

## some thoughts on international monetary reform

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*PRELIMINARY DRAFT – NOT FOR QUOTATION*

Is the International Monetary System responsible for the financial crisis ? Many analysis and a significant part of the policy agenda are predicated on a positive answer to that question. A detailed analytical argument, however, is still missing. The task is enormous and well beyond the scope of this paper. Rather, this note presents some remarks which, on balance, would cast a note of caution before considering a fundamental overhaul of current arrangements.

The state of the debate can be summarized as follows :

- few people would argue that saving - investment imbalances in different parts of the world should be ignored when considering the build up to the crisis. The "saving glut" ( and its unequal distribution across regions) caused both current account disequilibria and low real interest rates ( which, in turn, may have induced excessive risk taking)
- no consensus exists as to whether those imbalances effectively caused the crisis. The argument is forcefully made by the IMF in its " lessons to be drawn from the crisis". But it is hardly convincing . First, it could be better framed by saying that common causes lay behind global imbalances and the financial crisis. And, second, at least three alternatives (and not exclusive ) explanations stand out : deficient regulation and supervision of financial activities; asymmetry in financial development between emerging and developed economies which would explain why financial capital flows "upward" from developing to industrialized countries ; finally a global shortage of liquid and safe assets, creating excess demand for US financial instruments, thus contributing to the credit and real estate bubble.

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<sup>1</sup> the opinions expressed are strictly mine and do not represent the views or positions of the Banque de France

- even less consensus can be found on whether a different International Monetary System would have prevented the crisis. Some observers argue that US monetary policy helped and sow the seeds of the turmoil : by keeping interest rates too low for too long, the FED may, according to this thesis, have encouraged excessive risk taking. Even if we accept the argument, which is debatable, nobody would make the case that international monetary arrangements did influence Fed's policymaking process during that period. Conversely, even those who think that different exchange rate arrangements for EMEs (including China) could have reduced - or limited- global imbalances do not argue that they would have prevented the crisis from bursting.

So, is the discussion on the reform International Monetary System irrelevant ? Certainly no. For one thing, the crisis may have revived worries in many countries about the appropriate level of foreign exchange reserves. It raises new concerns on the provision of international liquidity as illustrated by recent decisions on the creation of the Flexible Credit Line and a new general allocation of SDRs. And, second, one consequence of the crisis has been to cast doubts on the ability of some assets, up to now considered as riskless, to serve as reliable stores of value. So, there may be both increased demand worldwide for risk free assets and less certainty on the future supply of those assets. It is not hard to imagine the potential disruptions which could result as countries, either seek to protect themselves from future shocks by accumulating forex reserves and/or limit capital movements, or start searching for new ways of preserving the value of those reserves, thus triggering huge volatility in asset prices and exchange rates.

The rest of this paper will thus be devoted to two interrelated questions, - the international store of value and the provision of liquidity - which are central to the preservation of an open and efficient international financial system. Critical issues will be left aside, such as the appropriate exchange rate and capital account regimes. While crucial for the future, it is not clear how the crisis may have changed our (widely divergent) ways of approaching those questions.

## **stores of value**

It seems reasonable to assume that global imbalances are here to stay, at least for the foreseeable future<sup>2</sup>. In the short run, any attempt to quickly reduce them would certainly deepen the recession. Financing is more important than adjustment. Hence the decisions recently taken at the London G20 Summit to increase five fold the resources available to the IMF.

In the longer run, saving - investment imbalances may persist and commodity producers may register huge and lasting surpluses, once the recession is over. So, it is likely that stocks of foreign claims will keep growing, in aggregate, at the world level. It is important that uncertainty as to their value and return be minimized for three reasons :

- first, the safer investors feel about the risk-return profile of their holdings, the bigger the exposures they are prepared to accept. Structural characteristics of the International Monetary System therefore have an influence on the sustainability of global imbalances.
- second, once uncertainty settles in, it would likely be accompanied by extreme volatility as investors, whether public or private, constantly reshuffle their existing portfolios between countries and currencies in order to manage their exposure ;
- finally, and most important, many oil and commodity producers face an intertemporal choice between extracting resources or keeping them on or under the ground. According to standard economic reasoning (the Hotelling rule), one important determinant is the return earned on financial assets, to be compared to the expected commodity price increase over the long run. The possibility of large valuation losses on financial assets makes it optimal to reduce the rhythm of extraction, which would durably lower the supply of oil and other commodities.

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<sup>2</sup> according to the "Bretton Woods II" approach, they are the outcome of an efficient and mutually beneficial equilibrium between the United States and the rest of the world.

Several policy approaches can be envisaged.

Governor Zhou, of the People's Bank of China, has mentioned the creation of a "super sovereign reserve currency", whose issuance would neither be linked or determined by a single country. Such a currency would serve as a source of international liquidity (more on this below). Its ability to provide a stable store of value, however, would depend on its issuance modalities<sup>3</sup>. Looking at history, finding the right balance is going to be challenging. If the "super reserve" is a basket of existing currencies (such as the SDR today) it would basically serve as an instrument for diversification of foreign exchange reserves (or private portfolios), and such a diversification can easily be achieved by using existing currencies. On the other hand, the "super sovereign" could be issued as such as a fiat currency. Then, the international community would have a basic choice : the new currency could be made "strong", and never depreciate against any other major existing currencies, which probably means that its supply would be severely restricted. Or, the "super sovereign" would be issued according to pre-specified rules, and depreciation against existing currencies could not be excluded. Then, it would only provide partial protection against exchange rate volatility and valuation losses. These are important questions which would deserve further study and exploration.

As a response to the need for stability in portfolios' value, it may be that some diversification in international reserves will occur. Experience shows, however, that this process is very progressive and incremental.

One very promising avenue would be, for countries which have surplus savings, to develop their own internal stores of value by expanding the range of financial assets available to domestic and international investors. This would address both the causes of international imbalances and the roots of the financial crisis. According to the analysis developed by Caballero and others, the world suffers from an "asset shortage". The supply of liquid and safe financial instruments is insufficient to meet demand, and that supply is asymmetrically distributed across the world. As the US is

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<sup>3</sup>in the words of Gouvernor Zhou such a currency would have " stable value, rule - based issuance and manageable supply"

the primary supplier of liquid and safe assets, it attracts inflows of capital, a process which accentuates global imbalances. Furthermore, excess demand for those assets pushes their prices up, which triggers financial bubbles. During the last decade, financial innovation has been organized to "transform" illiquid and risky instruments into (apparently) safe and liquid assets. That unsustainable process has brutally come to an end with the burst of the credit bubble. Financial development in surplus countries would solve both problems at once: it would eliminate the asymmetry at the source of global imbalances; it would also reduce the asset shortage, thus the probability of future bubbles.

### **international liquidity**

Foreign exchange reserves have grown dramatically during the last decade, both in absolute and as a percentage of world GDP. One cannot assume, however, that an equilibrium has been reached and that the demand for reserves will stabilize.

In 2008, international banks repatriated liquidity to their home countries and, as a consequence, many emerging economies experienced significant capital outflows. Overall, they managed the shock well, through a conjunction of exchange rate flexibility and moderate depletion of reserves. There is a possibility, however, that, once the crisis is over, many countries will revise upward their reserve targets and the demand for reserves will start growing again.

In a sense, countries face the same dilemma as financial institutions when deciding on their appropriate liquidity position. On the one hand, liquidity has a cost, and should therefore be reduced to a minimum. On the other hand, liquidity provides an insurance against shocks and a guarantee of independence. For private financial institutions, there may be a tendency to underestimate liquidity needs in normal times, with the expectation that the lender of last resort will bail them out if and when a shortage occurs. For countries, the bias goes in the other direction. With no international lender of last resort, precaution motives will lead to overaccumulation of liquidity.

Recent and ancient history has shown that both domestic and international capital markets can experience aggregate liquidity shocks. The literature usually focusses on the permanent – structural – sources of international liquidity provision. Hence the renewed interest in the "Triffin dilemma" : what will happen to international net liquidity supply if and when the US current account start to contract ? But, in the short run what matters is *gross* liquidity. Shocks to international liquidity occur when financial institutions leverage – or deleverage – their positions towards non residents. These are the shocks countries seek insurance against by building excess reserves. The associated costs are well known : potential loss of monetary autonomy ; valuation risks ; distortions in the allocation of national savings; possible exchange rates misalignment. Is there a better system? If yes, it must be based on credible and permanent multilateral arrangements.

The reactions to the crisis provide some encouraging signs. Existing swap arrangements in Asia have been extended and augmented. New agreements were concluded by the FED and the Eurosystem with a number of emerging countries. A Flexible Credit Line (FCL) has been created by the IMF, which has met with considerable success. Finally, an SDR general allocation has been agreed up to an amount of 250 bn USD. Overall, the collective reaction of the international community has been quick and decisive.

These are, however, revocable and limited sources of liquidity provision. Swaps agreements can be terminated. Out of the total, only a small part of the SDR allocation will benefit to countries which may effectively need to use them. Finally, it is not clear that regional arrangements will provide an effective buffer against global aggregate liquidity shocks. More is needed to effectively substitute for national foreign exchange reserves as a permanent insurance mechanism.

A possible avenue would be to create a process of periodic general allocation of SDRs, according to a predetermined schedule. Those SDRs, however, would not be immediately available for use by their beneficiaries. Rather, they would be "frozen" and unblocked only in specified circumstances. Criteria for use would not be defined on the basis of individual countries' situation, but on consideration of the conditions prevailing in the global economy and international capital markets. If properly

constructed, such a scheme may provide, for no cost, the kind of insurance that countries are currently seeking by building excess reserves.

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This paper has very limited ambitions. It does not describe the desirable - or feasible- features of an international monetary system for the 21<sup>st</sup> century. The implicit assumption, which might be debatable, is that global imbalances are here to stay. It is highly desirable that, in the long run, a better equilibrium be reached in a number of countries between national saving and investment. It is also important to keep those imbalances under control, so that volatility in exchange rates and asset prices may be avoided. Surplus and deficit countries share equal responsibilities, in this regard. Fundamental corrections, however, will take time. There is a limit to the pressure that international monetary arrangements can exert on domestic policies. In the meantime, it is essential to try and preserve the openness and smooth functioning of international financial markets, which has proved so important for our prosperity.