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Seminar—Where is Global Finance Heading? Status of the International Monetary System and the Stake of Emerging Economies

Session VI: What are the Options for the International Monetary System?

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What Could be Next on International Monetary System Reform?

The remarkable instability that ensued from the global crisis, in particular the unprecedented exchange rates movements in scope, speed and magnitude, have been a stark reminder that monetary issues are at the core of this crisis. It is therefore all the more surprising that so far international monetary issues have not featured more prominently in the main international policy fora. The G8 L'Aquila joint declaration only provides a token statement that participants will refrain from competitive devaluations of their currencies and promote a stable and well-functioning international monetary system. The G20 gave a nod towards the need for reform with a new SDR allocation. The IMF has been mostly silent on the issue and the BIS in its recent annual report did not even mention the notion of international monetary reform.

Notwithstanding, there *is* mounting momentum for a reform of the international monetary system. For the first time in recent economic history emerging markets seem to give both impetus and direction to the debate. Recent initiatives by China and Russia have revealed an increasing desire to lead this debate supported by discussions held at the BRIC summit in Yekaterinburg during June. The issue now is whether discourse will be followed by actions. The question to be raised is therefore what could be next on international monetary system reform?

There seems to be increasing consensus about the shortcomings of the present system. The management of international liquidity is based on a fundamental asymmetry, namely the fact that while the U.S. represents about 25 percent of world GDP the dollar represents 65-75 percent of central bank international reserves. This implies that there is an undue reliance on national currencies to manage international liquidity; that is the U.S. Federal Reserve is unlikely to subordinate its domestic policy objectives to the needs of the international economy.

Possible policy responses include: 1) agreement on a new international monetary system; 2) enhancing the role of the IMF's Special Drawing Rights; 3) diversification of national currencies. The seeming lack of political willingness to pursue a new monetary system indicates that other issues will most likely have priority; this would include a return to any type of commodity standard given the fickle supply conditions of gold and other commodities. The institutional constraints of SDR allocations significantly limit the role of SDRs as dominant reserve assets but are set to adopt a complementary role. National currencies are most probably to remain the main vehicle for managing international liquidity. Given the limitations of using a few national currencies, the adoption of a broad multi-currency regime seems the most feasible approach.

The adoption of a broad multi-currency regime rests on two fundamental assumptions: 1) that use of several currencies provides greater stability and more liquidity for the international monetary system, as official asset holdings will be more balanced across currencies; and 2) that positive externality effects of using few currencies can be overcome amid technological change and low transaction costs. While the possibility of substituting the dollar is very limited in the short to medium term, the objective should be to identify complementary regimes that can be adopted today to allow for an orderly transition over the long term.

Emerging markets are set to represent about half of world GDP at market prices within the next 10 years and are the largest holder of international reserves. Yet their currencies are not being used internationally. This imbalance between economic and political and monetary proliferation risks being inherently unstable. Emerging markets will therefore naturally be at the heart of any reform effort. They have also realised, as most pointedly told by the recent history of the euro, that any international political ambition must have monetary issues at its heart.

Central banks today can be both catalyst and driver for the adoption of a broad multi-currency regime. The large accumulation of international foreign exchange reserves has bestowed central banks with sufficient resources to guide and affect market behaviour. Key currency attributes are also endogenous to central bank reserve holdings and reserve allocation can be a channel for currency use to result in a virtuous circle of greater stability and currency use, that is, U.S. treasury securities are perceived as safe in large part because China has decided to hold them.

Central banks can simply allocate part of their reserves to new currencies. They could preannounce that they would diversify their international reserves into currencies, for example, other than SDR currencies by a given amount of 3-5 percent of their holdings over the next 24 months. Similar to the central bank gold agreements this would help anchor market expectations that the exit from existing reserve holdings will be orderly. Central banks may also grant each other special access to their on-shore markets where prevailing capital controls may not allow to do so. This would create a platform for policy dialogue and possibly greater policy cooperation. Such initiative could also be seen as a first leg for countries planning a gradual capital account liberalisation. Central banks, being mostly buy-and-hold investors, would lend stability to and help deepen and develop local markets. Such a move should ideally be done collaboratively and involve advanced economies and emerging markets central banks.

For many central banks, the very notion of investing in emerging markets currencies still amounts to heresy. However, the crisis has brought to the fore that the most basic notion of risk needs to be recalibrated, namely is it still conservative and prudent to invest in a very narrow set of assets where those assets are less and less representative of the underlying forces of the international economy? Or put differently, do current prevailing international reserve allocations remain consistent with one of central banks' most elementary objective, namely of providing international monetary stability?

The crisis needs an international monetary system response. The global imbalances that many have associated with the underlying causes of the crisis while reduced remain unresolved. This will have implications for exchange rates and in particular the dollar and will affect above all emerging markets. As such, international monetary reform should not be seen as an add-on but rather as an integral element for achieving a sustainable resolution of the current crisis.

However, the pace of international monetary reform will largely depend on emerging markets themselves. Many emerging markets still do not provide conditions conducive to allowing greater international use of their currencies. Their response to reform will therefore be essential to establish credibility of their own intentions and is likely to define the reform debate momentum going forward.

Central banks can today play a key role in establishing greater symmetry in the international economy by assuming a more diversified international reserve portfolio. It would represent the clearest sign yet that policy makers are willing to support their stated policy intentions. This may require a new vision for the management of the international economy, namely that an increasingly multi-polar world will probably be better off with a multi-polar currency system. It may not be clear how such a new system will look like but as one of the leading economists on international monetary issues Robert Triffin put it as far back as in 1963 in a similar context, the worst choice would be inertia.

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