

Concrete steps towards realistic reforms of the international monetary system

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The posting of Governor Zhou Xiaochuan's famous paper in 2009 awakened the debate on the international monetary system (IMS) from a three-decade long state of apathy. In the run-up to the 2011 French presidency of the G20, 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 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 and there is therefore a strong case for moving towards a multipolar monetary system whose main planks are likely to be the US 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 US dollar. To reform the rules of the game is an ambitious enough endeavour. 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 G20, to be discussed at the finance ministers meetings, in view of decisions to be taken at the heads of states and governments summit in Cannes, in November.

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

- First, to create consensus on policies towards 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 to sudden stops;
- Third, to prepare and plan for a change in the composition of the SDR, that would strengthen the multilateral framework while favouring evolution towards 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 IMF 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, say 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% of the Board of governors would be needed – not impossible, but demanding in view of the remaining 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 Fed (and, to a lesser extent, other key central banks) proved instrumental in providing US dollar liquidity to national central banks. However these were unilateral, discretionary initiatives, 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 institutionalisation 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:

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

The pooling of official reserves has already been practiced at regional level and it could conceivably be extended to multilateral level. While efficiency-enhancing, it raises however difficult questions as regards the sharing of the exchange-rate risk and, even more importantly, as regards 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.

IMF facilities are a way to channel reserves to countries hit by capital outflows. The recent evolution has been towards 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 Fund's Global Stabilisation 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, however, 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 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 a 85% majority within the Board is needed to decide an SDR allocation). This avenue cannot be considered closed but it presents serious hurdles.

A new SDR

Several SDR-based proposals are on offer. One aims at addressing a different shortcoming of the IMS, namely the lack of safe assets at global level. The idea is to create a new investment vehicle through allowing international financial institutions, including the IMF, to issue debts

securities denominated in SDR. 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 is needed at the global level. Another one, 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 to the needs for market infrastructures for SDRs, IMF members are likely to be reluctant to renounce to the oversight of IMF resources they currently enjoy.

Rather than trying to create an SDR market from scratch, we suggest to adapt the existing SDR to the new global environment not only through more frequent allocations, but also through planning the inclusion of the RMB in the SDR basket (which presently only includes the 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 this country. Such reform would be consistent with the fast shift of the global economy in favour of China. It would put the largest reserve holder at the centre 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 G5 circle.

Interestingly, the RMB needs not be immediately included in the SDR, and China needs not immediately open up its financial account for China to play a part in financial safety nets. The PBoC has already started extending swap lines to a number of foreign central banks in RMB, 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 G20 and provide SDR-denominated loans. Without waiting for China to have moved to free convertibility and to have been integrated 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.,.

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

Would these three reforms be conducive to addressing the shortcomings of the International Monetary System? Partially only. But they would represent concrete step towards change and pave the way for longer-term evolutions.