Indian Council for Research and International Economic Relations

New International Monetary Order: A Systemic Evaluation

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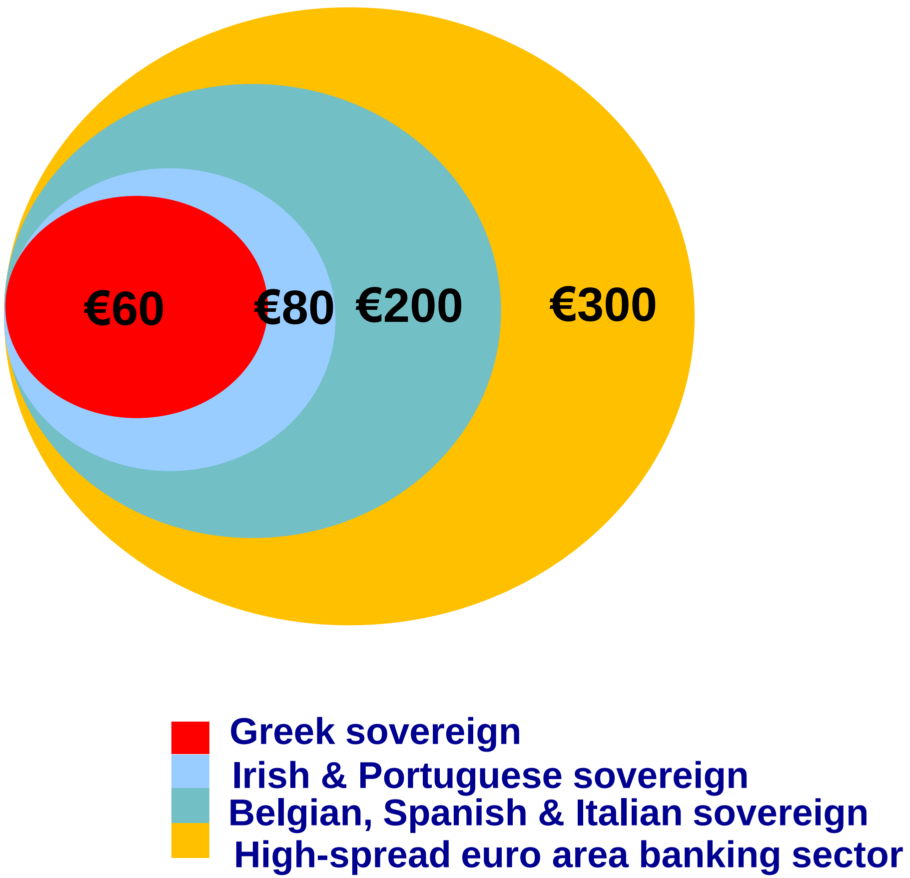
Views are personal to author

A Growing Crisis of Confidence

Private debt	• Subprime crisis originates in US banks
Banking	• Systemic banking crisis spreads from US to Europe
Sovereign	• Problems in euro periphery sov. debt • Medium-term debt burdens in core AE
Political	• Difficulty in reaching political consensus on fiscal consolidation and adjustment

Euro area sovereign risks have spilled over to the EU banking system ...

Cumulative Spillovers from High-Spread Euro Area Sovereigns to the European Banking System (€ bn)



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Key Messages

1. Triffin dilemma remains unresolved: “when the world currency is a national currency, there is an unsurmountable inconsistency between the domestic needs of the country that issues it and the external needs of the world that uses it.”….Tommaso Padoa-Schioppa, 2010.
2. This insurmountable inconsistency has been magnified in the post-1971 Frictionless Financial World, in which the State has lost ability to regulate financial markets without massive moral hazard.
3. Reforms to date have been treating cyclical issues rather than structural. Unless the issue of stabilizing global money is resolved, IMS will lurch from crisis to crisis.

Why is a Globally issued currency logically only Reserve Currency?

- Can a deficit country be reserve currency? Credibility of national issuer will always be questioned by market when its NFA goes into deficit.
- Therefore, only Global Currency can do this because NFA of world = 0.
- In other words, Triffin Dilemma does not apply to a globally created (multipolar) reserve currency.

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"The difficulty lies, not in the new ideas, but escaping from the old ones."

—— John Maynard Keynes

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Outline

1. Post-1971 Changes in Financial Landscape
2. Analysis of current crisis drawing on Asian experience
3. Options for reform for IMS
4. Tentative suggestions

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What is different from 1971?

1. Power has shifted from authorities to market forces, as financial markets gain speed, size and leverage
2. Large capital flows (carry trades) are largely leveraged and monetary policy has lost efficacy. Add naked shorts and CDS make it very difficult for central banks to defend either FX or bond prices at "stable" levels.
3. National governments not measuring shadow and offshore credit for monetary and financial stability concerns.
4. Collective Action Trap: No national government can control global money created through offshore shadow banking.
5. Huge moral hazard, as leading prime brokers/shadow banking are TBTF, so Heads I Win, Tails You Lose for defending central banks.

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1. Globalized Finance is out of sync with Real Sector

- **Financial assets (exc. Derivatives) rose from 108% of GDP in 1980 to 400% of GDP in 2009, 555% for EU)**
- **Notional value of OTC derivatives rose 15 times from $41 trn in 1995 to $615 trn in 2009. Gross market value increased 10 times from $2.2 trn in 1995 to $21.6 trn in 2009.**
- **Notional value and gross market value are 10.6 times and 37.3% of 2009 global GDP.**
- **Global FX turnover rose from $1.2 trn daily in 1995 to $4 trn daily in 2010 (BIS data). Turnover was FX and OTC turnover has risen from 8.9 times global GDP to 17.5 times in 2009.**
- **Only 13.4% of trading with Non-Financial Sector, with 38.9% with reported dealers and 47.7% with other financial, with higher degree of concentration (top 9 accounting for 75% of turnover). Tail is wagging dog.**

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1. Non-linear Escalation in IMF rescue packages: from $17 bn to $372 bn to >$1 trn?

- **Aug. 1997 – Thailand - $17 bn (NFA = -90% of 1997 GDP)**
- **Dec. 1997 – Korea - $55 bn (NFA = -17.2% of 1997 GDP)**
- **May 2010 – Greece €110 bn ($150 bn) – (debt = 143% of GDP; NFA = -76.3% of 2008 GDP)**
- **Nov. 2010 – Ireland €85 bn ($116 bn) (debt = 95% of GDP; NFA = -58% of GDP 2008)**
- **May 2011 – Portugal €78 bn ($106 bn) (debt = 83% of GDP; NFA = -100.5% of GDP 2008)**

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Escalating Resources Needed for Potential Rescues

- **EFSF - €750 billion ($1,020 bn)**
- **Total SDR allocation as at Aug. 2011: $328 bn.**
- **Spain - $2.2 trn, or 64.5% of GDP (-NFA -79.6% of GDP 2008)**
- **Italy - $2.5 trn, or 118% of GDP (NFA -23.1% of GDP 2008)**
- **Current size of rescue funds if Spain or Italy get into trouble will not be sufficient.**
- **Capital required for banks if PIIGS default - €300 billion ($408 bn. IMF GFSR Sep.2011)**

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FX Reserve size of $9.6 trn small relative to Market

Notional size of OTC derivatives $615 trn (gross mkt value of $22 trn and bank net FX positions of $30 trn (BIS) and notional OTC FX of $49 trn (IMF)

Rescue Issue is both Funding and Enforcement

- **Asian crisis revealed that *IMF is not lender of last resort.***
- **Surplus savings in non-crisis countries can be lent to crisis countries, but there must be no moral hazard – the easier to borrow and default, the less will to bear pain of restructuring.**
- **Hence, IMF is not LoLR, but ENFORCER of LAST RESORT – the bad cop to ensure that reforms are carried out.**
- **Only through painful consequences of bad decisions (enforcement) can moral hazard be addressed.**

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Current Moral Hazard IMS: Risk Shift or Risk Sharing?

- Debt contracts try to shift all risks to borrower (to bear loss burden).
- However, when debt burden reaches insolvency, then market lender automatically and involuntarily assumes insolvency loss.
- However, in most cases of sovereign debt, the issue is liquidity at reasonable rate of interest (lower than real growth rate) so that there is time to restructure and recover
- Nevertheless, the lender (even IMF which is guaranteed by all members) are subject to insolvency loss, when borrowers cannot repay.
- Present system of TBTF Shadow Banking shifts losses from market failure to public sector books, thus creating sovereign debt crisis.

2. Carry Trade is highly leveraged offshore Shadow Banking Credit that wins from Momentum Trading

- **Carry trade has leveraged self-fulfilling momentum especially for small open markets. Double play – win from zero cost of carry, higher asset prices, appreciating invested currency, and depreciation in borrowed currency.**
- **Central banks with limited FX reserves cannot defend stability against large momentum play, especially when CDS and ability to naked short currency or sovereign debt is added.**
- **Bank of Thailand 1997 experience is that leveraged defense using forwards can lead to high loss.**

3. Shadow Banking credit and offshore FX credit not measured for monetary and financial stability purposes.

- **Domestically, shadow banking is "black hole". In 2007, US shadow banking system was US$21 trillion in size, 95 percent larger than the traditional banking system and 44 percent larger than US GDP. Not included in monetary survey nor for financial stability oversight.**
- **Use of Net capital flows disguise Gross Capital Flows (e.g. European bank funding in USD to finance HQ).**
- **Use of Net disguise leverage of shadow banks and their offshore carry trade activities. Low Loan Risk Premium and lower interest rates due to Global (Shadow) Banking Glut. – Shin October 2011).**

Who is creating global money?

- Money is good if it is accepted ..Minsky, Offshore Shadow bank credit is “good money”, because national central banks bail them out.

- Five Banks Account For 96% Of The $250 Trillion In Outstanding US Derivative Exposure (OCC data)

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Global Money from Global Banking Glut

Growth in Money Supply

= Net Credit to Government (bonds - govt deposits with banking system) +

Net Credit to Foreign Sector (FX reserves - FX liabilities) +

Net Credit to Private Sector (Loans - Fixed deposits of private sector) +

Net Other Assets (Other Assets - Other Liabilities - Capital and Reserves)

2003-2009 (in $trn) – GDP growth $21.7 trn

Global Money (98.3) = NFA (5.4) +NCG (16.4) + NPBonds (24.4) + NBankCredit (52.1, of which Bank FX credit 15.5 and FX debt 14.9)

Source: Tables 2 & 3, GFSR 2010 and 2005, BIS International Banking Statistics

4. Specialization and Partial View of Global Economy creates Fallacy of Composition and Collective Action Traps

- **Academic specialization causes partial views of world, with models being linear, mechanistic and their analyses "do not add-up". Fallacies of composition lead to pro-cyclical behaviour by both market and national policy makers.**
- **Globalization means that Fragmentation of Global Governance to National levels, and fragmentation at national level to different agencies is flawed. This leads to Collective Action Traps. No single country can change Global Reform requirements.**

Mervyn King: Banks are global in life and national in death".

Global credit is created, with no national capital or real interest constraints

- Shadow banks are global in life and national in death.
- Creation of offshore shadow credit is regulatory arbitrage and cannot be constrained because the larger the credit, the lower the interest rate and risk premia (Global Banking Glut).
- When TBTF banks fail, loss are underwritten nationally.
- Unless this is addressed, present system is unsustainable Moral Hazard of escalating losses.

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Ineffective Monetary Policy and Gridlocked Fiscal Policy

- **At ZIRP, advanced economies in Japanese-style Liquidity Trap. ZIRP only adds distortion for emerging markets and helps speculation and leverage, not real savers and efficient resource allocation.**
- **Fiscal Policy gridlock due to pressure to cut taxes and increase welfare, but debt crisis means limits reached.**
- **Priority should be to create jobs through new job structure, improve infrastructure and deal with global warming and social equity threats.**

- **We are in the two most difficult stages of the recovery:**
  - **Political economy of allocating losses arising from the crisis**
  - **Changing the incentives that led to the crisis in the first place**

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We have systemic Twin Crises

- **The current crisis fundamentally results from two simultaneous crises with one common origin — overconsumption of global resources financed by over-leverage, particularly in the advanced countries.**
  - **Short-term financial (crisis of fiat money)**
  - **Medium to long-term crisis (global warming, ecological degradation)**

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Options for Addressing New International Monetary Order

- Euro debt crisis is global crisis that needs global solution
- Move SDR first towards unit of account and store of value for surplus countries. IMF to concentrate on disciplinary role and recycling surplus savings
- Introduce FTT (Tobin Tax) to tax Financial Sector and create some "friction". Emerging markets would welcome same global FTT.
- Start measuring global shadow banking credit and capture these for monetary and financial stability concerns.
- Phase in capital, liquidity and prudential requirements for Global Shadow Banking.
- Restore balance of risks, especially addressing moral hazard inherent in current TBTF system.

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How can Asian businesses weather complex uncertainties ahead?

- To deal with the complexities of a sustainable global new order, we need to break out of the gridlock that appears to haunt global and regional room for manoeuvre
- It is common to call for leadership, but in the absence of such political and intellectual leadership, what should Asia do?
- In the meantime, the rise of Asia has brought about expectations over its role in shaping the future world order

Asian cooperation is likely to be bottom-up rather than top-down

- **Asian economic cooperation starts with the growing level of intra-Asian trade, today at nearly 55% of total trade**
- **Asian cooperation has been pragmatic and business-like, driven more by the formation of the Asian global supply chain than regional diplomacy**
- **We need a broader, inclusive analytical framework so that Asia can engage the world in global discourse as partners of global sustainable development**

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What should Asia do?

- The first priority to promote system change is to foster a sense of community and cultivate networks.
- We have major system changes to cope with major transformative shifts, with grave resource constraints.
- Asian cooperation is likely to be bottom-up rather than top-down.
- We need better dialogue and research into global issues, with Asian perspectives.

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Multi-dimensional cooperation with increasing social and business interconnectivity

- Social networking technology is integrating Asia (not just within Asia, but with rest of the world) in ways we could not imagine only five years ago
- Institutionalisation of cooperation will be transformed by new Social Networking
- The Fung Global Institute (FGI) is one such institutional innovation to generate and disseminate innovative thinking and business-relevant research on global issues from Asian perspectives

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Asian Perspectives – Global Issues

Four major research projects:

1. **Global Supply Chains**
2. **Asia Finance 2020**
3. **Governance [Markets vs State] – comparison between India and China 12th Five Year Plans**
4. **Sustainability**

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Thank you for your attention

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