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Issues of and Prospects for International Monetary Reform: Perspectives of East Asia's Emerging Economies

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Many of the economic problems confronting the global economy today—global recession, a high degree of volatility of capital flows and exchange rates, excessive leveraging and risk taking on the part of systemically important global financial institutions, and global trade imbalance, to name a few—may have some of their causes in the deficiencies of the international monetary system. If they are, then the deficiencies are likely to be found in the two major components of the international monetary system-the monetary and exchange rate arrangements of countries and the reserve currency system.

1. The US dollar, the SDR, and New Reserve Currencies

Like their counterparts in Europe and elsewhere, East Asian policy makers are concerned about the world currency system under the control of the US—the world's single largest debtor—and the weakening of and erosion of confidence in its currency, the dollar. But they do not see any new reserve currencies—for that matter any new global currency—emerging on the horizon that could replace the role of the dollar.

There has been a growing interest in the expansion of the role of the SDR and potential of transforming it into a global medium of exchange and reserve holding (Stiglitz 2010). While the jury is still out on the feasibility of such a transformation, it appears there are more skeptics than believers. From the perspectives of emerging economies, SDRs are held as part of their international reserves, because they can be converted into major reserve currencies when they want to use them—that is, because they are backed by the US dollar and other reserve currencies. It is difficult to imagine a situation where emerging economies would want to exchange their holdings of SDRs for non-reserve currencies.

Emerging economies are obliged to accept SDRs in exchange for their holdings of reserve and other currencies, but they are willing to comply with this obligation because they know that other countries will also agree to a similar exchange when they need US dollars. Any increase in SDRs is equivalent to an implicit commitment on the part of reserve currency countries—mostly the US and the euro area—to exchange new issues for their own currencies. As Wyplosz (2010) puts it, new SDRs are in effect new reserve currencies—dollars, euros, yens, etc. The appeal of the SDR, that its supply is not controlled by any national central bank, is also their fundamental weakness. International reserves are also held in safe and liquid public debt instruments. At present, the US is the only country which can supply such assets. There are very few other candidates.

These weaknesses of the SDR are well known and underscore the fact that if the SDR is going to be elevated to a global currency, it will have to be used as a means of transactions and a store of value in the private sector. And it has to be issued by a global central bank. Whatever its imperative, the creation of a global central bank is unthinkable. Therefore, before advocating the international role of the SDR, the advocates will need to explain how the new global role will help improve the efficiency of the global exchange rate arrangement in managing global macroeconomic adjustments and rectify the failures of international financial markets that came to light during the 2008 global financial crisis. The list of the problems they need to address may also include the exorbitant privileges of *de facto* global currency countries.

The World economy is destined to live with a global exchange rate system that consists of free floating, managed floating, and fixed exchange rate regimes. This diverse system has not worked well as manifested by its failure of mitigating the growing trade imbalance between East Asia and the US, yet there is no serious discussion on reform of the global exchange rate system. In fact, few question the rationale behind the apparent preference of emerging economies for managed floating with prudential capital control and intervention in the currency market. The skeptics of the SDR may then ask how the reform of the reserve currency system will facilitate global macroeconomic adjustments or help emerging economies better manage their exchange rate policy.

While there is a need for improving the efficiency of the reserve currency system, to many pundits and policy makers from the region, the reform of the international monetary system is also a political issue that may require a protracted period of discussion and negotiations on plausible alternative systems at many international fora. The G-20 should address the issue, but it must be prepared to deal with it as part of its long term agenda. Otherwise, the G-20 may direct too much of its resources and time to the reserve currency reform at the expense of other short term issues that deserve closer attention and solutions.

2. Global Imbalance and Quantitative Targeting

Despite the growing concerns and numerous proposals for policy reform and structural changes to be undertaken by surplus and deficit countries alike, the global imbalance has defied an easy solution and shown little sign of abatement. Since practically all of the members of ASEAN+3 have been running surpluses on their current accounts, accounting for more than a half of the global imbalance, they realize the exigencies of embracing rebalancing growth to rely more on domestic demand for growth and to increase flexibility of their exchange rates.

In this regard, the focal point of the debate on East Asia's adjustment has so far been the undervaluation of the RMB. China has been reluctant to accommodate the demand for a substantial appreciation of its currency, and its RMB internationalization strategy would reduce further the room for flexibility of its exchange rate policy (Park and Song 2011). Other emerging economies in the region, many of whom are competing against China in many export markets within and outside East Asia would not move unless China does first in adjusting their exchange rates.

The economic profession is not unanimous on effectiveness of the exchange rate adjustment as a means of correcting the imbalance. If the G-20 leaders could not reach an agreement on appreciation and greater flexibility of East Asian currencies including the RMB, then they may need to turn to a quantitative adjustment as a complement to the exchange rate adjustment.

- Setting numerical targets

There appears to be an emerging consensus among the countries responsible for the imbalance including China and the US that a current account imbalance—surplus or deficit—

on the order of 3-4 percent of GDP is sustainable. Given this acceptance, the G-20 may consider reviving the idea of quantitative targeting of the current account to be achieved over a number of years by both surplus and deficit countries. This approach has several advantages over the exclusive reliance on the exchange rate adjustment. It is transparent. It allows the countries concerned a larger room and menu of policy adjustments including the exchange rate change. And the targeting could be better enforced.

- Currency internationalization in emerging economies

One of the main reasons for the large accumulation of reserves in emerging economies has been the self-insurance against a sudden evaporation of liquidity in reserve currencies. If these countries can borrow from global financial markets in their own currency, then their precautionary demand for reserves will not be as large as it is now. The internationalization will therefore contribute to taking pressure off the resolution of the global imbalance .

If an emerging economy succeeds in improving the international status of its currency to be used widely as a means of exchange and store of value outside it national border, it will be able to issue bonds and other types of financial instruments denominated in its own currency to raise funds on global financial markets. This ability will help reduce the need for holding a large reserve and mitigate the problem of currency mismatching in the balance sheets of financial institutions, thereby making it less vulnerable to external shocks. Unfortunately, however, not much is known about the conditions under and the process through which a domestic currency can be transformed into an international currency. The G-20 may consider including internationalization of the currencies of emerging economies as part of its long-term agenda

3. Capital Control and Post Crisis Exchange Regime for Emerging Economies

There has been a broad agreement on the need to intervene in the foreign exchange market to smooth out fluctuations in the exchange rate around its level that is consistent with economic fundamentals. At the Seoul G-20 summit the leaders also articulated the need of introducing capital control—to be managed in a prudent manner to moderate large capital inflows—in particular speculative portfolio capital in emerging economies. The IMF has softened its traditional position and has been working on a set of guidelines on capital control (Ostry 2011). This approbation of capital control together with currency market intervention raises a number of issues all related to the reform of the international monetary system.

- Beggar thy neighbor exchange rate policy

From the perspectives of emerging economies, the explicit or implicit approval of capital control is tantamount to accepting some type of managed floating as an appropriate post crisis exchange rate regime for emerging economies. If it does, the prevalence of managed floating could pose a risk of exacerbating the adjustment process of the global economy. Unless the modality and rules of managed floating are specified and agreed upon, some of the emerging economies could easily succumb to the temptation of taking advantage of the managed floating to change the level of the exchange rate through market intervention to improve their export competiveness. Since capital control is a complement to the foreign exchange market intervention, it could be used more frequently and extensively as an instrument of stabilizing the nominal exchange rate.

- Effectiveness, Instruments, and Scope of Capital control

The effectiveness, instruments, scope and intensity of capital control as a means of moderating capital inflows have long been controversial issues to which neither theory nor empirical evidence has been able to provide answers. Emerging economies will have to rely on the rules of thumb based on the past experiences of other countries. In this regard, it is important that the G-20, in cooperation with the IMF, set the rules and conditions under which capital control could be activated to remove confusion and uncertainty surrounding its implementation.

- Controlling source as well as host countries

Capital control may work in moderating capital inflows, but experiences of emerging economies show that it is of little use in taming capital outflows, in particular in time of a crisis. As was witnessed during the 2008 global financial crisis, financial market participants could overreact to deterioration of financial market indicators and macroeconomic variables such as the current account deficit in an emerging economy to throw it into a liquidity crisis.

When an economy is engulfed in a crisis, free floating often fails to serve as a first line of defense, because a large depreciation of the exchange rate triggered by an outflow could put it on an implosive trajectory.

There appears to be no effective measures of capital control that could prevent unexpected outflows. Given that emerging economies cannot prevent by themselves unexpected and speculative reversal of capital inflows, the G-20 may be better advised if it highlights the importance of imposing control on capital outflows at the source-excessive lending and investments by large global financial institutions operating out of the source countries. The G-20 may also prose a system of exchanging and sharing information on capital movements between the regulators of the host and source countries, thereby establishing symmetry in capital control between host and source countries in managing a capital control regime.

4. Liquidity Safety Net

One of the lessons to be learned from the 2008 financial crisis is that global financial markets are highly susceptible to the failures associated mostly with information asymmetry, which are manifested in the overreaction—euphoria or excessive pessimism—and herding of market participants. One type of the failures that has plagued many emerging economies has been the sudden reversal of capital inflows that often provokes a liquidity crisis. This failure justifies market intervention.

If a global central bank were to be created, it would intervene as it is expected to assume at the global level most of the functions of a national central bank as a lender of last resort. One of such functions is supplying an adequate amount of liquidity to global financial markets to safeguard against liquidity shortages and preventing runs on banks—at least those systemically important ones. Since it is highly unlikely that the global economy is ready for a global central bank anytime soon, a second best solution needs to be found, and that solution is the creation of a global liquidity safety net. At this stage of discussion, the proposal for the safety net-deliberated at the G-20- consists of (i) the new IMF facilities—FCL and PCL—and (ii) regional organizations for liquidity support.

- Regional liquidity support arrangement

ASEAN+3 established a regional liquidity support system—CMIM—that is designed to provide short-term liquidity to the members suffering from a speculative capital outflow almost ten years ago. Since its inception, it has never been subjected to a market test so that its effectiveness is yet to be known. Regional arrangements such as the CMIM could be an important component of the global liquidity support system, but little is known on how it should be structured and managed to be a reliable source of short-term liquidity. The G-20 may address viability of establishing similar arrangements in other regions. But before endorsing other regional arrangements, the G-20 may need to undertake a review of the size and operational details of the CMIM together with its linkage with the IMF to determine whether it could be an effective regional mechanism.

Now that the EU has decided to construct a European monetary fund operated independently from the IMF, new questions have risen as to what type of the linkages of these regional institutions with the IMF would be appropriate and how their activities could be coordinated to consolidate and improve efficiency of the global safety net.

- Enlargement of the currency swap network: Global reserve pooling

The IMF will be the key institution of the global safety net. It is expected to supply the bulk of liquidity to emerging economies when it is needed. But it cannot serve as a global central bank: it is basically structured as a global credit union among its members. Korea needed the three swap lines amounting to $90 billion to ward off the currency speculation in the fourth quarter of 2008. The IMF alone may not able to supply enough liquidity to all emerging economies suffering from a major global financial crisis. During the crisis, Korea alone had to secure three swap lines amounting in total $90 billion before stabilizing the foreign exchange market during the fourth quarter of 2008.

Only the US Fed and in part the ECB—assuming that the euro will be able to survive the ongoing crisis—could serve as the *de facto* global lenders of last resort. If anyone has any doubt about the global role of the US Fed, all he has to do is estimate the amount of dollar liquidity the Fed has had to inject into the global financial system since the 2008 global crisis erupted. The global economy may not be ready for a global central bank, but in its place it may be able to organize a group of major central banks which could in part assume the role of a global lender of last resort.

The Fed established currency swap lines of unlimited amounts with the central banks of the EMU, the UK, Japan, and Switzerland to be activated in a global financial crisis in 2008. Later in 2009, six more central banks of advanced economies were added to the list. The Fed also offered swap lines to the central banks of four other emerging economies.

As noted earlier, in the case of South Korea, the Fed swap played an important role in breaking up a speculative attack, not because of the swap amount-$30 billion- was large enough, but because of the implicit back up by a *de facto* global lender of last resort (Park 2011). One may question whether a similar support in terms of the availability of liquidity provided by the IMF could have been as effective as the Fed swap line.

In view of the effectiveness of the Fed swap in preventing liquidity crisis, one could make a strong case for enlarging the network by including the central banks of emerging economies active in global finance. At this stage of discussion, it is premature to identify those central banks qualifying for and to determine the amounts of swap lines to be accorded. Most of the countries qualifying for either FCL or PCL at the IMF could be potential candidates.

Once established, the enlarged global swap arrangement will send a clear signal to the market that the G-20 members are prepared to work together to activate the swap system whenever necessary to avert any impending liquidity crisis in countries belonging to the system. This signal will make speculators think twice before attacking any currency.

Among the reserve currency countries, there is a concern that the enlargement could pose the risk of creating a moral hazard problem on the part of the emerging economies participating in the swap system. Once they have the liquidity backing, the argument is that these economies may lose discipline in managing macroeconomic policy. It is difficult to imagine that any emerging economy would let its current account deficit expand beyond a sustainable level, would be reckless in borrowing in reserve currencies, or heedless in improving the safety and soundness of its financial institutions.

However, if the moral hazard is a potentially serious problem that dissuades the reserve currency countries from expanding the swap network, the swaps could be offered only to those emerging economies suffering from a capital account crisis of a short-run nature triggered by evaporation of reserve currency liquidity. The emerging economies belonging to the network could also be required to make available some of their reserves in extending swap lines to other members. Depending on how it is structured, the safety net could be transformed into a system of global reserve pooling.

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