

PP5182: 10–11.  
Global Public Goods and the International Financial  
Architecture

LKY School of Public Policy

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2016 Sem 1

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OUTLINE

1. Case Study in History: Global Imbalance
2. Global Savings Glut: Asian Thrift
3. Exchange Rate Policy: Impossible Trinity
4. The World's Reserve Currency: "Exorbitant Privilege"
5. Implications for the Global Public Good
6. Conclusion

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Case Study in History: Global Imbalance

2008 Global Financial Crisis Over Its First Year

1. Destroyed US\$26tn world stock market value (more than 50% world GDP; 10-fold UK GDP; double the size of the US economy).
2. Pushed into unemployment 34mn worldwide (an increase of 20%). (US lost 9mn jobs 2007–2009.)
3. Reduced incomes in developed economies by up to 5%.
4. Threatened total collapse of the world's financial system.

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### Why? Many possibilities including:...

1. Subprime credit extension. Securitisation. Financial Engineering
2. Weak governance. Ratings capture. Inadequate regulation
3. Moral hazard
4. Political economy of inequality

and

“... it is impossible to understand this crisis without reference to the global imbalances in trade and capital flows that began in the latter half of the 1990s.”

(Bernanke, 2009)

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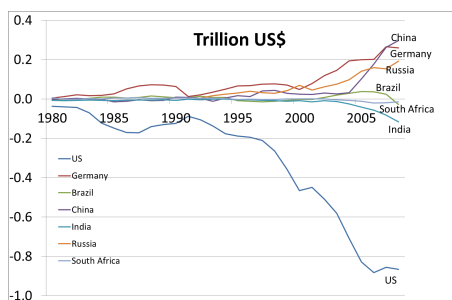
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### Global Imbalance of the 2000s

- Large persistent trade deficits in the US (and to a smaller extent elsewhere)
- Matching surpluses in emerging economies, in particular China, the oil-exporting countries, parts of EU



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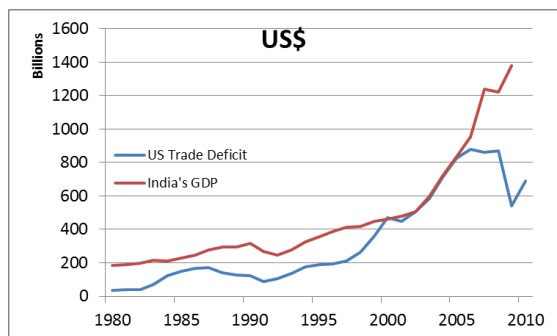
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### The US Trade Deficit ... and a GDP



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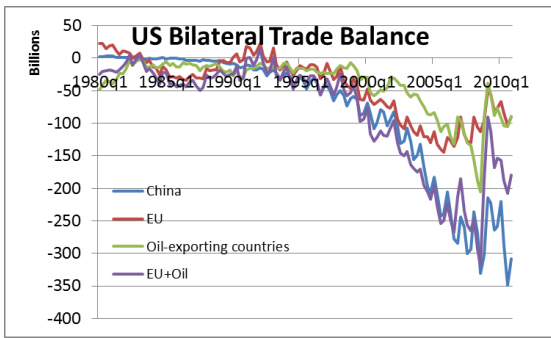
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### Policy Setting: 2010

“Once again, a troubled world is taking out its frustrations on China. In recent months, the United States has imposed trade sanctions on Chinese tires, coated paper products, and steel piping and grating. The European Union has done the same with respect to several steel products, sodium gluconate, and aluminum road wheels.”

(Wall Street Journal Op-Ed 28 January 2010)

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### Trade Fallacies

1. Bilateral trade deficit (“We’re losing to China”) vs overall trade deficit. Plus multi-link value chain.
2. “Running a trade deficit means we’re losing money”. Current account vs capital account. Trade deficits, savings, and investment
3. “Running a trade deficit means we’re losing more jobs from importing stuff, than we gain from exporting.” (Japan’s last three decades of consistent trade surpluses. US 2007–2009, 5.8% to 2.7% unemployment. US in 2000, among the largest trade deficit years, but unemployment only 4%.)
4. “Trade is good for everyone.” It is, and it isn’t—displacement, adjustment

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## Roach on US-China Trade

“We don’t have a bilateral trade problem with China. We have a multilateral trade problem with over one-hundred different trading partners. Last year, the United States ran bilateral trade deficits with almost one hundred countries. And the reason for that is that we have a savings problem.

“If we were to close down trade with China through some ill-begotten trade legislation or currency adjustment, we don’t save the deficit. It just goes somewhere else. And they usually go to a higher-cost producer, which taxes the American public.”

(Stephen Roach, CFR interview, 22 October 2009)

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## Trilemma. Impossible Trinity

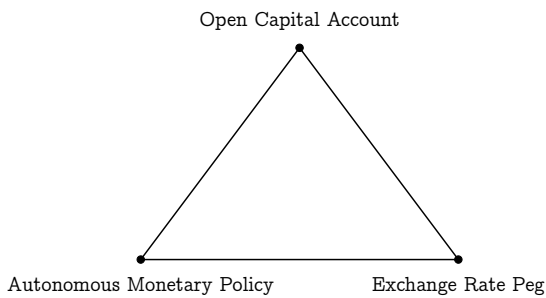


Figure: Location only possible towards triangle boundary. Impossible to have all three (in the middle).

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## Impossible Trinity (2)

- Open capital account and uncovered interest parity: Stable currencies imply monetary policy.
- Open capital account and monetary policy: Exchange rate peg only for limited time, especially depreciation pressure
- Most of world effectively open capital accounts—FDI
- Most advanced economies: Northwest (except within Eurozone)
- Hong Kong, most of Asia: Northeast

In developing economies with open capital accounts:

1. Exchange rate peg implies procyclical monetary policy
2. Exchange rate peg implies pent-up pressures

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## International Financial Architecture

"China's leaders talk of the yuan's internationalisation in peaceful terms. A more diverse monetary system will breed financial stability for the world, they say. But China's rise poses a bigger threat to America than America's did to Britain. For all the paeans to mutually beneficial development, China is a possible adversary, governed by an autocratic regime with a statist approach to the economy."

(The Economist newspaper, 01 August 2015)

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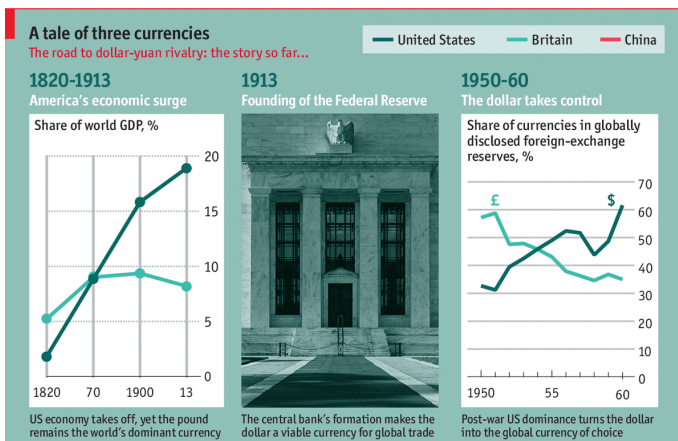
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Source: The Economist (2015). Clash of the Currencies

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## Who Gets To Do This?

- Measures
  1. Holdings in official reserves and private portfolios
  2. Unit of account—international trade invoices and cross-border assets and liabilities
- Advantages
  1. Seignorage
  2. Shift currency risk
  3. Deep market; lowered borrowing costs
  4. Political leverage. Sanctions
- Disadvantages
  1. Triffin Dilemma
  2. Artificial boost to exchange rate

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## What Matters?

UK, US: 1872

1. GDP
2. Low and stable inflation
3. History. Persistence but tipping point
4. Financial market
5. Soft power
6. Not just (or even primarily) exchange rate value of currency

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## Turnover of Foreign Exchange Derivatives, by Currency. April daily average, % share

	1998	2001	2004	2007	2010	2013	2016
USD	87	90	88	86	85	87	88
EUR		38	37	37	39	33	31
JPY	22	24	21	17	19	23	22
GBP	11	13	16	15	13	12	13
CNY	0	0	0	0	1	2	4

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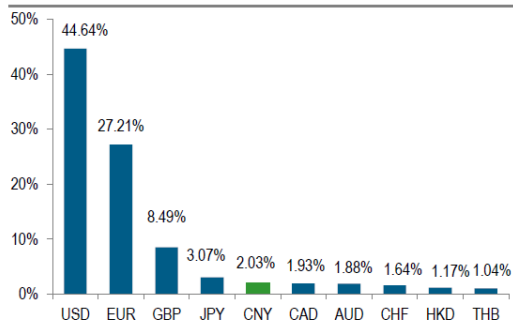
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Source: Bank of International Settlements (2016). Triennial Central Bank Survey of Foreign Exchange and OTC Derivatives Markets in 2016. Extract from Table D11.3

**Figure 14: Top 10 payment currencies in the world**  
% of global payments, as of March 2015



Source: SWIFT, Standard Chartered Research

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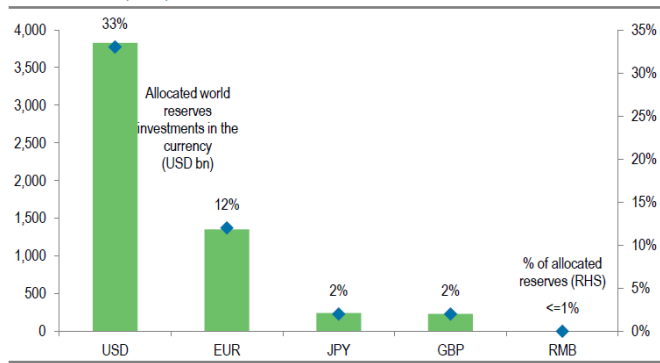
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**Figure 16: Global FX reserve investments by currency**

Allocated reserve investments (USD bn), allocated reserves investment as % of World reserves(RHS)



Note: Allocations to RMB are the Standard Chartered Research estimates; Source: IMF, Standard Chartered Research  
 Source: SDR: One Small Step for China, One Giant Leap for CNY (Standard Chartered Global Research, 15 May 2015)

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4. The World's Reserve Currency: "Exorbitant Privilege"

### Foreign Exchange Holdings of Official Institutions

(in mn US\$)	1899		1913	
	Amount	Share	Amount	Share
Pound Sterling	105.1	63.4%	425.4	47.7%
French Franc	27.2	16.4%	275.1	30.8%
German Mark	24.2	14.6%	136.9	15.3%
Other Currencies	9.4	5.7%	55.3	6.2%
<b>Total</b>	<b>165.9</b>		<b>892.7</b>	

Source: Chinn and Frankel 2008; Linder 1969; author calculations

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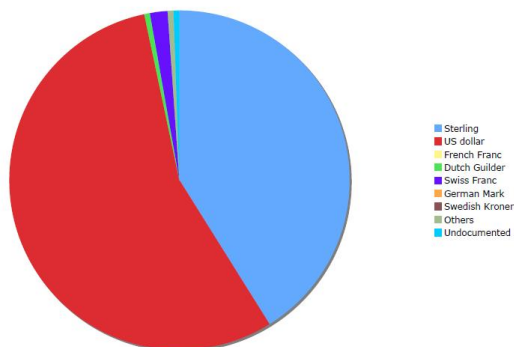
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4. The World's Reserve Currency: "Exorbitant Privilege"

### 1929 Aggregate Foreign Currency Holdings



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Source: Barry Eichengreen and Marc Flandreau (2008)

## “Our Currency, Your Problem”

For the world as a whole:

- Convenience of a single money
- Who runs monetary policy, and for whom?
  1. Federal Reserve System rules: look out only for US citizens.
  2. The world economy not really inter-connected anyway.
  3. Anyone affected “high current-account deficits, high fiscal deficits, and relatively high inflation” already.
  4. "What's good for America is good for the world".
- Can the system adjust to disturbances?

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## “Asymmetric Obligations”

- Maintaining an overvalued currency. Unsustainability
- Maintaining an undervalued currency and running trade surpluses
- Keynes, Dexter White at Bretton Woods

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## Concepts to remember and use

1. Trade: A backdrop for foreign policy, rightly or wrongly. Trade deficits v bilateral trade deficits
2. Seignorage and other advantages to be the economy that issues the World's Reserve Currency
3. IFI: Empirics and History
4. Global policy

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## Balance of Payments

Home Exports	+	Capital Inflows	=	Demand \$
minus		minus		
Home Imports	+	Capital Outflows	=	Supply \$
Trade Balance		Capital Flows		Balance of payments

1. The balance of payments is always ... balanced
2. The trade balance can be in surplus (+) or deficit (-)...
3. ...exactly matched by net capital outflows or inflows.
4. Current account. Capital account
5. China has "capital flowing uphill"

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## Open Economy Macro

$$Y = C + I + G + (X - M)$$
$$\Rightarrow Y - C - G \stackrel{\text{def}}{=} S = I + (X - M) = I + \text{NCO}$$
$$\Rightarrow X - M = \text{NCO} = S - I$$

Higher savings implies greater surplus on the balance of trade (and net capital outflows).



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