

UNU-WIDER Conference - Think Development

Helsinki 13-15 September 2018

Parallel Session 5.2 *The International Monetary Non-system*

Valpy Fitzgerald Oxford University



Resetting the International Monetary Non-system

- Outstanding integration of history and policy; fresh insight into a much debated topic from the viewpoint of smaller countries.
- Contains three main elements:
 - a. **(Non)system** International Monetary System Since Bretton Woods; The Provision of Global Liquidity; The Global Reserve System; Global Monetary Cooperation; the Exchange Rate System
 - b. **Management** Capital Account Liberalization and Management; Resolution of Balance of Payments Crises; Emergency Financing and Debt Workouts
 - c. **Reform** The Governance of the International Monetary System; Reforming the (Non)System
- Provokes an important academic and policy debate - starting here!

Two crucial JAO graphs: collective versus individual insurance against financial shocks

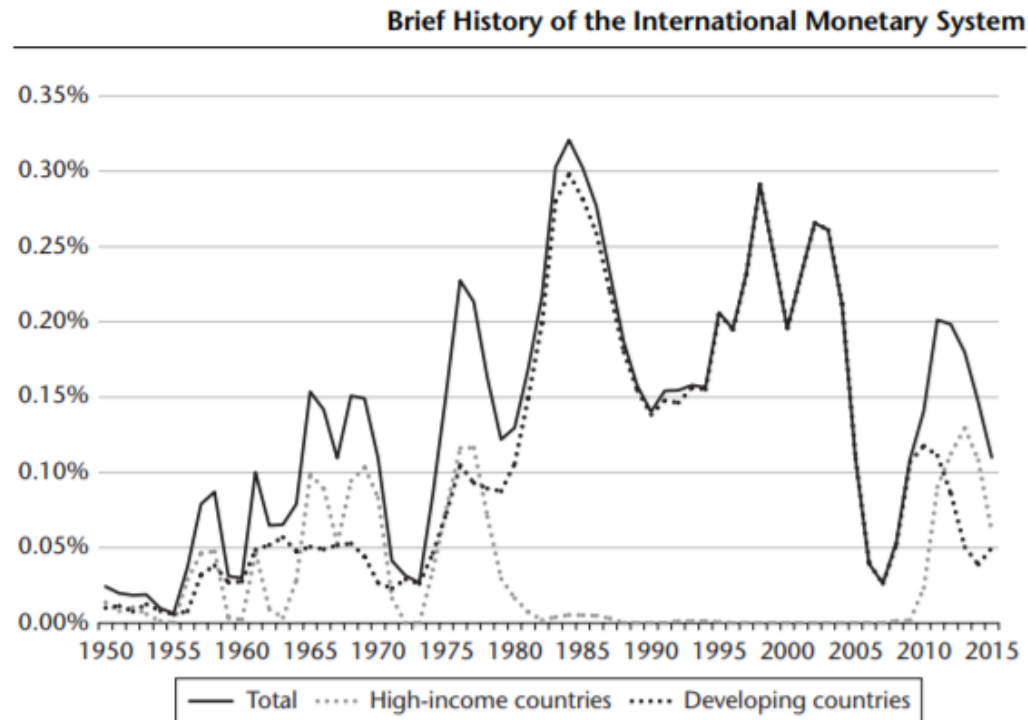


Figure 1.1 IMF loans as % of world GDP

Source: Author's estimates based on IMF database. World GDP according to the World Bank.

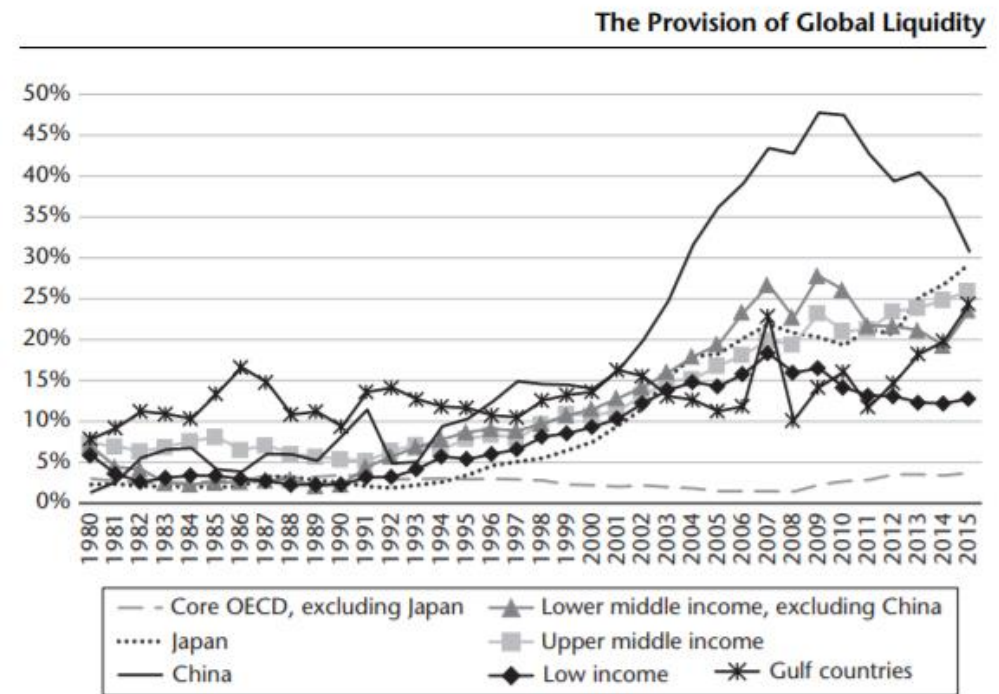


Figure 2.3 Foreign exchange reserves by level of development (% of GDP)

Source: Author's estimates; World Development Indicators, based on information from the IMF. Series refer to total reserves minus gold. Country classification by level of development according to the World Bank in 2000.

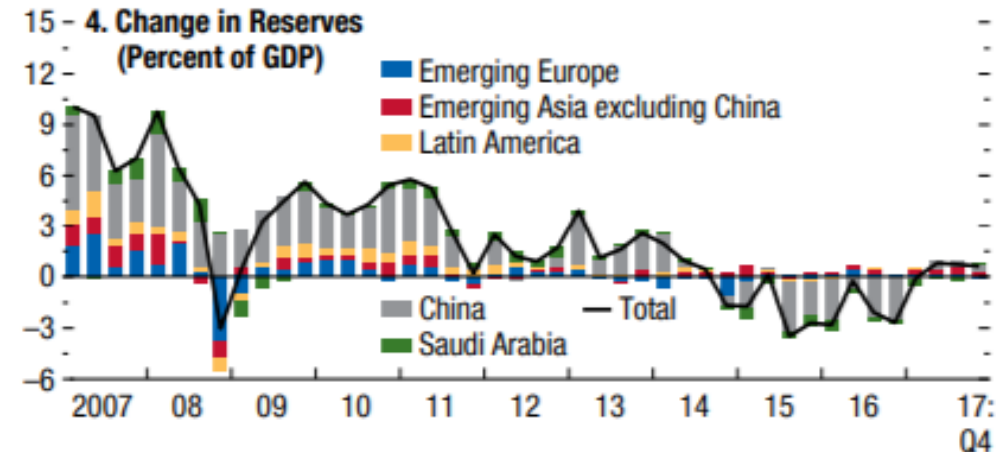
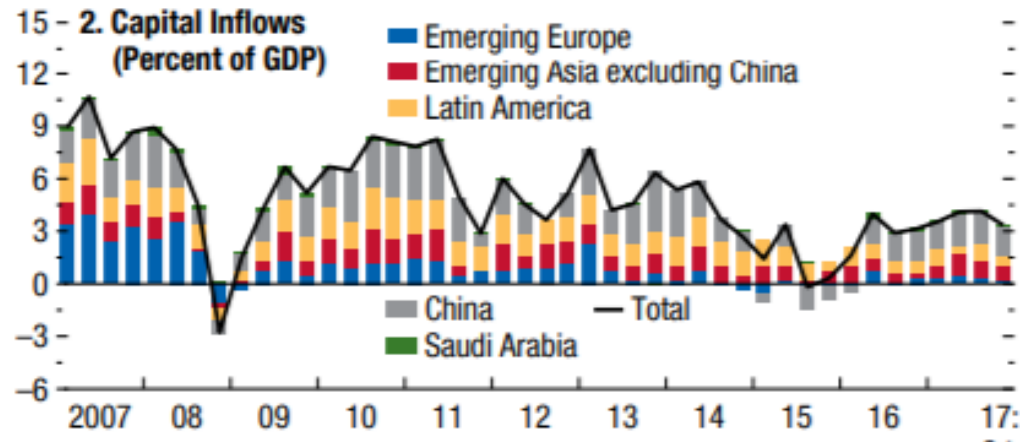
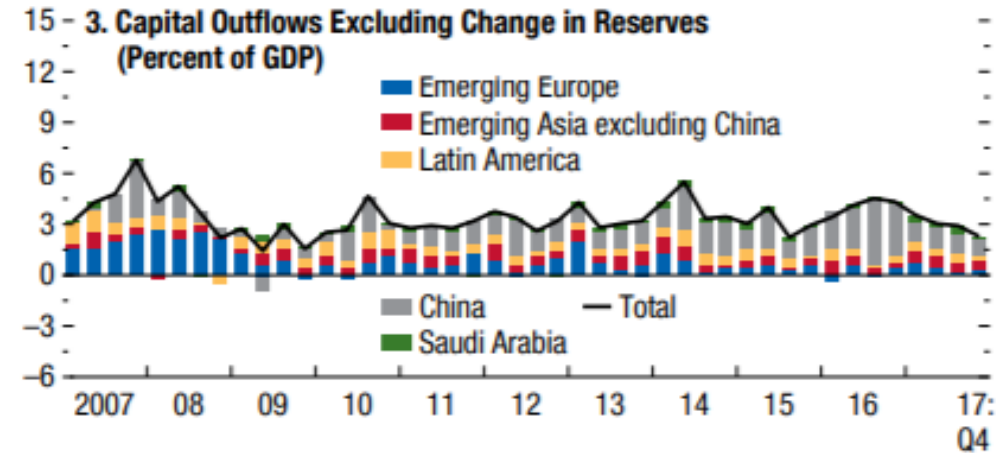
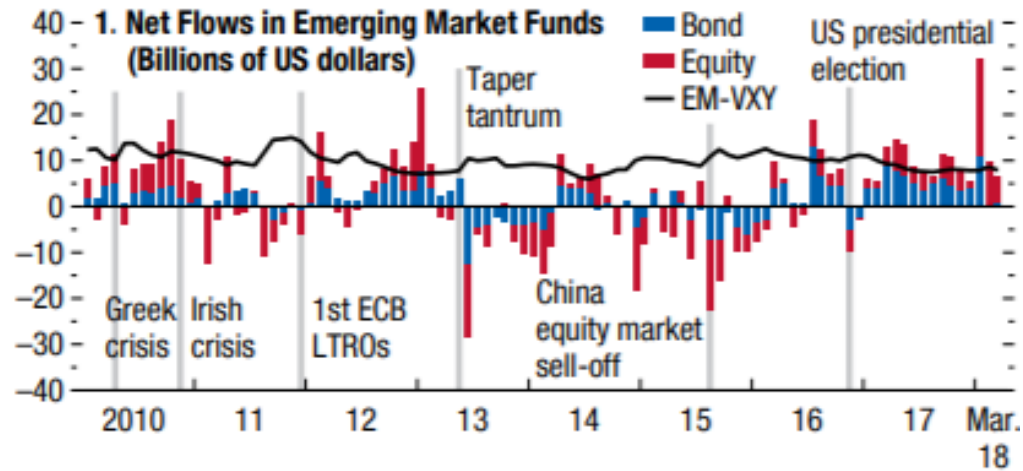
JAO's bold institutional proposals

- New **global reserve system** (active use of SDRs and broad currency basket)
- Better G20 **macroeconomic coordination** (includes exrate target zones)
- Improved **crisis management** (capflows regulation, unconditional facilities, debt workout)
- Strengthened **international governance** (representative IMF, GECC, multilayered)

So where do these shocks come from?

- No longer a Bretton Woods world where public flows dominate and private flows are registered and controlled
- Asset *demand* crucial; as opposed to looking just at asset supply (liability volume, quality i.e. EM debt)
- Balance sheet approach; every liability is somebody's asset. So IMF etc support is changing asset ownership and reconfiguring investors' asset structure as well as EM's liability structure.
- Key issue is then not just 'fundamentals' (whatever these might be) of the liabilities but also crucially contagion, uncertainty, return on *other* assets and above all risk appetite/aversion from the investors' point of view.

Private market capital flows (FDI = *intrafirm* flows) data and commentary from IMF/GFSR



The demand for emerging market assets depends as much on investors' home market conditions as it does on EM 'fundamentals'

The demand function for emerging market assets (f) in a home investor's portfolio (P) at time (t) is

$$P_t^f = \frac{[E_t(r_{t+1}^f) - E_t(r_{t+1}^h)] / R}{\sigma_f^2 - \sigma_h^2} + \frac{\sigma_h^2 - \sigma_{hf}}{\sigma_f^2 - \sigma_h^2}$$

where r is the return on home and EM (h, f) assets, R is the parameter of relative risk aversion, σ_h^2 and σ_f^2 are the respective variances of returns, and σ_{hf} is their covariance.

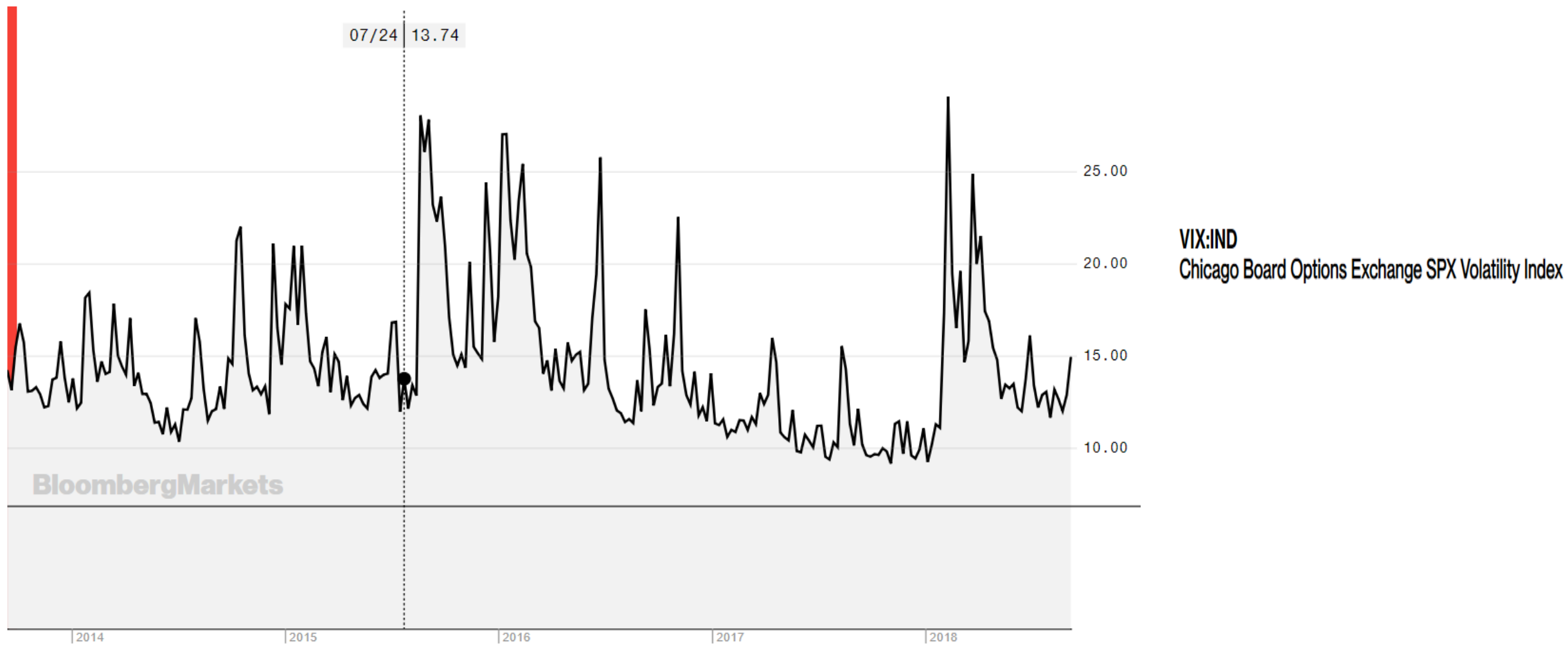
Thus the demand for emerging market assets depends in part on 'fundamentals' (r_f and σ_f^2) but also on *home* - or other foreign - market conditions such as risk aversion and home volatility (R, r_h and σ_h^2) and the correlation between different markets (σ_{hf}) which underpins 'contagion'. All of which vary strongly and rapidly causing 'external shocks'.

The empirical evidence indicates that the latter is at least as important as the former; especially during crises (when both risk aversion and market covariance rise).

Volatility in return/price; comovement and regional shocks



Risk aversionhow much the market thinks the S&P 500 Index will fluctuate in the 30 days from the time of each tick of the VIX Index. an indication of the fair market price of expected volatility at particular points in time



What does this private balance sheet/asset demand approach imply for JAO's proposals?

- Reveals the *systemic instability* of private capital flows and how much/little the international financial system does to stabilise these (the asset demand side) as opposed to compensate with reserve lending, capital controls etc (asset supply side).
- Basically the present approach means swapping (or standing credibly ready to swap) the assets private investors do not want at that crisis moment for ones that they do, until normal conditions return. No attempt to counter origins of the shock.
- The solution lies partly in G20 macro-financial coordination to reduce 'home' fluctuations (as JAO suggests, but what authority could a GECC have without fiscal coordination - look at the Eurozone?) but further, implies greater concern for their *externalities*

Possible elements of a demand-side approach

- ‘Resegmentation’ of large/vulnerable asset classes to ensure longer-term holdings (reducing effect of holders with fluctuating risk appetite); combined with market-making obligations for bond issuers (increasing liquidity and thus reducing perceived resale risk)
- Redefinition of LoLR function of IMF etc in terms of provision of market liquidity and thus reduce market uncertainty as opposed to debt rollovers or BoP loans which cannot ever be truly ‘automatic’.
- Domestic bank regulation (to avoid balance sheet currency mismatch) may be the most effective form of capital controls. Extension of these regulations to large domestic firms with significant external exposure.