Financial Crises and the International Monetary System

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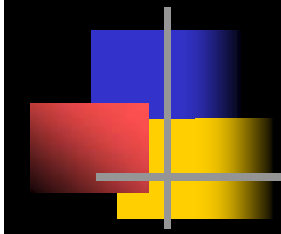
Outline



- Financial Crises and the IMS
- The Evolution of the IMS
- The Bretton Woods System
- Fluctuating Exchange Rates
- Crises Under Fluctuating Rates
- The Euro
- The 2007-9 Financial Crisis
- Five Goats of the Crisis
- What is to be Done?
- Policies for Rest of the World
- Toward a Global Currency

International Crises and the IMF

Exchange Rates and Crises

- Financial Crises national or international.
- Frequency depends on the type of international monetary system.
- Large fluctuations in exchange rates a major cause of financial crises.

Sequences of International Monetary Systems

Bimetallisms	600 BC –47 BC
Gold Standard	46 BC- 1203
Bimetallisms	1204 – 1789
Flexible Rates	1789 – 1814
Free-Coinage Bimetallism	1815 – 1873
The Gold Standard	1873 – 1914
Anchored Dollar Standard	1915 – 1924
Gold Exchange Standard	1925 – 1933
Anchored Dollar Standard	1934 – 1971
Dollar Standard	1971 – 1973
Flexible Exchange Rates	1973 – 1998
Currency Areas	1999 – ?

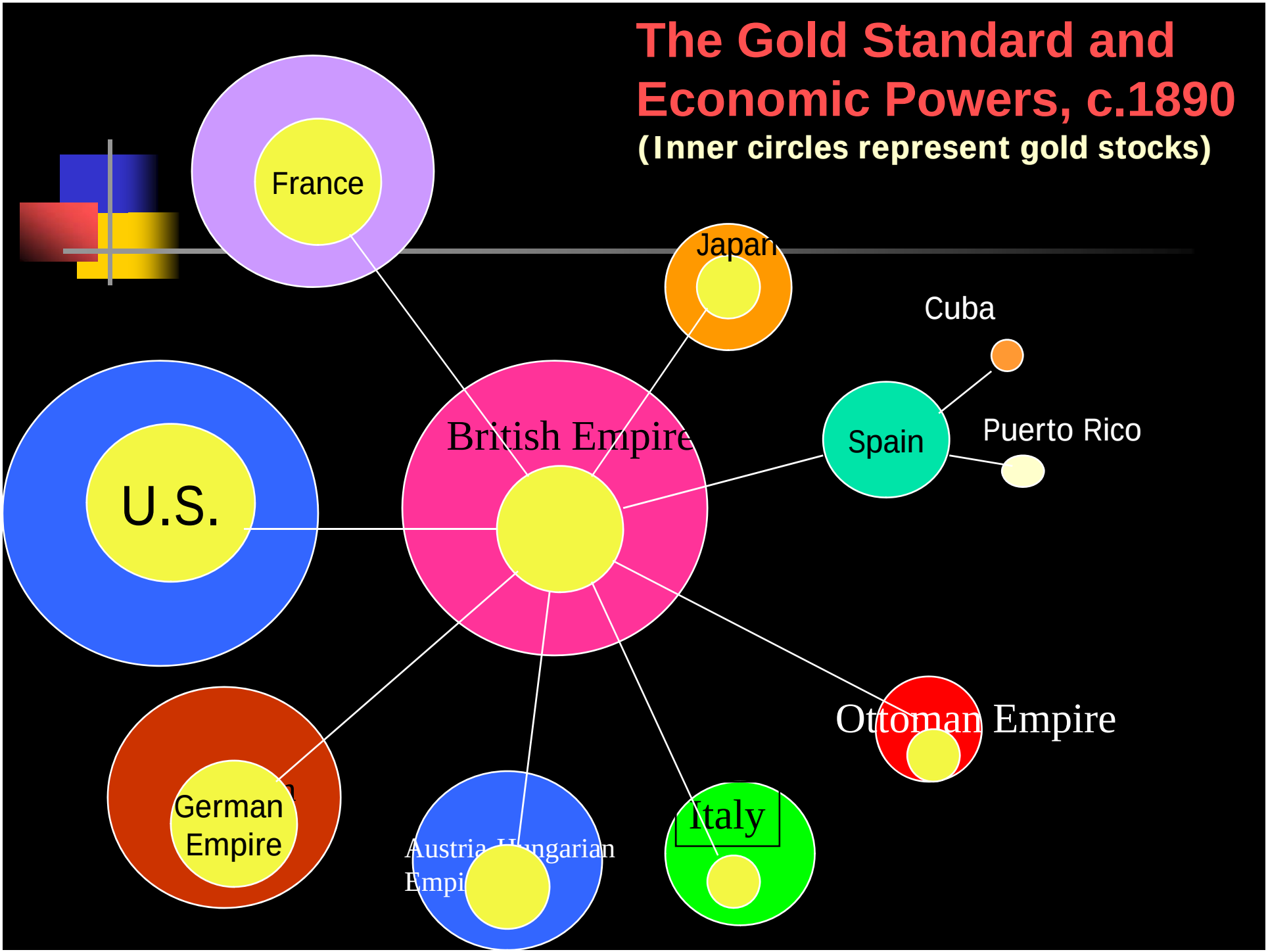
Recent Phases of the International Monetary System

Date	System	Reserve Asset(s)	Leader(s)
1803-1873	Bimetallism	Gold & Silver	France
1873-1914	Gold Standard	Gold and £	Britain
1915-1924	Anchored $ St.	Gold and $	U.S.
1924-1933	Gold Standard	Gold,$ and £	US, UK, France
1934-1971	Anchored $ St.	Gold and $	U.S., G-10
1971-1973	Dollar Standard	$	U.S.
1973-1985	Flex. Ex. Rates	$, DM, £,	U.S., FRG
1985-1999	Man. Ex. Rates	$, DM, ¥	U.S.
1999-2009	Dollar and Euro	$, €, ¥, £	U.S. EMU
2009-?	Currency Areas	$. €, ¥, C¥, £	US, EMU

2. Evolution of the International Monetary System

The Victorian Age

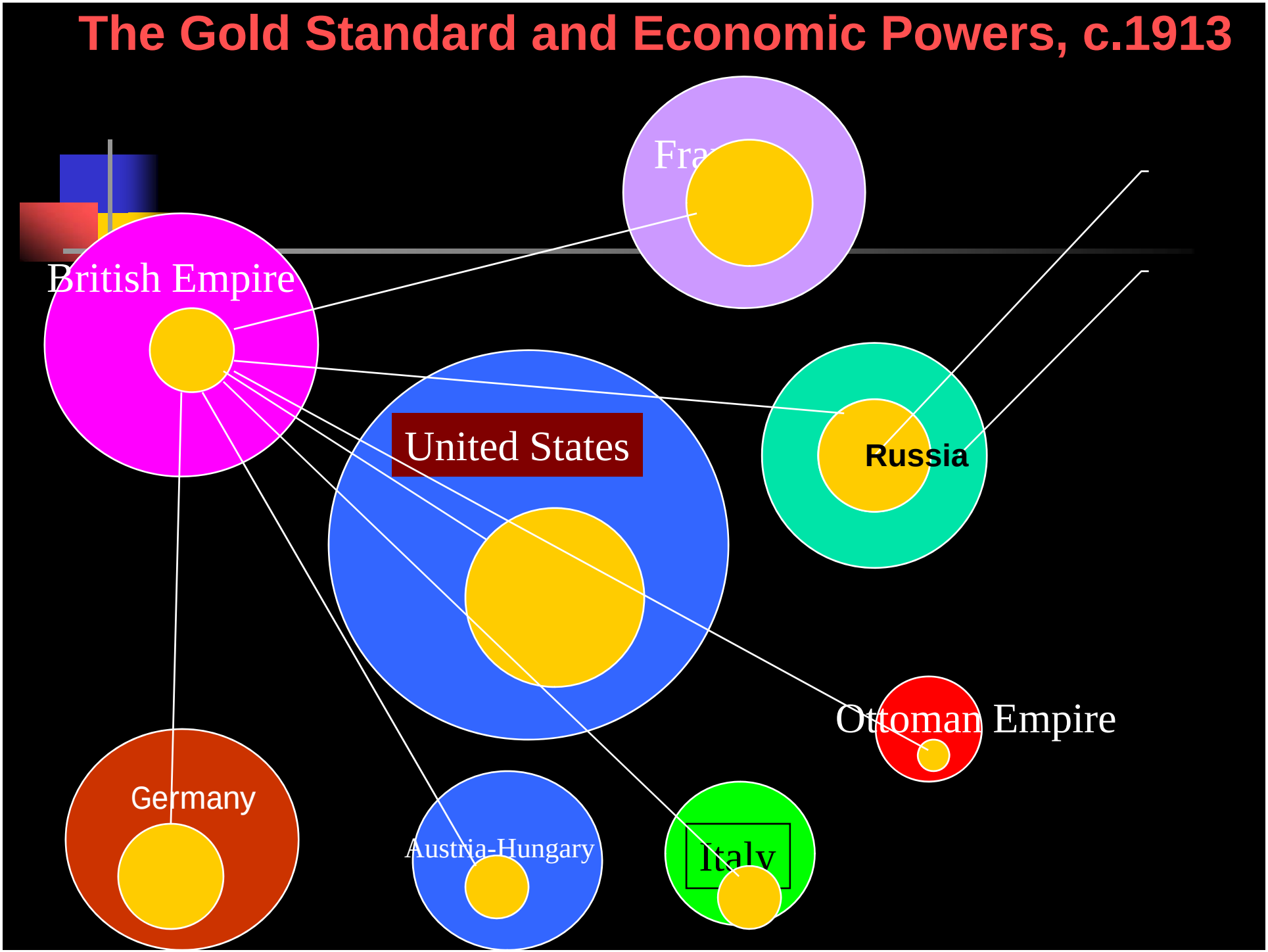
- In the nineteenth century, the British Empire was the first-among-equals great power, the pound sterling was the most important currency in the world, and London was the financial center of the world.
- There were no major banking crises that affected the stability of the system.


The Gold Standard and Economic Powers, c.1890
(Inner circles represent gold stocks)
France
Japan
Cuba
Puerto Rico
Spain
British Empire
U.S.
Ottoman Empire
German Empire
Austria-Hungarian Empire
Italy

U.S. on the Brink

- By the outbreak of World War I, the United States was on the verge of superpower status.
- The Federal Reserve System (1913) gave the U.S. a central bank and concentrated its monetary power.
- The US economy was alreadybigger than the next three biggest economies put together.

The Gold Standard and Economic Powers, c.1913

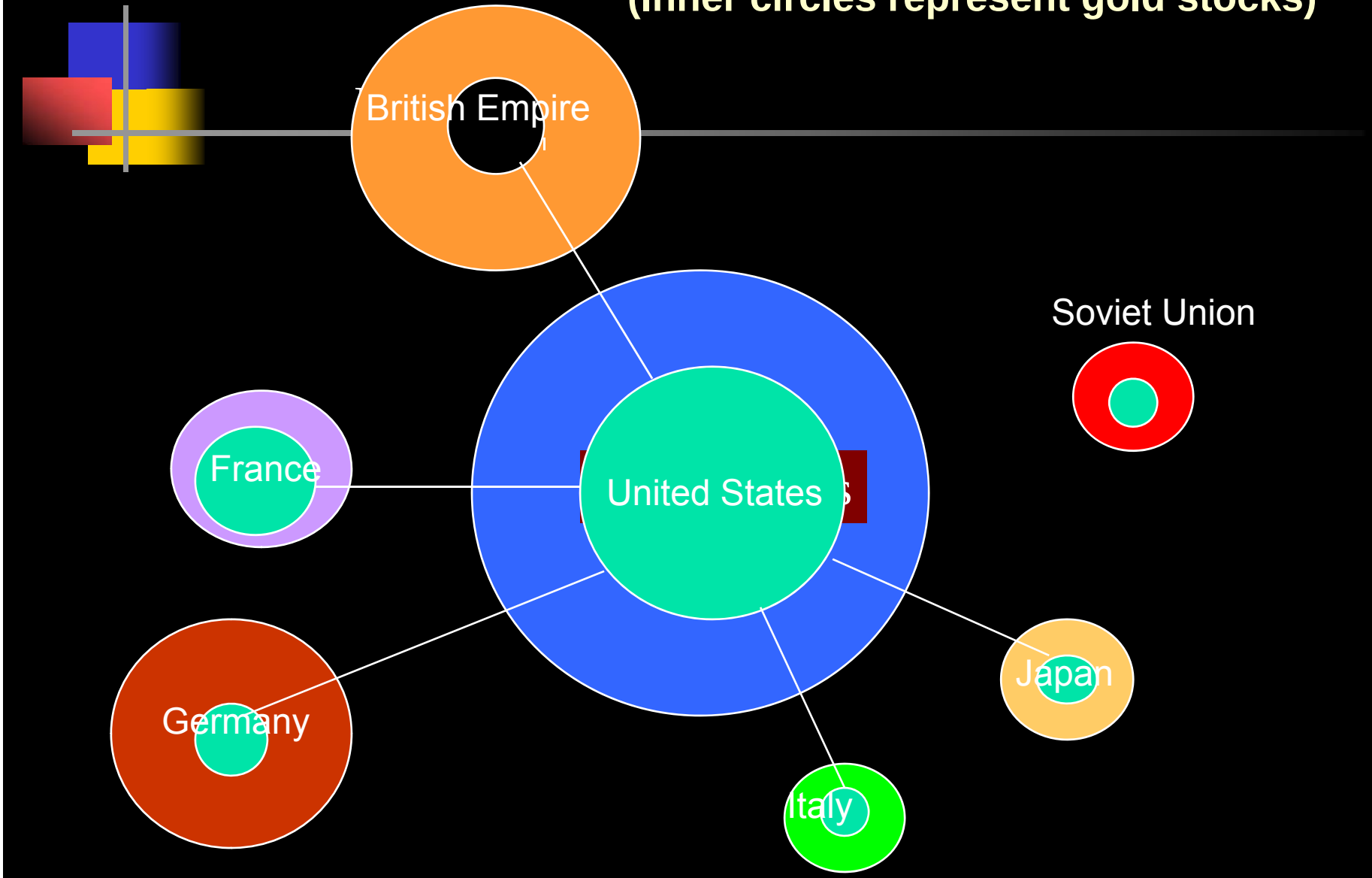


The Late 1920s

- The U.S. had half the world's monetary gold.
- Europe and the rest of the world had gone back to the gold standard, creating deflation.
- France enacted its monetary law.
- The world economy was just a year away from economic doom!

The Gold Standard and Economic Powers, c.1928

(Inner circles represent gold stocks)

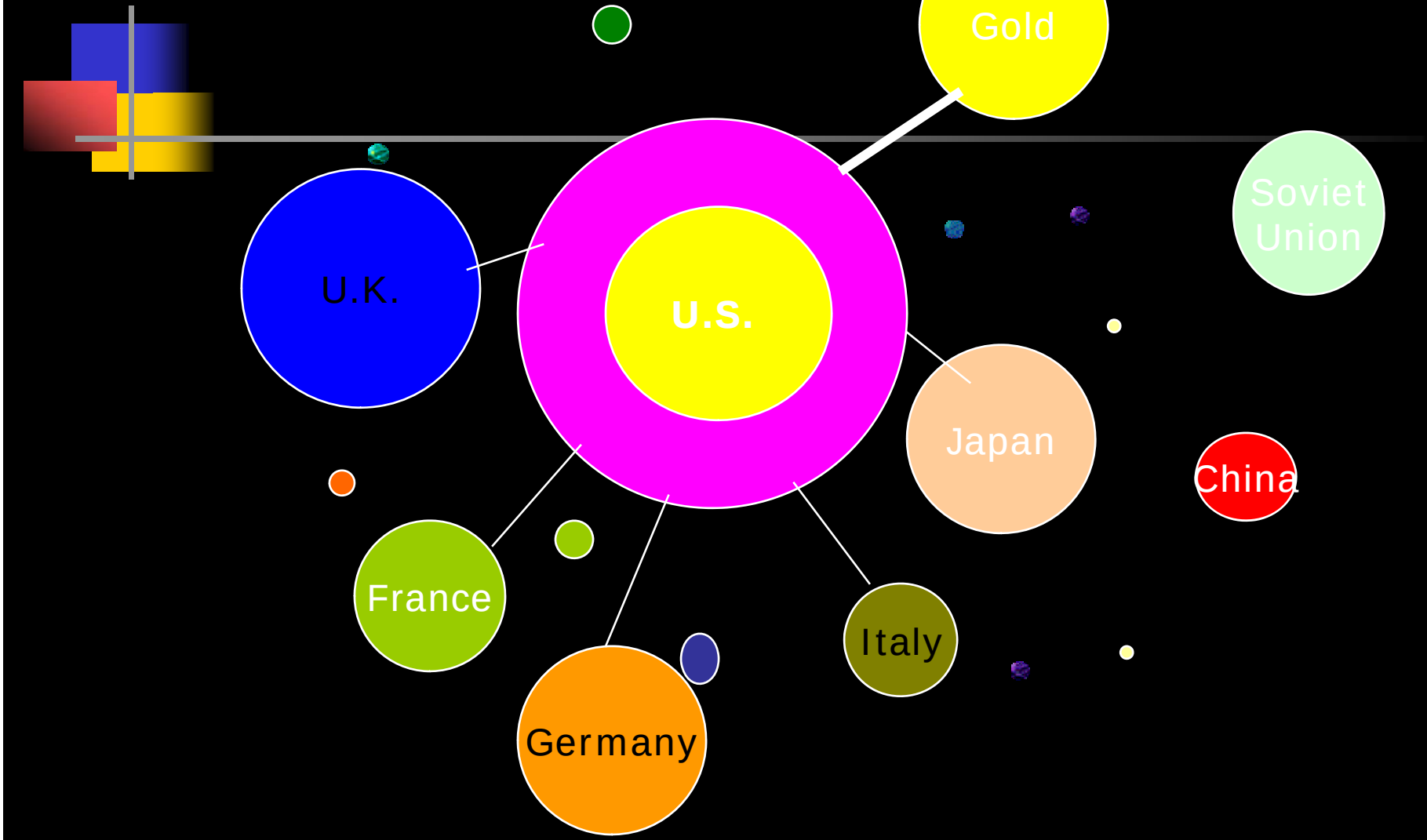


3. The Bretton Woods System

1934-71

- Deflation led to the breakup of the gold standard and the U.S. went off gold in 1933.
- In 1934, however, FDR devalued the dollar and put the U.S. back on a weak form of the gold standard.
- This made the U.S. explicitly the center of the international monetary system for four decades.

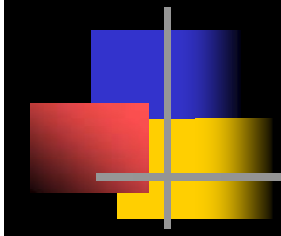
Dollar Standard 1934-1971.
A.K.A. the Bretton Woods "System"



Bretton Woods and the IMF

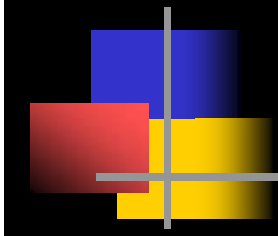
- At the meeting of 44 nations in Bretton Woods, New Hampshire, U.S.A., in 1944, the IMF was set up to supervise the fixed exchange rate system.
- The original British and American plans included a world currency, but 1944 was a presidential election year and it was not good politics.

Defects of the Bretton Woods System



- There was no world currency.
- There was no mechanism for keeping the world price level in line with the fixed price of gold (US sterilization).
- IMF assets included junk currencies that had no use internationally, so it couldn’t be a revolving credit system.

Flexible Exchange Rates the Result of Failure to Negotiate



- The BW System broke down because the world price level tripled while the price of gold was kept at $35, the price set in 1934.
- When President Nixon took the dollar off gold on August 15, 1971, the other countries took their currencies off the dollar.
- None of the major countries wanted to scrap the system but a reformed system could not be negotiated.

Fluctuating Exchange Rates

Monetary Nationalism

- Fluctuating exchange rates meant that each country was responsible for its own monetary stability.
- It inaugurated an era of monetary nationalism.

A Chaotic System

- There are 185 members of the IMF today.
- Scores of countries on flexible rates would have meant chaos.
- E.G. if there are N = 200 countries in the world with separate currencies, there are ½ x N x (N-l) = 19,900 exchange rates!

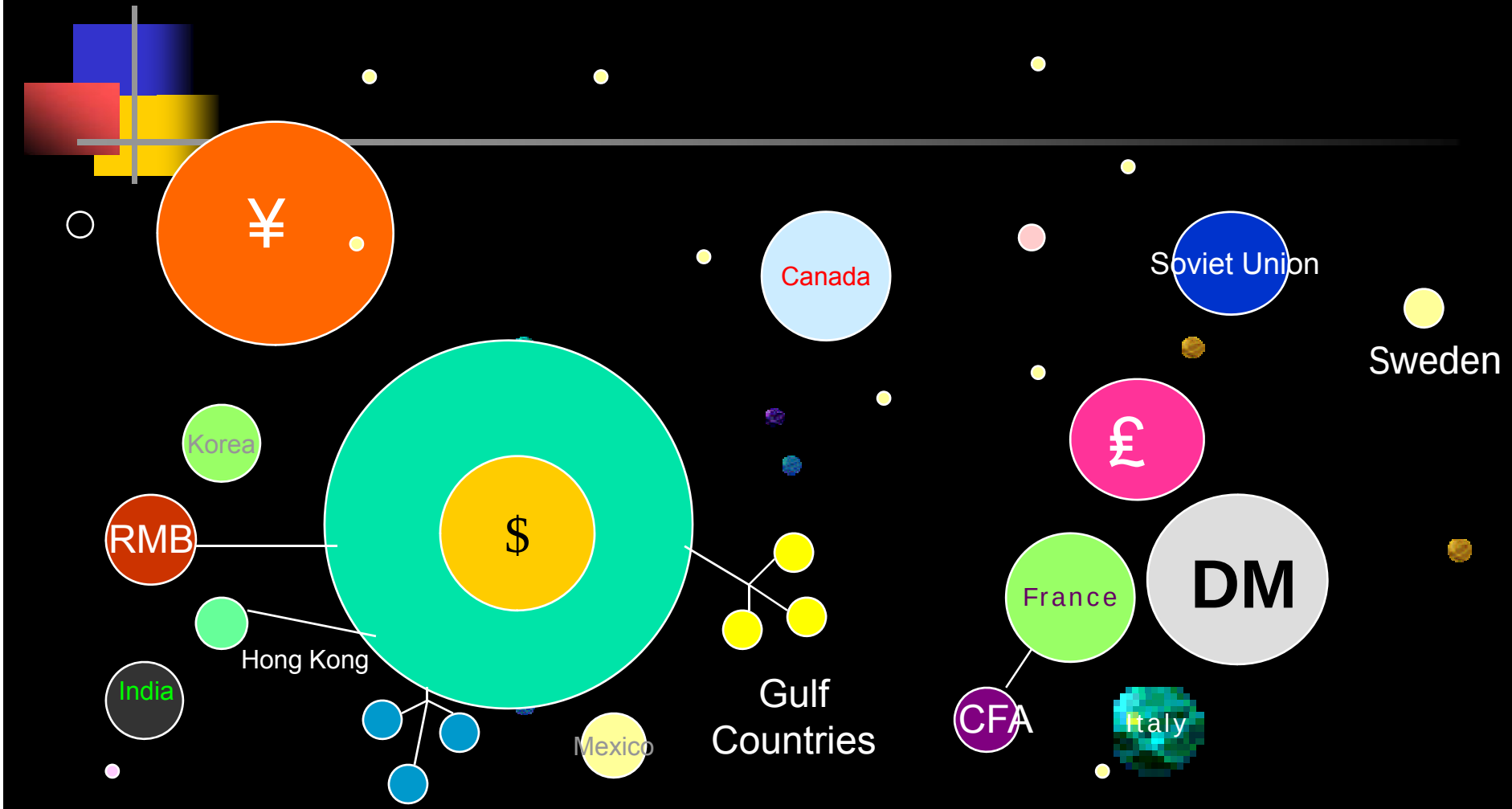
Fluctuating Rates the Worst Idea

- Fluctuating rates a system of monetary nationalism.
- The smallest countries lose the most, the biggest countries might gain.
- The idea was invented by the superpowers, Britain in 19th C and U.S. in 20th C.
- Idea never subjected to careful scrutiny.

National Monetarism

- Under the fixed exchange rate system, the smaller countries could benefit from being part of the huge dollar area.
- The breakup of the fixed exchange rate system by the monetary nationalists shifted power and seigniorage to the United States.
- What DeGaulle called “an exorbitant privilege.”
- The U.S. did not want to share the gains of its large currency area with the rest of the world.

Flexible Rates 1973-99

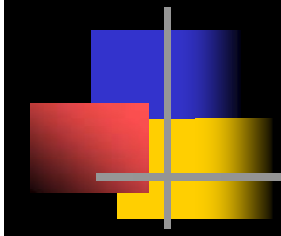


Unofficial Dollar Standard

- In practice flexible exchange rates did less harm because countries could use the dollar as a unit of account and keep currency reserves in dollars.
- For most countries “the exchange rate” meant the rate on the dollar.
- The Federal Reserve became an unofficial world central bank, providing global reserves, supplying the unit of account, and sometimes acting as lender of last resort.

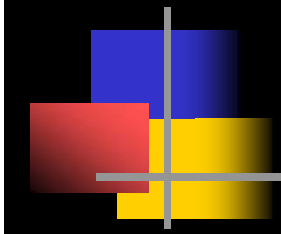
Crises under Fluctuating Rates

Financial Crises Under Fluctuating Rates

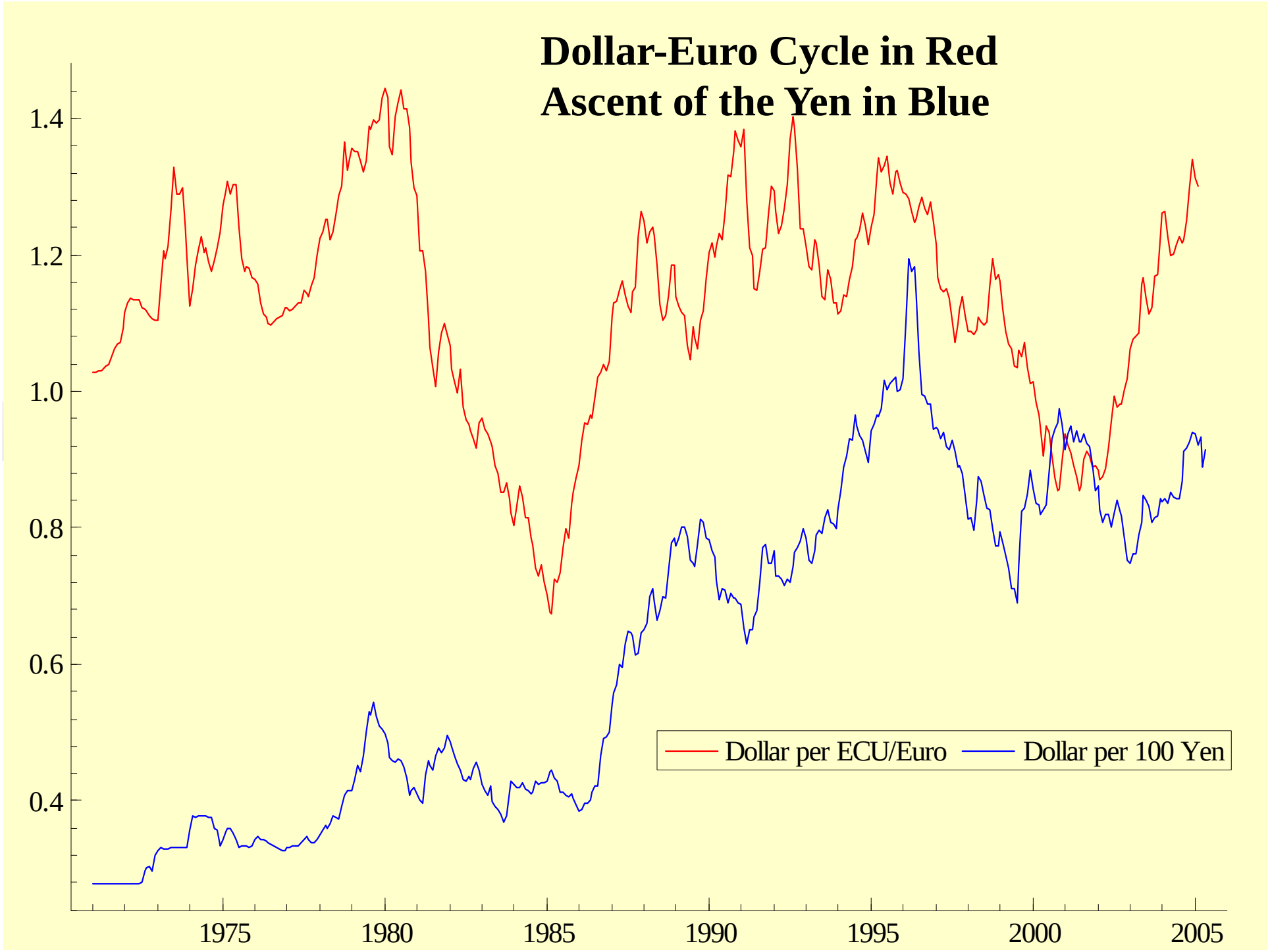


- There were no banking crises under the Bretton Woods System.
- By contrast there were four banking crises under fluctuating rates.
- They were all associated with large swings in major exchange rates.
- The two major exchange rates involved were the dollar rate against European currencies, and the dollar-yen rate.

The Four Crises Under Fluctuating Rates



- The S&L Crisis – early 1980s
- The International Debt Crisis – 1982
- The IMF-Asian Crisis – 1997-8
- Lehman Shock and World Crisis - 2008

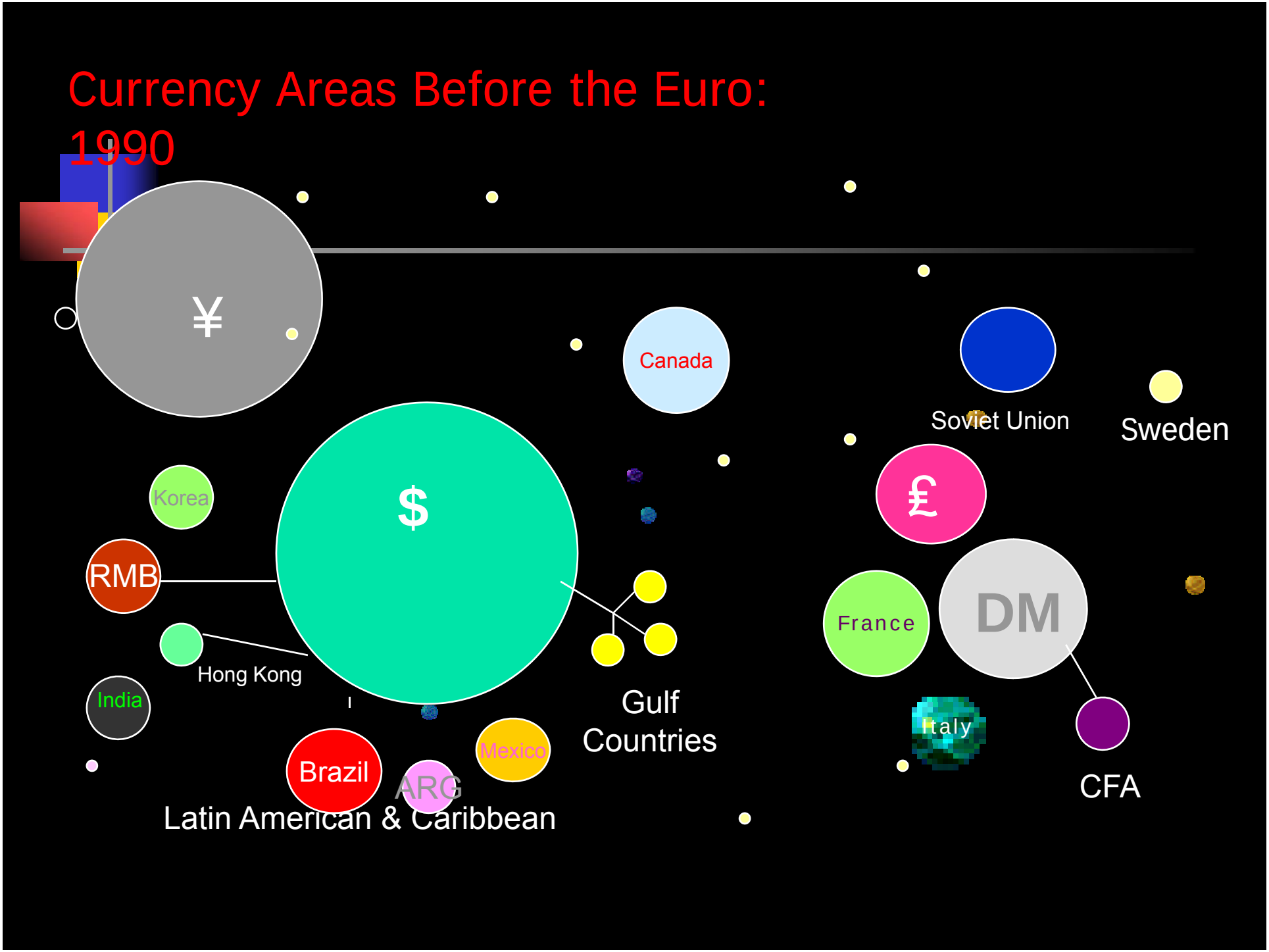

Dollar-Euro Cycle in Red
Ascent of the Yen in Blue
1.4
1.2
1.0
0.8
0.6
0.4
1975
1980
1985
1990
1995
2000
2005
Dollar per ECU/Euro
Dollar per 100 Yen

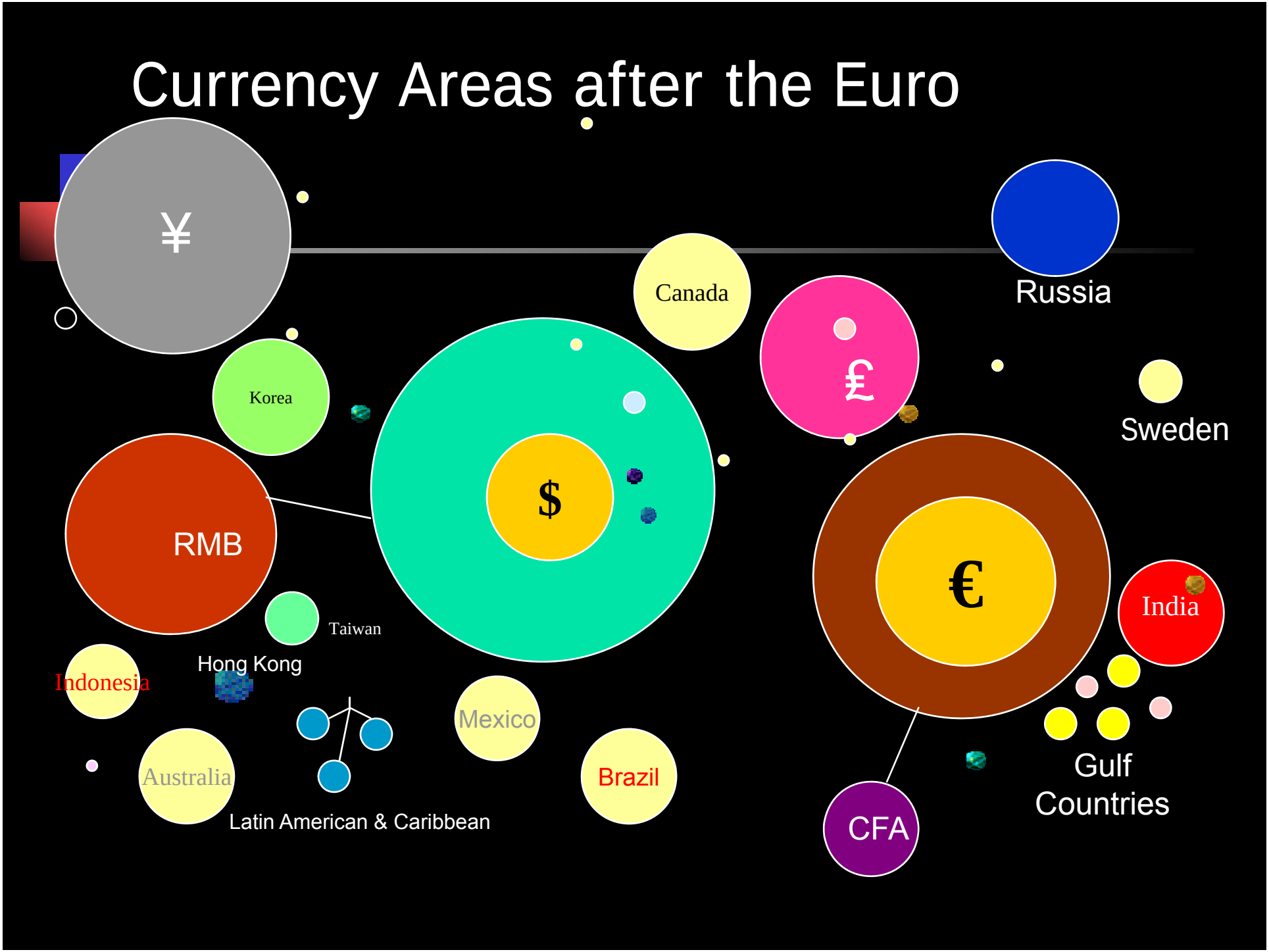
6. The Euro

European Currency

- Europe most of all disliked flexible rates and the power it gave the dollar.
- Europe embarked on its project for a common currency even before the system broke up.
- My plan for a European currency (called europa) was presented and published in 1969.

Currency Areas Before the Euro: 1990




Currency Areas after the Euro
¥
Canada
Russia
£
Korea
Sweden
$
RMB
€
India
Taiwan
Hong Kong
Indonesia
Mexico
Australia
Brazil
Gulf
Countries
Latin American & Caribbean
CFA

Creation of the Euro

- The creation of the euro in 1999 concentrated the monetary power of Europe.
- Upon its creation, the euro overtook the yen as the #2 currency in the world.
- Had Britain joined it, the euro area would be as large or larger than the dollar area (depending on the exchange rate)

The 2007-9 Financial Crisis

The Origins

- The early origins go back to the Federal Reserve policies used to cope with the global slowdown of 2001-2.
- With very low interest rates and a low dollar in the recovery, a housing boom developed.
- As long as house prices were rising there was a cushion of safety between mortgages and house values.

End of the Boom

- When the house prices stopped rising and began to fall, the boom ended.
- When house prices fell below mortgage values, homeowners walked away from their mortgages.
- Sub-prime mortgage assets became toxic, creating a devastating hole in balance sheets.

Five Trouble-Makers

- Securitization of mortgages
- Derivatives
- Credit-Default-Swaps
- Mark-to-Market Accounting Rules
- Variable Rate Mortgages

Financial Innovations

- Securitization of mortgages cut link between issuers and holders.
- Derivatives created new systemic risks.
- Credit default swaps enabled insurance without ownership.
- Mark-to-market accounting in investment accounts created intertemporal instability in balance sheets.

Massive Liquidity Crisis

- Sudden awareness of the problem in the summer of 2007 created a massive balance sheet problem for banks amounting to hundreds of billions of dollars.
- Mark-to-market accounting forced them to cover the holes.
- The scramble for liquidity was completely unprecedented in the annals of finance.
- A financial panic was about to occur.

The Liquidity Crisis: Aug 9-10, 2007

- The panic was averted by prompt action by the ECB. It offered unlimited credit at 4% on August 9.
- 95 billion in euros were lent at that rate
- More came from the Fed and other central banks when their markets opened later and the next day the lending continued.

Injections by ECB and FRB in Billions of Dollars in August 2007

	Thursday August 9	Friday August 10
ECB	130	54
FRB	24	38

Solvency Problem

- The prompt actions of the ECB and FED and others in August 2007 solved the **liquidity** problem at the time.

- What remained was the **solvency** problem of those institutions with big holdings of these defaulting assets.

Slowdown and then Recovery

- After the resolution of the liquidity crisis there was relative quiet for 13 Months.
- The great expansion of 2002-2007 came to an end in the U.S. with the great slowdown in 2007 (4) and 2008 (1) and a near recession.
- But then expansion came in 2008 (2) with growth of 2.8%.
- A recovery seemed to be coming.

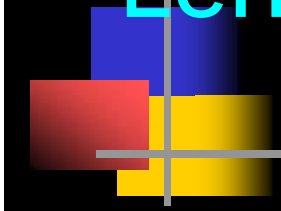
The Spring Recovery

- In the spring of 2008 it looked as if the U.S. economy was recovering. There was 2.8% growth in the second quarter of 2008.
- Bear Stearns was a problem – the biggest bailout since LTCM in Sept 1998 - but it seemed to be settled with its absorption into J.P. Morgan in May 2008.

Financial Blowout and Recession in 2008-II

- But instead of recovery in the last half of 2008 we got the greatest financial disasters in American history and a an unambiguous recession with two consecutive quarters of negative growth in 2008 (3) and 2008(4).

Lehman's Collapse



- Lehman's demise was the biggest failure in world history.
- Previously, Enron in 2002 had been the biggest.
- But the Lehman failure was six times bigger than Enron.

Credit Dried Up

- The most serious cost of the failure of Lehman was a colossal increase in the demand for money on the part of both banks and the public.
- Money became even tighter. Credit became unavailable except for super-solvent firms. Credit for ordinary enterprises dried up.

Two Questions

Two questions arise:

1. What put Lehman Bros in danger?

2. Why did the Fed and Treasury let Lehman fail?

Lehman's Collapse

- Lehman was too big to fail BUT THE FED AND TREASURY LET IT FAIL.
- It was a mind-boggling mistake.
- It put other institutions at risk and made the take-over of AIG, at a cost of $78 billion+++ inevitable.

The Big Question

- Why did the financial crisis occur and why did it happen to come about in August and September 2008?
- What caused the debacle that September?

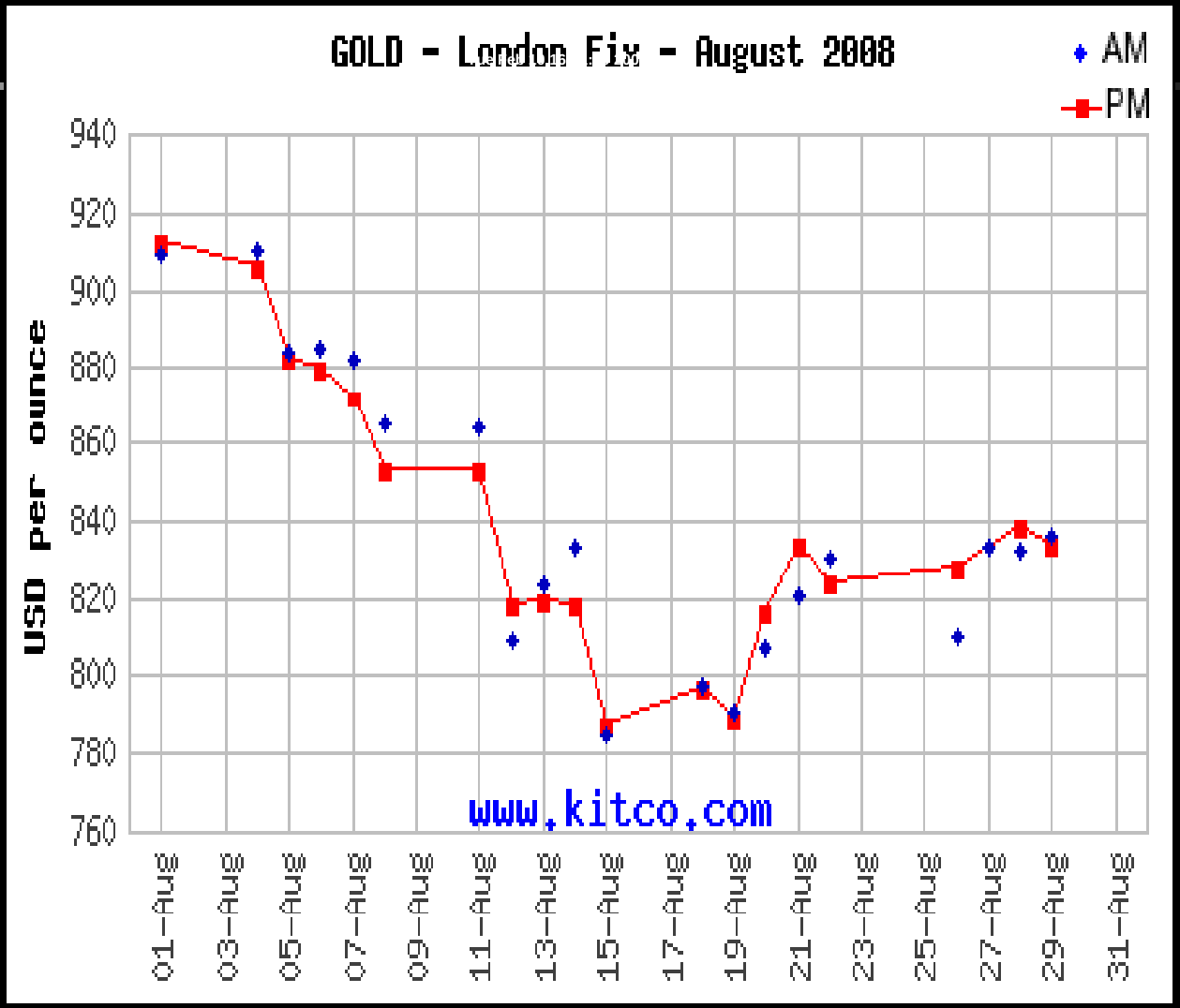
Currency Appreciation and Tight Money

- The dollar soared in July-September and the price of gold fell.
- These are two symbols of tight money.
- True, interest rates were low and monetary expansion was enormous, but not enough to offset the increase in the demand for money.

The Dollar in Euros and the Price of Gold in Dollars in July and November 2008

	Euros per Dollar	Dollars per Euro	Gold ounce per Dollar
July 15	0.63	1.60	980
Oct 27	0.80	1.25	720

The price of gold plummeted.



Low Gold, Strong Dollar

- The soaring dollar and falling gold price were symptoms of a shortage of dollar liquidity.
- Had the FED recognized this shortage and bought foreign exchange to prevent the appreciation, there would probably have been no financial crisis in the fall.
- Instead, the dollar appreciation overvalued US dollar assets including all fixed income securities and mortgages, tipping Lehman Bros and other banks over the edge.

The Fed Screwed Up!

- The Federal Reserve cut off the economic recovery in 2008(2) and tipped the economy into recession and financial crisis.

Joint Fed-Treasury Mistake

- This does not exonerate the Secretary of the Treasury for the joint Fed-Treasury mistake in letting Lehman Brothers failed.
- The failure greatly increased the demand for money further, creating the casualties that followed.

Five Goats of the Crisis

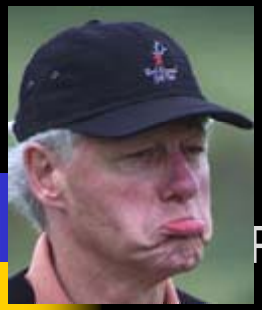
Five Goats Who Contributed to the Financial Crisis

- Ranieri
- Clinton
- Greenspan
- Bernanke
- Paulsen

s Ranieri

ch Guardian.co.uk (26/01/09)

- The bond trader who turned home loans into tradable securities
- The father of securitized mortgages
- Pioneered mortgage-backed bonds in 1980s
- “Mortgages are math”
- Created collateralized pools of mortgages
- Lost connection between original borrowers and lenders
- But ranked by Business Week with Bill Gates and Steve Jobs as one of the greatest innovators of the past 75 years.



Clinton

Finch Guardian.co.uk (26/01/09)

- Strengthened the 1977 Community Reinvestment Act to force mortgage lenders to relax their rules to allow more socially disadvantaged borrowers to qualify for home loans
- In 1999 repealed Glass-Steagal Act, which ensured complete separation between commercial banks, which accept deposits, and investment banks, which invest and take risks, prompting the era of the superbank and primed the sub-prime pump.
- In 1998, sub-prime loans were just 5% or all mortgage lending; by 2008 it was approaching 30%

n Greenspan

Julia Finch Guardian.co.uk (26/01/09)

- Kept interest rates too low, dollar too week, for too long, led the housing bubble to develop
- Supported sub-prime lending
- Advocated variable rate mortgages
- Defended derivatives: “Derivatives have been an extraordinarily useful vehicle to transfer risk from those who shouldn’t be taking it to those who are willing to and are capable of doing so.” Senate Banking Committee, 2003

aurice “Hank” reenberg

- The founder of AIG, the biggest insurance company in the world.
- Conducted a vast business in credit default swaps (CDS).
- Insured mortgage assets for a regular premium for people/institutions that didn’t own them.
- Similar to insurance, but different because the buyer of a CDS does not need to own the mortgage asset or even suffer a loss from a default event.
- Allowed mass multiples of derivatives.

n Bernanke

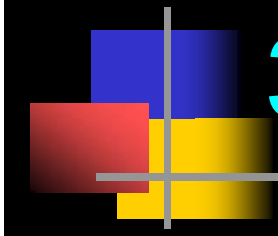
- Allowed dollar to soar as the euro fell from above $1.60 in June to below $1.30 in October 08.
- Failed to realize this appreciation surge freezing of credit markets and extreme shortage of dollar liquidity.
- Dollar surge brought on the recession in last half of 2008 and the financial crisis with Fanny Mae, Freddy Mac and Lehman and AIG etc.

Hank Paulsen

- Bailed out Bear-Stearns but allowed Lehman Bros. to fail.
- Failure of Lehman Bros. made it necessary to save AIG.
- Failed to notice significance of dollar appreciation in third quarter of 2008

What Should be Done?

Summary of 6 Proposals: 1, 2, 3



- 1. Issue Dates Spending Vouchers to increase effective demand.
- 2. Cut corporation tax rates from 35% to 15% to allow recapitalization of corporations and increase competitiveness.
- 3. Government Takeover and Restructuring of Insolvent Banks for subsequent privatization to rehabilitate the banking system.

Proposals 4, 5, 6

- 4. Stabilize dollar-euro rate with the euro fixed at limits between $1.20 and $1.40 to avoid beggar-thy-neighbor exchange rate opportunism.
- 5. Establish an International Macroeconomic Advisory Council as a global version of the Volcker-Chaired Obama Advisory Council to deal with the coordination of international macroeconomic policies.
- Issue 1 Trillion SDRS to IMF members in proportion to quotas or according to a new formula introduced to distribute the seigniorage more equitably.

1. Dated Spending Vouchers

- Dated Spending Vouchers (DSVs) of $500 billion (divided up among individuals) that expire after three months. Retailers would use the executed vouchers as tax credits.
- This would amount to stimulus in one quarter that would represent a potential 12.5% increase in spending in the quarter's income.
- It is superior to a tax change because it is temporary and flexible: it doesn't change the tax structure and it can be repeated as needed.

Proposal 1, Cont'd

- Given the fact that there is great uncertainty about the needed amount that is necessary, a tool that targets spending per quarter is flexible is superior to a one-shot guess.
- It would involve a once-for-all redistribution that benefits lower income groups and maximizes the proportion of it that will be spent.

2. Slash Corporate Profits Taxes

- Cut the corporate tax rate from 35% to 15% to recapitalize banks and corporations and spur investment.
- This measure takes account of the fact that the government is already a non-voting shareholder in corporations with 35% of the stock – without adding any capital to the corporation or share in any losses.
- Instead of the government buying stock in corporations to recapitalize them, the tax cut would let the corporations recapitalize themselves.
- (Note that Germany recently cut its corporation tax from 25% to 15%, and its overall taxes on corporations from 38.7% to about 30%.)

Corporation Tax Cut, cont'd

- Economists have been behind the curve on the impact of the corporate profits tax on investment and growth and employment. It is usually looked upon as an instrument for redistribution from the rich to the poor, ignoring the negative effects on the allocation of resources.

- Elimination of the corporation tax has long ben a project of tax experts like the late William Vickrey, Nobel-prize-winning tax expert who, although a left-leaning liberal, regarded the corporation income tax as an "abomination" because of its harmful effects on output, growth and efficiency.

- A large cut in the corporate tax rate would make the stock market soar and restore the health of ailing corporations and banks and together with the DSVs jump-start investment and recovery.

3. Restructure and Privatize Insolvent Banks

- Government should take over and restructure large insolvent banks for subsequent privatization.
- Several key banks are at present technically insolvent if their assets were written down to their market value, and the purpose of this measure is to avoid the unproductive trauma of new bank failures.

3, cont’d

- Government takeover of prominent insolvent banks.
- Selection and removal of taxic assets.
- Reconstitution followed by privatization.

4. Dollar-Euro Anchor

- 3. Stabilize the dollar-euro rate and let the dollar-euro be the new anchor for the international monetary system around which an international currency can be based.
- The stabilization can be done gradually by creating a band of fluctuation at the margins of which the banks intervene and then narrow the band as the FRB and ECB get more comfortable at coordinating monetary policies.
- The Treasury/FRB can start by putting a floor to the euro (and a ceiling for the dollar) at $1.20 and the ECB put a floor to the dollar (and a ceiling for the euro) at $1.40.

$-€ Anchor, cont'd

- The Federal Reserve should modify its policy of sterilizing automatically all foreign exchange intervention.
- Japan and China could also be invited to take part in the stabilization program as could the United Kingdom

5. International Macroeconomic Advisory Council

- Work to establish for the world as a whole an International Macroeconomic Advisory Council as a counterpart to the Volcker-chaired Obama Advisory Council.
- Form a committee of 10-15 wise people from around the world to advise and evaluate economic strategy and make recommendations.
- These could raw materials for an International Economic Advisory Council for policy at the Global Level.

6. Trillion SDR issue

- It is imperative to provide public money to especially the smaller countries who do not have a lender of last resort.
- The SDR is the best mechanism for dealing with this.

6. The Trillion SDR Issue

- SDRs were initially issued with a gold value guarantee.
- The amount 9.5 billion SDRs issued in 1970-72 would now be worth $270 billion.
- The world has changed greatly since then and the requirements for international money are correspondingly greater.
- Such an issue would prevent the collapse of the banking systems in the rest of the world.

Policies for U.S.

- Dated Spending Vouchers (DSVs)
- Corporate tax cut from 35% to 15%
- Stabilization of Dollar-Euro Exchange Rate and Plan a World Currency
- Reform of Banking System with Reconstitution of assets and Privatization.
- Initiate Trillion SDR allocation to save the global banking systems.

Policies for Rest of World

Policies for Rest of World

- Establish an international counterpart to the Volcker-Chaired Advisory Committee
- Stabilize exchange rates were feasible
- Support Trillion SDR allocation.
- Initiate change of name of SDR.
- Support and Contribute to Formation of Global Currency
- Bretton Woods Type Conference in Shanghai in 2010 to restructure the International Monetary System.

Toward a Global Currency

Regionalism

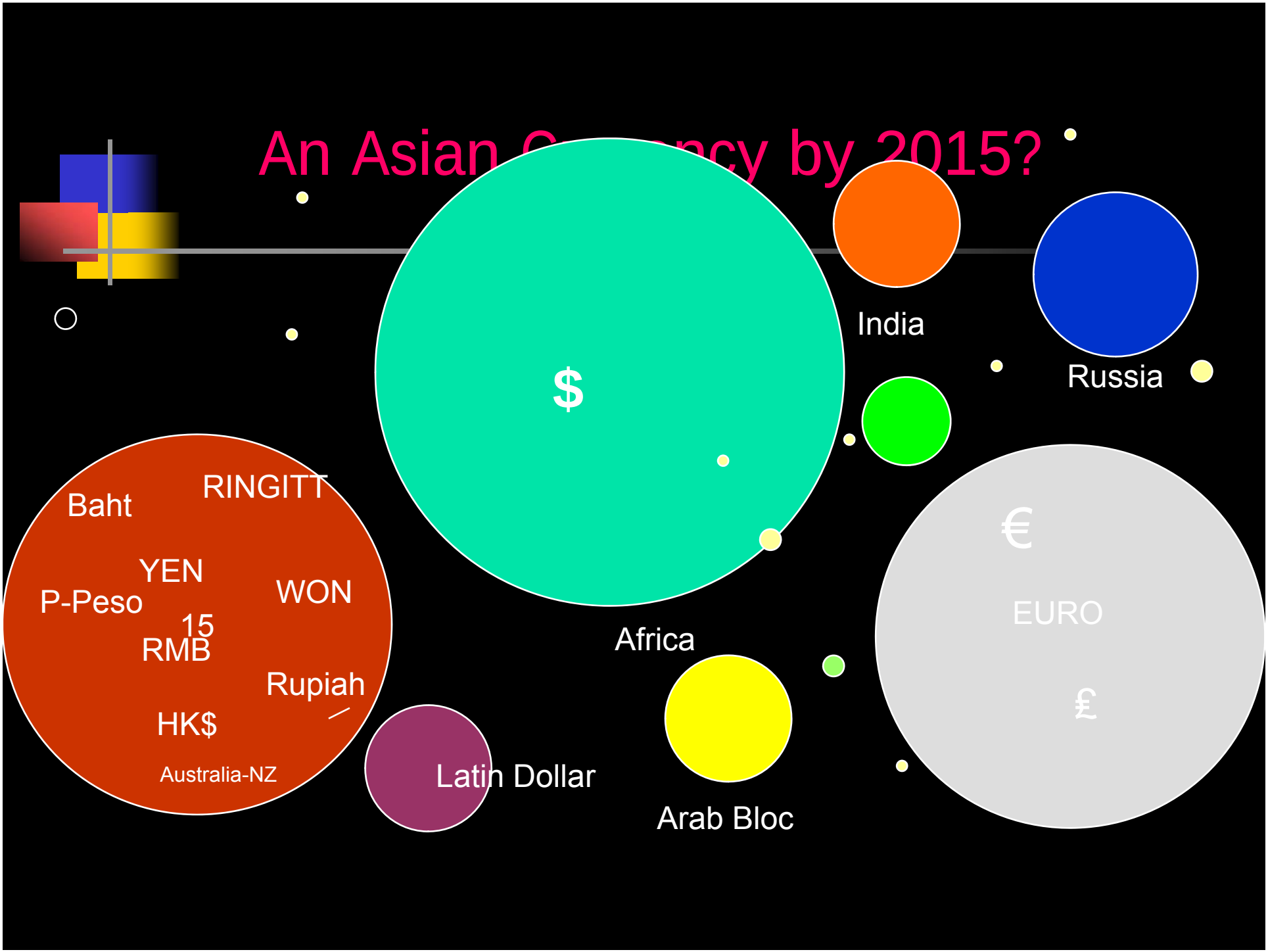
- If the major countries do not support a multilateral approach toward a restoration of the international monetary system, Asia and the other continents should act for itself by creating an Asian currency.

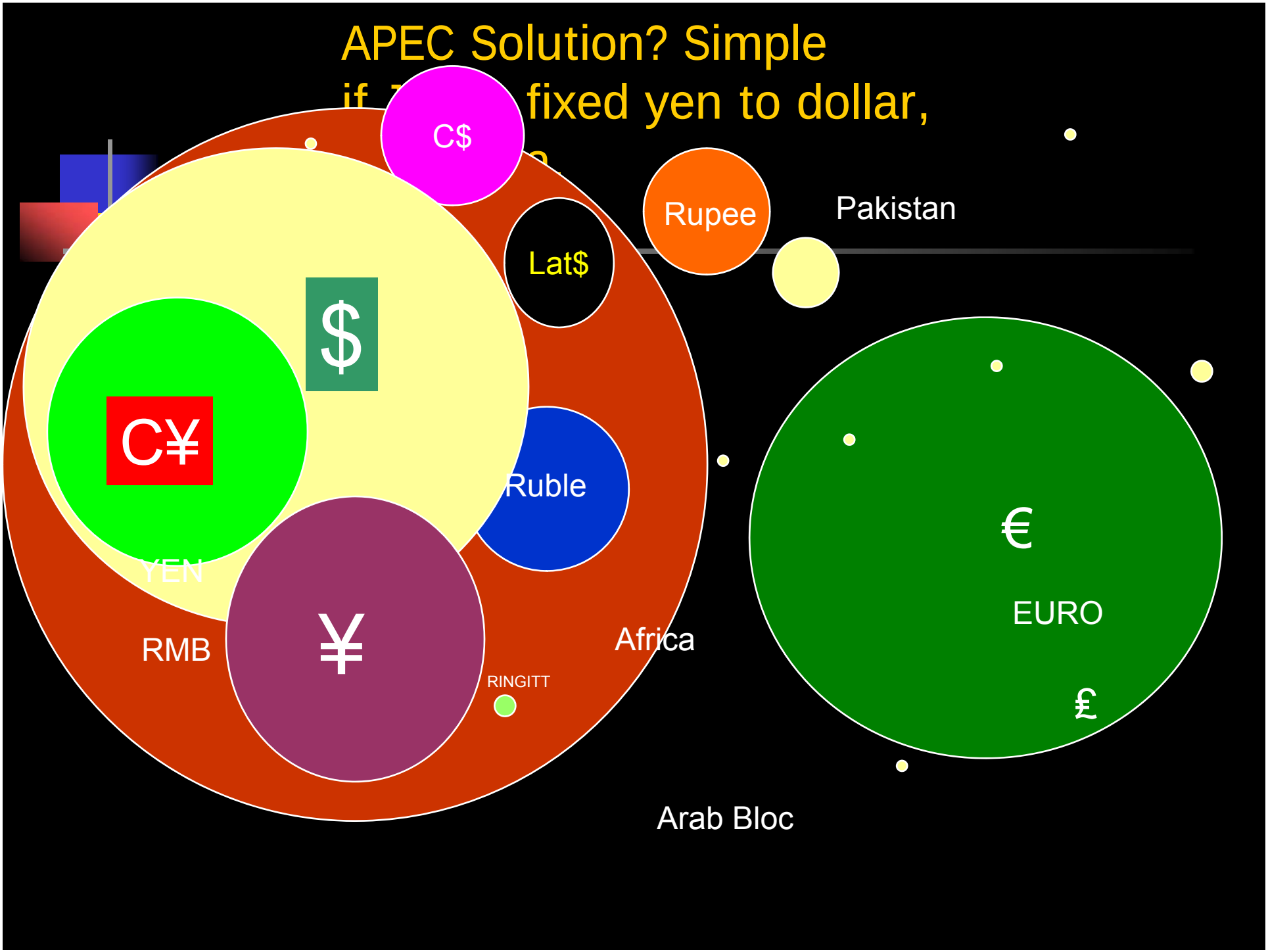
World Currency

- The Long Run Goal is a Global Currency.
- As Paul Volcker puts it, the global economy needs a global currency.
- The problem is to devise a way to achieve it.

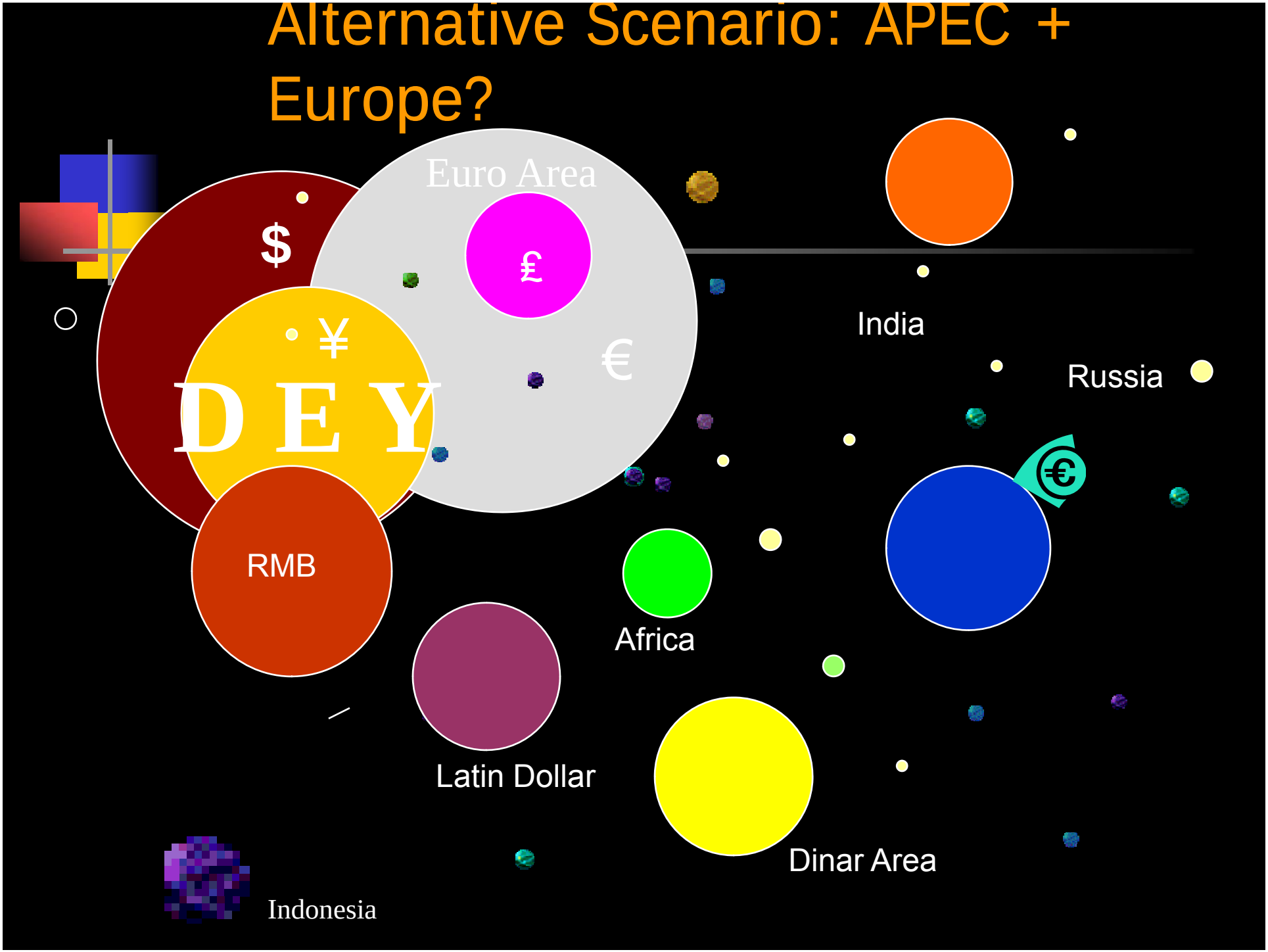
Several Competing Approaches

- Regionalization Approach
- Dominant Currency Approach
- Precious Metals Approach
- Intor Approach


An Asian Currency by 2015?
India
Russia
$
Baht
RINGITT
YEN
P-Peso
WON
15
RMB
Rupiah
HK$
Australia-NZ
Latin Dollar
Africa
Arab Bloc
€
EURO
£


APEC Solution? Simple
if
fixed yen to dollar,
C$
Rupee
Pakistan
Lat$
$
C¥
Ruble
YEN
¥
RMB
RINGITT
Africa
€
EURO
£
Arab Bloc

Alternative Scenario: APEC + Europe?



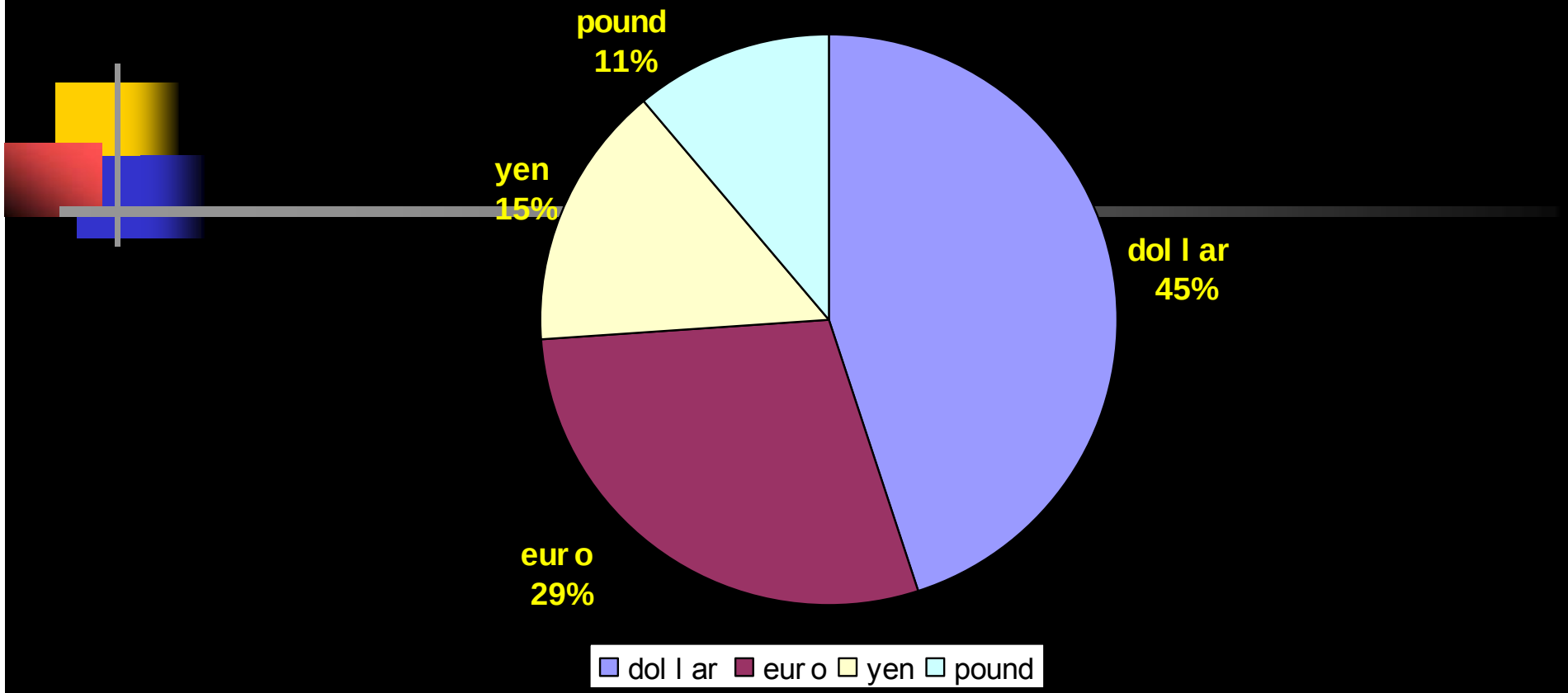
Three Stages of Monetary Reform

- Stage I. Convergence of DEY (Dollar-Euro-Yen) Exchange Rates and G-3 Monetary Policy
- Use of DEY as platform, possibly with gold, for world currency, the INTOR
- Creation of INTOR and Ratification by the Board of Governors of IMF.

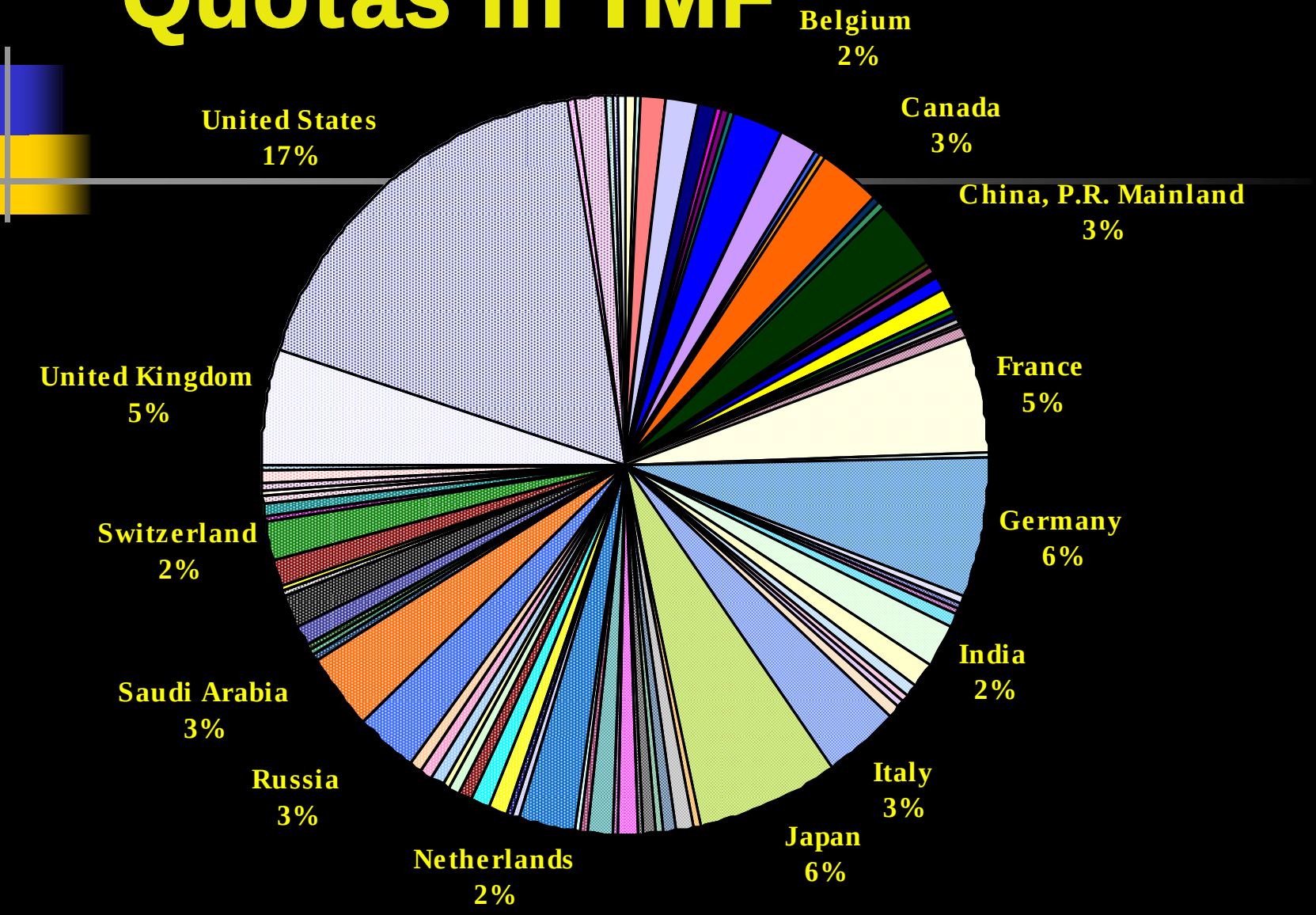
The INTOR: What could we expect?

- A single unit for quoting prices.
- A common unit for denominating debts.
- A common rate of inflation for participating countries.
- A common interest rate on risk-free assets.
- A global business cycle.

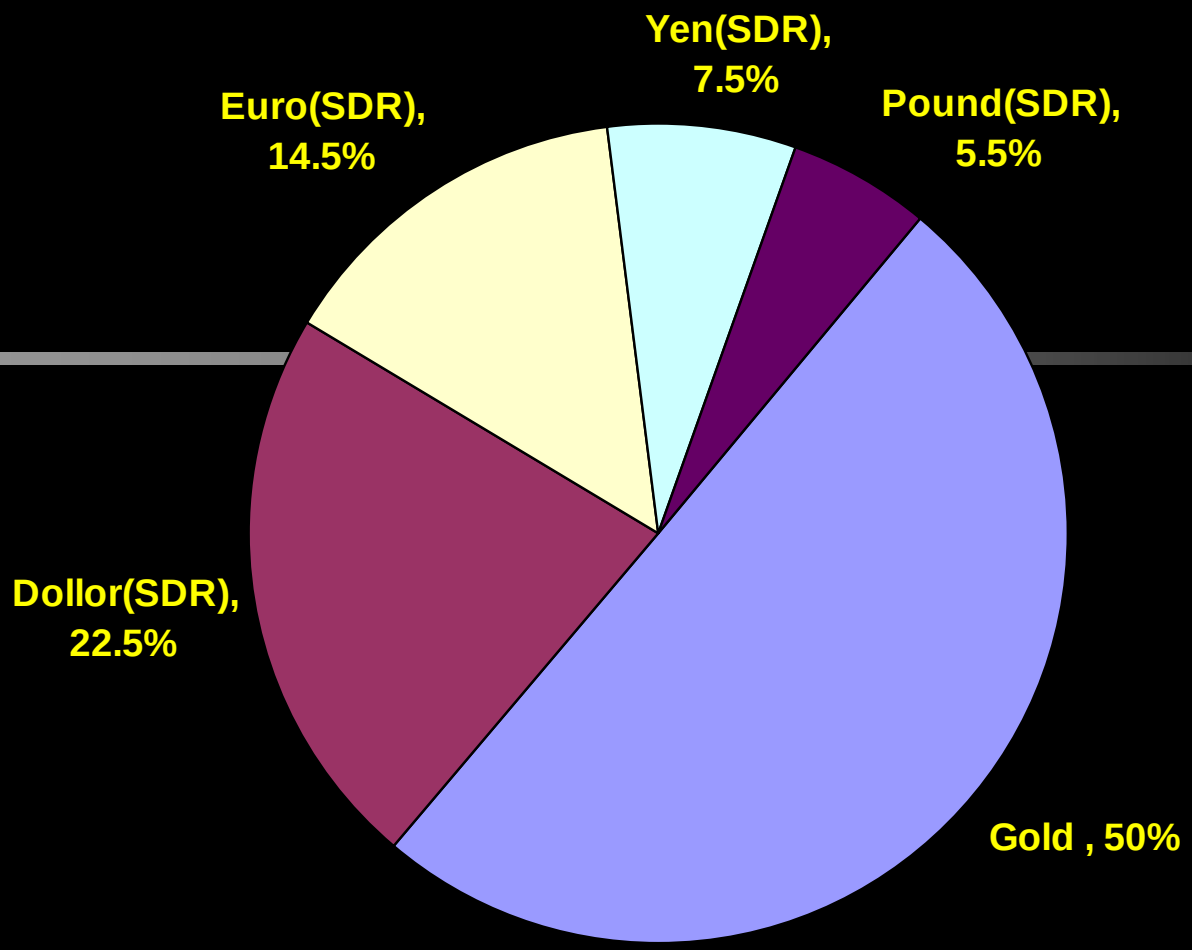
The SDR Basket
SDR = dollar + euro + yen + pound



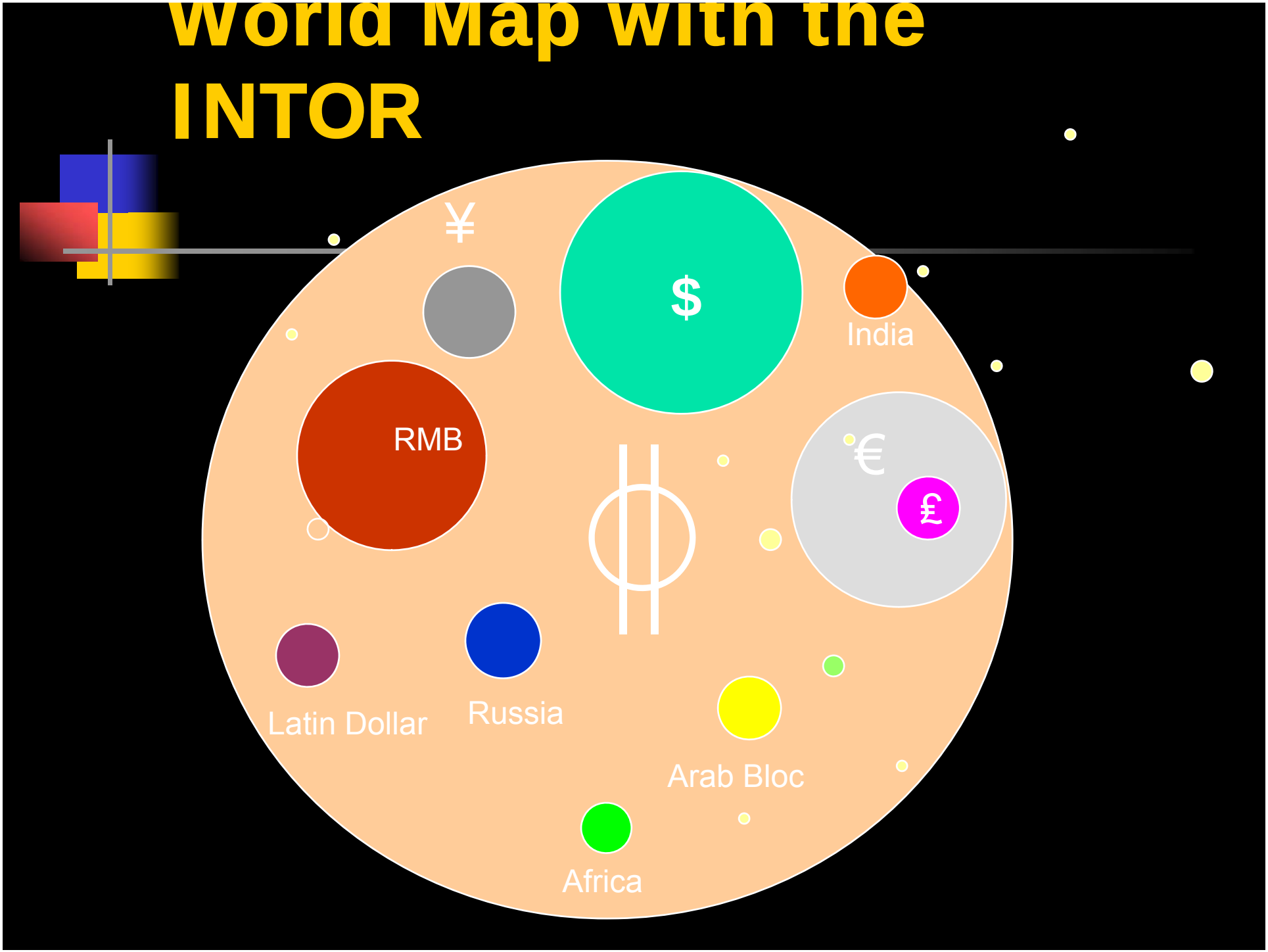
Quotas in IMF



Intor Sandwich



World Map with the INTOR



Thank You