Lecture 4
THE REFORM OF THE INTERNATIONAL MONETARY SYSTEM

Lectures in the Theory of Interest and Monetary Policy

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Summary

1. ‘Legacy’ Problems

2. Elimination of ‘Macroeconomic Imbalances’

3. Currency swaps

4. Special Drawing Rights

5. Return of the Keynes Plan?

6. International Debt and Liquidity Management

1. Legacy Problems

The international monetary system consists of:

- international payments system (depends on convertibility);
- System of ‘inherited’ international credit and debt (‘legacy’) requiring servicing and refinancing.

Dilemma of assuring payments + dealing with ‘legacy’ issues.

Vs. new start without ‘legacy’.

‘Legacy’ problems

- International debt of Low Income Countries (mainly Africa, reduced by Highly-Indebted Poor Countries – HIPC Initiative 1990s; Sustainable Development Goals 2000; Addis Ababa Action Agenda 2015); External indebtedness of poor countries rose by 73% between 2013 ($300bn.) and 2019.

- Eurobond Issue of low and Middle Income Countries (since 2008…)

Structures of international credit and debt

- Private Sector foreign indebtedness of middle income countries (Latin America – private sector debt is still claim on government foreign exchange reserves) (but capital controls in China, India and South Africa);
- Covid effects: Rising indebtedness of governments in rich countries (over 100% of GDP) and jump in poor countries' government debt from 29% GDP in 2012 to 49% in 2020. Debt Service Suspension Initiative of G20 governments in May 2020 extended official debt payments of 73 poorest country governments to July 2021.
- But G20 does not speak for all official creditors – China operates independently.

In the context of:

- Rising expenditure demands on governments for Covid medical emergency and employment while restricting carbon emissions;
- Low export commodity prices;
- Populist pressures to reduce aid to poorer countries.

2. Elimination of ‘Macroeconomic Imbalances’

- Favoured solution of Bretton Woods institutions and fiscal conservatives>
- Macroeconomic imbalances: fiscal and trade deficits;

i.e., if

$$S - I = (G - T) + (X - M)$$

and terms on right hand side = 0 then

$$S = I$$

Obstacles to elimination of imbalances

- Does not deal with legacy of debt, (medical emergency, commodity price super-cycle etc.)
- Any trade surplus to service/pay down foreign debt creates deficit elsewhere in the system.
- Utopian to expect trade balance in all countries.
- Elimination of *fiscal* deficit overlooks distinction between internal (domestic) debt and external debt.

3. Currency swaps

Swap (repurchase) agreements between *central* banks;

Vs. Foreign exchange swaps of *commercial* banks:

Central banks create *bank reserves* that they exchange with other central banks using repo agreements;

Commercial banks create *bank deposits* that they exchange with other commercial banks using repo agreements.

Role of Federal Reserve Bank of New York

Federal Reserve announces list of the central banks that have access to Fed currency swaps, namely:

Central banks of Canada, Australia, New Zealand, Japan, European Monetary Union, UK, Sweden, Denmark;

among emerging markets only central banks of Mexico, South Korea and Singapore.

Currency swaps reinforced since Covid in March 2020.

Effective extension of US dollar zone

- Dependence on US foreign policy

4. Special Drawing Rights

Basket currency held by IMF. Issued in proportion to IMF quotas.

So, allocation of $650bn on 23 August 2021 is split:

Advanced economies: $376bn;

Emerging markets: $253bn;

Low income countries $21bn;

(Russian Federation $17.6bn)

But…

Make up less than 3% of non-gold reserves ($ more than half);

Mostly benefits rich countries;

Political process of issue prevents use of SDR’s to regulate liquidity in international monetary system;

May only be used for payments between governments and IMF;

But would free up dollars from reserves for use in more general financial circulation.

5. Return of the Keynes Plan?

Keynes's 'Bancor' allocation on a much greater scale than SDRs.

'Legacy' situation of 1944 very different to 2021: No private foreign debt.

Overlooks opposition to Keynes Plan from US (White Plan; Williams proposals) and developing countries (Kalecki-Prebisch): Bretton Woods agreement was not global.

6. International Debt and Liquidity Management

- Governments need to maintain existing levels of (non-financial) expenditure to prevent deflation and internal private sector debt default;
- Additional expenditure needed for Covid (care, income replacement and recovery);
- Additional climate change expenditure (to limit carbon and methane emissions).

Paying for new expenditure:

Fiscal imbalances to be addressed by increased

taxes on wealth and higher incomes (with

investment allowances – Kalecki 1954);

Fiscal deficit financing in domestic markets at long-term maturities

Government can set the terms for domestic debt;

Long-term government bonds as basis for financial development;

Sale of long-term bonds absorbs excess liquidity from financial markets (‘sterilization’) to prevent dollarization and exchange rate instability;

Require permanent policy of central bank open market operations (buying and selling bonds) to regulate liquidity in domestic financial system.

Foreign aid?

Foreign aid needed to maintain expenditure in less developed countries

(to prevent defaults in private and government sectors).

Difficulties

Domestic borrowing discouraged by excess liquidity in international monetary system (esp. since 2008)

+ doctrine of ‘saving deficiency’ in poorer countries (classic, neo-classical economics, Thirlwall).

In practice….

Institutional mechanism may be needed for converting excess foreign borrowing into domestic currency debt:

- Mexican reliance in late 1980s on capital inflow to refinance government debt from $ to domestic pesos, burdened Mexican corporations privatised in this way with foreign debt.

Conclusion

- All global solutions have utopian elements.
- Regional solutions may work better (e.g., European Monetary System with reformed Franc Zone).