GLOBAL FINANCIAL SYSTEM

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What is a global financial system?

- The Global Financial System refers to those financial institutions and regulations that act on the international level, as opposed to those that act on a national or regional level
- This is the interplay of financial companies, regulators and institutions operating on a supranational level
- The global financial system can be divided into regulated entities (international banks and insurance companies), regulators, supervisors and institutions

When the global financial system has emerged?

- Birth of the global financial system is directly connected to the growth of international economic relations
- International trade in a global scale started in the late 19th century
- International trade is complicated by the fact that most nations have their own currency, and that the rules and regulations governing financial transactions vary widely between countries

Evolution of the global financial system (1)

- Late 19th – early 20th centuries – little coordination of international finances
  - Gold standard – financial obligations were settled in currencies redeemable in gold
- World War I involved vastly larger international capital flows than ever before
  - European nations such as Britain and Germany went deeply in debt, borrowing heavily from other nations, especially the United States
- The Great Depression of the 1930s resulted partially from sharply declining international trade caused, in part, by high tariffs
- World War II disrupted world trade and led to international cooperative arrangements to facilitate economic stability and growth

Evolution of the global financial system (2)

- 1944 – Bretton Woods Conference
  - John Maynard Keynes and Harry Dexter White successfully proposed a new international financial order
  - The International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (World Bank) were created
  - Dollar was established as a main reserve currency (Keynes had argued against the dollar having such a central role in the monetary system, and suggested an international currency called Bancor used instead)
- 1947 – General Agreement on Tariffs and Trade (GATT - WTO)
  - Dramatic reductions in barriers to international trade
  - Led to the creation of a system of international financial arrangements and deeper economic / financial integration (especially EU, NAFTA)
- 1971 – Dollar's convertibility into gold was suspended
- 1973 – Abandonment of fixed exchange rates

International monetary systems

Date	System	Reserve assets	Leaders
1803 - 1873	Bimetallism	Gold, silver	France, UK
1873 - 1914	Gold standard	Gold, pound	UK
1914 - 1924	Anchored dollar standard	Gold, dollar	USA, UK, France
1924 - 1933	Gold standard	Gold, dollar, pound	USA, UK, France
1933 - 1971	Anchored dollar standard	Gold, dollar	US, G-10
1971 - 1973	Dollar standard	Dollar	US
1973 - 1985	Flexible exchange rates	Dollar, mark, yen	US, Germany, Japan
1985 - 1999	Managed exchange rates	Dollar, mark, yen	US, G7, IMF
1999 - ?	Dollar, euro	Dollar, euro	US, Eurozone, IMF

Source: IMF

International reserve currency

is a currency used as a reserve or store of wealth, as if it were an asset itself

- Source of wealth for whoever has the privilege to issue that currency
  - Un-cashed cheque at everyone else's expense
  - Permits deficit financing (Vietnam and Iraq wars, current US bank bailout)

Historic role of reserve currencies

- No reserve currency has ever been permanent
- Reserve currencies reflects political power and authority
- UK pound sterling is a reserve currency for more than 100 years
- The exorbitant privilege refers to the benefit the country has in its currency being the international reserve currency: this country would not face a balance of payments crisis, because it purchased imports in its own currency (concept created by Valerie Giscard d’Estaing)

The exorbitant privilege for euro?

Operating reserve currency brings costs

- Euro area lacks political will for unity and avoids promoting Euro as reserve
- Euro area not de-coupled, but connected, to US crisis
- Flight to quality is thus benefiting dollar

Global financial system based on US dollar

- China's dollar dependence (Not just China, but Brazil, India, Russia and oil-exporting Gulf states all similarly attached to US situation)
  - Reserve accumulation over $1tn
  - Power to destabilise US financial system but only at huge cost to itself
- US domestic economy transformed (like in 19th century in UK) to financial services while neglecting exports, manufacture and jobs
- Weaker dollar needed to stimulate US economy but counter-balanced against damage it does to its partners
- US lacks surpluses given its economic weakness to sustain strong dollar as reserve

Features of the post-BW system

- Volatility drastically increased
  - Contradicting expectations and orthodox economic predictions
- Volatility created need to hedge against fluctuating prices
  - New markets in volatility-management tools: derivatives
  - Created marketplace for speculative profits and amplified the use of these tools
- Assault on transparency
  - Vast majority of derivatives 'OTC' – over the counter and not traded on exchanges
  - Created mechanism to avoid supervision or regulatory oversight
- New markets in derivatives allowed huge profit opportunities via speculation on price movements that were disconnected from real economic activity

Post-BW global financial system

- Financial crises have been more intense and have increased in frequency by about 300%
  - All financial crises since 1971 have been preceded by large capital inflows into affected regions
- Investors have frequently achieved very high rates of return, with salaries and bonuses in the financial sector reaching record levels

Institutions of global financial system

- International Institutions
  - IMF - keep account of international balance of payment of members states, also acts as lender of last resort
  - World Bank - provide funding, take up credit risk and offer financial favorable terms to development projects in developing countries
  - WTO - negotiate international trade agreements, settles trade disputes
  - Bank for International Settlements (BIS)
  - Institute of International Finance (IIF)
- Government institutions
  - Financial ministries, tax authorities, central banks, securities and exchange commissions, etc.
- Private participants
  - Commercial banks, pension funds, hedge funds, etc.
- Regional institutions
  - Eurozone, NAFTA, CIS, Mercosur

Bank for International Settlements

is an intergovernmental financial organization of central banks which fosters international monetary and financial cooperation and serves as bank for central banks

- Regulates capital adequacy
- Encourages reserve transparency
- Leads the changes of banking regulation and supervision through the Basel Committee on Banking Supervision passing global regulatory standards (Basel II, Basel III)

Institute of International Finance

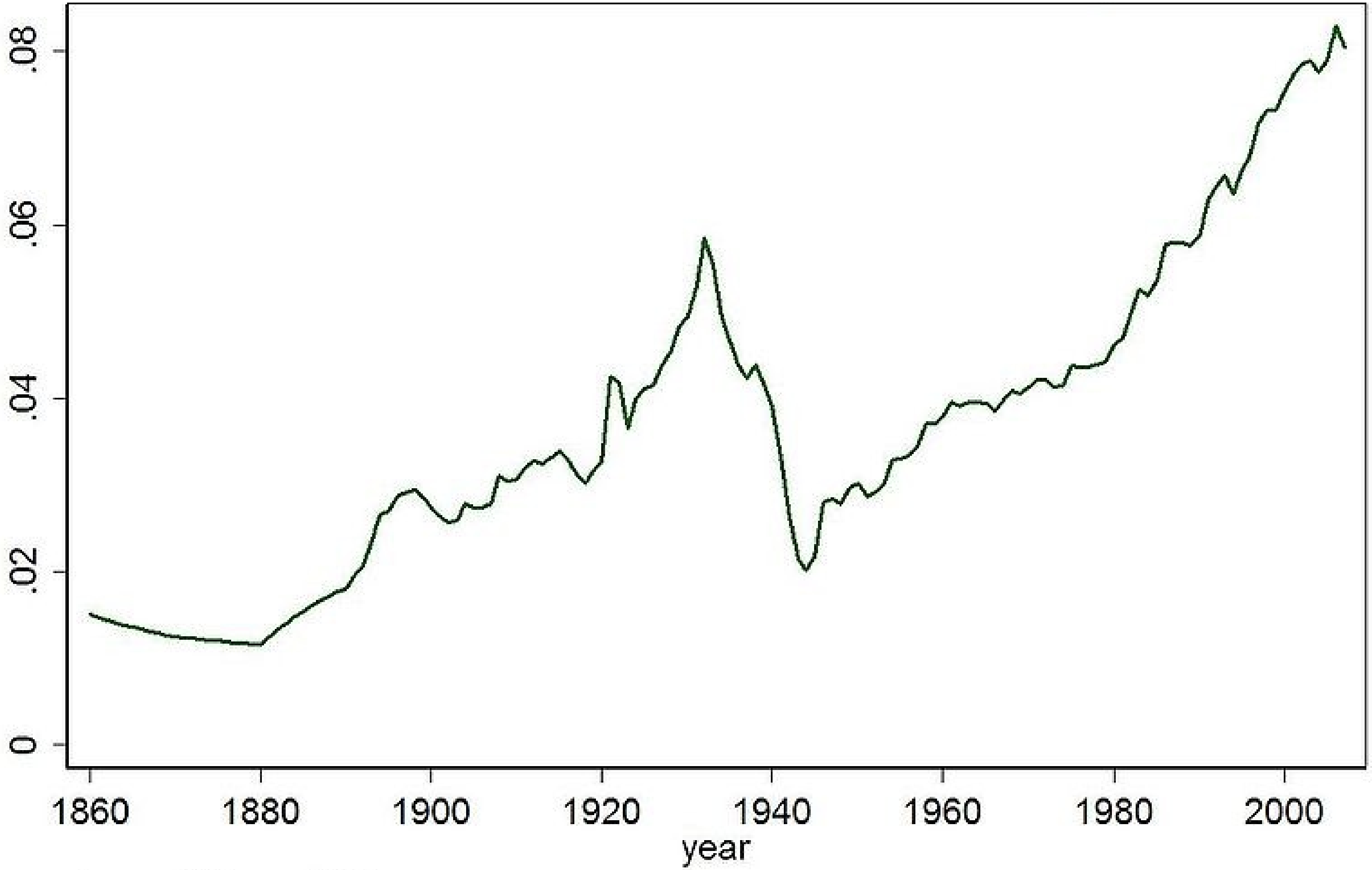
is the world’s only global association of financial institutions

- Providing analysis and research to its members on emerging markets and other central issues in global finance
- Developing and advancing representative views and constructive proposals that influence the public debate on particular policy proposals, including those of multilateral agencies, and broad themes of common interest to participants in global financial markets
- Coordinating a network for members to exchange views and offer opportunities for effective dialogue among policymakers, regulators, and private sector financial institutions

The era of financialization

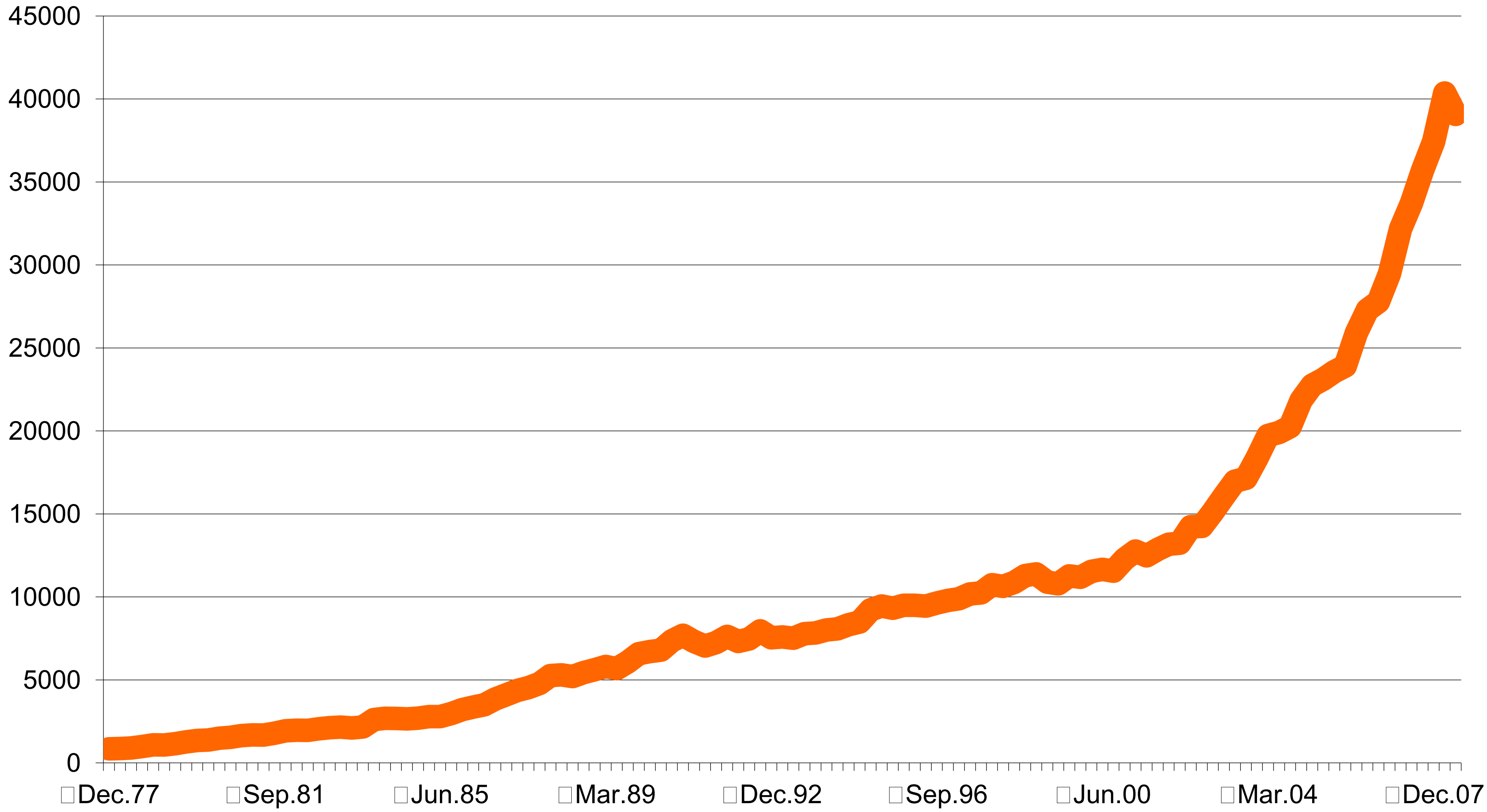
- Developed countries' financial systems exploded relative to other parts of economy, particularly the role of banks
- Climate of greater general indebtedness and increased gearing (debt to equity ratios)
  - Financial assets and debts become larger proportion of GDP
  - Banks strategically became focused upon commissions business and speculative operation

GDP share of US financial industry



Source: Philippon, 2008

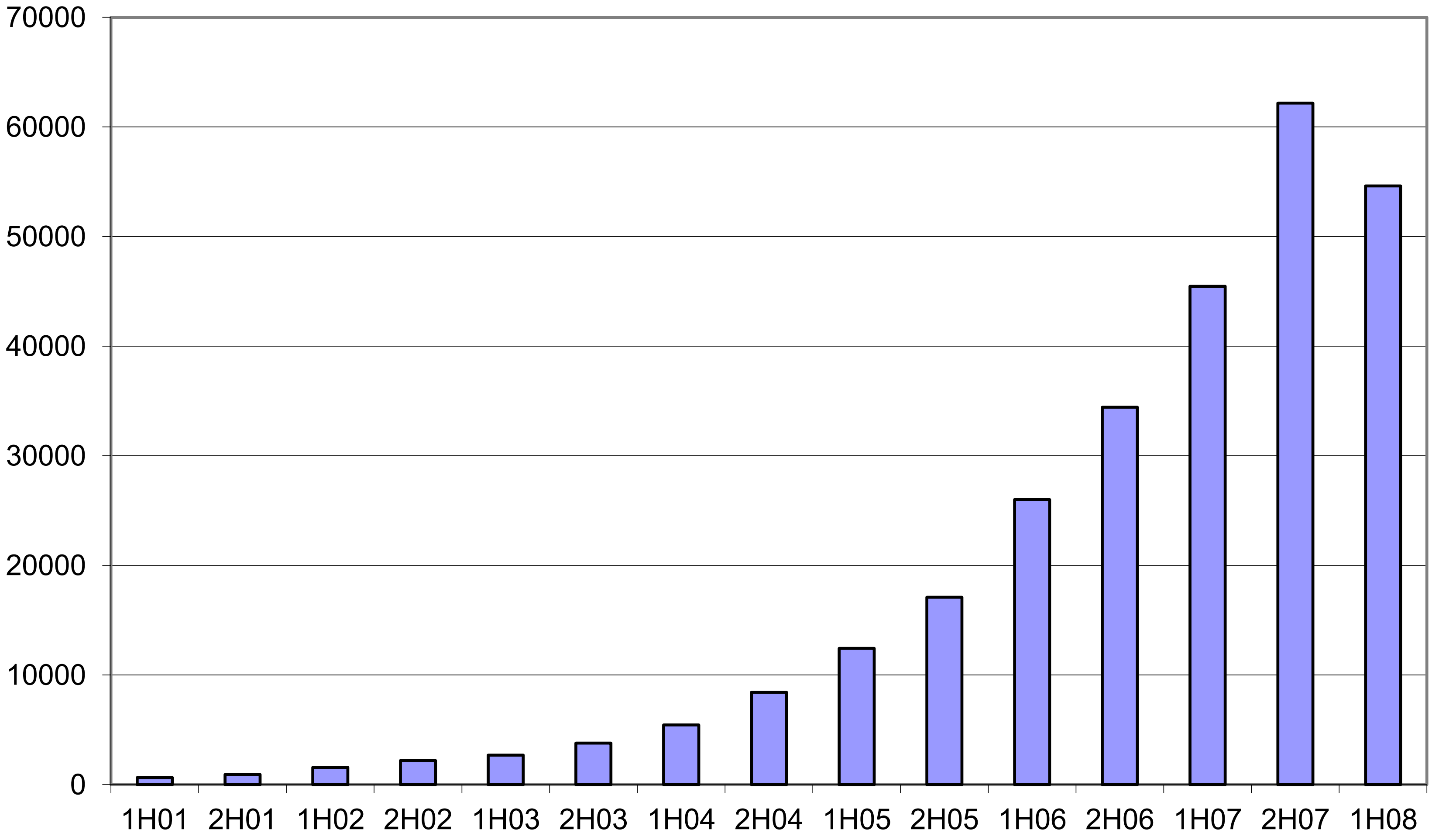
Bank assets, $ billions



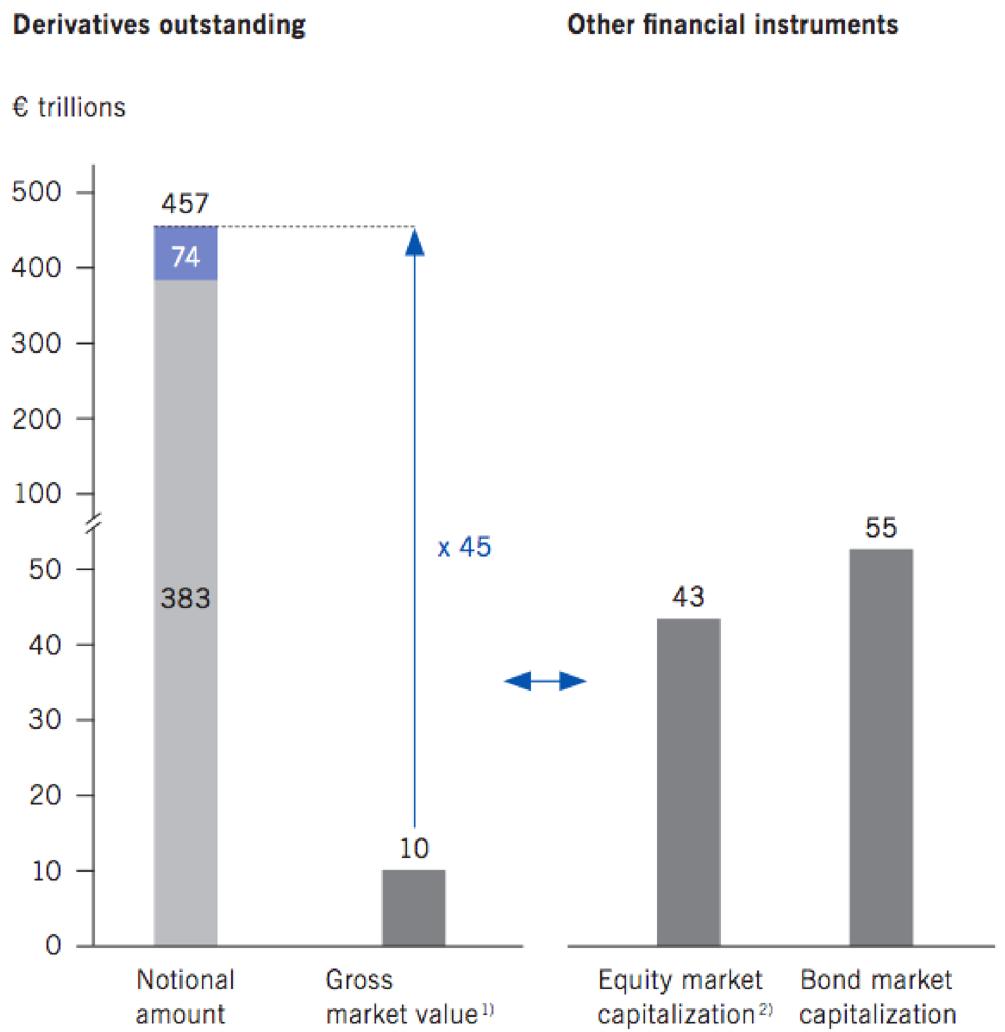
Financialization

- Speculative price bubbles
  - Debt being used to inflate value of assets against which more debt is raised to re-start the cycle
- Financial innovation
  - Also used to evade legislative oversight, e.g. 1999 Amendment to US Community Reinvestment Act which excluded banks' mortgage investment in securities from scrutiny – then sub-prime lending doubled from 2001 to 2006
- Policy mistakes
  - Ignored bubbles and stoked consumer spending via indebtedness

CDS contracts outstanding in $ billions



Growth in derivatives



Key features of international financialization

- Liberalisation of capital account
- Capital flows increasingly taking form of FDI and portfolio investment
- Inflation targeting priority over growth, jobs, health or other social outcomes to protect value of investment capital