

International Monetary System vs. International Financial System — and the Significance for Policy Makers

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International Monetary System

The International Monetary System (IMS) constitutes an integrated set of money flows and related governance institutions that establish the quantities of money, the means for supporting currency requirements and the basis for exchange among currencies in order to meet payments obligations within and across countries. Central banks, international financial institutions, commercial banks and various types of money market funds — along with open markets for currency and, depending on institutional structure, government bonds — are all part of the international monetary system.

The key distinguishing factor for the IMS is that money (in contrast to financial assets) is not interest bearing. Money is used as a unit of account and/or a medium of exchange to support and foster the exchange of goods and services, and capital flows, within and across countries; to calibrate values and advance the exchange of financial assets; and to foster the development of financial markets.

Traditional definitions of money also include its role as a store of value, but that role has been largely assumed by financial assets. Although this view may be controversial, the store of value for money is, at a minimum, shared with the international financial system and may be completely assumed by it.

The following contribution formed part of the Chatham House Gold Taskforce's investigation into what role gold could play within the international monetary system, which was developed through a series of consultations and workshops. The views expressed are the sole responsibility of the individual Gold Taskforce contributor(s) and do not reflect the views of Chatham House staff, associates or Council. Nor do they necessarily reflect the agreed views of the Gold Taskforce itself, as expressed in its final report.

International Financial System

The international financial system (IFS) constitutes the full range of interest- and return-bearing assets, bank and nonbank financial institutions, financial markets that trade and determine the prices of these assets, and the nonmarket activities (e.g., private equity transactions, private equity/hedge fund joint ventures, leverage buyouts whether bank financed or not, etc.) through which the exchange of financial assets can take place. The IFS lies at the heart of the global credit creation and allocation process.

To be sure, the IFS depends on the effective functioning and prudent management of the IMS and the ready availability of currencies to support the payment system. Nevertheless, the IFS extends far beyond IMS's common payments and currency pricing role to encompass the full range of financial assets, including derivatives, credit classes and the institutions that engage in the exchange of these assets as well as their regulatory and governing bodies. The IFS encompasses the IMS — but extends in function and complexity well beyond the IMS.

Government debt links the two systems, as government debt can function as “near money” in a zero interest rate environment. Many financial transactions pass through a stage of payment in money (i.e., a demand deposit) — quickly — to a “riskless” interest-bearing asset, like government bonds. When “riskless” assets become more “risky” and less liquid, the payment system slows down and may even be upended.

Examples

The sovereign debt crisis, such as the one now under way in Europe, is primarily a crisis of the IMS. Sovereign debt lies at the heart of a monetary system because it constitutes a source of riskless assets that balance the risk profile of other assets held on bank balance sheets. When interbank markets become concerned about the quality of sovereign debt, the event creates counter-party risk that disrupts interbank borrowing, which is a critical instrument of shared bank liquidity. As is the case in the current European crisis, the liquidity crisis within the banking

system can have liquid currency implications because the mix of currencies on bank balance sheets may not match the mix of currencies required to meet payment obligations.

To date, the European crisis is primarily a crisis of the IMS because it has not influenced international financial markets and/or the international economy in any systematic way — yet. Global financial markets certainly suffered a shock in the summer from the intensity of the euro crisis. Thus far, the monetary crisis has not undermined confidence in global financial asset values or had a significant effect on trade and economic growth.

The Asian financial crisis of the 1990s was a crisis that began as a monetary crisis but quickly migrated into a full-fledged financial crisis. It was the inability to access U.S. dollars in sufficient amounts to cover withdrawals from Asian banks and the dollar-based debt obligations of Asian governments and businesses that created a liquidity crisis. The result was a capital withdrawal from virtually all asset classes in the region. In short, the Asian financial crisis was an international monetary crisis that turned into an international financial crisis.

The recent global financial crisis worked in the opposite direction. The global financial crisis started in the financial system with high-profile bankruptcies prompted by financial innovations in the derivatives markets that purported to create near-riskless assets from a combination of low-grade mortgage debt, other debt (including government debt) and supposedly smart equity structures that concentrated risk in the issuer. The magnitude of the collapse of major financial institutions and government support of the banking system transmitted the liquidity crisis from the financial sector to the nonfinancial sector as nonfinancial business raced to translate working capital into cash. These events rocked the global economic and financial systems back on their heels and produced a banking crisis in Europe that had important monetary dimensions (e.g., shortage of U.S. dollars in the payment system).

Policy Implications

The distinctions between the IMS and IFS are important for policy makers because these events demand different policy responses. IMS events are often about the availability of liquidity, especially U.S. dollar-based liquidity, in the financial system to meet current payment obligations. IMS events can be resolved primarily through central bank action and common agreement. A critical factor here is the inherent limit in the international environment of a nationally determined currency. The problem is often not that there is too much of a given currency but that there is too little, and it is concentrated in the wrong places.

IFS crises are more complex and far reaching. They can involve regulatory and reporting changes; they have significant and enduring economic effects. In the extreme, central banks can be asked to play a role as “lender of last resort.” In carrying out this role, central banks purchase “nonperforming” market assets to reduce the overall supply of “toxic” securities in the marketplace and rebalance the demand and supply of credit-worthy financial market assets. Remedial actions and regulation tend to concentrate in financial institutions and markets rather than at the core of the monetary system — although the monetary system can be damaged by the severity of these events.

The term “anchor” is often used with respect to the IMS when it is really intended to refer to the IFS. We would like to have a benchmark, a signal that the financial system is creating too many assets for the credit base to support. One approach is the regulatory system — but that is a slow moving process.

The problems of the monetary system tend to be a geographic mismatch in the supply of liquidity, particularly U.S. dollar liquidity, during times of financial stress. There is very little difference among the various measures of money growth, per se, among all of the advanced economies, where inflation is not particularly a problem. All of these would be signals of a need for an anchor.

Where money growth and inflation appear problematic is in the emerging world. To some extent, rapid money growth is a product of interest rate/currency management and not sterilizing capital inflows — together with very rapid real economic growth rates. These problems are more matters of domestic money management rather than of the international monetary system.

The international monetary system clearly needs to evolve. However, this evolution should be predicated on the need for stable trade, related financial and payments requirements and self-regulating imbalances in global trade and capital accounts as well as take into account the special needs of the payments systems during financial crisis events.