

An intermediary step for the reform of the International Monetary System

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Hong Kong – What is wrong with our global financial system? Are national-based policies ineffective today in a highly integrated global financial system? There is growing awareness that with increasing globalization of financial markets and porous capital controls, over-burdened monetary policies and debt-constrained fiscal policies are losing effect in dealing with secular deflation at the national level. National financial cycles are getting more and more synchronized across countries as globalization deepens. No single country is now large enough to push or pull the global economy out of its pro-cyclical financial cycle, as the larger economies are either stuck in slow growth or slowing growth.

As identified by [Borio and others](#), the global financial cycle is longer and larger than real economic cycles, and is closely associated with the fluctuating value of the dominant reserve currency, the dollar. When the dollar is weak, as the US runs larger current account deficits, global credit increases with capital flows, and growth is stimulated. But the associated problems for emerging markets are inflation, asset bubbles, and currency appreciation brought about by capital inflows and irrational exuberance of domestic and foreign investors. When financial and geopolitical risks increase, however, the dollar becomes stronger, and emerging markets struggle with bursting asset bubbles, currency devaluation and capital flight back to the dollar. In a situation with zero-interest rates, and an inability to reflate the economy, a strong dollar plays in today's global markets the same deflationary role as the gold standard during the 1930s.

This begs the question whether we need a global set of monetary and fiscal policies to deal with global secular deflation. Keynes's vision of Bancor as a global currency was perhaps a step too far for the US Treasury economist Harry Dexter White, whose view prevailed at the 1944 Bretton Woods conference for a global financial structure centred on the dollar as the dominant reserve currency. White's view is fine if the US is willing, as the Triffin Dilemma dictates, to run larger and larger current account deficits to meet global demand for liquidity.

However, if the US becomes more inward looking, as the election mood seems to signal, and wanted to move to balanced budgeting or increased savings, the world would be plunged into further secular stagnation. With Europe and Japan in stagnant growth and the Chinese economy slowing, the only possible source of global reflation is the unsatisfied demand for global public goods (infrastructure investments to deal with climate change and needs of emerging markets). Nicholas Stern has estimated that climate change investments are in the order of \$6 trillion annually for the next 16 years or \$90 trillion.¹ **The \$6 trillion annual investments are equivalent to 7.7 percent of global GDP** and are within the capacity of global financial markets to fund. But it is quite clear that there is a market failure, because the current level of investments are not more than \$1 trillion, even at near zero real rates of interest.

There is no doubt that the world has both the need (to regenerate growth and jobs) and the imperative (avoiding climate disaster) but not necessarily the collective will. Initially, it was thought that the US

¹ Stern, Nicholas. 2015, October 19. "[Why are We Waiting? The Logic, Urgency, and Promise of Tackling Climate Change](#)." Grantham Research Institute on Climate Change and the Environment, Centre for Climate Change Economics and Policy and London School of Economics and Political Science.

may not be willing to give up its “exorbitant privilege”. But as former Fed Chairman [Ben Bernanke has recently claimed in his blog](#), that privilege is no longer so large as seigniorage declines in value with zero interest rates.

The Triffin dilemma can be solved if the global reserve currency is a n+1 currency, not a national currency, because the world as a whole does not have a current or capital account deficit. The Special Drawing Right (SDR) can serve as the n+1 global reserve currency, but it has only been given powers as a unit of currency, but not as a means of payment or a very significant role as storage of value. Its current issuance size **(of \$285 billion)²** is small relative to global official reserves of **\$10.5 trillion** (excluding gold)³. We believe that an incremental step for the role of the SDR in the new global financial architecture can be made without major disagreement that disturbs the geo-political balance. The purpose is not for the SDR to replace the role and power of the national reserve currencies and their issuers, but to *supplement* global liquidity and make the transmission mechanism more effective.

The current political mood is such that many advanced economies are unwilling to increase either their tax levels or their fiscal debt burden, which has placed the adjustment burden primarily on monetary policy. Between 2007 to 2014, the G4 reserve currency central banks (issuers of the dollar, euro, sterling and yen, all component currencies of the SDR) increased their balance sheet by \$7.2 trillion, which bloated their broad money (M2) by \$9 trillion, of which private sector credit increased by only \$1.8 trillion. This showed that unconventional monetary policy (UMP) increased liquidity within the banking circle, but its transmission channel to the real sector is flawed.

Indeed, whilst UMP has reduced the debt servicing burden by lowering interest rates, the level of global debt has increased, rather than declined. With declining inflation, the real burden of debt has actually increased. As long as households and corporations continue to attempt to deleverage, the world will going through a balance sheet recession.

We argue that the solution to the deflationary trend is Keynesian in nature by reflating global growth through investments in global public goods. The funding of this investment can be done through the central bank community. Since they do not consider that they should be involved in resource allocation (the domain of fiscal policy), then the resources they generate from balance sheet expansion should be invested through the IMF in the form of increased SDRs. SDRs actually have the characteristic of being equity, since they comprise voting rights. Being equity, the SDRs that the IMF issues can be correspondingly invested in the World Bank and other multilateral development banks (MDBs) as equity, which will then decide on which sectors of global public goods deserve the resource allocation. Since the board and voting rights of the MDB are essentially controlled by national ministries of finance, they will continue to drive the resource allocation function. Since the initial funding by national central banks are recycled back into their markets by the IMF until full drawdown by the MDBs, the monetary policy effects are “neutral” at the country level.

In the past, the level of financial resources available for investment was constrained by the level of national savings. However, UMP revealed that liquidity and credit can be created against global savings

² IMF. 2016, April 6. "[Factsheet: Special Drawing Right \(SDR\)](#)."

³ IFS. 2015. "[Total Reserves Excluding Gold, US Dollars](#)."

with relatively little impact on inflation, provided there is excess capacity in production and insufficient effective aggregate demand.

If member central banks can increase their SDR allocation in the IMF by \$1 trillion, then a 5 times leverage would enable the IMF to increase either lending to member countries or investments in MDBs by at least \$5 trillion. The drawdown of such SDR allocation can be fine-tuned to avoid causing too much global inflation.

The MDBs (with co-funding from financial markets) can use the \$5 trillion to fund global public goods, such as tackling climate warming and infrastructure investments in mostly emerging markets. MDBs can also leverage their equity by borrowing in markets. Depending on the quality of such projects in terms of governance and cash flows, these assets could be sold back to market as asset-backed securities to fund new projects.

In other words, as long as IMF and global central banks are willing to provide equity and liquidity against such long-term lending, global public investments can be undertaken to achieve global growth recovery,

We believe that this small step in using SDRs to fund global public goods are both consistent with current global rules and consistent with the G-20 objective of better global collaboration for strong, balanced, and sustainable growth.