The Search for Symmetry in the International Monetary System

Jean-Pierre Landau – Remarks at the Central Bank of Iceland Annual Conference - September 2017

The quest for symmetry has been a constant feature of international monetary relations over many decades.

The Gold Standard was typically and essentially a symmetric system. The so-called *price specie flow* mechanism worked to submit surplus and deficit countries to identical adjustment mechanisms. Movements of gold across borders would trigger domestic monetary expansions and contractions, followed by price increases or decreases that would restore equilibrium between countries. Of course, this perfect symmetry was contingent on the strict observance of "rules of the games" that prescribed to let the adjustment proceed through perfect price flexibility, both upward and downward. Those rules proved very hard to follow when countries had to absorb significant shocks in the presence of domestic price and wage rigidities. This led to the ultimate demise of the system.

By contrast, Bretton Woods was designed, from the start, as an asymmetric system, with a core and a periphery. Under the Gold Exchange Standard, all currencies, but one, were been defined by their exchange rate to the dollar. The US currency, therefore, served as an anchor and effectively determined the overall monetary stance and conditions across the world. This arrangement collapsed under the double pressure of growing capital flows and divergences in monetary policy requirements. At the heart of Bretton Woods demise was a refusal, by many participants of its inbuilt asymmetry and the desire to regain their full autonomy in monetary policymaking.

Floating exchange rates were expected to produce some symmetry by providing a spontaneous adjustment mechanism in the balances of payments. That did not occur either, for many reasons. Exchange rates in many emerging countries were never allowed to float freely. Also, the insulating and stabilizing properties of floating may have been overestimated, especially when financial channels of transmission between countries are taken into account.

If anything, the floating rate regime has reinforced the US dollar dominance which today accounts for a majority of cross border transactions and credit, as well as foreign exchange reserves and gross foreign assets

Today's world is highly integrated from the point of view of trade and financial flows. Foreign external assets are at their highest level ever. This world is also unprecedented in its diversity of nations with equal status and ambitions, many of them wanting to be active participants of the International Money System. That diversity fuels the desire for symmetry. It contrasts with relative simplicity and homogeneity of both the Gold Standard and Bretton Woods regimes, which, for Bretton Woods, made it easier for participants to accept its hierarchical nature. In this very diverse world, the question of symmetry becomes much more complex and

multidimensional. This paper discusses symmetry along four such dimensions: institutional, doctrinal, cooperative, and finally, "architectural".

1/ - the institutional dimension

It mainly relates to the governance of the international financial institutions: the IMF and World Bank. Formally, the relative importance of countries depends on their quotas. Quotas determine the voting power of each country. They form the basis for allocating seats at the Executive Board. The rigidity of the quota system, which can only be adjusted periodically and incrementally has generated great frustrations. It has nevertheless allowed the ascension of China as the IMF third shareholder (almost equal to Japan in the second rank). More vexing, from the Emerging Economies' perspective, has been the persistence of informal arrangement through which US and Europe are sharing the two top positions in the IMF and World Bank.

Outside the Bretton Woods institution A very significant evolution has taken place with the creation of the G20, which is progressively taking over an expanding the G7 functions – including, recently, on exchange rate management. The G20 is (almost) a truly universal institution.

Institutional weights, of course, have a strong symbolic power. Over long run, they may also influence the substance of policy recommendations developed by the International Financial Institutions and the associated conditionality.

2/ - the doctrinal dimension

The question of symmetry is often raised, implicitly or explicitly, when International Financial Institutions and market participants formulate policy recommendations or exercise market discipline to emerging economies. IMF surveillance and conditionality, for instance, have been labeled as asymmetrical between large and small countries, the former being treated with more understanding and benevolence.

More generally, the "one size fits all" doctrine that underpins policy recommendations, designated as the "Washington Consensus", may be inspired by the dominant view and perspectives of large advanced economies and insufficiently adapted to the diversity of structures and national objectives of emerging countries. A. Greenspan has famously formalized this dominance by saying, in the midst of the Asian financial crisis, that: "*one consequence of this Asian crisis is an increasing awareness in the region that market capitalism, as practiced in the West, especially in the United States, is the superior model*" (Greenspan, 1998)

Ten years later, of course, the situation looks very different. Following the 2007-2009 financial crisis, some of the "Washington Consensus" core components are progressively revised. The IMF has nuanced its support of capital account opening and convertibility in a review of its

"institutional view" published in 2016 (IMF, 2016). Some research conducted in the institution has vigorously questioned the "neo liberalism" vision that predominated for several decades (Ostry et al, 2016). Outside the official sector, some academics, first of all D. Rodrik, have shown that successful emerging countries, have adopted very diverse growth strategies, and called for an end to uniform approaches to policy and conditionality (Rodrik, 2007).

3/- the cooperation dimension

Asymmetry is pervasive in an open global economy.

It is an inescapable fact that market discipline is asymmetric between surplus and deficit countries. There are no limits to the accumulation of (current account) surpluses whereas deficits have to be matched by net capital inflows – which might, or not, be coming. It is also a fact that external financial shocks are asymmetric between large and small countries.

It has also been argued that monetary spillovers are mostly one way– going from the dollar to emerging economies, giving US (and to a lesser extent Euro and Japan) a driving role in determining global monetary and financial conditions. The adverse effects of those spillovers may have been amplified, as advanced economies hit the zero lower bound. In that situation, any further accommodation in those countries (through, in particular asset purchases) may essentially have "demand switching" (and not "demand creating") effects, through depreciation of the exchange rate, and at the detriment of other countries – recipient of capital flows (Rajan, 2016).

This situation has revived calls for greater monetary cooperation and coordination between countries to attenuate those ingrained asymmetries. R. Rajan (2016) has proposed the discussion of new "rules of the monetary game" that would guide or inspire the actions of monetary authorities. J. Caruana (2017) has suggested that advanced economies "internalize" the effects of their monetary policies on the rest of the world, which would be in their interest since they are affected through reverse spillovers by the situation of other countries. Finally, considerable efforts are being devoted in the G20 to try and set up "multilateral safety nets" with mutual liquidity support being provided between participants through symmetric currency swaps.

Attempts at coordination have met with considerable difficulties, especially with regards to monetary policy. Central Banks have domestic mandates and they would not consider themselves as legitimate in pursuing objectives different from those for which they have been delegated independence and authority. In addition, some of their actions have direct or indirect fiscal consequences. Currency swaps, for instance, may involve counterparty risks if and when one of the currencies involved meets with convertibility problems.

Those difficulties illustrate a fundamental reality. Asymmetries are deeply ingrained in the architecture of the International Monetary System. The search for symmetry can only succeed in the long run if this architecture progressively evolves. But it may not be an easy path. In the

foreseeable future, participants to the International Monetary System may have to "live with asymmetry" (Obstfeld, 2011).

4/- the "architectural" dimension

Over the last two decades, there has been a constant growth of foreign exchange reserves with an equally constant share of the dollar in the denomination of those reserves. The amount of foreign exchange reserves far surpasses all "reasonable" measures or indicators based on GDP, trade or financial openness. There is a strong and permanent demand for the liquidity and safety that only those reserves can bring.

That quest for safety is a broader phenomenon. Gorton et al (2012) have shown that the share of safe assets in financial portfolios has stayed constant over many decades. With increasing financial wealth/GDP ratios, the demand for safe assets will most likely keep growing in the future.

Here lies the ultimate source of asymmetry. There are only a few issuers of safe assets (reserve currencies) in the world. One of them, the USA, is dominant. Those issuers enjoy some "privileges" as there is natural demand for their domestic assets, bringing capital inflows and driving down domestic risk premia. Their currency and Government debt serve as worldwide stores of value. And because there is a natural synergy between the different functions of money (those currencies also serve as medium of exchange and unit of account.

The Issuers of safe assets determine the world risk free rate and have strong influence on worldwide financial conditions. This explains why spillovers of monetary policies are asymmetric most of the time.

It is interesting to note that this "natural" asymmetry - between issuers and holders of safe assets - coexists with another one, less structural but permanent: between surplus and deficit countries. In some cases, such as the euro area today, there is an overlap: the main surplus country - Germany - is also the major issuer of safe assets. At the world level, the opposite situation prevails: the principal issuer of (reserve) safe assets – the US- has been permanently running current account deficits for several decades.

One would conjecture that the system is more stable in that second configuration. The demand for safe assets provides a natural financing of the current account deficit of the issuing country. Of course, as underlined by Obstfled (2011) , there is still a need for the Government, the dominant issuer of safe assets in the long term, to run a sufficiently high deficit. And that raises the traditional " Triffin dilemma" with an added fiscal dimension. But the system has worked. Indeed, the US current account and budget deficit maybe the main reasons why the IMS has proven so resilient to the persistence of global imbalances over the last decades.

By contrast, when the issuer of safe asset is running a current account surplus, things are more complicated. The country is accumulating net claims on others while it also must issue gross

safe liabilities. While theoretically feasible, this implies that the domestic economy accepts a significant risk mismatch, with a net exposure to foreign outside risk growing consistently with time. Fiscal implications may be difficult to accept and manage.

Ultimately a more symmetric world will only come with a diversification in the supply of safe assets. Three remarks can be made, the last one mostly speculative.

First, while major emerging economies may legitimately pretend, over time, to the status of reserve currency, it is also clear that being an issuer of safe assets is very demanding. The country must have a deep and liquid domestic financial market. It must keep a fully open capital account in all circumstances, as the freedom of movements in and out of assets is one prerequisite of their safety. And, finally, it must be prepared to accept some "risk transformation" in its national balance sheet (even more if surplus country)

The second remark relates to debt regimes. Most of the safe assets worldwide are in the form of public debt. There is a tendency today to consider that debt – especially in emerging economies – should be state contingent and easy to restructure. While easy restructuring provides a welcome flexibility in case of economic shocks, it is also incompatible with debt serving as a reliable store of value. State continent debt regimes would prevent an increase and diversification in the supply of safe assets. They would perpetuate the current asymmetry in the International Monetary System.

Finally, in a very speculative and long-term perspective, there would be room for the IMF to expand its role and diversify its interventions to contribute to the expansion of the universe of safe assets worldwide. The issue is traditionally considered from a "liability" perspective when looking at the Fund's balance sheet. Then, the debate boils down to the desirability and modalities of issuing new SDRs. A different approach would be to look at the asset side and examine whether the Fund could not imitate Central Banks and issue liquidity (SDRs) through repos with financial institutions. The (global) assets that would be eligible to such "refinancing" would de facto have great liquidity, an essential component of safety. They could be used as collateral for cross border financial operations. That would expand significantly the worldwide universe of safe assets. For the Fund and its shareholders, those operations would carry much less risk than a "pure" allocation of SDRs. This new role, of course, would entail a deep revolution in the role of the Fund. By providing liquidity to markets (and institutions) instead of countries, as it has done for seventy years, the IMF would assume a new and major role in the international financial system and its stabilization. There is little chance that its membership would countenance such an evolution. However, things may be different at the regional level. Where countries have decided to integrate financially, they may find useful to create regional safe assets and if, necessary, to support them with a multilateral liquidity provision arrangement.

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