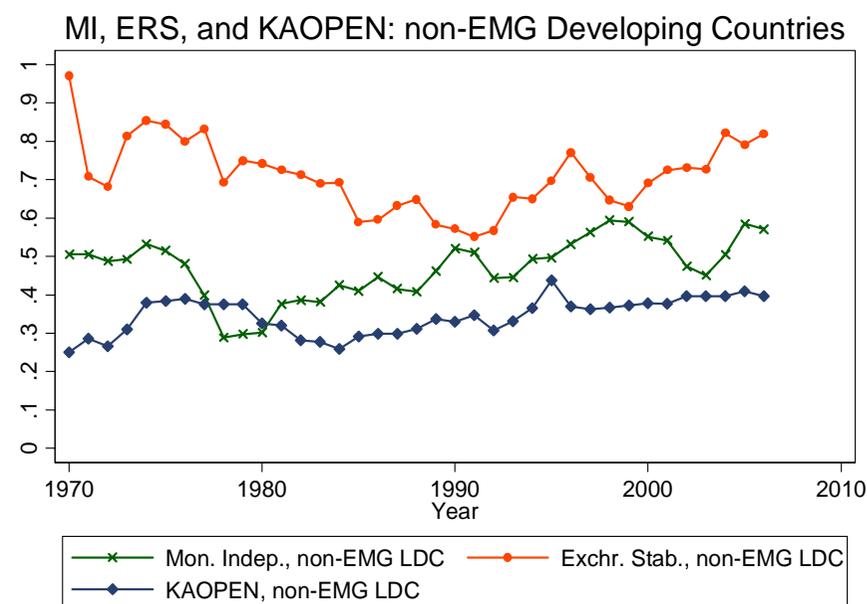
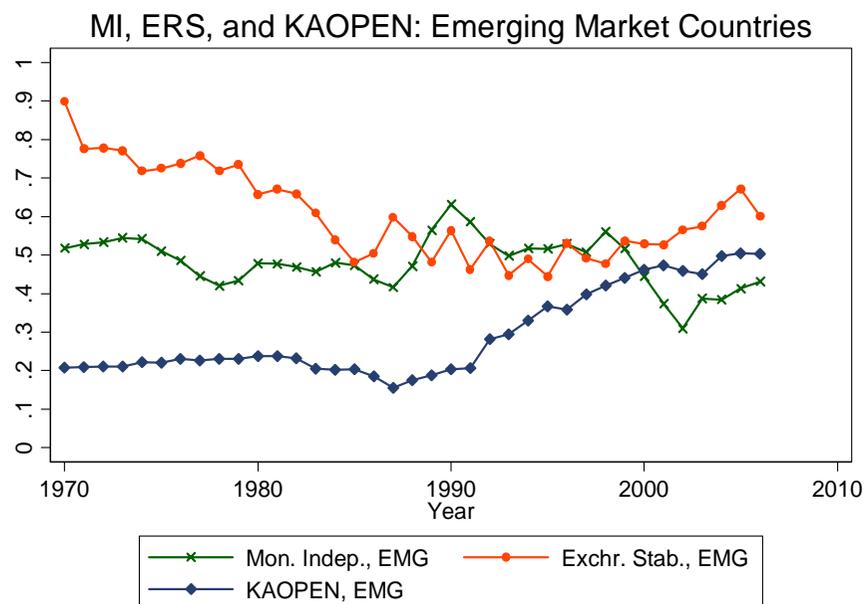
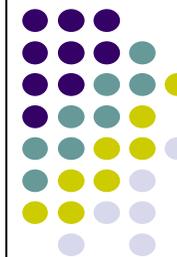
# Possible future trends and challenges



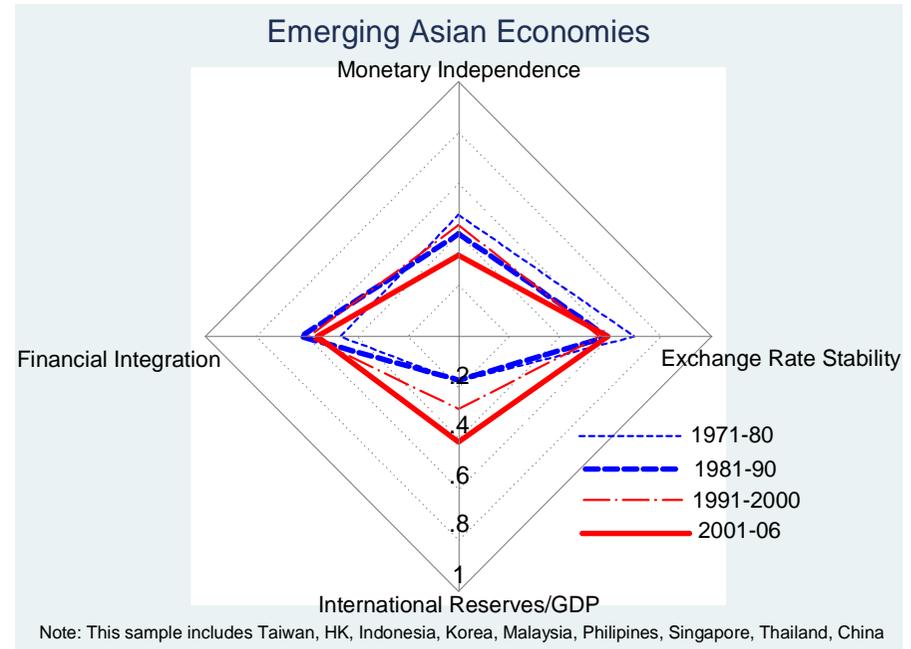
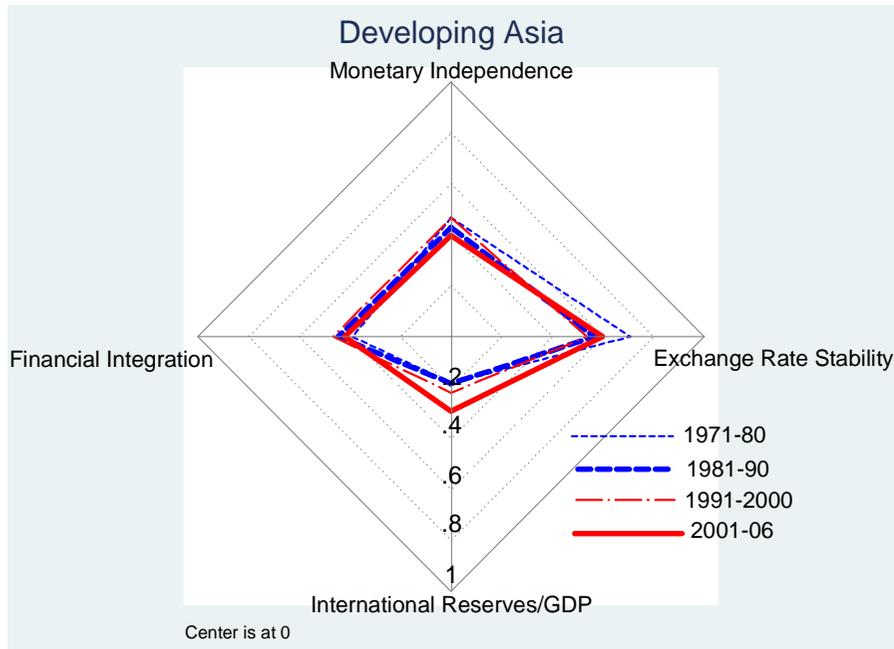
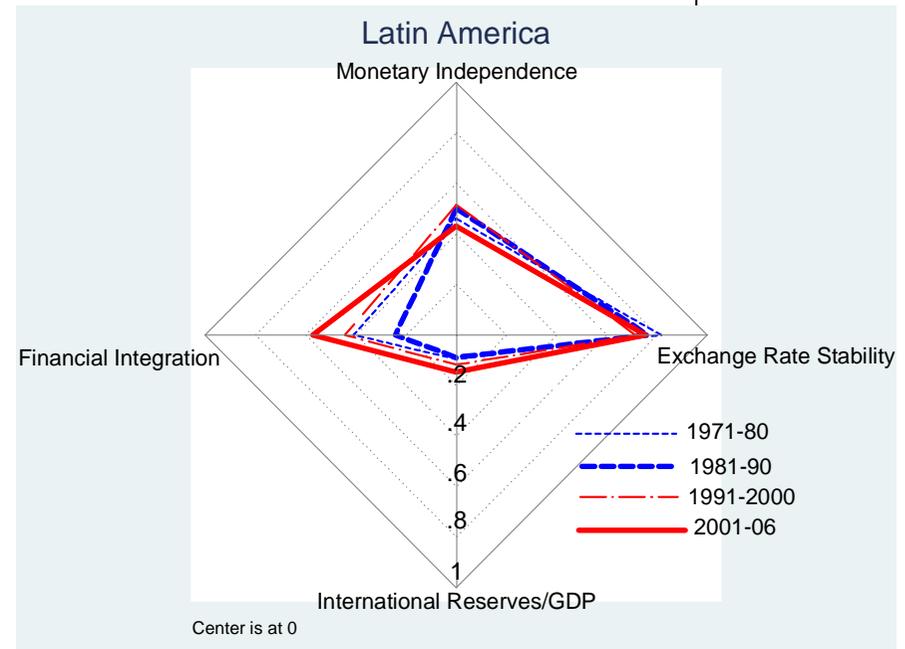
- The desirability of uninhibited capital mobility would be revisited.
  - Need to coordinate and reform prudential regulations of all countries.
  - EMs would benefit by more cautious approach to financial integration.
- Within 15 years, the possible emergence of unstable tri-polar configuration of competing global currencies: US \$, Euro and Chinese Yuan.

# “Assessing the Emerging Global Financial Architecture: Measuring the Trilemma's Configurations over Time”

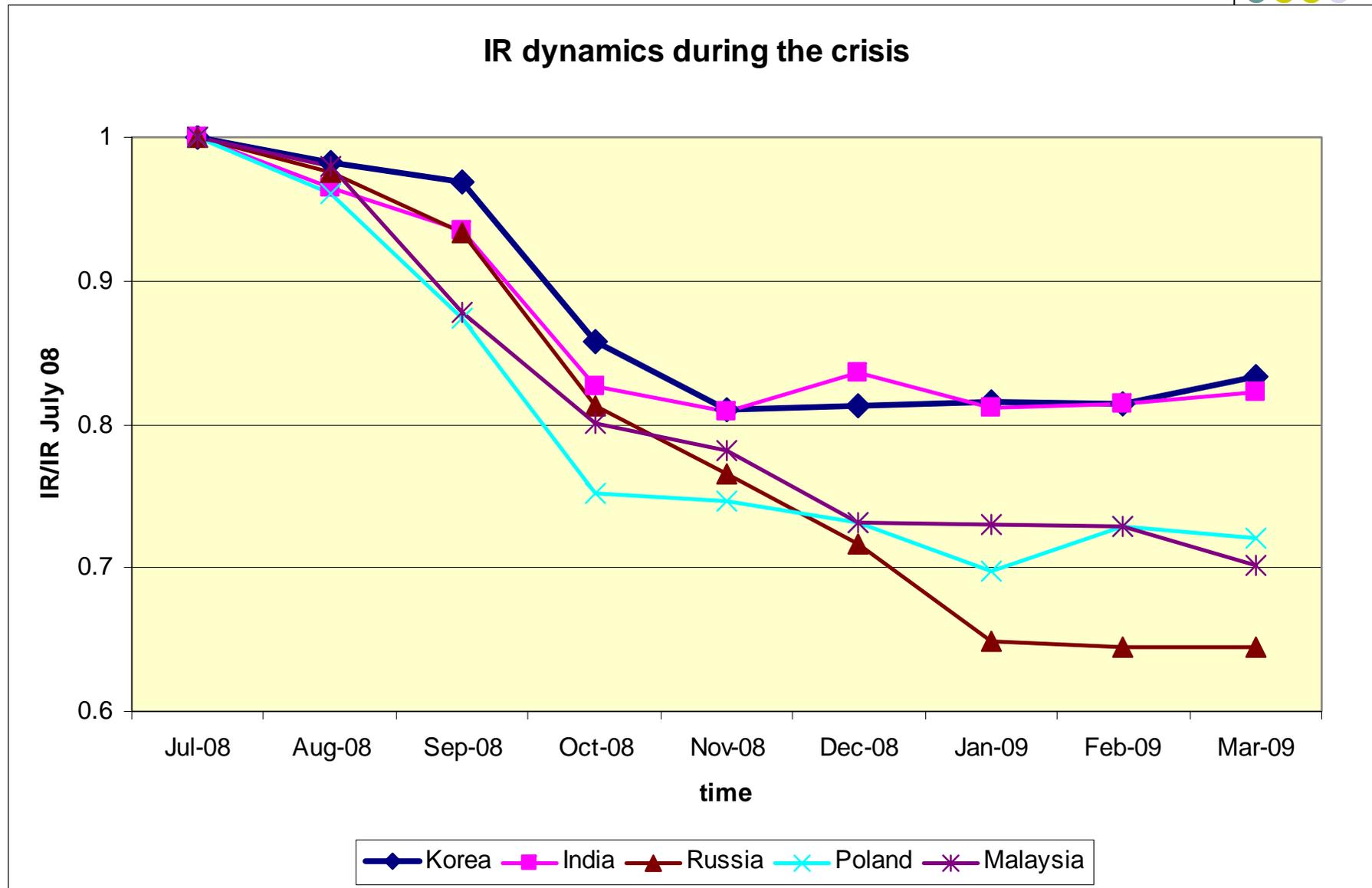
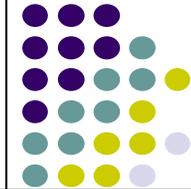
Aizenman, Menzie and Ito, *NBER WP # 14533*



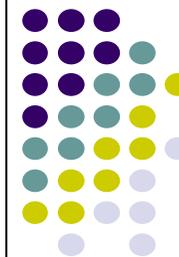
# Trends, 71-06



# The fear of losing IR

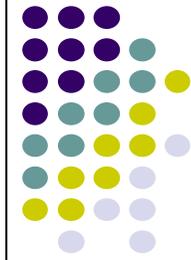


**Fear of losing IR** may signal a deterioration in the credit worthiness of a country.



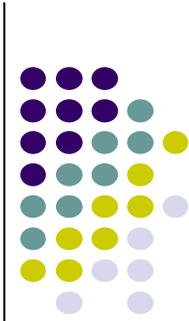
- Managed exchange rate flexibility cushioned the adjustment by a combination of ER depreciation and a drop of IR.
- CBs have been reluctant to further draw down their reserves, fearing that it will signal growing vulnerability; adverse externality due to “keep with the Joneses’ IR”.
- Brazil, Chile and others have preferred to adjust mostly through ER depreciation, saving their IRs for even leaner years, should a prolonged period of weakness in their terms of trade occur.

The unprecedented provision of \$120 billion in swap lines to 4 EMs by the FED provided welcome relief and an important signal. Yet,



- Exposure of US banks to these EMs is the most important selection criterion for explaining the “selected four” swap-lines.
- These ad hoc facilities would not suffice in protecting exposed countries from a crisis similar to the Asian financial crisis in the absence of self insurance.
- Mitigating this concern should be the prime responsibility of the IFIs. There is room for deeper involvement of the IMF and regional swap and ‘self insurance’ arrangements.

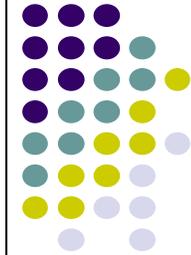
# Swaps



- It's in the self interest of source countries to engage in bilateral credit arrangements with EMs as long as they have had a strong track-record in good times.
- Countries with lukewarm economic track-record in good times would find that the IFIs may be the main sources of help.
- Consistent with the recent willingness of key OECD countries to expand rapidly the size and the role of the IMF, and with the lukewarm attitude of countries in the core of Europe towards the provision of deep swaps-lines to Eastern European countries.

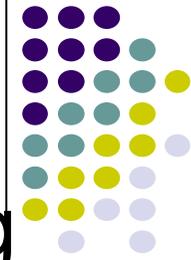
# Proliferations Swaps Lines

FED swaps      ECB swaps



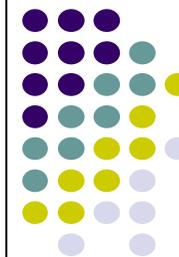
Brazil	\$30.00	
Hungary		€ 5.00
Korea, Rep.	\$30.00	
Mexico	\$30.00	
Poland		€ 10.00
Singapore	\$30.00	
Australia	\$30.00	
Canada	\$30.00	
Denmark	\$15.00	€ 15.00
Iceland		€ 1.50
Japan	<i>\$120.00</i>	
New Zealand	\$15.00	
Sweden	\$30.00	
Switzerland	<i>\$60.00</i>	
United Kingdom	<i>\$80.00</i>	

## Under-regulation in good times: possible interpretation



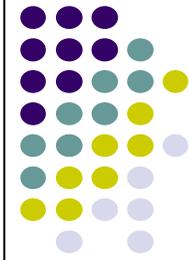
- Prolonged economic tranquillity and long spell of no crisis leads to complacency
  - lower demand for regulator's services
  - under regulation → ... financial calamity.
- The identity of agents that benefit from crisis avoidance is unknown; yet regulation costs are transparent.
- Crises that have been avoided are imperceptible, and are under-represented in the political discourse.
- **The demand for regulation declines during prolonged good times, thereby increasing the cost of eventual crises.**

# A regulatory structure that mitigates these concerns



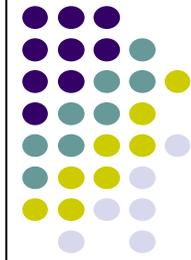
- **Improving confidential information disclosure:** needed to allow assessment of systemic risks triggered by “too big to fail” concerns.
- **Increasing the independence of the regulatory agency from the political process;** needed to reduce under-regulating in good times.
- **Centralizing the regulatory process and increasing its transparency;** mitigates asymmetric information problems.
- **Global standards of minimum prudential regulation and information disclosure, enforced by the domestic regulator;** a commitment device mitigating under-regulation in good times, reducing regulatory arbitrage.

# The challenge:

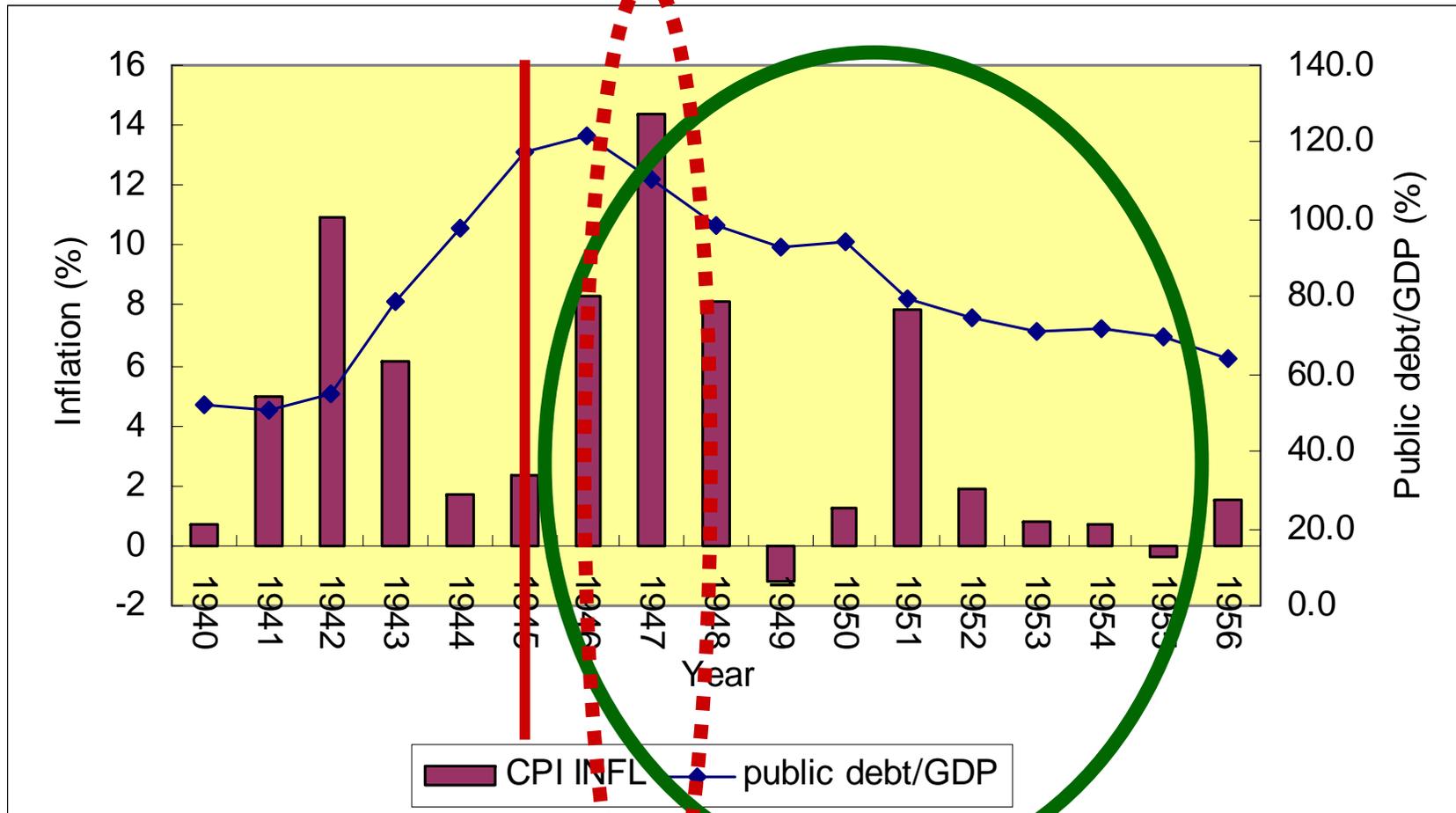


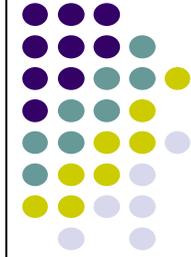
- To adopt Goldilocks regulations, mitigating the temptation to under-regulate in spells of good time, preventing overregulation in the aftermath of a financial crisis.
- The risk of not meeting these challenges:
  - Some affected countries will opt to reduce their financial integration;
  - Some will overshoot the regulatory adjustment inducing lower future growth;
  - Others will remain exposed to the hazard of replaying crisis dynamics in the future.

# Possible US exit strategy: replay of 1945-1955, with fiscal adjustment?



Average inflation, 1946-55: 4.2%

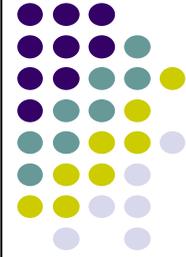




# Global implications

- Higher anticipated inflation and shorter debt maturity → smaller scope for the inflation mechanism, the deeper would be the needed fiscal adjustment.
- Risk of acceleration and instability [1947]
- Transition into tripolar ‘global currency’ world, with \$, Yuan, Euro competing.
- Three may not an efficient (or stable) configuration... Krugman, “Is Bilateralism Bad?” 1989.

# *Thank you!*



For further discussion of these issues see

- Aizenman (2009) "Reserves and the Crisis: A Reassessment", *Central Banking*, 2009, Vol. 19, No. 3.
- \_\_\_\_\_ (2009) "Financial Crisis and the Paradox of Under- and Over-Regulation", NBER WP # 15018.
- \_\_\_\_\_ and Pasricha (2009) "Selective Swap Arrangements and the Global Financial Crisis: Analysis & Interpretation", NBER WP # 14821.