Global cooperation for sustainable growth and development: views from G20 countries

Session 3: The International Monetary System

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IMS Reform Alternatives

- We have here three stimulating presentations on a perennial issue, which periodically becomes critical.
- Agnes Benassy and Paola Subacchi note the strong trend toward multi-polarity. They provide a very useful analysis of the current disorder and consider a multiple-currency solution based on flexible exchange rates and free capital flows. Jim Boughton tries to show the SDR- Dodo how to fly.
- I will try to provide an overall perspective by way of considering the prospect of refurbishing the dollar, which paves the way for other options.

Dollar/US Exceptionalism?

- Dollar is in widespread use: euro a threat but less so now. Incumbent has the advantage: why not build on that?
- US (revealed) preferences
  - it should be free to focus on domestic monetary requirements
  - RoW should adjust using flexible exchange rates
  - One way of resolving Triffin's dilemma
- From US perspective
  - If US needs to tighten monetary policy others should depreciate
  - If US needs to loosen others should appreciate
- US exceptionalism: what is good for the US is good for RoW
- Problem is when others peg: this creates imbalances
  - US claims its domestic monetary policy is destabilized
  - E.g. if US monetary policy is loose others accumulate reserves, invest in the US and force interest rates down making monetary policy looser

RoW's reaction to US exceptionalism

- Pure dollar standard tried, 1971-73 (Smithsonian) with the sop of a small SDR allocation: it fell apart because France and Germany found US monetary policy too lax
- Further, if RoW floats to accommodate US needs they destabilize their own economies: e.g. if US pursues easy money policy and they appreciate they export employment to the US
- Also questionable whether pegs and net saving flows destabilize the US
  - Was the tight US monetary stance of 1979 caused by oil producers abstaining from placing their savings in US treasuries, which forced interest rates up and deflated bubbles? If so, US could have applied less tight monetary policy
  - Is the current lax US monetary stance caused by excess Asian and other's savings in US treasuries, which force interest rates down and generate bubbles? If so, US could apply less expansionary monetary policy
  - Seemingly excessive Asian savings is not old fashioned mercantilism of hoarding gold, which is a negative-sum deflationary game. It involves hoarding paper which can easily be printed by the issuer without deflationary effects. Indeed, the US claim is that excessive foreign hoarding is US domestic inflationary!

But what does the Rest of the World (or most of them) want of the IMS?

- Most countries prefer stable exchange rates: e. g. EMS followed by euro-zone; Asian semi-formal pegs (Bretton Woods II); Gulf economies' dollar pegs, etc.
- Who likes volatile exchange rates? Speculators, hedge funds, and financial centres. But do they really reduce risk or act as rent extraction vehicles?
- Friedman erred: speculation is often destabilizing not stabilizing; floating exchange rates do not insulate domestic monetary systems or even save on reserves (e.g. huge increase in reserves after onset of floating); they reduce overall investments and growth (Bretton Woods <u>was</u> a golden age); they generate financial crises (none under BW); and, a really fundamental conceptual issue, floating exchange rates confound price signals for production with those for asset holding.
- Since US obtains seigniorage and other benefits should it not be duty bound, in exchange for this 'exorbitant privilege', to focus on ROW's needs and subordinate its domestic monetary policy?

Bridging the impasse: A dollar option

- The US and other countries wish to have an independent domestic monetary policy.
- Countries, except for the US, face a trilemma. What should they sacrifice?
  - Free capital mobility? But capital controls are not a sustainable solution: the world is now too globalized with banks, firms, etc engaging freely in cross-border transacting.
  - Exchange rates? But these should be stable and production oriented
  - It has to be monetary policy
- The impasse, dilemmas, and trilemmas are all resolved when all, including the US, abandon independent domestic oriented monetary policy monetary policies.
- A solution would be for the US to provide the monetary standard, set an acceptable overall rate of money growth, and act as the global central bank. In exchange it gets to keep the seigniorage.

Who bells the cat?

- However, the dollar solution, even if it were accepted by the US, is not incentive compatible as there is always the alternative of setting up a new monetary standard, administered by all, and where all share the seigniorage.
- Governor Zhou (2009) has floated the idea of a gradual move to an SDR based standard.
- But would such a move be feasible?
- Long ago Harry Johnson posed a similar issue and asked 'who will bell the cat?' . He concluded no one as long as they were mice.
- But some of the mice are now growing into big cats, and can define their own domains.
- The problem is when they confront each other

Conclusion

- The emerging balance of forces is likely to dictate a multi-currency solution based on floating rates between the dollar, euro, and the RMB or some Asian composite.
- This is not likely to be beneficial as it could generate conflicting exchange rates, and pave the way for more financial crises -Minsky moments.
- A better solution would involve <u>fixed exchange rates</u> between the multiple currencies, and subordinated monetary policies.
- The SDR could then have a role as representing the resulting composite. The Dodo may yet fly.

Thank You