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Development of Financial Markets and Institutions

VII. Financial Liberalization and Integration

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VII. FINANCIAL LIBERALIZATION AND INTEGRATION

1. Rise of the Dollar and Modern Currency Markets
2. Fall and Rise of International Capital Markets
3. Financial Liberalization in Emerging Markets
4. Fixed Exchange Rates – Gold Standard vs. Fiat Currencies
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1. RISE OF THE DOLLAR AND MODERN CURRENCY MARKETS



THE DOLLAR STANDARD

Phases of Dollar Ascendancy

- First phase: the dollar the second reserve currency after sterling in 1920s
- Second phase: Bretton Woods, the dollar the sole reserve currency
- Third phase: the post-1971 “non-system”

The “Non-System”

- No convertibility into gold
- Floating currencies
- Attempts at cooperation globally and locally (euro)
- Smaller nations pegging their currency

THE DOLLAR AS RESERVE CURRENCY

Early Use

- Briefly the dominant currency in the late 1920s (Eichengreen and Flandreau 2009)
- Sterling dominance reasserted in the 1930s
- Commonwealth and British trading partners kept most of their reserves in sterling

Return to British Dominance

- Gold suspension 1931 eased the pressure on the BoE and on the British economy
- Dollar devaluation 1933-34 increased uncertainty
- British (paradoxically) and American devaluation made dollars relatively unattractive

THE DOLLAR AFTER BRETTON WOODS

Why Keep Dollar Reserves?

- To economize on gold, on “barren” cash
- Dollar reserves are mainly financial assets – so central banks earn an interest return
- Necessary in the Bretton Woods system – but also attractive

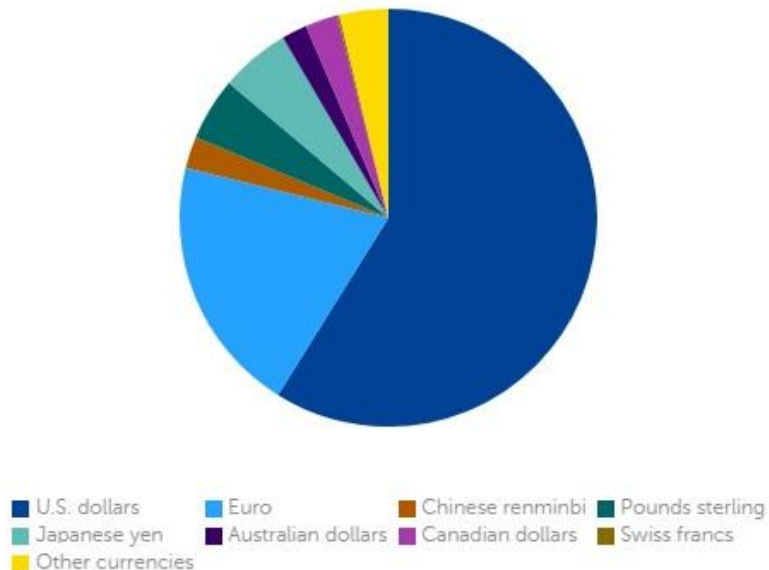
After Bretton Woods

- After Bretton Woods, one could have expected the dollar to decline
- Gold appreciated, the dollar inflationary
- European cooperation could lead to a new system on a non-dollar basis
- However, this did not happen: today, the dollar is still the main reserve currency
- Dollar claims fluctuated between 58-78 percent of reserves over the last 25 years

OFFICIAL RESERVES TODAY (SOURCE: IMF)

- Dollar reserves: 58.88 percent
- Euro reserves: 19.97 percent

World - Allocated Reserves by Currency for 2023Q2



THE AMERICAN POSITION IN THE SYSTEM

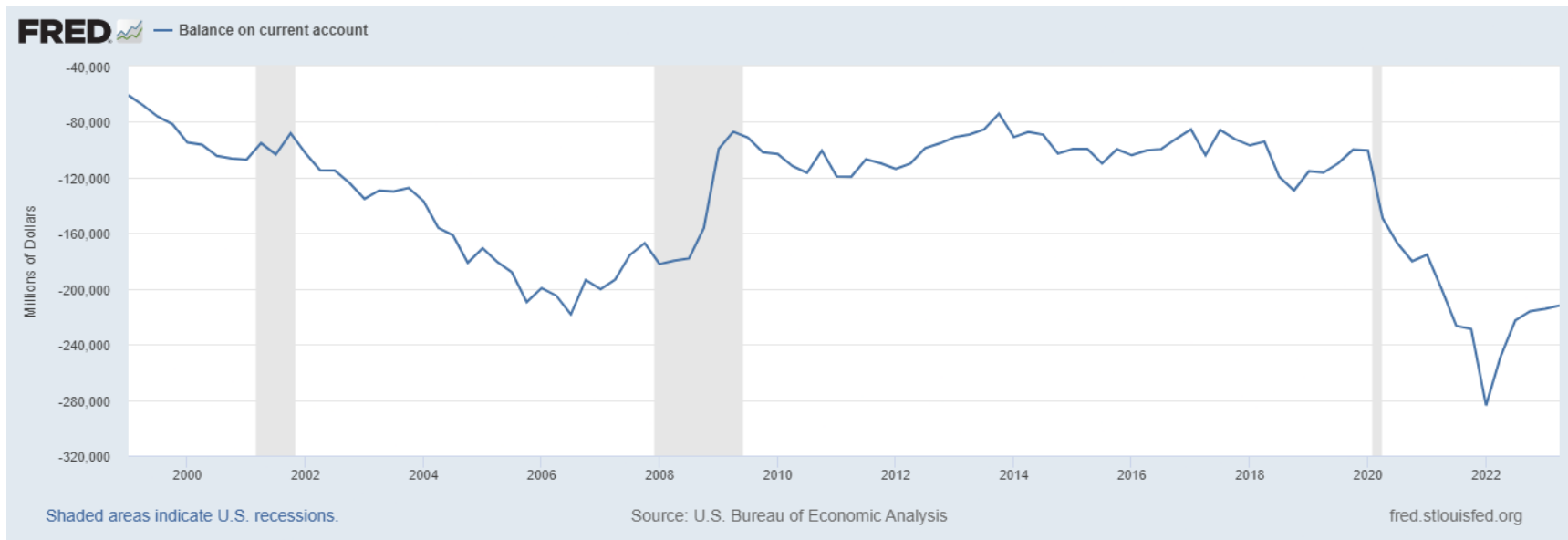
Subsidized Capital Imports

- The US enabled to have a large current account deficit permanently
- Capital transfers, or “exports” of financial assets from the US, finance the deficit
- Dollar-denominated financial assets pile up in foreign reserves – official and unofficial
- US consumption – private and government – financed by debt

The Causes Behind Capital Transfers

- High demand for dollar assets as reserves – partly from monetary policy
 - To maintain interest rates, exchange rates, expand credit, etc.
- Inflation skews the terms of trade against the US
 - Imports rise, exports fall – but no correction mechanism

US CURRENT ACCOUNT, 1999-2023Q2



THE (NON)-SYSTEM AFTER BRETTON WOODS

Two General Tendencies After 1971

- Fluctuating currencies, a general system of fixed exchange rates abandoned
- Attempts at maintaining fixed exchange rates
 - First globally with the Smithsonian Agreement 1971-73
 - Locally in Europe, with the EMS, ERM, eventually the euro

Informal Cooperation

- American pressure on Japan in the 1980s to revalue the yen
- Coordinated gold sales in the late 1990s
- Coordinated policies after 2008

CURRENCY MARKETS

Liberalization of the Monetary System

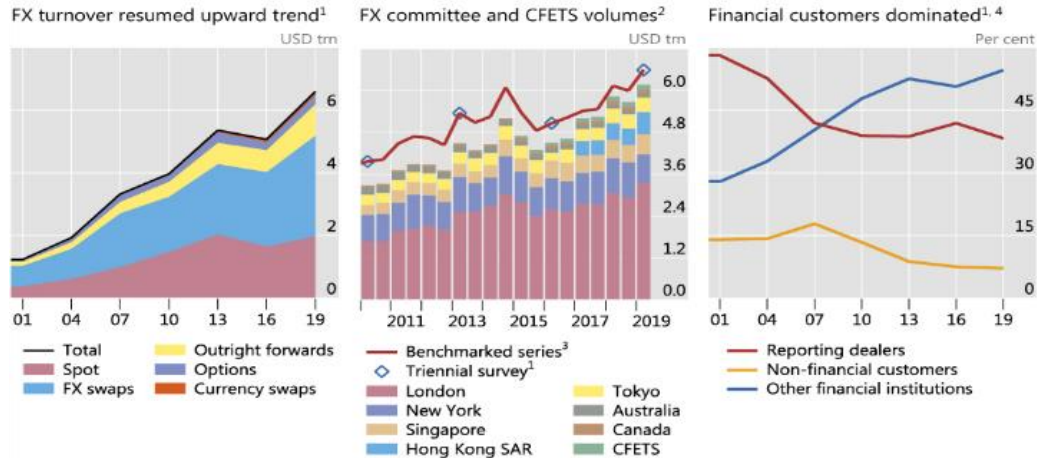
- Capital and financial controls abandoned from the 1980s on
- Fixed exchange rates largely abandoned, capital account liberalized
- Increased financial integration and exponential growth of currency markets resulted

Modern Currency Markets

- Each fiat currency is valued (priced) according to its purchasing power (PPM)
 - There is no connection to gold
- Speculation in foreign exchange is mainly about foreseeing evolution of PPM
 - Central bank policies are a key parameter: supply of currency
- The dollar is the main *vehicle currency* for all currency markets

SIZE OF CURRENCY MARKETS (SCHRIMPF AND SUSKO 2019)

FX turnover rises with more trading in FX swaps and by financials Graph 1



¹ Adjusted for local and cross-border inter-dealer double-counting, ie "net-net" basis; daily averages in April. ² Semiannual data, referring to April and October. Additional increase in stacked bars due to the inclusion of China Foreign Exchange Trade System (CFETS) turnover in April 2015 and the Hong Kong Treasury Markets Association survey in April 2017. ³ The benchmarking using the proportional Denton technique allows us to assess the evolution of FX trading volumes between Triennial surveys. For a description, see Bech (2012). ⁴ Expressed as a share of total turnover.

Sources: M Bech "FX volume during the financial crisis and now". BIS Quarterly Review, March 2012, pp 33–43; foreign exchange committee surveys; Bloomberg; BIS Triennial Central Bank Survey; authors' calculations.

SIZE OF CURRENCY MARKETS

Currency Markets

- The daily turnover in currency markets is above \$6 trillion – mainly speculative
- Hedging by large companies engaged in trade, speculation by arbitrageurs
- Swaps and forwards 2/3s of market, almost all dollar-denominated (2019)

Financing Trade (the Current Account)

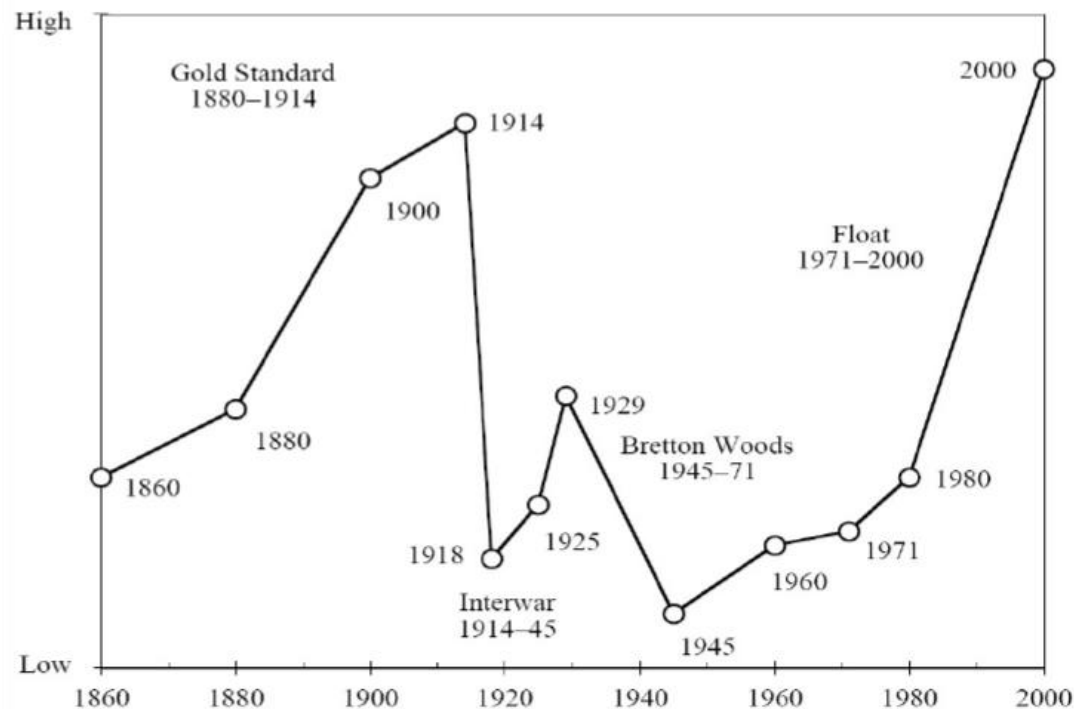
- Financed by exchange of claims the “old-fashioned way”
- These claims can now be instantaneous: transfers from bank account to bank account
- Exchange rates change in response to imbalances in flows – demand and supply
- Germans import goods from a British supplier, exchanging a euro for a sterling claim
- This is demand for sterling – exports from Germany is demand for euros

2. THE FALL AND RISE OF INTERNATIONAL CAPITAL MARKETS



TWO ERAS OF FINANCIAL GLOBALIZATION

- History is not a tale of constant improvement!
- First period: 19th century until WWI
- Retrogression: 1930s-70s
- Second globalization: 1980s onwards



International Capital Mobility Index (Obstfeld and Taylor 2003, 127)

THE FIRST ERA OF GLOBALIZATION

The Gold Standard Era

- An integrated monetary system led to an integrated global financial system
- Capital could easily be raised in London or Paris and then transferred to other countries

Direction of Capital Flows

- Capital tended to flow to where the expected rates of return were highest
- Capital-poor but resource rich countries
- Countries with institutions supporting economic development

The Gold-Exchange Standard

- Surge in flows in 20s – but in the opposite direction
- Into Great Britain, accumulation of sterling balances in other countries

THE END OF THE FIRST ERA OF GLOBALIZATION

The Crash of 1929

- Breakup of the gold standard due to inflationary policy
- Emergence of blocs – e.g., the sterling bloc
- Rise of protectionism, capital controls to prevent “hot money” flows

Disintegration after WWII

- Communist countries cut off
- Capital controls instituted to protect exchange rates, prevent the flows of “hot money”
- Protectionism limited trade – hence also limited the need for international finance
- Costs of international transfers overall hampered after the end of the gold standard

BRETTON WOODS – GLOBALIZATION WITHOUT FINANCE

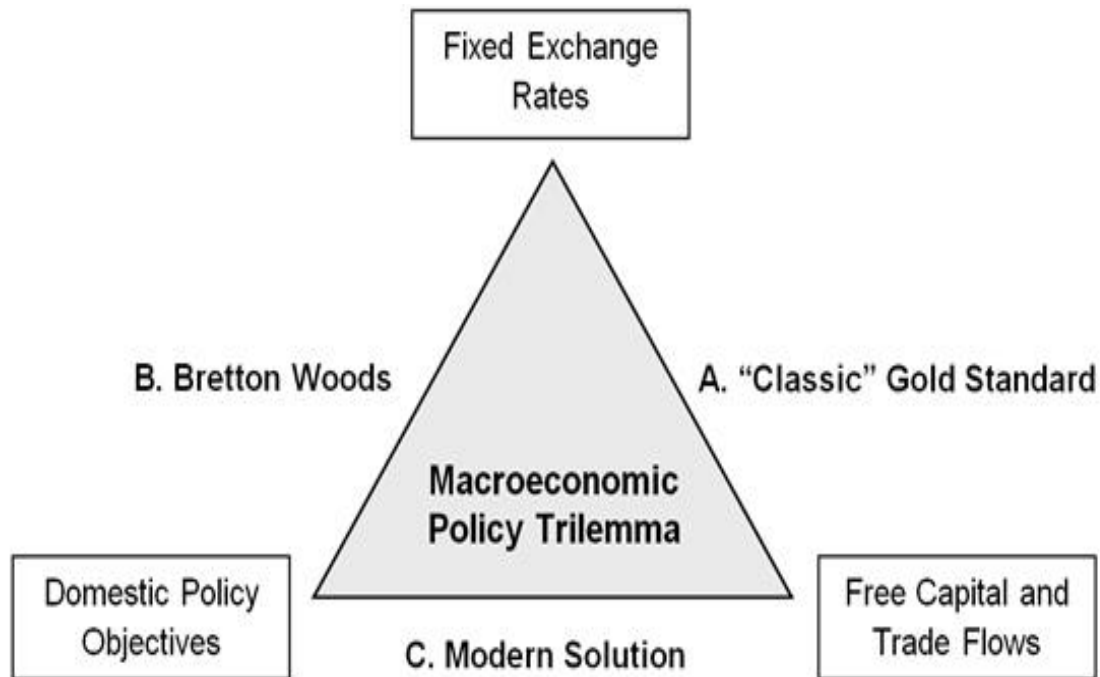
Gradual Return to Free Trade

- Institutions such as GATT, EFTA, EEC led to freer trade
- This rise in trade was not accompanied by financial liberalization
- This can be conceived of as current account liberalization plus capital controls
- Free flows of capital were incompatible with the Bretton Woods system

The Impossible Trinity (Mundell 1963)

- A fixed exchange rate and monetary sovereignty excludes capital flows
- Free capital flows and a fixed exchange rate excludes monetary sovereignty
- Monetary sovereignty and free capital flows exclude a fixed exchange rate
- Bretton Woods was a system of fixed exchange rates and monetary sovereignty

THE IMPOSSIBLE TRINITY



THE SECOND ERA OF GLOBALIZATION

After Bretton Woods

- Exchange rates now simply reflect the purchasing power of the different currencies
- No need to control exchange rates, flows of money: currency markets freed
- There is no longer any obstacles to capital account liberalization, financial development
- An international capital market reemerged for companies and governments

International and Domestic Liberalization

- Rajan and Zingales (2003) argue that liberalization of capital flows undermined domestic opposition to financial liberalization
- Liberal reforms improved the functioning of domestic capital markets
- Capital now more speedily, more cheaply allocated to most productive purposes

MEASURES OF FINANCIAL GLOBALIZATION

- Rajan and Zingales (2003) estimate various measures of financial development
- European countries in general more financially developed than the US in 1913
- Financial development in all countries declined after 1929, reaching nadir around 1980
- Pre-WWI level first reached again in the late 1990s
- One interesting measure: the stock market as a fraction of GDP
- 1913: France 0.78, USA 0.39
- 1980: France 0.09, USA 0.46
- 1999: France 1.17, USA 1.52



3. FINANCIAL LIBERALIZATION IN EMERGING MARKETS

LIBERALIZATION IN EMERGING MARKETS

Efficient Capital Allocation

- Liberalization of the capital account and domestic capital markets leads to more efficient allocation of capital
- Capitalists search for high returns, invest in underdeveloped sectors
- Natural resources better exploited, wages rise

Final Equilibrium

- Productivity and wages in emerging markets rise to level of other countries
- Global market rate of interest equal

But...

- We need to take account of the role of money – not simply of capital – in this process

CAPITAL RESTRICTIONS IN DEVELOPING COUNTRIES

Developing Countries = Capital-Poor Countries

- Market value of production structure low
- The capital goods necessary for production lacking
- The financial sector is usually highly restricted in such countries
- Capital account is controlled, limiting international flows
- Domestic financial markets are restricted, e.g., through an interest ceiling

Capital Allocation under Restrictions

- Financial resources are allocated by government agencies controlling the capital account
- Favoured actors, public or private, absorb the limited capital at low real interest rates
- Political connections, not profitability, the deciding factor in capital allocation

LIFTING RESTRICTIONS

Domestic Liberalization Primary

- Domestic financial markets must be freed before international markets
- Otherwise, there will be no demand for international capital
- This means eliminating interest ceilings, allowing free entry, abandoning favouritism
- Foreign capital then allocated through domestic financial institutions and markets

The Role of Money (McKinnon 1973)

- Improvement in monetary institutions primary
- Inflation must be ended, it makes investment unattractive
- Extreme measures: currency board, dollarization
- Less extreme measures: stopping inflation, credibly commit to low inflation

THE TWO EFFECTS OF SOUND MONEY (MCKINNON 1973)

The Conduit Effect

- If the value of money is not destroyed through inflation, there is a positive return to holding money
- Therefore, saving and self-financed investment will be incentivized

The Competing-Asset Effect

- If the return to holding money is very high (i.e., falling prices / an increasing value of money), investment may be discouraged
- Since the expected return on investment is lower than the return on holding money
- In a developing country, it is likely that the demand for real cash balances and the demand for physical capital are highly complementary

THE CONDUIT EFFECT

Low-Quality Money

- People tend to invest in capital goods, durable consumer goods to preserve their wealth
 - And then consume the rest
- This leads to more investment in goods that will spoil, leading to a loss of capital
- It leads to overinvestment in fixed capital goods beyond what is necessary or optimal
 - These goods are then underutilized, wasted

Higher-Quality Money

- Saving in money becomes attractive
- Entrepreneurs can now save in money and only invest in productive assets
- Investment becomes overall more attractive as opposed to consumption

THE CONDUIT EFFECT (MCKINNON 1973, 63)

If the real return on holding money is low or negative, a significant proportion of the physical capital of the economy will be embodied in inventories of finished and semi-finished goods that are not used directly for production or consumption. A small farmer may keep unduly large rice inventories as the embodiment of his savings - a portion of which the rats eat every year. Alternatively, a wealthy member of some urban enclave may build an unusually elaborate house, which he hopes will also maintain its value under inflation. A businessman might deliberately “over-invest” in plant capacity or in certain stocks of raw materials, relative to his current operating needs.

In summary, the quality of the capital stock is directly and positively related to the real return on holding money.

THE COMPETING-ASSET EFFECT

Good Money as A Competing Asset

- Holding money an attractive alternative to lower-yielding investments
- Accumulation of money consequently increases when the best investments made
- With banking, the entrepreneur can deposit his money at interest
- Banks and other intermediaries then seek out profitable investment opportunities

Some Problems

- Increased demand for money does not depress interest rates – it depresses prices
- This brings real balances into equilibrium with demand, increases PPM
- Marginal utility of money then falls below marginal utility of investment (future money)
- Increasing value of money attracts foreign investors, or leads to appreciation
- Any positive rate of interest yields profits to the investor – also with good money

DOMESTIC VS. FOREIGN CAPITAL

Limits of Domestic Capital

- Development would be slow in the absence of foreign capital
- Domestic savers can only supply a limited amount of capital out of net savings
- Even with strong protection of property rights, skilled labour, enforcement of contracts, efficient capital markets etc.

Efficacy of Foreign Capital

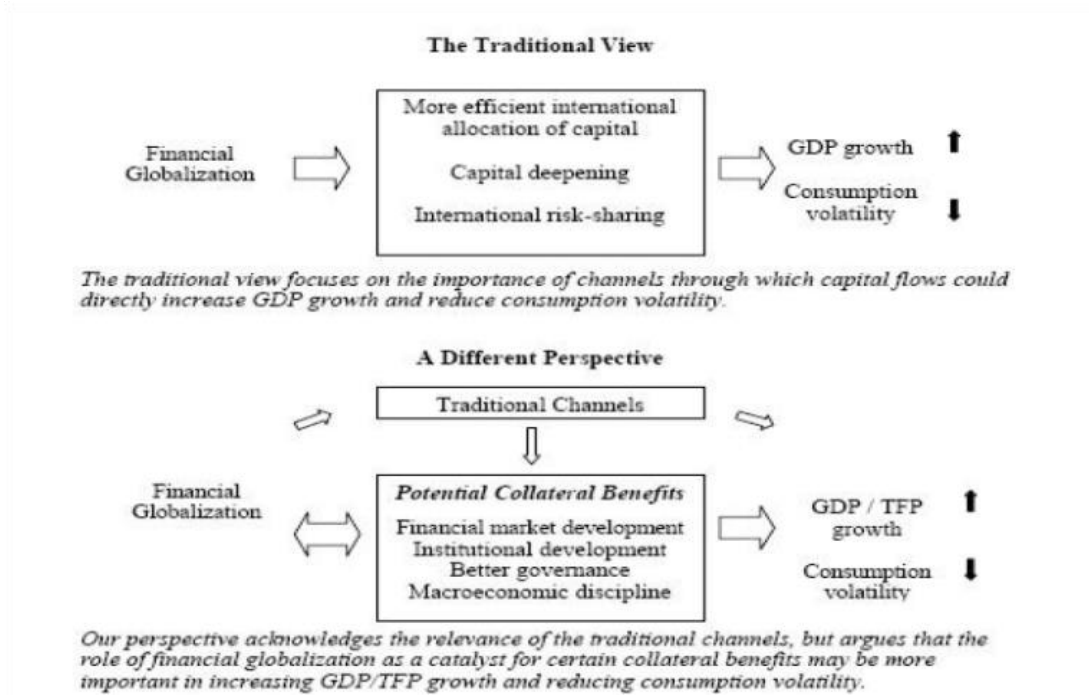
- It greatly accelerates economic development
- Active foreign investment: setting up companies, buy out natives, appoint management
- Passive foreign investment: lending to domestic firms, investment in domestic bonds
- Passive investment is more risk-averse and more likely at a later stage of development

THE IMPORTANCE OF FOREIGN CAPITAL (MISES 1998, 496-7)

Let us look at the condition of a country suffering from such scarcity of capital. Take, for instance, the state of affairs in Rumania about 1860. What was lacking was certainly not technological knowledge. There was no secrecy concerning the technological methods practiced by the advanced nations of the West. ... If the aid granted to the Rumanians on the part of the advanced foreign nations had consisted merely in providing them with technological knowledge, they would have had to realize that it would take a very long time until they caught up with the West. The first thing for them to have done would have been to save in order to make workers and material factors of production available for the performance of more time-consuming processes. Only then could they successively produce the tools required for the construction of those plants which in the further course were to produce the equipment needed for the construction and operation of modern plants, farms, mines, railroads, telegraph lines, and buildings. Scores of decades would have passed until they had made up for the time lost. There would not have been any means of accelerating this process than by restricting current consumption as far as physiologically possible for the intermediary period.

However, things developed in a different way. The capitalist West lent to the backward countries the capital goods needed for an instantaneous transformation of a great part of their methods of production. It saved them time and made it possible for them to multiply very soon the productivity of their labor. The effect for the Rumanians was that they could immediately enjoy the advantages derived from the modern technological procedures. It was as if they had started at a much earlier date to save and to accumulate capital goods.

THE EFFECTS ON GROWTH (KOSE ET AL. 2009)



**4. FIXED
EXCHANGE
RATES: GOLD
STANDARD VS.
FIAT CURRENCIES**



THE MEANING OF EXCHANGE RATE REGIMES

- Fixed exchange rates work differently under different monetary standards

On the Gold Standard

- From the nature of the system exchange rates are fixed
- If 1 franc = 0.3225 grams of pure gold, 1 pound = 7.3218 grams of pure gold
- Then 1 franc = $1/22.7$ pound and 1 pound = 22.7 francs
- Exchange rates can fluctuate within the bands set by the cost of transporting gold

In a Fiat System

- Each currency is valued independently according to its purchasing power
- Exchange rates are set by relative purchasing power
- Under these conditions, a fixed exchange rate is a price control

FIXED EXCHANGE RATES AND GOLD

Monetary Flows Under the Gold Standard

- Flows do not affect the exchange rate
- Outflows simply lead to a contraction, inflows to an expansion of the money supply
- If demand for a country's product declines, a balance of payments deficit emerges
- Initially, gold flows out to finance imports
- Over time, imports too decline, as people adjust to the change

On the Classical Gold Standard

- Flows also meant a credit contraction or expansion, with the disruptions that entailed
- In terms of the impossible trinity, the gold standard means giving up monetary sovereignty – or giving it to the individual, rather

GOLD-EXCHANGE AND BRETTON WOODS

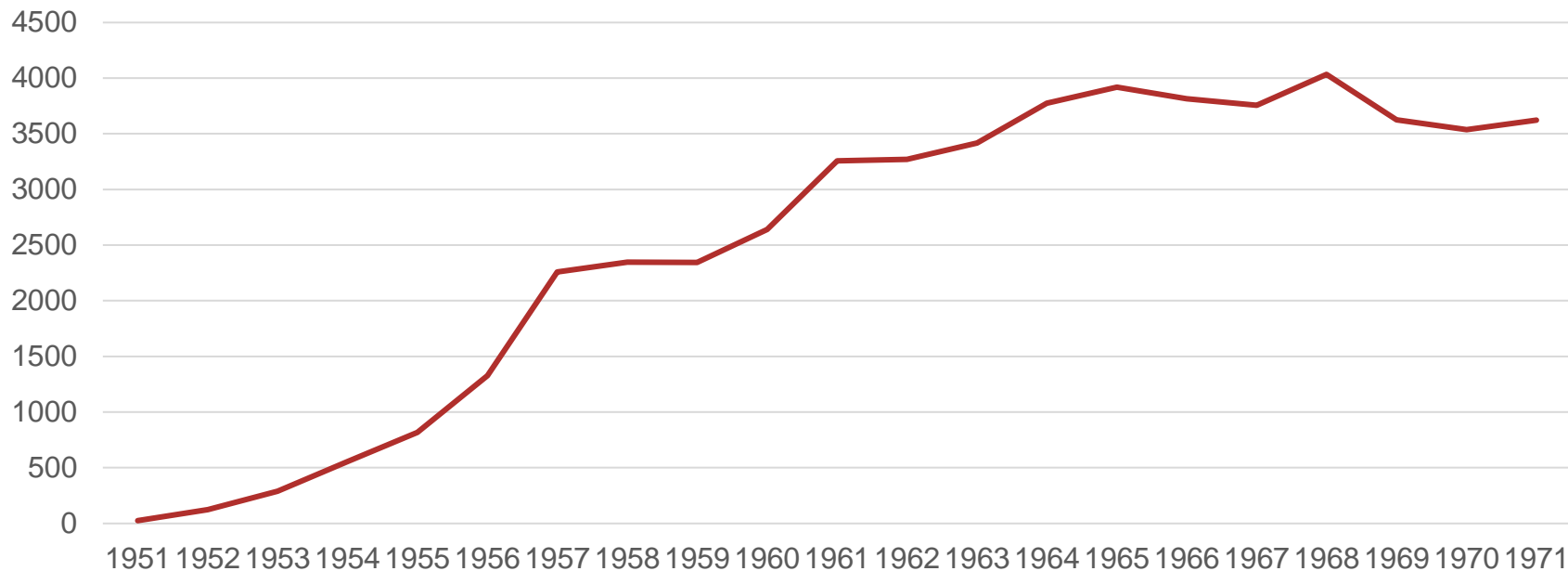
The Purpose of the Systems

- To avoid the discipline of gold
- The desire was to keep expanding the money supply, no matter the state of the balance of payments
- Capital controls were necessary to maintain the appearance of fixed exchange rates

Revaluation and Gold Redemption

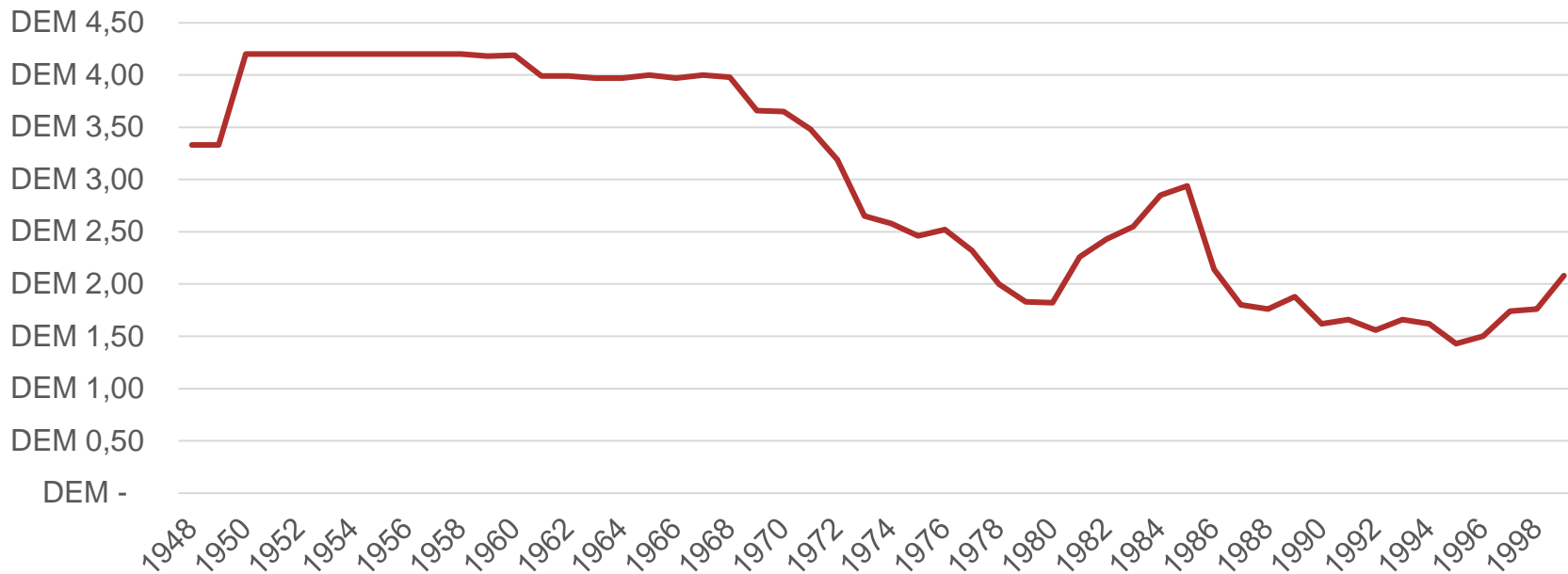
- The way to escape the Bretton Woods System
- E.g., as the D-Mark appreciated and dollars depreciated, dollars flowed into Germany
- To limit this imported inflation, Germany periodically revalued
- Other countries forced to devalue: e.g., Great Britain in the 1960s

GERMAN GOLD HOLDINGS 1951-1971



In metric tons.

DEUTSCHE MARK PER DOLLAR 1948-1999



FIAT MONEY

Fixed Exchange Rates Under Fiat

- Makes little sense, hard to manage
- Everything that impacts the value of money causes a change in exchange rates
 - Changes in incomes and productivity
 - Central bank policy and the rate of inflation
- The central bank would have to constantly intervene simply to maintain the par

Two Alternatives

- Floating currencies **or** unification of monetary systems
- Floating leads to free currency markets, currency risks and speculation
- Unification greatly expands the power of monetary authorities

5. LITERATURE



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