GLOBAL STRUCTURE, NATIONAL ORIENTATION:

INTERNATIONAL MONETARY SYSTEM AND THE CRISIS

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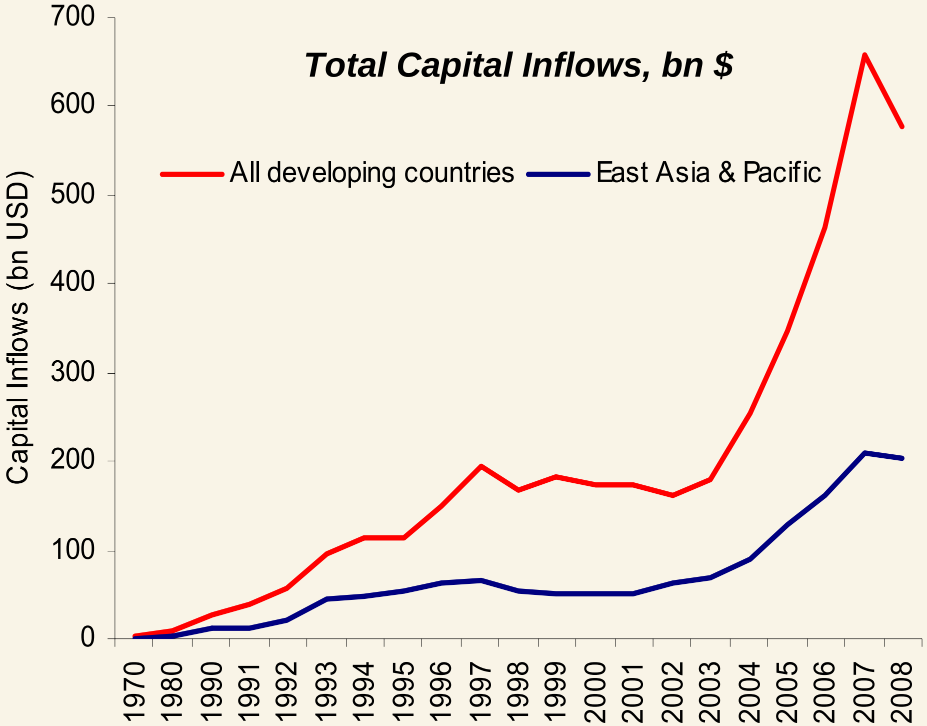
Where is Global Finance Heading
Reinventing the Bretton Woods Committee and The Central Bank of Peru

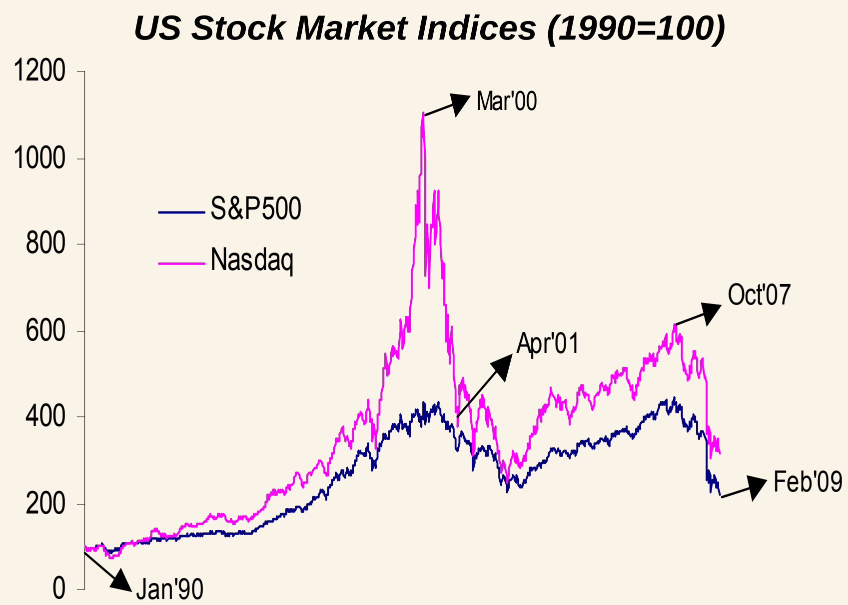
Sources and Dynamics

The role of globalization and international monetary system in each crisis have always been questioned and discussed.

- **Developing countries debt crises in 1982,**
- **The Mexican crisis in 1994**
- **The East Asian crisis in 1997**
- **The Russian crisis in 1998**

This time, the bubble occurred in financial services sector, which has experienced higher productivity with higher investment expenditures, along with the real estate market, similar to the 1990s IT sector boom.





Source: WB

Sources and Dynamics

Macro-structural Dynamics

- *Monetary policies (Great Moderation)*
- *Global imbalances and exchange rate regimes*
- *Global integration and interconnectedness*

Micro-structural Dynamics

- *Financial innovation,*
- *Change in risk taking behaviour and*
- *Deficiencies in financial regulation*

A Perfect Storm

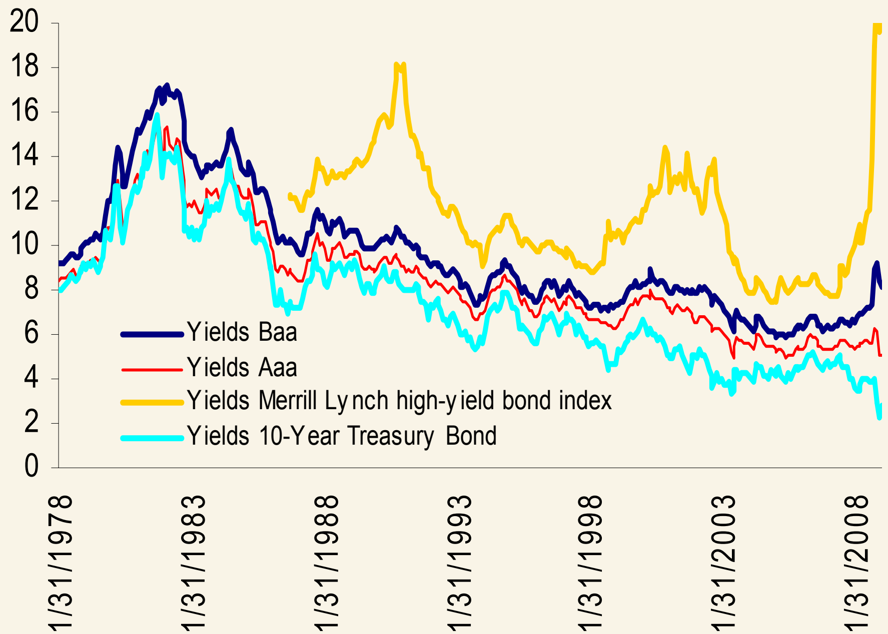
PERFECT STORM: Refers to the simultaneous occurrence of weather events which, taken individually, would be far less powerful than the storm resulting of their chance combination. Since the non-fiction book written by Sebastian Junger, and the 2000 movie by the same name, the phrase has gained popularity and grown to mean any event where a combination of circumstances will aggravate a situation drastically

THREE FACTORS CAME TOGETHER:

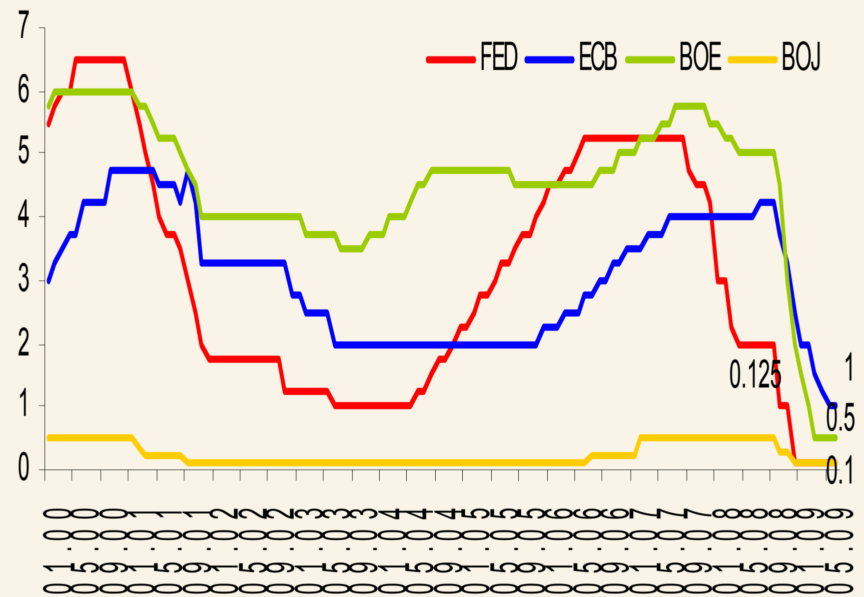
1. **Monetary accomodation-Financial engineering**
2. **Foreign exchange regimes-Global imbalances**
3. **Financial globalization-Reinvesting in reserve assets**

A long period of low interest rates

US Interest Rates (%)



Main Central Banks' Policy Rates (%)



Source: Bloomberg

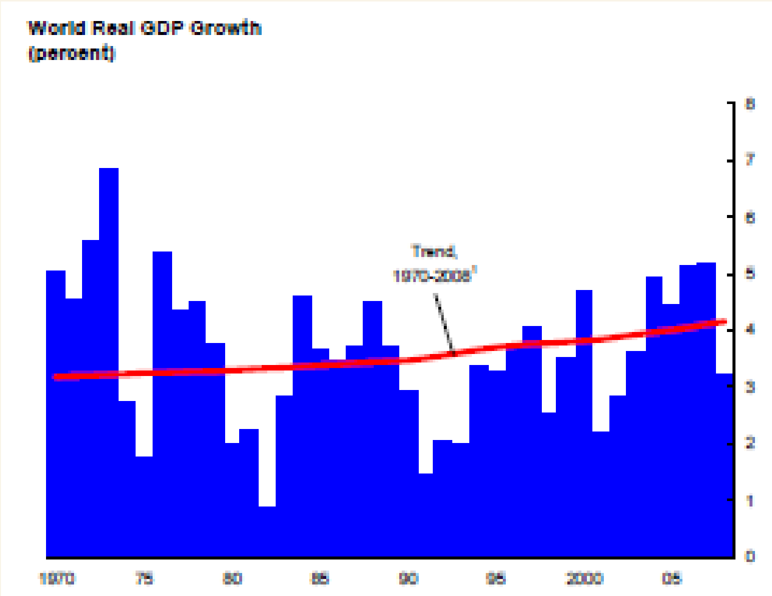
Asian crisis, Russian crisis and its contagion, euro adoption adversely affected global demand.

Late 1990s, Fed's policy moved to a tighter stance, and monetary tightening ended up bursting, the dot-com bubble in 2000-01. A fear of deflation following a series of above mentioned crises between 1997-2001, led policymakers to keep short-term real interest rates low. Abnormally low real interest rates:

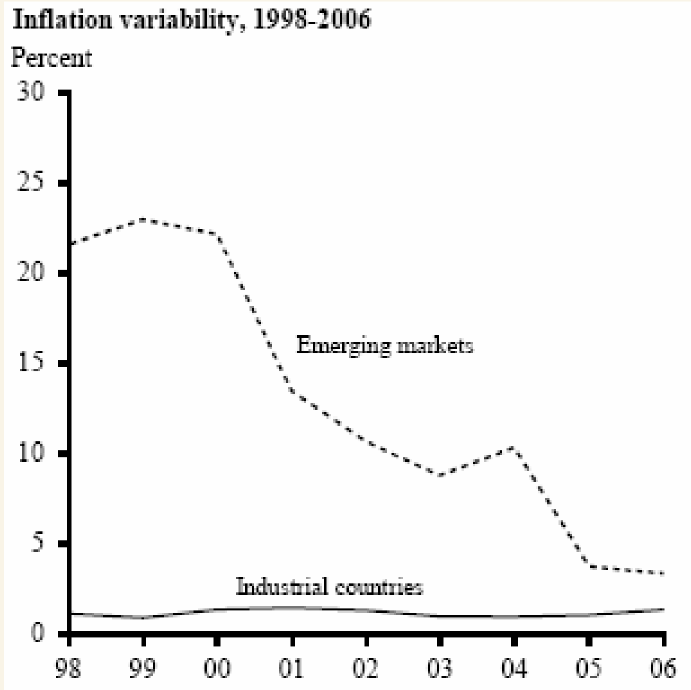
- **Decreased cost of capital and supported risk appetite**
- **Greased the wheels of financial engineering**

Great Moderation

Benign Macroeconomic Conditions



Source: IMF

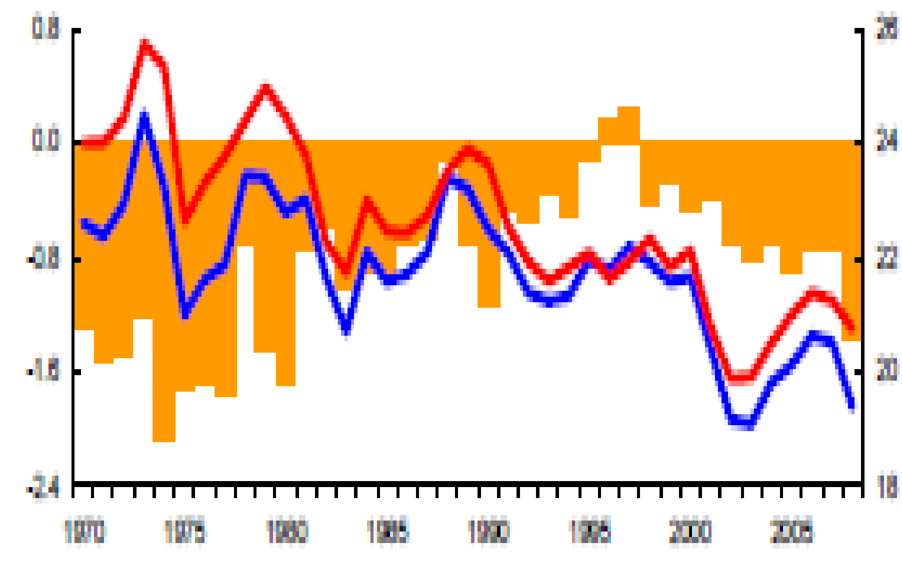


Source: IMF

Improved policies, which stabilized inflation and better anchored inflation expectations, are an important reason for loose monetary policy amidst high growth; structural changes in the economy such as deregulation, improved inventory control methods, and better risk-sharing in the financial markets also contributed

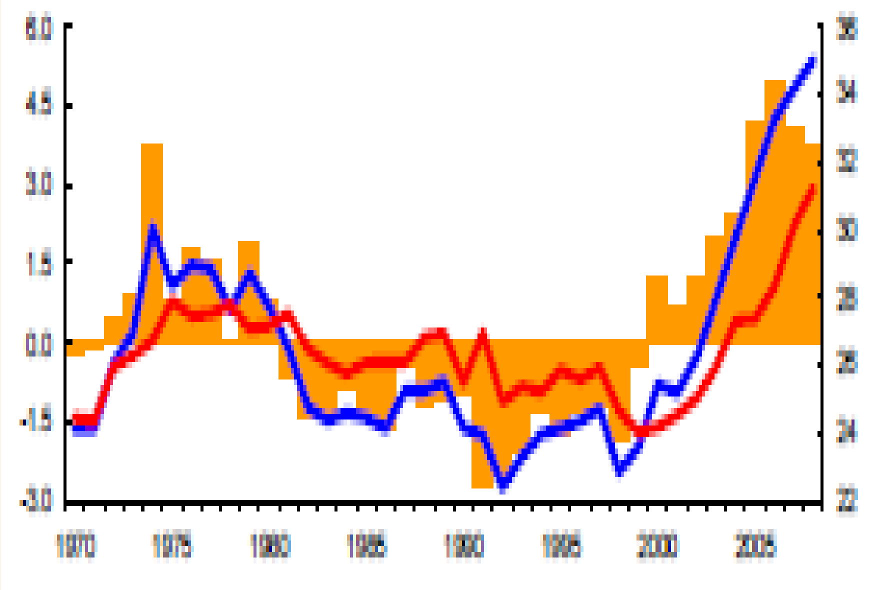
Global Saving, Investment and Current Accounts

Advanced Economies



Source: IMF

Emerging and Developing Economies

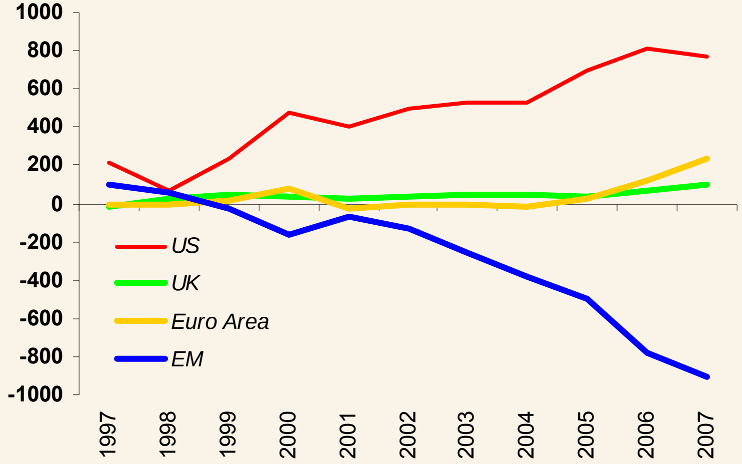


Source: IMF

- **Various factors contributed to this so-called "savings glut." In emerging Asia, the main contributor was a steady increase in private savings.**
- **High levels of corporate saving and strong precautionary motives for savings in the absence of a well-working system of social insurance, rapid rise in public savings in Middle Eastern oil exporters as a surge in oil prices, general trend towards higher public savings as governments took advantage of strong revenue growth to consolidate fiscal positions**

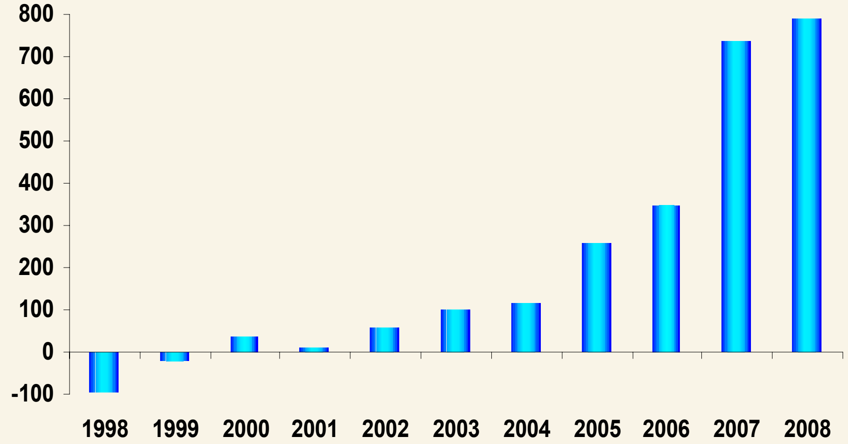
Global Imbalances and Exchange Rate Regimes

Net Capital Flows (bn $)



Source: IMF

Current Account Balance of Emerging Economies (bn $)



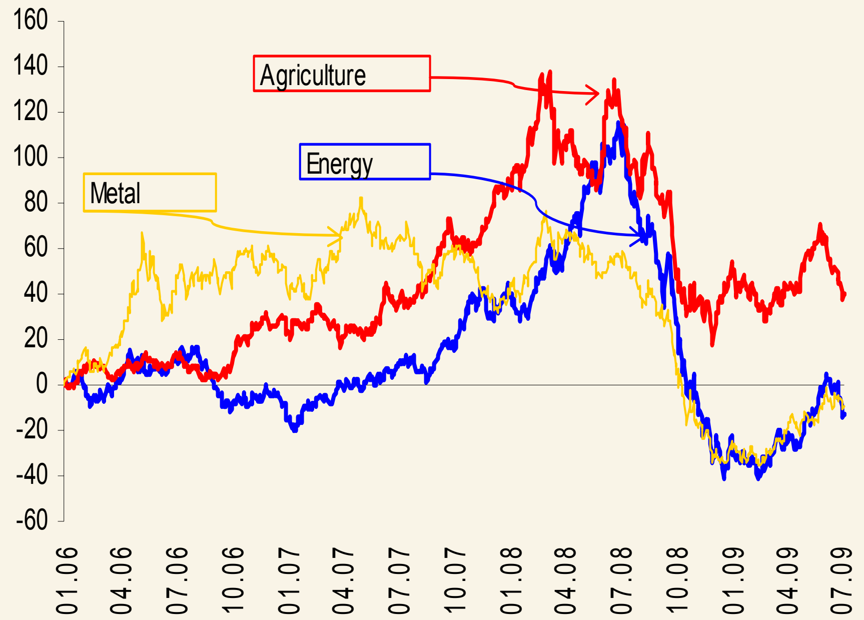
Source: IMF

- **The high level of the saving rate in the emerging economies and its low level in the United States were associated with the large current account deficits and surpluses resulting in capital flows from emerging economies to developed economies.**
- **Developing countries hold massive dollar reserves in return of their exports and reinvest these reserves into US financial markets.**

→ Breakdown in macroeconomic adjustment mechanisms

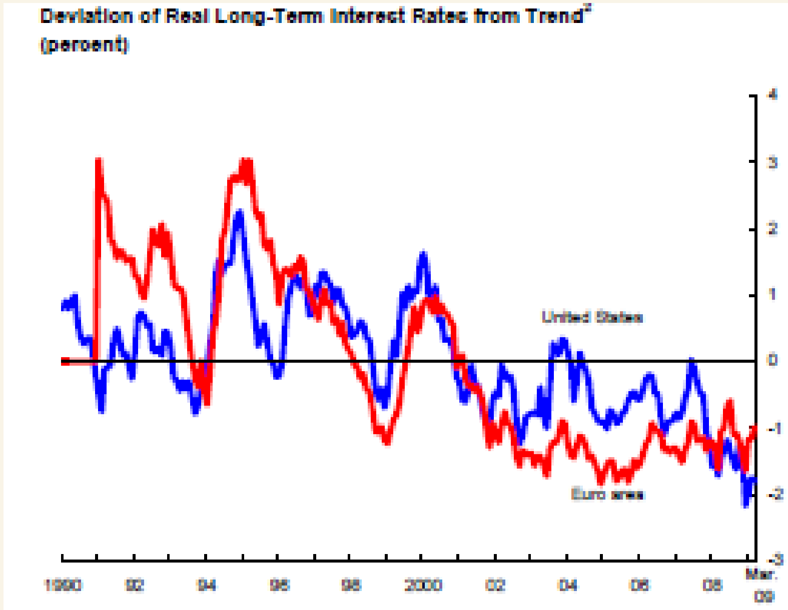
Asset Price Boom

Commodity Prices(03.01.2006=0)



Source: Bloomberg

Monetary Accomodation

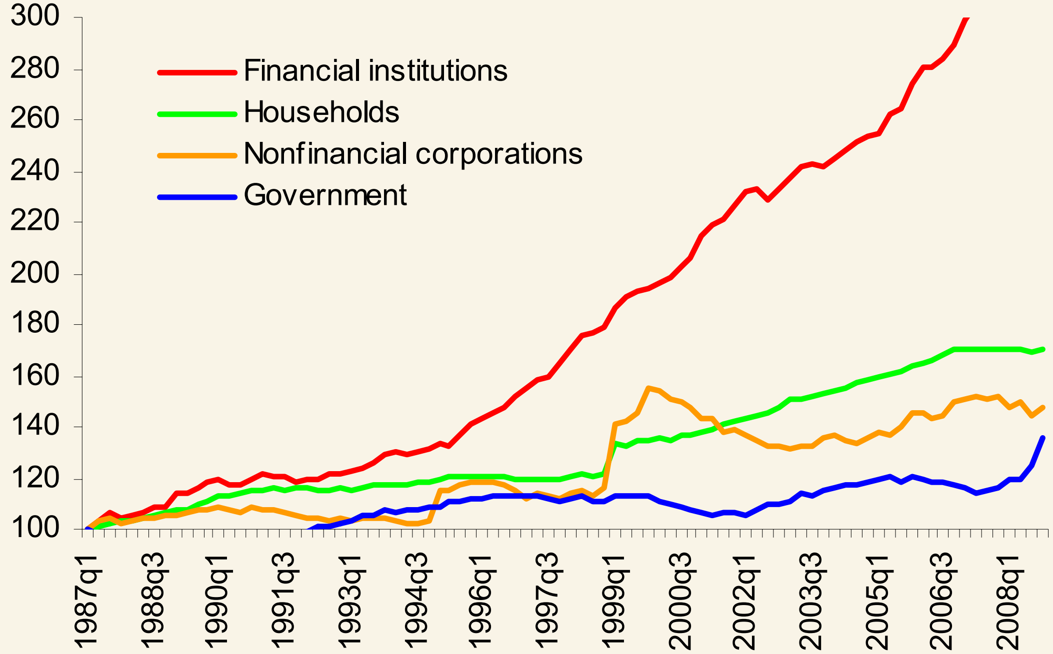


Source: Office of Federal Housing (OFHEO)

- First, low interest rates led to a credit boom in major economies.
- Second, low interest rates were the main reason to drive up asset prices. Housing boom and continuous rises in stock markets are the main examples.

What makes the difference: Leverage

Ratio of Debt to GDP in Advanced Economies
(In percent, GDP-weighted, 1987 = 100)



Source: IMF

- **Most importantly, low interest rate environment has changed the risk taking behaviour of the financial institutions and laid down the foundations of the current crisis.**
- **For the sake of higher returns, financial institutions have distorted their risk perception, and the risk management strategies in the financial sector were totally changed. This also led to acceleration of financial innovation.**

Is the History Simply Repeating Itself?

Triffin Dilemma

- The use of a national currency as global reserve currency leads to a tension between national monetary policy and global monetary policy

  e.g. 1982 Third World Debt Crisis

Gambling with the Future or Adaptive Behavior

- Dutch Tulipmania (1634-37)

The immense expansion of commerce [in the Netherlands] encouraged gambling upon profits to be made from speculation in all kinds of products

- Great Depression

"Buying now and paying later" or "telescope the future into the present"

Between 1925 and 1929 the total amount of outstanding instalment credit more than doubled, by 1928, with over 21 million cars on the roads, there was roughly one car for every six Americans

→ car, steel and metal, fuel, textile

→ construction industry grew nearly 50%: house (suburbs), hotels, factories

Micro-structural Dynamics

Financial innovation

•As massive capital inflows to the US had been financing its current account deficits, financial institutions intermediated the vast liquidity into consumer credit and mortgages, which have converted into mortgage-backed securities (MBSs) and CDOs.

Change in risk taking behaviours

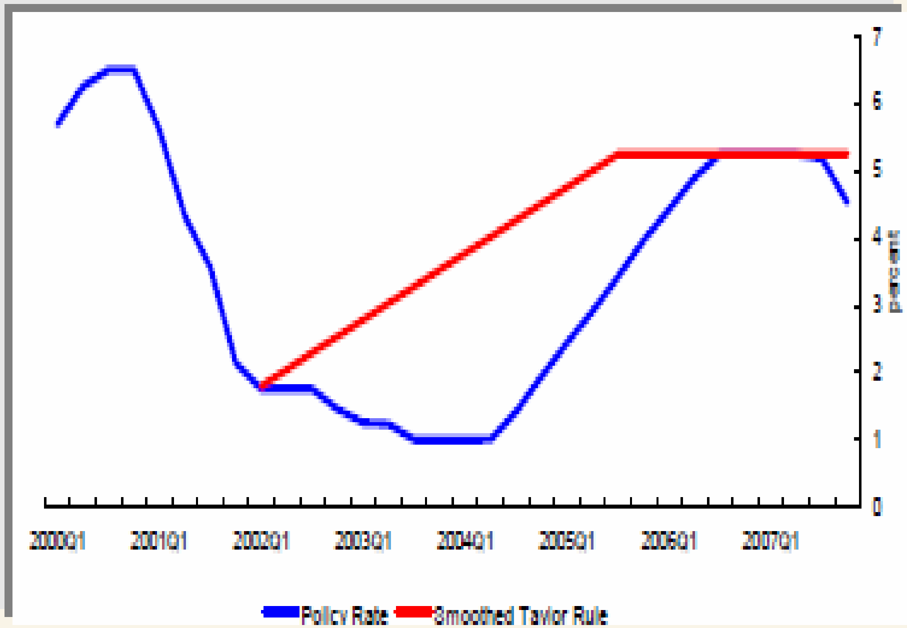
•Fast growing financial innovation in instruments, such as CDSs named as an insurance against risk, and the regulatory framework of the financial system caused deterioration in risk perception of the market players. As optimism in financial sector prevailed due to ongoing higher global growth, investors depended too much on credit ratings in risk evaluations, rather than deeply examining themselves the nature of assets they bought. No direct monitoring between lender and borrower, misallocation of loanable funds.

Deficiencies in financial regulation

•Regulation arbitrage opportunities in terms of (1) countries, and (2) instruments

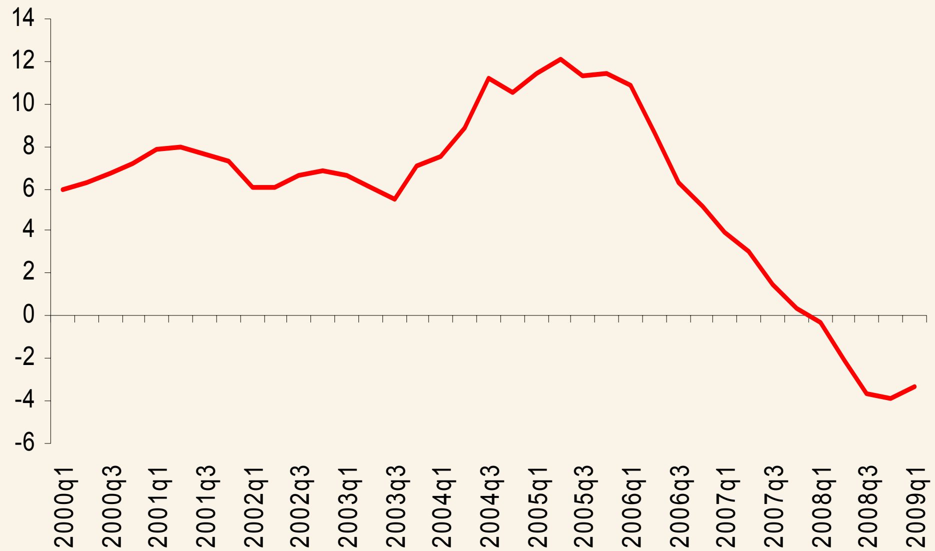
Monetary Policy

FED Funds Rate and Taylor Rule Path



Source: Taylor (2008)

US House Prices (yoy, % change)



Source: Office of Federal Housing (OFHEO)

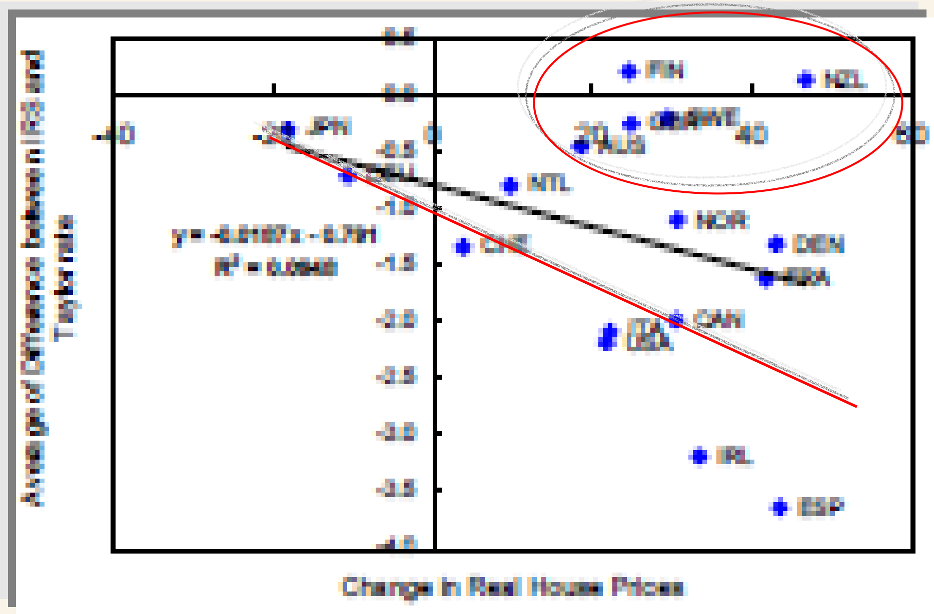
Taylor (2008) argues that monetary policy was too loose in the United States over 2002–04 as interest rates were lowered further even as the economy seemed to be turning around after the "dot-com" recession of 2001.

However; the optimality of the imposed rule is to be questioned and

Between 2002–04 deflationary pressures were greater than conventional output gap estimates, natural rate of interest is uncertain and subject to debate.

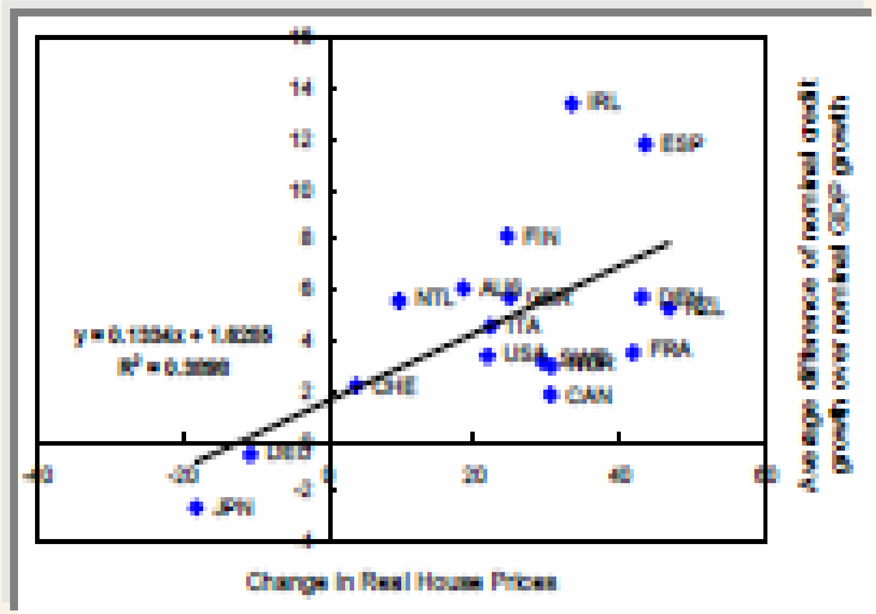
Monetary Policy and Credit Boom

Real House Price and Taylor Rule Residuals



Source: IMF

Real House Prices and Excess Credit



Source:IMF

Taylor rule residuals for 17 advanced economies and changes in real house prices over the period 2003:1 to 2006:4 show that looser monetary policy is associated with larger house price gains but the relationship is weak. However AUS, FIN, GBR, SWE, NZL excluded, it is more significant.

There is a very close relationship between house prices and the growth of money and of private sector credit. More evidence b/w monetary policy and asset prices through liquidity and credit

Shortfalls of Domestic Monetary Policies

UNCONTROLLABLE FACTORS

1. Globalization → Capital flows may weaken the effects of domestic monetary policy
2. Financial Innovation → Less effects of MP on structured products, private (outside) money

- ***Globalization led to a decline in the sensitivity of inflation to domestic output gaps and thus domestic monetary policy***
- ***Globalization reduced the scope for individual central banks to control domestic interest rates and so stabilize both inflation and output.***
- ***Effect of the interest rate channel on overall economic activity was diminished by greater trade integration as changes in domestic demand are offset by induced changes in imports.***

Global Crisis, Global Solution

MAIN CONFLICT/TENSION ARISES FROM THE DUALITY

CRISIS: GLOBAL

CRISIS RESOLUTION MECHANISMS: NATIONAL

TWO LAYERS CONCEPTUALIZATION

1. Globalization → global infrastructure.
2. Mechanisms → national superstructure

Global Crisis, Global Solution

Impossible Trinity of Economic Policies

First introduced by, Fleming (1962) and Mundell (1963)

Developed and applied to international trade theory by Obstfeld and Taylor (1998)

Frankel (1999) systematized and baptized as "impossible trinity" or "trilemma"

Under free capital movements

Either interest rate policy (independent monetary policy) or

exchange rate policy (fixed FX regime) is feasible

Global Crisis, Global Solution

Impossible Trinity of Economic Policies

Rodrik (Feasible Globalizations, 2002) established a similar methodology in order to discuss the problematic structure observed in global economic order.

Under the global economic integration

It is not possible to have both

full national independence/sovereignty and

democratic domestic policies

Conclusions

Acceleration of US productivity and the increase in household net worth mid-1990s, led an upward shift in private sector propensities to invest and to consume. The US monetary policy stance generally accommodated this development.

Expansionary monetary (and fiscal) stance sustained US domestic demand, contributed to a widening of the external imbalance, compensated by an imbalance of opposite sign in the external positions of major emerging economies

A number of countries that pegged their currencies to the US dollar accumulated very substantial official reserves. The investment of these in US Treasury paper contributed to lower long-term interest rates.

Low interest rates triggered a search for yield which, by squeezing risk premiums, tended to make financial conditions even more favourable for a broad range of borrowers. Low perceived risk, abundant liquidity and credit expansion, as well as regulatory failures in some markets, helped feed the asset price bubble.

Conclusions

Not a happy end: Increased global demand and commodity supply constraints caused a global inflation, monetary policies were gradually tightened. At that point, the large risk exposures that had accumulated in the financial system suddenly became apparent, precipitating the turmoil.

Credit and money markets crashed. Contrary to previous expectations (i.e. a hard landing for the US economy originating from a correction of unsustainable US current account imbalance, through a disorderly dollar depreciation) USD appreciated due to huge develeraging efforts all over the world.

The task of monetary policy in this context is problematic. Asset price cycles tend to happen with large changes in indebtedness and increase financial vulnerabilities. Whether and how monetary policy should react to asset price misalignments and financial imbalances? Whether central banks must and can target, with just a single policy instrument, more than just inflation?

Conclusions

- *The policy issues in national level caused and will continue to cause cross-border financial and macroeconomic spillovers in an integrated world economy.*

- *Neither national nor international measures or institutions are enough.*

- *The concept of "international framework" should be substituted by "global framework". The solutions should be redesigned within the globalized risk environment.*

- *The impossible trinity of global economic order should be addressed.*

- *Since the financial, economic and political globalisation is irreversible, the legislation of globalization should be first agenda item. Legitimate and supranational mechanisms should be established to monitor the global benefits of the national states.*

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