

The International Financial System and the Role of Central Banks in the Great 2007-9 Recession and the '*Monetary Peace*'

SPYROS VLIAMOS & KONSTANTINOS GRAVAS



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Abstract: This paper

1. examines the evolution of central banks as powerful institutions in the international economic system and
2. reviews the political and economic context of international policy cooperation since the ‘first globalization’ in 1876-1914.
3. examines the institutional arrangements that shaped monetary policy and led to the successful implementation of ‘monetary peace’ by the leading central banks (mainly Fed and ECB) after the Great Recession (2007 – 9).
4. claims that central banks’ cooperation has led to a new paradigm of ‘monetary peace’ in the aftermath of the ‘Great Recession’ in 2007-9.

Introduction

- **Central Banks:** From the classic Bagehot (1873) dictum that ‘...*central banks should address panics by lending freely at a penalty rate*’, (Bernanke, 2013) to monetary policy cooperation.

as

- **Powerful Institutions:** CBs independency played an important role in the modern design of monetary policy in response to the ‘*Great Recession*’ after Lehman bankruptcy and the perceived risk of the ‘*imminent collapse of the global financial system*’ (Bernanke, 2009).

Questions

- What was the role of CBs initially?
- How this role was influenced by economic and financial circumstances of the time?
- What is the role of central banks today in ensuring *monetary peace* after the 'Great Recession' of 2007-9?

International Monetary System

- As ‘*the political economy recognizes the fact that the performance of the economy depends ... largely upon the **institutional mechanisms** that society chooses to use*’ (Vliamos, 1992), the gradual strengthening of the role of CBs as sovereign institutions in the international financial system should be seen as a **reflection of changes in the (international) monetary system.**
 - ‘**Monetary Peace**’: The coordinated action of central banks cooperation between US - Germany (Eurozone) - China triangle, to **maintain the status quo (*regime*) of the US dollar as a global reserve currency.**

International Monetary System (cont.)

- ‘*First age of globalization*’: From (roughly) 1870 until the start of WWI in 1914.
 - crucial, both for
 - a. the evolution of the role of central banks and
 - b. international currency and trade relations.
 - ‘*The gold standard had been a remarkably efficient mechanism for organizing financial affairs.*’ (Eichengreen, 1992).
 - Great Britain, and her agent, the Bank of England, stabilised this **prewar monetary system** by acting as an *international lender of last resort*. (Kindleberger, 1986)

US Fed: The '*Great Experiment*'

- In the United States
 - I. after the **bad panic and ensuing recession in 1907**, bankers and the Congress decided to reconsider a centralized national bank.
 - II. over time, '*the **stability need** – i.e. the need of a public institution to establish “public” confidence in a currency that has no intrinsic value – remains an uncontested argument in favour of the central bank solution.*' (Padoa - Schioppa, 2003)
 - III. today, '*Fed independence is ... the institutional foundation for effective monetary policy*' (Goodfriend, 2014).

Central Banks Actions after the '*Great Recession*' of 2007-9 and '*Monetary Peace*'

Three topics:

- A. Cooperation among Central Banks
- B. IMF and Monetary Peace
- C. The fourth era of Central Banks

A. The cooperation of Central Banks

- The authors of this paper believe that:
 - a. CBs (Fed, ECB) institutional & operational independence implies, de jure AND de facto,
 - i. ‘**institutionalized cooperation**’ in the fields of monetary policy and
 - ii. the safeguarding of financial stability.
 - b. Preservation of the **existing ‘policy regime’** (*monetary peace*) leads to international cooperation between Fed and ECB, which reinforces their role as institutions within the international financial system.

Historical evidence

- **Prewar:** CB actions protected the gold standard and British sterling's status in the international monetary system.
- **Interwar:** Gold standard restoration. Institutional arrangements needed to avoid deflationary spiral due to mismatch between global gold production, on the one hand, and significant rise in prices due to the WWI, on the other.
- **Postwar:** Bretton Woods collapse 1971-3, ERM instability (£ attack 1992-3) -->
ECB (independent): a decisive step towards monetary peace within the European continent.

B. IMF and Monetary Peace

- In the **Greek unique case in 2010**, IMF bypassed the debt sustainability criterion of the lending institutional framework under extraordinary conditions.
- As **EMU lacked an institution comparable to the IMF**, the euro area made use of the expertise and assistance of IMF's fiscal adjustment Programme.
- We believe that main reason for these institutional arrangements has been to serve the objective of *monetary peace*.

C. The fourth era of Central Banks

- Academic literature after 2007-9 financial crisis, questions if there is a new era in the role of central banks.
 - 1980-2007: *'triumph of markets'* (Goodhart, 2010).
 - 1979-2007: *'(an independent) Fed was guided by a mandate of price stability and macroeconomic stabilization.'* (Rogoff, 2013).
- The fourth era that we already live in, after 2010, is **the epoch of monetary peace.**

Conclusions (I)

- *‘History suggests that international policy coordination is more likely when it is institutionalized’* (Eichengreen, 2013)
- ‘Classic’ lessons of the Great Depression (Friedman & Schwartz, 1963; Kindleberger, 1986) were learned for tackling the Great Recession after 2007-9.
- *Monetary peace* addressed the need to prevent a dollar collapse; Eurozone – and hence the euro – lacked the institutional conditions for approaching the status of an optimum currency area .

Conclusions (II)

- **A modest policy proposal...**
 - Yet, monetary peace for the sake of the international system, came at a cost of an **undeclared 'economic war' in the Eurozone between North and South:**
 - unemployment (especially youth), enlarged social inequality, inadequate demand for investments, asymmetry between North-South in the absence of the necessary surplus recycling mechanism.
 - The authors of this paper believe that **the euro was always, first and foremost, a political project, not just a financial one.**
 - We would urge European leaders to **end the *economic war* while still protecting *monetary peace*.** At the BW conference, Keynes suggested a 'surplus recycling mechanism'. While we are not quite sure if his ideas are more needed today than in 1944, we are certainly convinced that '*in the long run we are dead*'...



*Thank you
for your
attention*

SPYROS VLIAMOS
KONSTANTINOS GRAVAS