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Monetary Policies and the International Financial Environment

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original

with Felixes comment

+ taking Kindleberger's
comments into account

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"Monetary Policies and the International Financial Environment"

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As we contemplate issues in international finance and various attempts to direct and control economies it seems evident that "the more things change the more they remain the same" especially with respect to the fundamental factors that determine what happens. At all times of turbulence there will be attempts to interpret what is happening as being unique, i.e. unprecedented in history, and to use this claimed uniqueness to support novel approaches to policy. But claims to uniqueness more often than not are not valid. Furthermore these claims may act as barriers to understanding. They can lead to policy gimmicks that are ineffective and even perverse in their effects. ~~Monetarism, in its more rigid and formula bound versions, is just such a policy gimmick.~~

The current international monetary and financial system is not very different from the pre-World War I structure of international monetary and financial relations. The positions taken ^{by} and the operations of the Federal Reserve in the recent past--say since the middle ~~to late~~ 1970's--are analogous to the operations of the Bank of England in the years leading up to World War I. The current fluctuating exchange rate system, with the Federal Reserve as the key operating organization, is not essentially in the way it works different from the thin reserve gold standard system that ruled some seventy years ago. We can even explain much of what the Federal Reserve has been doing as "learning by doing". It has been learning how to be the central responsible organization for a "thin reserve gold standard equivalent" fluctuating exchange system.

between now and the pre World War I system
The reason for the similarity is that in the Pre World War era the Bank of England was the essential operator in a system characterized by a vast structure of indebtedness denominated in pounds or in its equivalent,

gold. Today the Federal Reserve is the essential operator in a system characterized by a vast structure of indebtedness denominated in dollars, albeit in a regime of flexible exchange rates so that gold plays no overt role. ~~Nevertheless,~~ ^B Because of the vast set of financial links among economies, as shown by the massive international debts now mainly dominated in dollars, significant shifts in Federal Reserve policies and objectives are related to the need to maintain the viability of the international structure of financial commitments. In particular the Federal Reserve shifted to monetarism in 1979 because the dollar denominated debt structure was under pressure as holders fled from the dollar and it abandoned monetarism in response to the flight to the dollar that peaked in the Mexican crises ^{Penn-Squad and} in midyear 1982. A money supply orientation to policy was the reaction to downward pressure on the dollar and an accomodating stance was the reaction to a rising dollar. There is now a moving band within which the dollar fluctuates, but it is a ^{flexible} ~~variable~~ band whose

boundries are given by market flights either to or from the dollar. *The autonomy of The Federal Reserve is limited by the need to maintain orderly conditions in financial markets*

To understand today's international financial system and the effects, sometimes peculiarly perverse, of monetary policy ~~actions~~ we have to start with each day's initial position: a structure of inherited international financial

linkages that takes the form of debts mainly to banks which in turn have "depositors". This international financial structure leads to flows of payments in the currency of denomination of the debt from the debtors to banks and from banks to the "depositors" in banks. To an overwhelming extent these

international debts are denominated in dollars, even though the debtor, the intermediating bank and the depositor of dollars in the bank are not necessarily of United States origin. *Vital special point*

Banks can run a book in any unit--dollars, marks, cigarettes or fur-pelts. A risk averter bank, especially in a regime of fluctuating

The following is very elementary but so basic I feel I must make this very precise for my argument

being in a bank they take risk invest deposit

conditions in financial markets

exchanges (no gold standard), will try to keep a balanced book: dollar deposits will be offset by dollar assets. Fixed exchanges--a gold standard--can be interpreted as limiting the potential losses and gains from having open positions.

Just as nature abhors a vacuum a banker abhors an open position. However the "closed" book will be a "banker's book" in that characteristically the liabilities will be of shorter term than the assets: A banker's book is not matched as to maturities. Each bank that runs a book in dollars has a rollover problem. During periods of financial turbulence, when holders of bank liabilities seek to ^{change} ~~adjust~~ the currency of denomination of their assets, the books of a bank may have open positions, as deposits ~~are~~ shifted among currencies even as assets remain in their initial currency. *(Such as the late summer of 79)*

The discount window ^{at the Central Bank} is a refuge for banks caught in a rollover problem. However access to the Federal Reserve is restricted to member banks or U.S. chartered banks. A German or Swiss bank caught in a rollover problem on its dollar book does not have direct access to the Federal Reserve. It has access to its home center bank. Dollars to meet withdrawals will be available either from a bank's own resources (securities that are marketable for dollars in New York) or from the home central bank. The availability of dollars from a central bank depends upon the central banks dollar balances and what arrangements have been put in place for swap agreements with the Federal Reserve. Either way the Federal Reserve is responsible for resolving any rollover or flight problem either by keeping orderly conditions in money markets as assets are sold off or by providing dollars to the home central banks by way say of swap or other arrangements. *[Banks' long term borrowing - "sure" - Frankfurt - "contain" - "new position"]*

Debts denominated in dollars mean that there are payments of interest and principal that must be made in dollars. Private or "national state" debtors

can have dollars to meet such payment commitments because of

- 1) A surplus units trade account(profits)
- 2) Borrowing
- 3) Sale of Assets
- 4) Stock of dollars in hand

We eliminate the fourth--stock of dollars--immediately. Cash in hand is a buffer that can contain the effects of transitory cash flow short falls. As our concern is mainly with the interactions among national states, we are mainly concerned with situations that are characterized by thin buffer stocks of money. Flexible exchange rate systems are characterized by thin reserve positions. Thus the sale of assets, borrowings and a trade surplus are the significant ways in which debtors can obtain the cash that is mandated by their debts.

Unfortunately in the recent past asset sales have ^{exacerbated} ~~exasperated~~ rather than ameliorated problems of making international payments. International payment difficulties lead to a fear of domestic political and social instability. This implies a felt need for a safe haven by asset holders. Downside pressure on the exchanges therefore can lead to a perverse increase in the demand for foreign exchange, thereby augmenting initial difficulties. Furthermore asset holdings are finite; current account deficits and a run can quickly erode any initial "buffer".

Market or non concessionary borrowing depends upon expectations of future incomes. In a national account sense, current borrowing reflects expectations of future balance of trade surpluses. The existence of a massive volume of dollar denominated debt in the rest of the world means that the rest of the world has to earn sufficient dollars on its trade and current services account to pay interest on its debts; if not now then in the reasonable future.

We can visualize the balance of payments of a country as a series of tiers. We will place interest and dividends in the first tier. The reason for doing this is that we visualize this amount--the financial commitments on account of debt--as if it was the overhead or fixed costs that units have to make before they can book profits. The current balance of trade and services account is the second tier. Normally, it has to be in "surplus" if the payment commitments on debt are to be made. The third tier consists of long term international capital movements and the fourth tier consist of the "balancing item" which can be either "credits" in the bank and money market or "gold".

During the gold standard days just prior to World War I, Britain had a huge accumulation of bonds and equity positions; as a result the British had a net "income" each year on its interest and dividend account. Britain ran a deficit in its current trade and services account; this deficit was smaller than its surplus so that Britain had a surplus in the sum of the "capital income flows ^{and} current account"

Payments:
Schematic Balance of ~~Trade~~ Pre World War I

	Britain	Rest of the World
I. Interest, Dividends	+	-
II. Trade and Services	-	+
Sum of I and II	$\leq +$	$\leq -$
III. Long term investments	-	+
Sum of I, II, and III	-	+
IV. Short term Capital, Gold	+	-
Sum of I, II, III, and IV	≤ 0	≤ 0

* Note that the repayment of "principal" is not included in this or any other tier. The assumption is that if interest and dividends are earned then maturing obligations can be rolled over.

Typically long-term investment was so great that the sum of the first three tiers was negative for Britain. The balance of payment balanced because short term capital movements or the movement of gold offset the deficit of the sum of the first three tiers. The movement of gold or short term capital movement always has the effect of augmenting the liquid asset holdings of the various countries that were either on a sterling or a gold standard.

In the mature gold standard of the quarter century prior to World War I the Bank of England held a very small amount of gold relative to the trade and debts that were denominated in sterling: Furthermore Britain was the "new issues" center of the world economy so that the long term investments (Tier III) was ^a significant item in its balance of payments.

Whenever the balancing item, short term borrowing by the British or gold outflows, became too great--threatening the viability of the Bank of England's gold standard--the Bank of England would react ~~to the gold drain~~ by raising the bank rate. A higher bank rate leads to higher short term interest rates, which in turn leads to higher long term borrowing rates. [As was seen in 1982 high rates can close down the long term bond market.] This in turn meant that the sum of the first three tiers for Britain became positive. For the balance of payments to balance short term borrowing had to become negative; gold had to flow to Britain. The balance of payments balanced not because of changes in trade but because of changes in the flow of long term investment funds.

II ~~But~~ The flow of long term investment funds depends upon the expected future income of the debtors. Under good banking and business practice long term debts will flow toward a country because of the expected profitability of the investment projects in the currency of the debtors and the overall trade balance of the country in question, which determines the ability of the debtor's local

currency to be transformed into the currency of denomination of the debt.

Under a gold ~~standard~~ or a sterling exchange standard the transformation of local currency earnings into the currency of indebtedness was taken for granted; under flexible exchanges an excess demand for the currency of denomination of the debt leads to a rise in the price of the demanded currency. This rise in the price of the currency of debt denomination increases the domestic currency burden of the debt. Such exchange rate movement is a barrier to further loans; the excess demand for the currency of denomination increases. The exchange rate depreciation will continue until domestic income falls sufficiently to decrease imports or the relative price changes increase exports and decrease imports.

In a "thin" gold standard, the flow of gold to the center country will prompt an expansion of domestic credit. In a sterling exchange standard, the sale of sterling assets will lower sterling interest rates -- inducing a domestic expansion ^{in Britain:}. In either case the fixed exchange rate standard imposes ^{financial} ~~an expansion~~ ^{conditions conducive to} an expansion on the appreciating country and ^{to} a contraction on the depreciating country, although the necessity of expansion is not as strong under a sterling (or a dollar) standard as under a gold standard.

In the early post-war period the indebtedness of the "third world" was at a minimum, due to the war time export booms in basic materials. In the immediate aftermath of the war, transfer payments dominated the balances for the advanced countries that required ^{imports} ~~inputs~~ due to recovery and reconstruction needs.

Balance of Payments - Early Post-War Period

	<u>U.S.</u>	<u>Rest of World</u>
I.: Interest and Dividends	0	0
II: Trade and Service	<u>+</u>	<u>-</u>
I + II	Σ +	Σ -
III: Long Term Investment	-	+
III+: Unilateral Transfers	<u>-</u>	<u>+</u>
I+II+III+IIIA	Σ -	Σ +
IV: Short Term Capital	<u>+</u>	<u>-</u>
	Σ 0	Σ 0

Early post war

Fundamentally the balance of payments of the ^{early post war} era was dominated by a U.S. trade surplus and a more than offsetting long term investment, so that there was a need for an "import" of balance items by the United States. This took the form of import of short term capital. This "capital import" took the form of bank balances and foreign owned treasury securities. These "assets" were the reserves for foreign banking systems. Given the felt need for liquidity and reserves, the result was a desired improvement in the position of the central banks of the rest of the world. This was a regime of mutual benefits; the trade surplus improved U.S. profits and employment, long term capital movements financed expansion and recovery, and the offsetting short term capital movement improved liquidity.

However as the long term capital movement from the United States exceeded the short term capital movements to the United States, there was an accumulation of indebtedness to the United States. As a result the "zero" interest and dividends item for the United States became positive. A positive interest item combined with a positive trade and service account led to

a need for larger long term investment on unilateral transfers and a smaller liquid asset gain; either way the interest and dividend item would tend to gain. The "solution" is for the United States to go "negative" in its trade and service account but this implies lower profits and an increased difficulty in achieving full employment *for the United States*

Balance of Payment - Current Schematic

	<u>U.S.</u>	<u>Rest of World</u>
I: Interest and Dividends	+	-
II: Trade and Services	<u>-</u>	<u>+</u>
I and II	$\Sigma - r +$	$\Sigma +$
III: Long Term Investment	-	+
IIIA: Unilateral Transfers	<u>-</u>	<u>+</u>
I+II+III+IIIA	$\Sigma -$	$\Sigma +$
IV. Short Term Capital	<u>+</u>	<u>-</u>
	$\Sigma 0$	$\Sigma 0$

We now live in a world where there is an enormous amount of external debt of the less developed and developing countries. To a predominant extent this debt is denominated in dollars. At the end of 1983 this debt -whether it is current or in potential default -may add up to well nigh \$700 billions. This means that the Tier I interest payments of the rest of the world will be anywhere from \$56 to \$70 billions over the year, depending upon interest rates.

This enormous amount of debt is not mainly direct debt in which citizens and non-bank institutions of the creditor countries own bonds of utilities,

private companies or government units of the debtor countries. Instead banks have interposed their guarantee between the debtors, who owe it money, and the creditors, to whom the bank owes money. The banks that interpose their guarantee are not necessarily United States domiciled banks; the debtors are of course of "foreign" origin and the creditors of the banks, the depositors, need not be United States entities (whose main concern is with dollar income and expenditure).

In the current situation this offshore ownership of dollar denominated deposits imparts a special dimension of instability to the international financial situations, for to some unknown extent the owners of deposits have no special need to be in dollar assets - as would be true of U.S. domiciled owners. Thus of the hundreds of billions of bank deposits that finance positions of banks in the dollar denominated debts of the less developed parts of the world, some large percentage would just as well be in say Swiss francs or German marks as in dollars.

Any move by owners of dollar denominated deposits to shift to deposits denominated in other currencies will put downward pressure on the dollar exchange rates. With the dollar depreciating and the currencies of the alternative havens for cash balances appreciating, there are incentives that indicate that a movement out of the dollar can quite quickly escalate to a run on the dollar. A financial system in which there is a large volume of international debt and several potential currencies of denomination is unstable, unless the net advantages of being in one currency or another cancel out. so that small changes in interest rates have large effects. This is what fixed exchanges, ~~or~~ the gold standard, achieves.

Central bank intervention takes place to prevent such runs. First of all the depreciating dollar will induce American inflation and the banks with

dollar assets might well be turned into open positions as they "finance" their dollar positions with ^{to} ~~debits~~ in currencies other than dollars. Open positions mean ~~ε~~ that a depreciating dollar will adversely affect the net worth of the banks that are involved: the Federal Reserve need intervene to contain and reverse such a run on the dollar.

In 1979 there was just such a run on the dollar; the run was not only from the dollar to other currencies within the international financial structure. There also was a "run" to gold, collectables and real estate as a "speculation," i.e. as an asset bought for capital gains, within the United States. The runs were triggered by domestic U.S. inflation and by the international depreciation of the dollar.

The Federal Reserve had to adopt an anti-inflationary position that had credence in financial markets. For a goodly number of years "money supply control" i.e. monetarism had been touted by economists of reputation and eminence (even with the Nobel Prize) as a rather painless cure all for economic ailments and most particularly as a way of assuring "no" inflation. The "adoption" of monetarist language and procedures by the Federal Reserve was accompanied by credit tightening which took the form of ever rising interest ^{rates} ~~rates~~.

It took much more than a 6% "deposit rate" at the international banks, but just as Bagehot's famous line to the effect that a "6% bank rate will draw gold from the moon" [^] indicates, the 1979, 1980, and 1981 interest rates reestablished the well nigh exclusive position of the dollar as the currency of denomination of international debts. The appreciating of and the high interest rates in dollars led depositors in the international banks to prefer dollar deposits. The multicurrency system that was emerging in the ~~the~~ 1970's was put to rest.

However the high interest rate policy of the Volker/Reagan years was adopted as much for domestic inflation control as for international stability. But one effect of the high interest rates is to "multiply" the interest and dividend payments due in dollars. These high interest rates plus the rapid run up of dollar denominated interest payments meant that the dollar appreciated. In the context of inelastic demands for import of items denominated in dollars as well as an inelastic demand for exports of the raw material producing countries, the rise in dollar interest rates meant that for many countries the interest on loans was "capitalized"; instead of paying interest by dollars earned through exports interest was being paid by borrowing from banks ^{or} international agencies. The interest due was "capitalized" into short term debts.

If international debt is denominated in dollars then the "component" of the total demand for dollars in the foreign exchanges that is due to interest payments has a "positive slope" with respect to the interest rate. If the *payments* international debt denominated in dollars is large relative to the balance on current account, then the noninvestment, nonbalancing part of the demand for dollars on the exchanges will be positively sloped with respect to interest and exchange rates. This implies that a depreciation of other currencies will take place, and will *continue as long as interest rates remain high* ~~get worse~~.

As payments imbalances increase a "run to the dollar" can take place. Such a run will lead to a depressed stock and bond market, ^{for high interest rates imply that domestic portfolio investors} as well as to larger and more frequent depreciations. Inasmuch as the domestic equivalents of dollar denominated debt increase *with each depreciation of the home currency of debtors*

will have such.

the burden of indebtedness becomes intolerable. Lender of last resort interventions as well as a shift from a money supply to an interest rate perspective by the Federal Reserve ^{and} forced by this emerging incoherence ^{in transition} ~~is~~ ^{and domestic financial markets}.

There is therefore a "narrow" corridor "of stability" ^{that is determined by} bounded by interest rates and exchange movements, beyond which runs to and runs from the dollar occur. The Federal Reserve has to operate monetary policy so that the excessive build up of dollar balances, such as occurred in late 1970's, and an excessive burden of interest payments by the rest of the world in dollars, as in 1982, ~~does~~ not occur.

If we look at the current situation there is a "peculiar" aspect in that a large portion of the interest due and the income that results from the dollar denominated debt does not "end up" as the income of United States entities. The large accumulation of dollar denominated "banked" or "money marketed" assets by the oil exporting countries that are thinly populated and the large scale dollar books of non-United States banks are cases in point. If we assume that the dollar income that validates debt has to be the result of a dollar trade balance, then given the nature of the offshore owners of dollar assets, the United States current account deficit has to exceed the United States income received as interest and dividends on offshore investments by a goodly amount.

But a United States deficit on current account that is large enough to provide dollars for interest and dividends on \$700 billion of outstanding debt will cause severe employment dislocations in United States industry as well as downside pressure on the overall profitability of ^{United States} industry. There will be pressures to try to close the gap in the trade balance - which is correctly seen to be a barrier to domestic well being. Let us assume this pressure

results in quotas and tariffs, which ~~will tend~~ ^{are} to decrease the current account deficit of the United States. But this will lead to an increased shortfall of dollars to meet payment commitments, so that the rest of the world's ^{ies} currency will depreciate against the dollar. As things now stand with the large volume of dollar denominated debts that are outstanding, the balance of factors relevant to the determination of exchange rates indicate a continuing strong trend in the dollar's exchange rate; a trendwise appreciation of the dollar seems to be in order. This of course means that as a trend the burden of indebtedness of the dollar denominated debt in the various domestic currencies will be increasing due to depreciation.

If we are to do better ~~then~~ the burden of furnishing dollars to offset the need for dollars by countries with dollar denominated debt will need to be lifted from the United States trade balance. In the heyday of the International Gold Standard the function of providing the rest of the world with income to service sterling or other gold standard denominated debt was shared by the British and other gold standard countries' current accounts and ~~a~~ long term capital movement [/] to the debtor countries. If dollars are furnished through investment account then the pressure on the current account and on the exchanges can be ^{eased} saved.

It is not necessary to reestablish a gold standard in order to have shared responsibility. All that is necessary is to recognize that the huge ^e ~~stock~~ ^{growth} of dollar denominated indebtedness exists and that this makes the dollar the de-facto fixed point for the world trading and financial systems. If the major potential sources of long term investment funds in international account agree to keep their currencies within a "corridor" around agreed ^{an} base

exchange rate to the dollar and if the United States and these other countries somehow or other furnish a part of the requisite funds to meet payment commitments by genuine long term portfolio investments in the countries with dollar denominated debt then the situation can be contained.

Only if long term capital movements provide a goodly share of the funds needed to meet the interest^a and dividends payments will it be possible to sustain profit levels within the "creditor" United States that will lead to a close approximation to full employment in the United States.

In the situation that now exists the Federal Reserve primacy as the operator of a "flexible exchange rate/central currency system must be acknowledged. The smooth or tolerably stable workings of that system depend upon recognizing the primacy of the Federal Reserve and the difficulty of American policy in reconciling domestic and international responsibilities. ~~At the~~

However the Federal Reserve must never again put on monetarist blinkers in which interest rates are ignored in the making of policy. With an existing volume of international indebtedness and an existing volume of dollars or dollar equivalent "deficits" there is an interest rate which implies that the debtors as a whole must "utilize" interest. Federal Reserve policy needs to be ~~revised~~ so structured that interest rate equal to ^{or greater} ~~interest~~ than this threshold rate do not rule except for exceedingly short term and dissatisfying situations. ~~How~~

A difficult problem is that there is a contradiction between what United States policy needs to be if the United States is to achieve full employment on a "competitive" industry and what United States policy needs to be if the international financial and trading system is to be sustained. The containing of

This contradiction ~~implies~~ requires that other major trading countries recognize ~~that~~ the special central position of the is essential and that this requires a shared shared responsibility for maintaining a ~~band~~ their currency in a narrow band around the dollar. In particular the policies of the various central banks must be coordinated so that a run from the dollar to some other currency of denomination not take place

Of course the major part of the some \$200 Billion of debt could be funded into below market dollar debt. But this implies a "subsidy" for the difference between market rates and the funded rate. Who is to pay the subsidy? I'll leave that big of answers

To others: revising the question is bad enough.