The international monetary and financial system

China in the World Economy, 2022

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- 6) What is the name of the current (failed) round of WTO negotiations?

International monetary system

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- In which currencies are **international debts denominated**?
- Which currencies serve as **foreign exchange reserves**?

International monetary system

- > **dominant role of the US dollar**

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- Commercial banks – take part in the creation of money, but are subordinate to their respective central banks
- **Private entities decide in which currency to do business** > this influences central banks‘ foreign exchange reseves and their preferences
- – „Hmmm, I guess euros are useful, I should hold more of them!“

International financial system

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- **>** influences the decision of people with savings about where to invest their money

International financial system

- **Safest assets – government bonds of rich countries (rated AAA)**

International financial system

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- More risky assets – private stock, bonds of developing countries – balanced by higher interest rates

IMS and IFS

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- IFS – **money as capital**
- „Which country is the best place to invest my **savings**?" ☺
- > flows of capital, we don‘t care about the specific currency

IMS and IFS

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- **A crisis in the IFS can endanger the IMS** > can lead to turbulences in exchange rates etc.

Exchange rate regimes

- **Fixed** (or pegged)
- **Floating**

Central bank tools for influencing the exchange rate

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- **Changing of interest rates** – higher rates attract foreign capital > this strengthens the currency!
- But it is a form of restrictive policy > lower GDP growth/recession

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- (The two goals are incompatible, a country may only have one)

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- > so that they can borrow from abroad and attract foreign direct investment

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- Why, how?

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- **This is true for both trade and investment**

Balance of payments

- Way of thinking about international transactions, tool of Central Bank accounting and statistics

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- Divides transactions into two broad camps:
- **Current account**
- **Financial account**

Balance of payments

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- - remittances, transfer of profits to shareholders or within multinational companies
- But most importantly, it covers trade

Balance of payments

- 2) **Financial (or capital) account** – purchase of **stock** and **bonds** and derivatives and other types of securities

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- > you purchase something as an asset, **you plan to hold it and profit from it**

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- Implication
- – **exporting countries also invest abroad**
- - **importing countries also acquire debt/take in investment**

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- Exporters **must do something with the money they earn in a foreign currency**

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- US – China relationship

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- > **Stronger currency will make your goods more expensive** > current account will become balanced again

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Balance of payments

- > Built-in stability mechanism
- **But only functions with a floating exchange rate!**

Balance of payments

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- But at least the pressure is slow and gradual
- = your trade deficit is never going to double overnight
- But capital inflows or outflows might!

Balance of payments

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- **FDI – relatively stable**
- **Portfolio investment – highly volatile and speculative – major threat to a fixed exchange rate!**

Balance of payments

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- Fixed rates – potential for a sudden and massive **monetary crisis**

Balance of payments

- Fixed rates are **artificial and invite speculative attacks by markets**

Balance of payments

- Fixed rates are **artificial and invite speculative attacks by markets**
- **If you want to have one, you must impose** **capital controls** = to limit and regulate capital flows and currency exchange

Capital outflow with a floating rate

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- Gradual depreciation > expansive imports = **inflation**

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- An unrealistic exchange rate might **invite** such an outflow!

You:

You:

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„Speculative“ outflow

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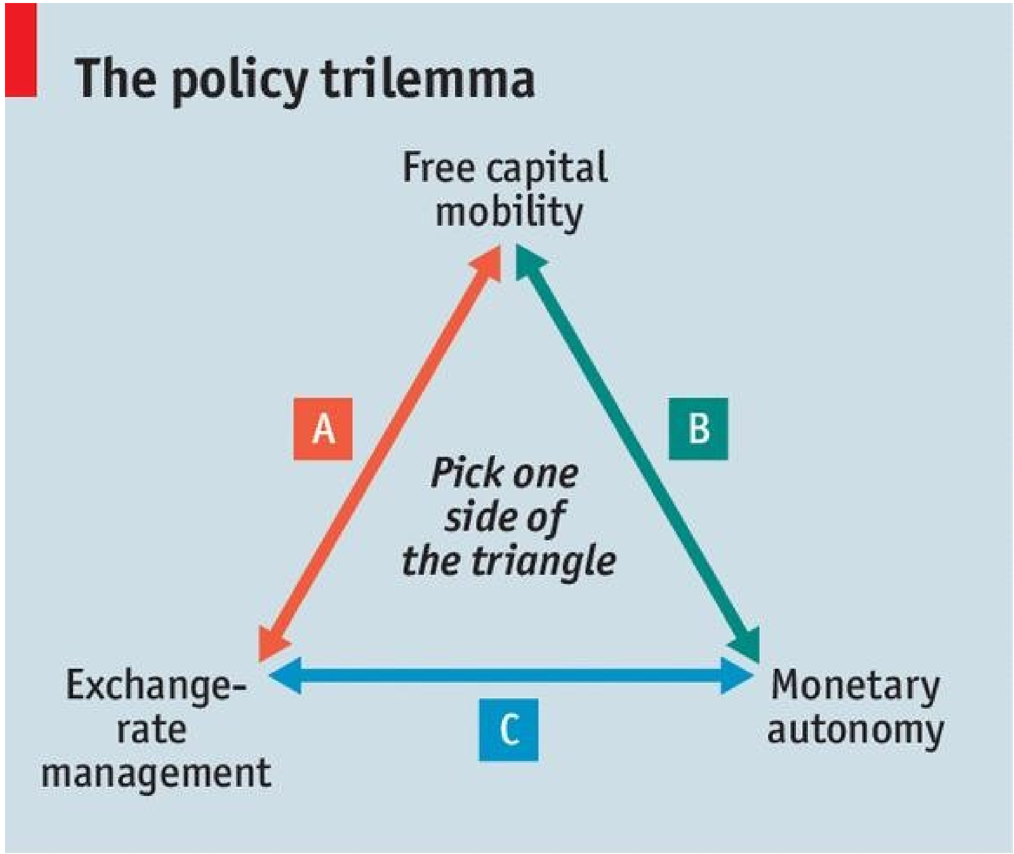
- Debate about the Asian monetary crisis of 1997/1998

„Mundell-Fleming trilemma“



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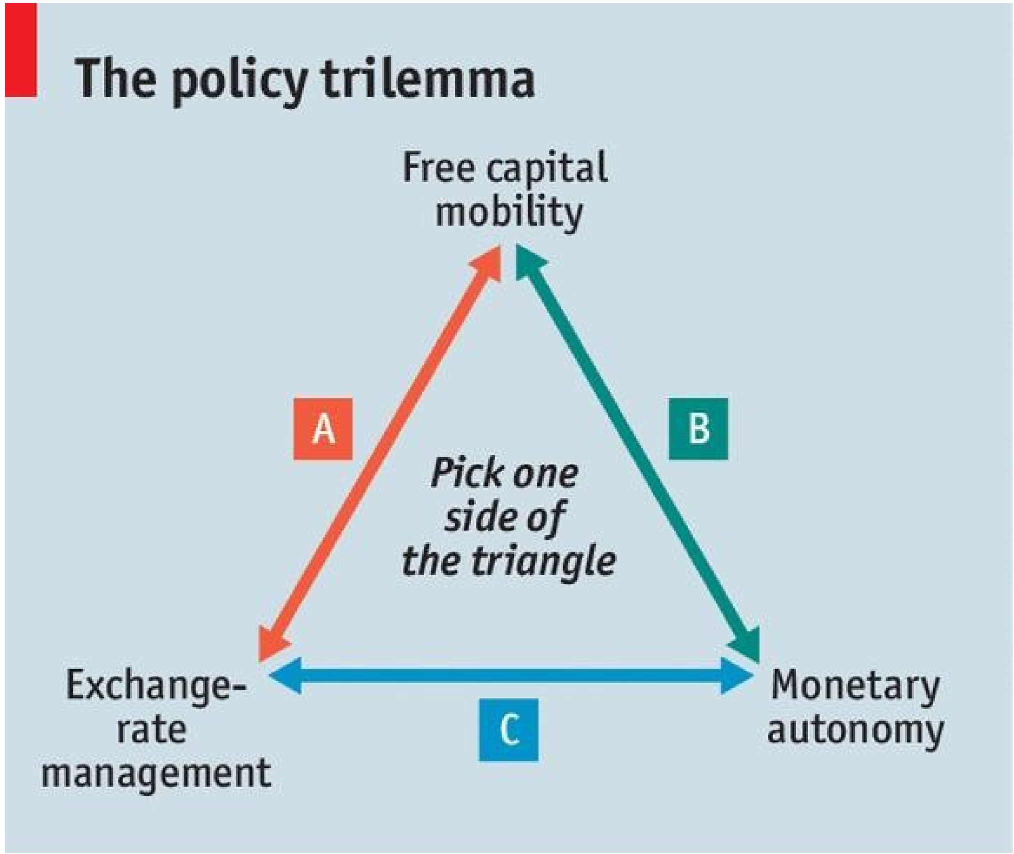

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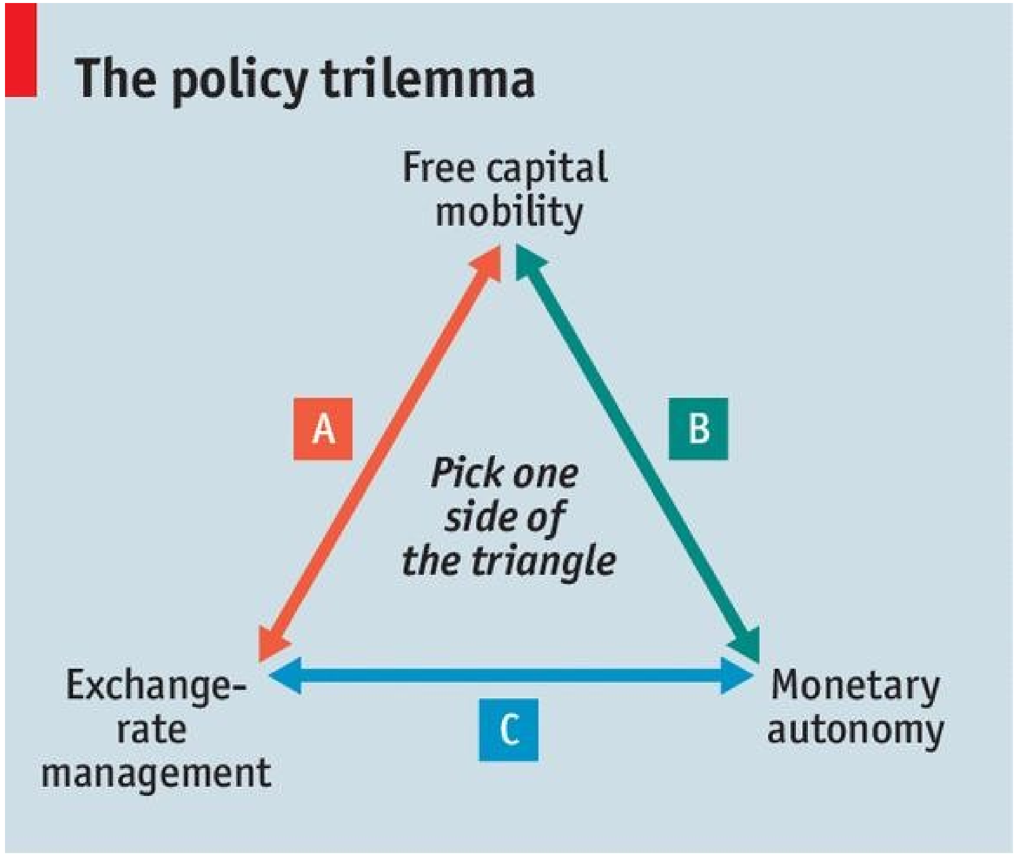

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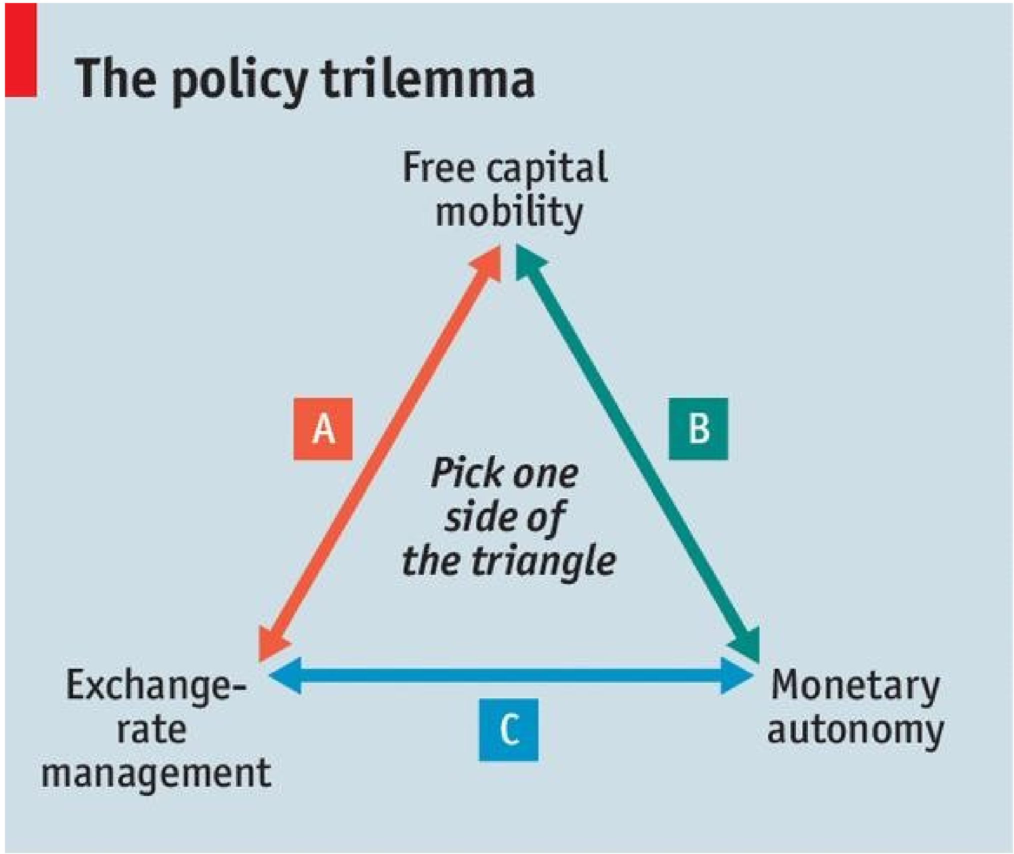

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- **Post-Bretton Woods (= Jamaica system) - B**

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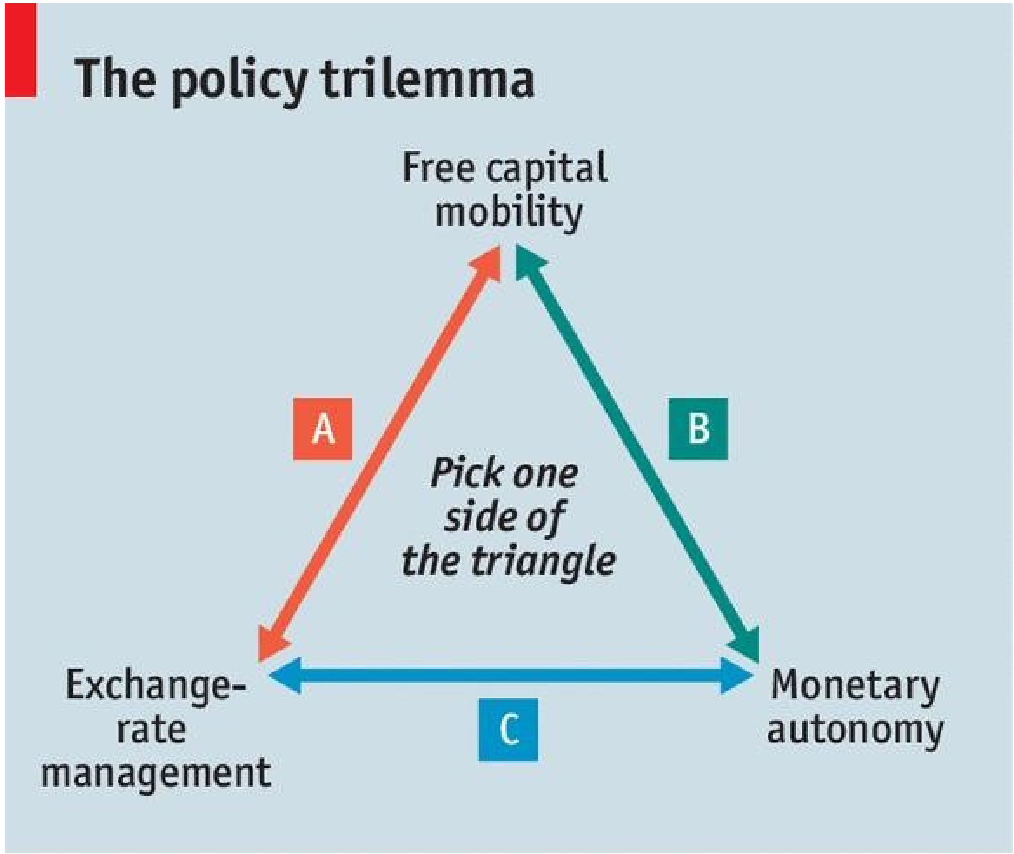

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Bretton Woods

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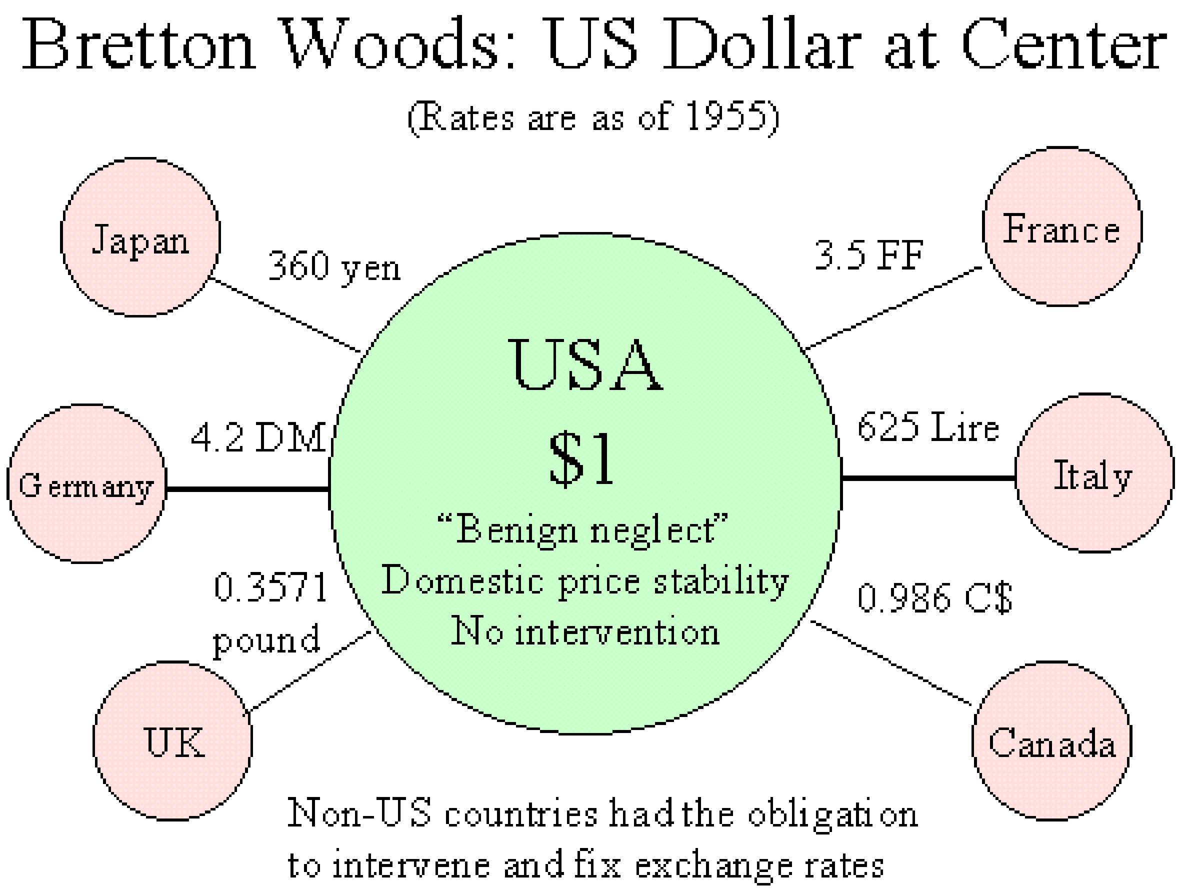
- Exchange rates between other currencies were derived from their relation to the dollar

Bretton Woods



Balance of payments

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- If investment was allowed, it was FDI, not portfolio investment – because it is much less volatile

Bretton Woods

- **The US dollar alone remained tied to gold**

Bretton Woods

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- Why only the US dollar?

Bretton Woods

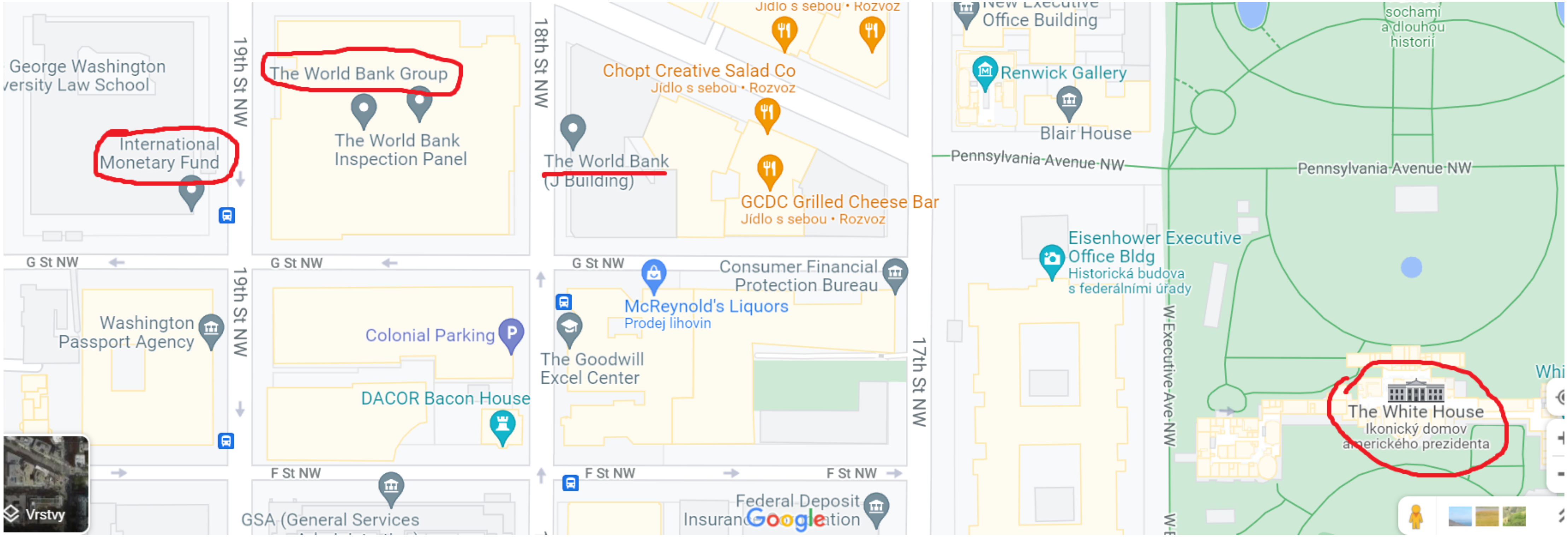
- **The US dollar alone remained tied to gold**
- Why only the US dollar?
- Wartime debts and import + Nazi plunder depleted the reserves of other advanced countries

Bank for International Settlements

Bretton Woods

- Overseen by „Bretton Woods Institutions“ = **„International Financial Institutions**“

Bretton Woods



Bretton Woods

- **International Monetary Fund and the World Bank Group**

Post-Bretton Woods

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Post-Bretton Woods

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- Because:
- Too many countries tried to exchange their dollars for gold
- + the US had a trade deficit and needed to devalue the dollar

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- **This destabilized the monetary system and Bretton Woods collapsed**

Post-Bretton Woods

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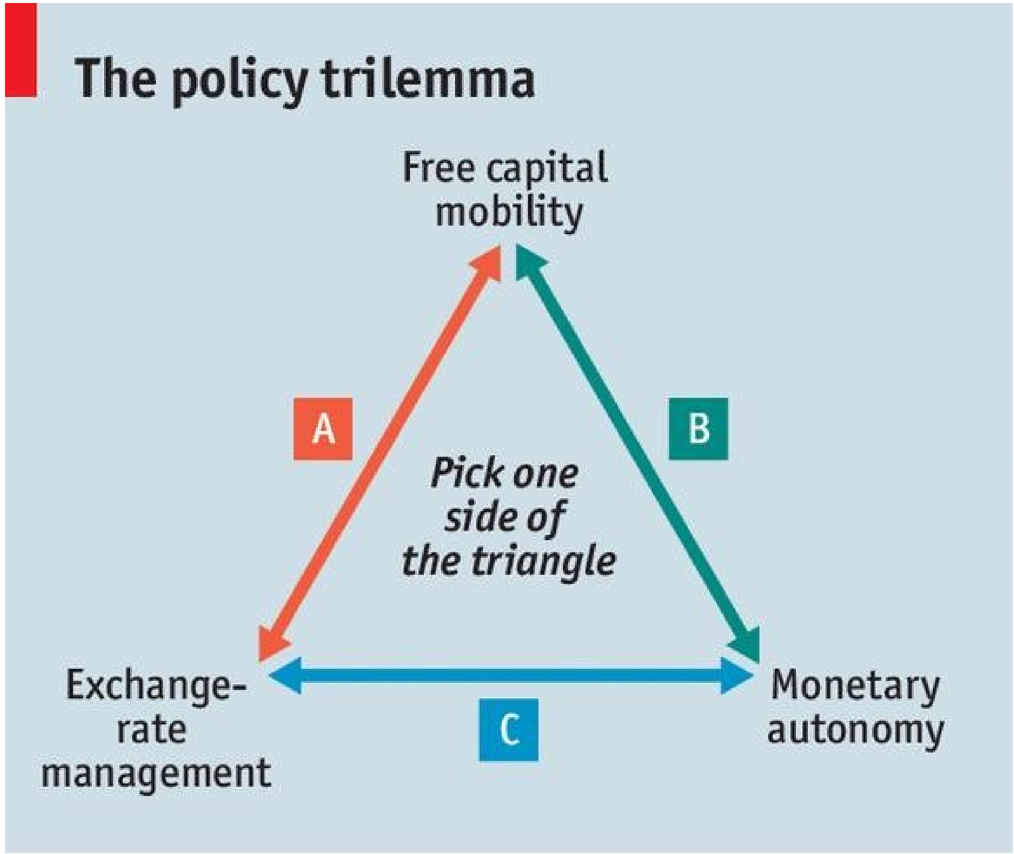

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- With floating, this is no longer a problem – we don‘t mind if exchange rates adjust

Post-Bretton Woods

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- **China today – fixed exchange rate with partially opened financial account**

Post-Bretton Woods

- **Debt crises + monetary crises**
- = problems that were not common during Bretton Woods!

Post-Bretton Woods

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- = problems that were not common during Bretton Woods!

- Both take place in countries with **an open financial account + fixed exchange rate**


DON'T DO ~~DRUGS~~ KIDS
Fixed exchange rates combined with free capital flows
IT'S BAD FOR YA
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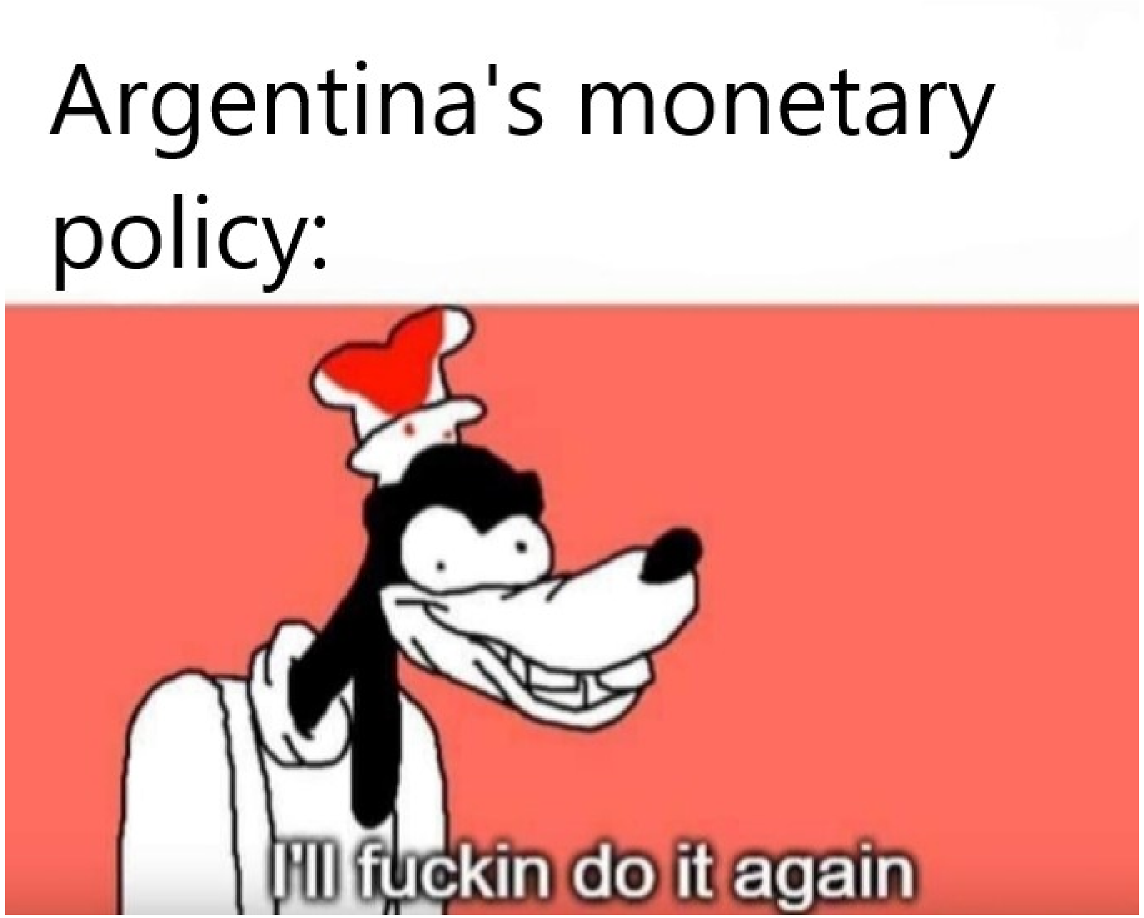
Argentina's monetary policy:
I'll fuckin do it again

Case study - mid-1990s Czechia

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- 1995 – entry into OECD – „Let‘s abolish capital controls, because it is required of members, and to be a member is cool“

Case study - mid-1990s Czechia

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- 1995 – entry into OECD – „Let‘s abolish capital controls, because it is required of members, and to be a member is cool“
- „Let‘s also keep our fixed exchange rate, which everyone else envies us!“ ☺


IMF
CZECHIA
FIXED EXCHANGE RATE
+ FREE CAPITAL FLOWS
(THINKING
ABOUT
ARGENTINA)
WELL DID IT WORK FOR THOSE PEOPLE?
NO, IT NEVER DOES, I MEAN, THESE PEOPLE SOMEHOW
DELUDE THEMSELVES INTO THINKING IT MIGHT, BUT...
...BUT IT MIGHT WORK FOR US.
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Case study - mid-1990s Czechia

- > textbook monetary crisis in 1997, fall of government

Debt crises

- You acquired debt **in a foreign currency**, now you can‘t pay it back ☹

Debt crises

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- Why is it not a problem with debts in the domestic currency?

Debt crises

- You acquired debt **in a foreign currency**, now you can‘t pay it back ☹
- Why is it not a problem with debts in the domestic currency?
- Because you can print money and **monetize** the debt! > **so you never technically become insolvent!**

Debt crises

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- What happened in the 1970s with money flows?

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- What happened in the 1970s with money flows?
- Rich countries **abolished capital controls** > money could flow to Latin America!

Debt crises

- Typically **tied to an overvalued (= fixed!) currency and trade deficit**
- = you can‘t export, but you can borrow, and your strong currency enables you to pay back the debts ☺
- Latin America in the 1970s > Latin debt crisis in the 1980s

- What happened in the 1970s with money flows?
- Rich countries **abolished capital controls** > money could flow to Latin America!
- **> much bigger debts and trade deficits!**

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- Also, **you might be unable to maintain the overvalued rate** on your side – if you suffer from a monetary crisis

Monetary crisis

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- > so some of them withdraw their money and change them into another currency
- > **everybody else starts doing this**
- > this puts **even more pressure on the exchange rate!**

Monetary crisis

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- High domestic interest rates > **recession!**
- Devaluation > high import prices > **inflation**

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- All three aspects **are ultimately about the lack of hard currency!**

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- **Devaluation and fiscal austerity**
- > balanced trade, balanced budgets; no more pressure against the currency

IMF in emerging market crises

- **The IMF – a fund of hard currencies**
- All three aspects of the problem are about not having enough of hard currencies

IMF in emerging market crises

- Current account crisis – not enough dollars to pay for imports
- Debt crisis – not enough dollars to pay the debts
- Monetary crisis – not enough dollars to support the exchange rate

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- New role the organization embraced after the collapse of Bretton Woods

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- *„The West imposed neoliberalism on Latin America/Russia/the Moon with horrible consequences in order to further its corporate profits"*
- De facto – **include a lot of the same stuff** (devaluation + higher taxes and lower expenditures) **that the countries' would have to do anyway!**

IMF in emerging market crises

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- It wants to make sure that the often unreliable debtors will pay it back to protect its core funds

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- Another possible motivation: face saving mechanism for the government to justify reforms to the public
- „THEY made us do it!“

Is the cure worse than the disease?

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- Debatable!
- Pro argument – bad outcomes in countries under IMF programs
- Counter argument – how bad would the situation be otherwise?

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- 1980s – Latin America + 1990s - Eastern Europe + **1997 East Asia**

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- But – narrative about it being forced is probably overstated
- Achieved mostly with **soft power** – recommendations, „Chicago boys“, etc.
- **Part of a global shift towards free markets**
- Desire of economically failed countries to **try something new**

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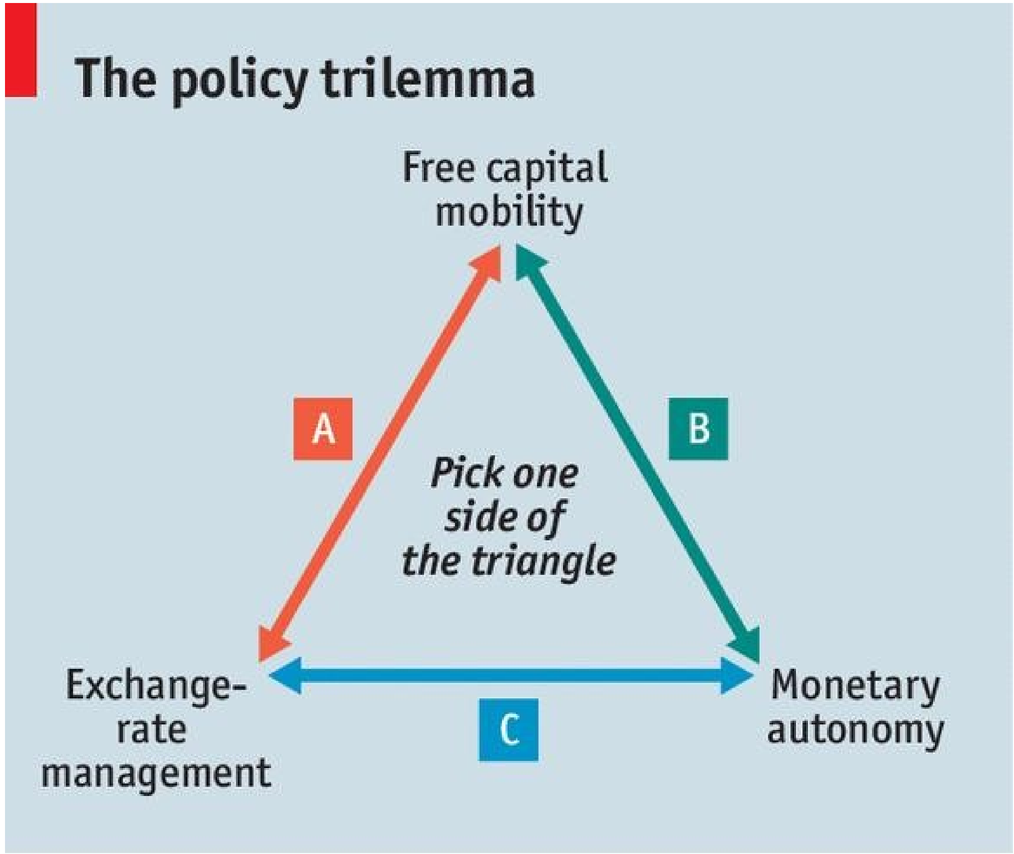
Is the cure worse than the disease?

- Most criticism of the IMF/WB refers to the 1980s/1990s policies
- Today – a much less strictly free-market outlook
- - focus on topics such as inequality, climate change, excessive austerity….
- Recent about-face – **capital controls may be necessary!**



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Next time

- China in the post-Bretton Woods monetary systém

- Country with a quasi-fixed exchange rate + capital controls
- Ambition to make its currency international