Conference on international cooperation in times of global crisis

Session 4: can the international monetary system be reformed?

A few remarks

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Some basic topics

- To what extent is the present-day IMS flawed?
- How irreversibly will the global financial crisis impact the IMS?
- What is the teaching of Mundell’s dilemma for the balance of conflicting national interests?
- Which prospects for the medium term?

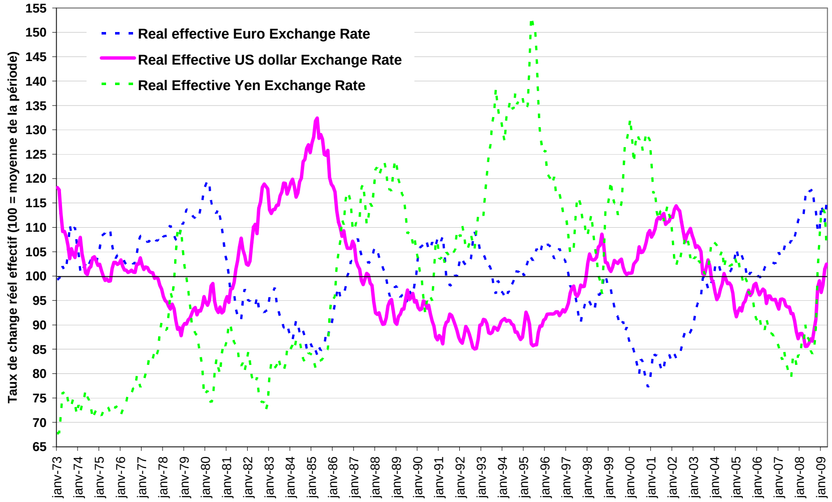
The IMS is a semi-dollar standard

- **A hybrid system:**
  - A small number of currencies have flexible exchange rates and completely open capital markets. Their dollar exchange rates fluctuate partly according to economic fundamentals, partly with portfolio diversification of institutional investors, and partly with the speculation of market dealers
  - A majority of currencies have capital controls and heavy managed exchange rates against the US dollar

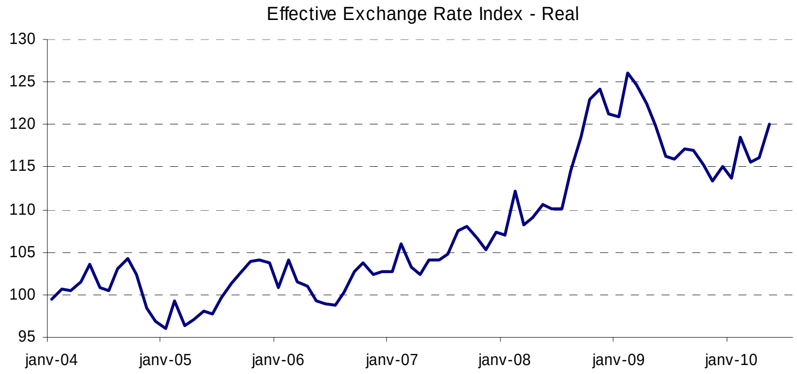
- **The worst of both worlds:**
  - High instability of exchange rates between convertible currencies
  - Accumulation of financial disequilibria with balance of payment polarization magnified by volatile capital flows leading to massive expansion of dollar reserves and world liquidity

Large changes in real effective exchange rates…

- Huge and persistent cycles for the main convertible currencies in real effective terms. The dollar depreciated 25% between Q4 2002 and Q2 2008



- The Yuan appreciated 20% between Q2 2005 and Q2 2010



…have had little bearing on saving investment imbalances and world liquidity explosion

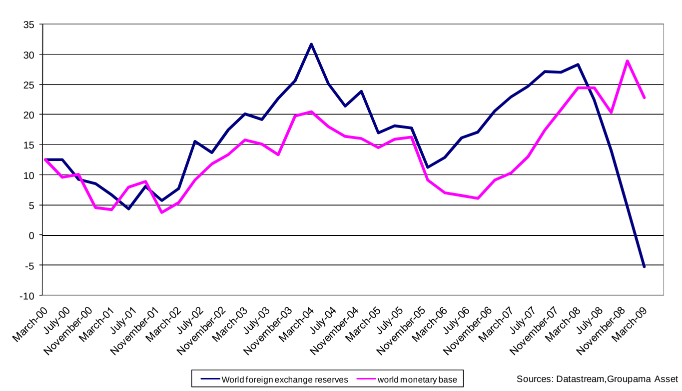
- The US deficit has massively deteriorated between 2002 and 2008

Sources and uses of world saving (net financial balances as % GDP)

Countries or regions	Average 1987-94	Average 1995-2002	2006	2008	2009
Advanced countries:	-0.7	-0.1	-0.6	-1.5	-1.5
US	-2.7	-2.3	-4.3	-5.6	-4.9
Euro Zone	na	+0.6	+0.5	-0.7	-0.4
Japan	+2.5	+2.4	+3.9	+3.1	+4.0
New Asian Indus. countries	+4.7	+3.4	+5.5	+4.5	+4.7
Dev and emerging countries:	-2.1	-0.5	+5.2	+3.9	+4.7
Africa	-1.2	-1.5	+5.5	+2.8	+3.1
Latin America	-1.4	-2.8	+1.6	-0.8	-1.1
Emerging Asia	-2.0	+0.8	+5.9	+5.8	+5.4
CEEC	-2.9	-3.3	-6.6	-8.0	-6.7
Middle East	-5.5	+3.3	+21.4	+19.1	+22.8
Russia and CIS	na	+3.8	+7.1	+4.7	+5.4

- World liquidity growth correlated with accumulation of foreign exchange reserves up to the crisis

Figure 2. World monetary base and foreign exchange reserve (y-o-y %)



Changing pattern in international trade and regional integration

- **Export-led growth to Western advanced countries will no longer be the main driver of catching-up**:
  - Post-crisis Western growth is going to be modest for considerable time
  - The distortions induced by that pattern of growth must be corrected by structural change in income distribution and structures of production
  - Quest for security of supply in primary resources will become predominant for high-flying countries

- **Globalization is getting less polarized**:
  - Enhanced regional integration in Asia and to a lesser extent Latin America
  - Diversification of trade links between emerging market countries

- **The semi-dollar standard does not fit well with a polycentric world compounded of large open economic regions**
  - A move towards convertibility of the currencies of large emerging countries
  - The need of a renewed international governance

The long route to Yuan convertibility

- **Why a new exchange rate regime?**
  - *Domestic reasons*: boosting household purchasing power, reducing import costs of primary commodities, inducing upgrading in production
  - *Foreign reasons*: enhancing convertibility to establish the Yuan as a vehicle currency for intra-Asian trade centered on China, developing the Chinese bond market

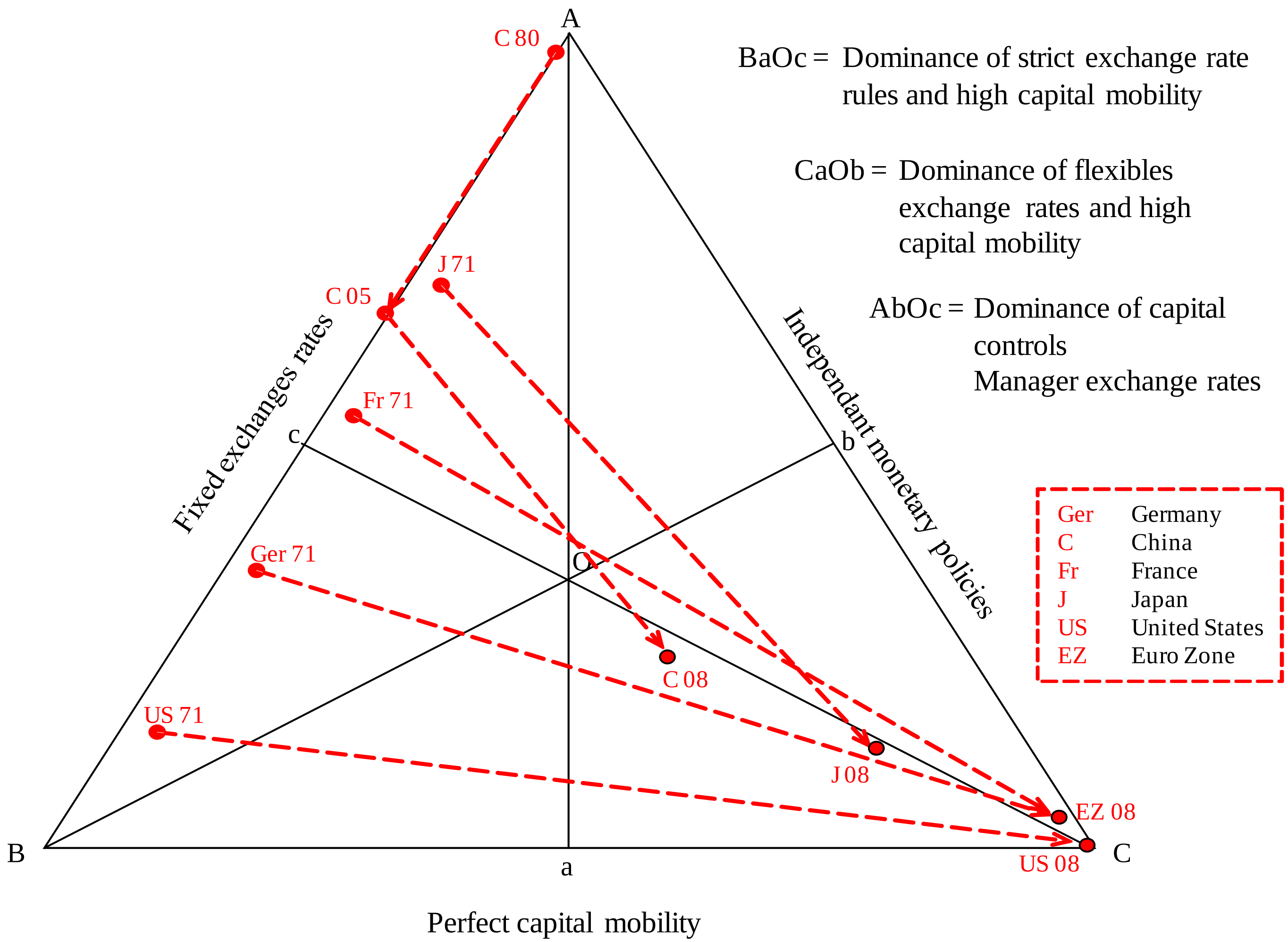
- **Likely exchange rate regime**
  - *Managed currency*: undisclosed basket, daily band (+-0.5%), discretionary fixing of central rate each day to create two-way risk for speculators
  - *Intervention and cooperation*: massive potential FX reserves to be committed, swap agreements with ASEAN+3 central banks to preserve consistency in exchange rates in the region
  - *Capital account opening*: QFIs authorized to invest Yuan holdings on the interbank domestic market and foreign trade partners permitted to hold transaction balances to settle intra-regional trade in Yuans.
  - *HK will become the world financial center in trading and investing xeno-Yuans*

Problems of a polycentric system

- **The public good character of international money**:
  - Providing adequate liquidity to international trade and finance
  - Providing an international mechanism to smooth correction of international imbalances before they become entrenched
- **Designing the system to deliver the public good**. Impossibility to combine:
  - Deep globalization/ Financial stability/ Conflicting national preferences
  - The failed Washington Consensus doctrine: enforcing deep globalization under the false belief of self-regulating markets at the expense of financial stability
- **Need to compromise between**:
  - A feasible degree of globalization / robustness of domestic financial systems
  - Compatible national regulation of financial systems
  - Acceptance of international governance institutions / national sovereignty

Possible international monetary regimes and impact of globalization

Mundell triangle



Overhauling the governance of the IMF

- **Objective of overall financial stability supportive of central bank implementation of macro prudential regulation:**
  - More emphasis on early warning indicators of systemic risk because there is no such thing as efficient capital market and perfect market liquidity
  - Feeding a multilateral dialogue among G20 governments on macroeconomic imbalances

- **Redistributing powers and responsibilities:**
  - Merging Euro zone quotas will give monetary sovereignty to the Euro, will increase the political influence of Europe and will release at least 12 to 15% of quotas
  - Reallocating the released quotas to emerging and developing countries
  - Repealing the ability of a single country to veto decisions at a qualified majority
  - Opening the designation of the executive Director
  - Transforming the Executive Committee into a decision-making body composed of high-level financial officials meeting once a month + emergency events

The SDR should become the ultimate reserve asset

- **Three reasons to enhance the role of the SDR:**
  - To alleviate the automatic acquisition of dollars by central banks
  - To reduce the incentive of central banks to pile up precautionary reserves
  - To enable countries overloaded with an excessive amount of dollar reserves to diversify off the Forex markets (Substitution Account)
- **To get those substantial benefits, the SDR must be commonly acceptable, e.g. avoid the shortcomings of past endeavors:**
  - In an inflationary world the allocations of SDR were quite restricted
  - The SDR was not attractive because it paid an interest rate below prevailing market rates on the underlying assets
  - Imperfectly related to market valuation and subject to complex rules, the SDR had a poor liquidity
- **All those impediments were not due to the intrinsic nature of the SDR: they were rule-made, hence politically determined**