Concrete Steps toward Realistic Reforms of the International Monetary System

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Governor of the People's Bank of China Zhou Xiaochuan's famous 2009 paper awakened the debate on the international monetary system from a three-decade long state of apathy. In the run-up to the 2011 French presidency of the G-20, many ideas have been floated about reforming the international monetary system, through reports, papers and conferences. These contributions have especially pointed out the deficiencies of the present system: dependence on a key reserve currency, which in turn leads to asymmetries in the process of adjustment; inability to provide incentives for surplus countries to adjust; disregard for spillovers effects of national monetary policies and as a result the possible inadequacy of the global monetary stance; the developing and emerging countries' costly reliance on self-insurance through reserve accumulation; inability to channel net capital flows from low-return, advanced economies to high-return, emerging countries; and large real exchange-rate misalignments, sometimes leading to "currency wars". Old policy dilemmas, such as that of Triffin, have been revisited and old ideas such as the expanding the role of the special drawing right (SDR) have been intensively discussed.

The need for a change in the international monetary system—what Keynes famously called the "rules of the game"—is accentuated by tectonic shifts in the balance of international power. These shifts were already visible in the last decade, but they have been accelerated by the financial crisis and its asymmetric effects on advanced and emerging countries. By 2020, the balance of economic power within the global economy will be more equal than at any time over the last two centuries. Therefore, there is a strong case for moving toward a multipolar monetary system whose main planks are likely to be the U.S. dollar, the euro and the renminbi.

In the short term however, there is no hope to rebuild the international monetary system according to any of the grand designs on offer. The weaknesses of the euro and the renminbi are too apparent for these currencies to constitute alternatives to the U.S. dollar. To reform the rules of the game is an ambitious enough endeavor. To rewrite them entirely, as some proposals suggest, is not on the agenda. We are not in 1944.

It is therefore time to focus the debate on the possible deliverables. Already, official working groups have been tasked with providing concrete proposals for the G-20 to discuss at the finance ministers' meetings in view of decisions to be taken at the heads of state and government G-20 summit in Cannes in November.

So what could concrete steps be? What reforms would help address fundamental deficiencies and command a sufficient degree of consensus? We suggest three avenues:

- First, to create consensus on policies toward capital inflows and provide a framework for international surveillance of national capital controls, reserves and exchange rate policies. This would help tackle the risk of "currency wars";

- Second, to draw on results from the Korean presidency in 2010 and strengthen financial safety nets so that countries do not have to self-insure through accumulating reserves or to rely on possible bilateral swap lines to access liquidity when confronted with sudden stops;

- Third, to prepare and plan for a change in the composition of the SDR that would strengthen the multilateral framework while favoring evolution toward a more multipolar system.

Exchange Rates, Capital Flows and Reserves

The first topic seems highly controversial at first sight because it touches upon the sensitive issue of exchange rate policies. It does not need to be so. To start with, it is increasingly apparent that the global crisis has had highly asymmetric effects, which call for a real exchange rate realignment between the advanced and the emerging world. This realignment is going to take place one way or another, either through nominal exchange-rate changes or through divergent inflationary developments. Higher pressure on consumer prices will lessen the willingness of governments and central banks in emerging countries to oppose exchange-rate appreciations through reserve accumulation and/or capital controls.

By the same token, the controversy about capital controls is abating. The International Monetary Fund is less reluctant than in the past to make room for such controls in the policymakers' toolbox. At the same time, it is increasingly recognized by policymakers in emerging countries that capital controls are only one instrument among several. They are part of a broad range of macroeconomic and macro-prudential tools that may be used to limit the detrimental impact of large, volatile capital inflows.

Policy consensus may therefore be within reach. What will be more difficult is to agree on institutional arrangements. To start with, the emerging international consensus should be written down in some sort of soft law such as a code of conduct. Second, the joint monitoring of capital controls and exchange-rate policies, with the aim to sort out macroeconomic and financial stability motives from mercantilist motives, would need to be allocated to an international body. This body should provide assessments and policy suggestions, as well as technical assistance when required. A natural candidate for this task would be the International Monetary Fund. However, this would require amending the Fund's statutes since the IMF presently has no legitimacy to review financial-account policies. Hence, a formal approval by 85 percent of the IMF's board of governors would be needed. While this is not impossible, it is demanding in view of the lack of trust in the institution in significant parts of the emerging world.

Financial Safety Nets

To build financial safety nets, two different routes may be taken: a strengthening of bilateral central bank swap lines and an extension of multilateral schemes. During the crisis, swap lines generously extended by the U.S. Federal Reserve and to a lesser extent other key central banks proved instrumental in providing U.S. dollar liquidity to national central banks. However, these were unilateral, discretionary initiatives and the benefits of which were reserved to some partners and whose repetition may not be taken for granted should another crisis hit.

One idea would be to institutionalize the network of swap lines under the supervision of the IMF. There would be a risk of losing in the process the flexibility demonstrated in the crisis. Understandably also and perhaps more importantly this project encounters vigorous opposition by central banks, whose independence is already questioned by their role in keeping ailing banks (or, in the European case, states) afloat, the threat of a return of fiscal dominance, and the extension of their mandate to macro-prudential surveillance. Formal commitments from central banks to extend swap lines to countries designated by an international institution are in these circumstances unlikely.

The institutionalization of bilateral swap lines would also amount to creating a two-tier system whereby countries would explicitly depend on the support of regional partners. Such schemes may be attractive to some countries where cooperation around a regional hub has developed, but it can hardly provide a global solution.

This leads to envisaging multilateral schemes. It is necessary here to distinguish three different variants:

(1) The pooling of central banks' foreign-exchange reserves, possibly with a transformation of part of them into SDR reserves;
(2) The creation of new IMF facilities;
(3) A more active policy of SDR allocations through more frequent and possibly counter-cyclical and/or targeted allocations by the IMF.

The pooling of official reserves has already been practiced at a regional level and it could conceivably be extended to a multilateral level. While this is efficiency-enhancing, it raises difficult questions in regards to the sharing of the exchange-rate risk and the use of the reserves. Reserve pooling would require rules on how each member could use these reserves, which would be difficult to do ex-ante. Furthermore, access rules would make reserve pooling inferior to unconditional self-insurance through reserve accumulation.

International Monetary Fund facilities are a way to channel reserves to countries hit by capital outflows. The recent evolution has been toward the creation of no-conditionality (the Flexible Credit Line – FCL) or low-conditionality (the Precautionary Credit Line – PCL) facilities that aim at crisis prevention rather than crisis management. Further proposals have been put forward such as the IMF's Global Stabilization Mechanism (GSM)—a new mechanism that would activate the provision of liquidity to systemic and vulnerable countries in case of systemic shock. The problem with such facilities is that potential beneficiaries may remain unsure of getting access to them in time of need, which makes them partial substitutes to reserves only.

New SDR allocations would not have this shortcoming. They would provide countries with SDR reserves that they could exchange for reserves denominated in the currency of their choice. If provided in limited quantity and in response to increases in the demand for reserves only, such allocations would be unlikely to have far-reaching consequences for global liquidity while providing a welcome buffer to vulnerable countries. But to make them a recurring feature of the provision of liquidity, a revision of IMF statutes would be needed since currently an 85 percent majority within the IMF board is needed to decide an SDR allocation. This avenue cannot be considered closed but it presents serious hurdles.

A New Special Drawing Right

Several SDR-based proposals are on offer. One aims at addressing a different shortcoming of the international monetary system, namely the lack of safe assets at a global level. The idea is to create a new investment vehicle by allowing international financial institutions, including the IMF, to issue debt securities denominated in SDRs. The liquidity of the SDR market could be enhanced by developing the private use of the SDR through commodity invoicing and subsequent demand for SDR-denominated bonds.

This is certainly not the only way to enlarge the range of safe and liquid assets that are needed at the global level. Another way, which should be encouraged, would be the development of national-currency bond markets.

Although consistent with the initial purpose of the SDR in 1969, the promotion of SDR-denominated securities through IMF borrowing is likely to encounter a number of obstacles. Aside from technical problems related to the initial liquidity premium (estimated 80-100 bp by the IMF staff) and the needs for market infrastructures for SDRs, IMF members are probably reluctant to renounce oversight of IMF resources that they currently enjoy.

Rather than trying to create an SDR market from scratch, we suggest adapting the existing SDR to the new global environment through more frequent allocations and through planning the inclusion of the renminbi in the SDR basket—which presently only includes the U.S. dollar, the euro, the yen and the British pound—in the context of an opening up of China's financial account and a move to a flexible exchange rate regime in China. Such reforms would be consistent with the fast shift of the global economy in favor of China. It would put the largest reserve holder at the center of the SDR liquidity-provision system and would create a natural venue for monetary policy dialogue and possibly coordination between the five countries involved in the SDR—a G-5 circle.

Interestingly, the renminbi need not be immediately included in the SDR and China need not immediately open up its financial account in order to play a part in financial safety nets. The People's Bank of China has already started extending swap lines to a number of foreign central banks in renminbi, aside from the Chiang Mai Initiative. It could also provide liquidity in dollars in exchange of a number of listed currencies—say the currencies of the G-20 and provide SDR-denominated loans. Without waiting for China to move to free convertibility and to integrate into the multilateral liquidity provision scheme, this would be a way for it to diversify its reserves smoothly while providing international liquidity in times of stress.

Conclusion

In brief, the most workable deliverables today seem to be: (1) guidelines and surveillance on capital controls, (2) a new regime for deciding on SDR allocations that would facilitate a less infrequent use of this instrument, and (3) the inclusion, after some delay and against financial opening up, of the renminbi into the SDR basket.

Would these three reforms be conducive to addressing the shortcomings of the international monetary system? Probably only partially. But they would represent concrete steps toward change and pave the way for longer-term evolutions.