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Reform of the Global Monetary System

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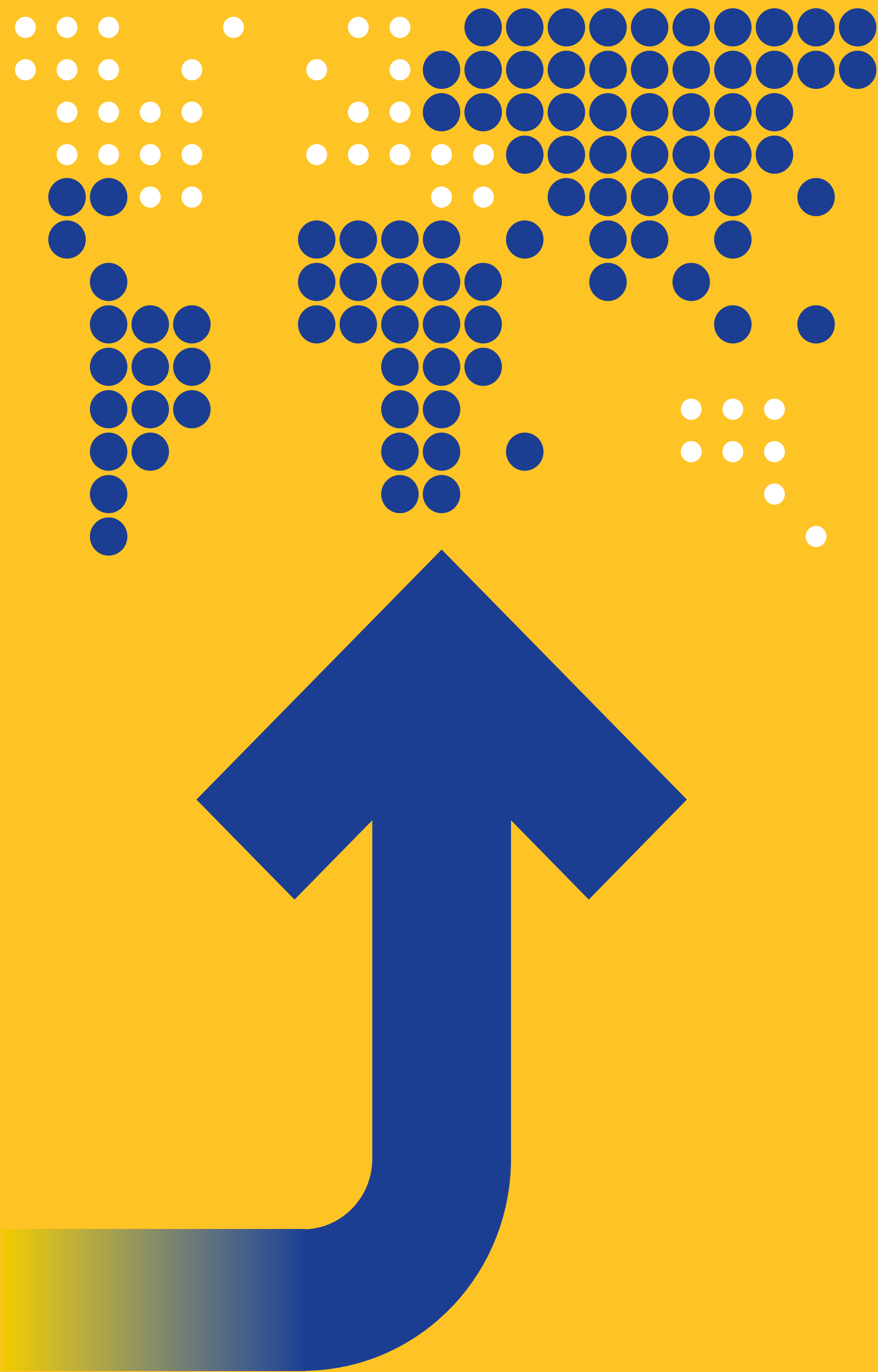

Emerging Markets Forum

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Reforming the international monetary system—A sequenced agenda

Chapter 4

Michel Camdessus & Anoop Singh

Introduction

It is close to a decade since the start of the global financial crisis (GFC)—the first of the 21st century—and its origins, costs, and recovery are being debated. The crisis raised critical questions about how the international policy framework monitors, regulates, and manages global liquidity and the consequent risks for international financial stability. Given the depth of the crisis, the enormous economic and social costs of the ensuing recession and, since then, the increased fragmentation of the global financial safety net, we need to consider how the international monetary system must be fundamentally reformed to ensure its greater stability.

The urgency of this reconsideration is reinforced by a number of factors that could have multiple effects on global liquidity. Most important among them is the ongoing historic rise of emerging markets, and the growing likelihood that tomorrow's key financial players—official and private—will come from emerging markets. Over the next decade, emerging and developing economies will likely account for at least half of global financial assets, with a number of systemically important banks. This historic shift of global activity and finance from advanced economies to emerging and developing economies has clear governance implications and their rising financial integration will also impact global liquidity. In the near term, the prospects and timing of the Federal Reserve's further "lift-off" are immediate factors. Coupled with renewed concerns about retrenchment in global markets already affected by ongoing regulatory reforms, they have increased financial market uncertainties.

These factors all confirm the importance of managing global liquidity as a global public good. We will turn to this issue next, before discussing an agenda for an in-depth reform of the international monetary system that is responsive to the needs of the changing world economy during the period reviewed by this book.

Liquidity—An evolving global public good

Liquidity is a global public good and the international economy is immediately and radically affected, at times, by its excessive volatility.[1,2] Today, private actors increasingly dominate the global provision of liquidity. Of course central banks play a key role in monitoring its developments and, as much as possible, in ensuring that liquidity is provided sufficiently to international markets. They have recently increased significantly the number of swap agreements but they have stopped well short of developing an institutionalized global swap network that some have favored to meet the needs of the system in all circumstances.[3] This is understandable as central banks are primarily driven by domestic mandates.

Why have the issues posed by global liquidity not been more effectively addressed despite the great debates that have taken place over the decades, including those sparked by Robert Triffin and Charles de Gaulle (who referred to the dollar's "exorbitant privilege") in the 1960s?[4] Many reasons have contributed to it—mainly, national differences that have prevented an effective consensus from developing, including after the Jamaica Agreement, on these issues.

The origin of the problem can be traced to Triffin's demonstration of the dilemma in which the country, whose currency dominates the global system, finds itself. Indeed, the lessons of post-Bretton Woods history are clear in that the main reserve currency country—the United States—has found itself unable to overcome the Triffin dilemma—how to manage the twin responsibilities of a domestic monetary policy and the provision of adequate global liquidity. For any reserve currency, once that country's central bank determines the volume of its currency issue, the needs

1. Details are explained in IMF (1969).
2. Keynes well recognized it in his proposal to establish a Clearing Union. Indeed, Keynes then emphasized the analogy with a national banking system and he saw the need for an instrument "of international currency having general acceptability between nations" (IMF 1969).
3. Edwin Truman has examined this issue in numerous papers, for example in Truman (10 September 2013).
4. Tommaso Padoa-Schioppa (25 February 2010) explained the long standing debate in his lecture delivered at Louvain-la-Neuve.

For any reserve currency, once that country's central bank determines the volume of its currency issue, the needs of its national economy overrides the needs of the global economy.

of its national economy overrides the needs of the global economy. As there is no pre-established harmony between the needs of the national economy in question—in this case the United States—and those of the global economy, the world faces a continuing risk of excess or shortage of global liquidity.

These debates led to the recognition of the need for a complementary asset created or managed by a global institution. Negotiations over this issue culminated in the creation of the Special Drawing Rights (SDR) instrument in 1969, designed to make up for the shortcomings of a system too dependent on fluctuations in the United States' balance of payments. The global community enshrined in Article 8 of the IMF's statutes the commitment of each of its members to make the SDRs "the principal reserve asset" in the international monetary system. However, the radical changes that affected the economic environment in the early 1970s—the devaluation of the dollar, the development of the Eurodollar market, the oil shock—effectively turned the SDR instrument into a stillborn asset, until the spectacular allocation of $250 billion in 2009 in response to the global financial crisis. Meanwhile, various attempts to revive the debate over the reform of the monetary system (namely a plan to create a substitution account, the Plaza and Louvre accords, the discussions of 1993-1994 around an 'equity allocation' to respond to the needs of countries in transition) have not gone forward.

More recently, following a suggestion of the Palais-Royal group (Boorman & Icard 2011), a new attempt at exploring the liquidity issue was undertaken by a group of experts at the Bank for International Settlements (BIS), chaired by Jean-Pierre Landau, Deputy Governor of the Bank of France. This group cast important new light on this issue, emphasizing that the nature of the problem has dramatically changed since the 1970s. During the early decades (1960–1980), the volume of global liquidity continued to be determined mainly by fluctuations in the United States' balance of payments. Increasingly, thereafter, private capital flows in international financial markets took over from the United States balance of payments, becoming the major driver of global liquidity creation, beyond the scope of any regulation. Thus, the world today is subject to two volatile sources of fluctuating liquidity:

- The United States' balance of payments, even though the Fed has stated its desire to have the international economic situation included, within its statutory constraints, in the determination of its monetary policy;
- Much more importantly, private capital movements, which together with very lax monetary policy in the United States, were at the root of the most recent crisis.

Hence the Landau-led group underscored the need to reopen discussions at the highest level, and for the global community to take necessary steps to gain better control over the volatility of global liquidity.

In the absence of such a mechanism, the world will continue to be vulnerable to the sudden drying up of liquidity or of disorderly acceleration in capital flows. This risk must be prevented. This makes indispensable an in-depth debate over the initiatives to be envisaged to address a major flaw in the current international monetary situation.

Consensus on this issue is, nevertheless, very slow to build. Why? Certainly, the G20 has been struggling to come up with answers; they have focused on an important array of banking and financial reforms, but they have stopped well short of addressing the fundamental problem of calibrating global liquidity to the needs of the global economy. This problem was clearly underlined already in 2010-11 by a group of veterans from past international monetary battles, in the framework of the informal meetings of the Palais-Royal Initiative.[5] They have been unanimous in warning that the crisis could repeat itself:

> "In the run up to the crisis, an unsustainable global expansion was facilitated by rapid growth

5. The members of this group convened by Michel Camdessus, Alexandre Lamfalussy, and Tommaso Padoa-Schioppa were former governors and ministers of finance of key financial centers and high level officials or experts from key central banks, ministries of finance, the IMF, and the BIS.

The IMF must be equipped with reforms consistent with the responsibilities the global community has already assigned to it over the years.

> in global credit. The result was a commodity price boom and what was subsequently recognized as a global asset price boom. Then the crisis struck…leaving central banks around the globe scrambling for hard currency financing. From peak to trough, gross capital inflows worldwide fell from nearly 20 percent of global GDP to less than 2 percent. Now they appear to be heading back to, or exceeding, their pre-crisis level, and the risk remains of a return to "business as usual." Such extreme fluctuations have critical effects on the functioning of the global economic and financial system and macro-financial stability at the country level" (Boorman and Icard 2011).

Five years after, a convincing solution to this problem has not yet been found. It is time to try again to take the reform agenda forward and to provide this global public good with a better system of monitoring and provision.

A sequenced reform agenda

The global community faces a heavy agenda to avert another global financial crisis. First, it must complete a series of reforms already on the table designed to equip the IMF with the ability to meet current needs. Then, it must actively prepare for negotiations to introduce a reliable mechanism for regulating liquidity. At a stage down the road, this could lead to the need to transform the IMF into a global monetary institution. This will imply a complex and prolonged negotiating process which needs to be carefully sequenced as the leaders of the system will have to face issues of immediate urgency while adapting it to the problems which will become more and more pressing during the next three decades. One could anticipate three critical steps that could finally deliver the global public good of a stable monetary and financial system:

- As a first step and without delay, a number of measures already identified by the IMF and/or the Palais-Royal Initiative should be discussed and hopefully adopted.
- Preferably simultaneously, or as a second step, a reliable mechanism for regulating global liquidity should be adopted and implemented.
- The third step—as part of a new Bretton Woods—should complete these reforms of the system by transforming the IMF into a full-fledged global monetary institution.

These are the issues to be examined in the rest of this paper.

Overdue IMF reforms

The first step is clear—the IMF must be equipped with reforms consistent with the responsibilities the global community has already assigned to it over the years. These reforms have been frequently elaborated on the basis of suggestions of IMF management and staff since the global financial crisis. The Palais-Royal Initiative provided a comprehensive set of recommendations in 2010–11. These were taken up by the G20 but, following the sovereign debt crisis in Europe, their implementation has lagged.

In summary, four major areas still require work:

- Tailoring the IMF's surveillance methods and instruments to today's problems;
- The volatility of exchange rates;
- Strengthening the IMF's legitimacy and governance; and
- Taking stock of the new dimensions of the global liquidity issue and building the SDR instrument to better deal with it.

In each of these areas, major problems remain unresolved. We will focus for now on the first three areas, and then address the last issue when searching for a mechanism to monitor global liquidity.

Tailoring the IMF's methods and instruments to today's problems

There are three major issues here:

- The equity and effectiveness of its surveillance;

The continuing problem is that IMF surveillance, in practice, has unequal effectiveness. It carries much more weight in countries that depend on the IMF for financing—until recently, generally emerging market or developing countries—than those that don't, such as the advanced countries.

- The necessary broadening of its scope to capital movements; and
- The introduction of a sovereign debt crisis resolution mechanism that would prevent repeats of several regrettable cases, including the Greek experience.

First, at least as much as crisis response, surveillance is the IMF's primary function. If effectively conducted, it should prevent crises from developing.[6] In the wake of the recent global crisis, and in response to requests from the G20, the IMF's surveillance instruments have been appropriately broadened.[7] However, the continuing problem is that IMF surveillance, in practice, has unequal effectiveness. It carries much more weight in countries that depend on the IMF for financing—until recently, generally emerging market or developing countries—than those that don't, such as the advanced countries. While these other countries cannot ignore IMF findings, they are only very inconsistently taken into account; this includes the IMF's findings in its flagship reports that are crucial to its global responsibilities, and part of the recent modifications in global surveillance implemented by the IMF. There have been many recommendations to address this issue, such as developing indicative guidelines of imbalances, as recommended by the G20, among others, but these have not been carried forward effectively enough. Hence, we have the conundrum that the countries with the most influence on the global environment, and on financial markets, generally evade the influence of the institution tasked with ensuring balance in the global economy. What is still needed is a paradigm shift in this area, which could be driven by the G20, which has recognized the problem.

Secondly, as has become so apparent, at least since the 1994–95 Mexican crisis, capital movements have become fundamental determinants of the stability of the global system. The global community has fully recognized this, certainly since the IMF-World Bank meetings in Hong Kong in 1997, and also the need for the IMF to be assigned monitoring responsibility over movements in capital account balances, same as it exerts over current account balances. This will need an amendment to the IMF's Article of Agreement, but consensus on this amendment has not been reached, the world remains dangerously vulnerable in this area.

Third, the same situation applies to sovereign debt, a problem of increasing importance as countries open their capital accounts in the framework of global international financial integration. Efforts to develop a statutory mechanism for sovereign debt resolution have not moved ahead, although progress has been made in including collective action clauses (CACs) in the issuance of sovereign bonds on the international capital markets. However, a reliable resolution mechanism remains to be established, particularly as other forms of sovereign borrowing have mushroomed.

Thus, much remains to be done. This is also the case as far as the volatility of exchange rates is concerned.

This volatility adds perniciously to the instability of the system. Tensions are more and more damaging in the context of financial globalization. This calls for increased discipline on the part of the countries, and it is time to make countries' obligations of exchange rate policies more specific. The suggestions of the Palais-Royal Initiative concerning the use of benchmarks based on macroeconomic fundamentals to identify and reduce instability and misalignment deserve careful consideration. This is particularly the case for the major countries, in light of their special responsibility to mitigate large swings of their currencies and their negative impact on global markets.

Strengthening the IMF's legitimacy and governance8

To anchor the IMF's role as a global monetary institution, especially in the present context, issues of its legitimacy and governance need to be effectively addressed. Among these, three in particular are worth highlighting.

6. As explained in Article IV of the IMF's Articles of Agreement signed by each IMF member.
7. Details are contained in IMF (2014c).

8. This point is further addressed in Chapter 5 of this book.

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First, there is the problem with its democratic governance in a changing global environment. Whereas the G8 and G20 have been constantly assigning new responsibilities to the IMF, they have only very gradually responded to repeated criticism from emerging market and developing countries, and civil society, with regard to its governance structure. Their responses have generally taken the form of periodic quota reviews, based on complex and questionable methods for adjusting country quotas, that have been agonizingly slow in changing the representation at the Executive Board, and in voting rights, in response to the changing realities in the global economy.

Although a partial correction of quotas was adopted in 2010 at the G20 Summit in Seoul, its ratification by the United States Congress faced repeated delays, and was finally only just completed, some five years later, at end-2015. Even with this correction taking place, the problem remains, as the global economy has changed further in this period. China's voting share, for example, has now doubled, but is still just 6 percent despite its economy weighing well in excess of 10 percent of global GDP. Even though most decisions are adopted by consensus, this situation does serious harm to the institution's legitimacy and image. There is a long way to go yet.

Second is the issue of reforming decision making at the IMF, and bringing it more in line with what was agreed in principle in the Jamaica Accords. In a world where monetary and financial transactions are of vital importance and the political dimension of economic questions is key, the time is ripe to entrust final decision-making power at the IMF to a body comprising ministers and central bank governors, rather than the present Executive Board of senior officials. This reform would have the merit of officially placing responsibility in the hands of the final decision makers and of better recognizing the role central bank governors should play in the institution.

The third issue concerns the legitimacy of the G20 itself, which has established itself as the ultimate global forum for management of the global economy. Although this grouping played a very useful role during the last crisis, its legitimacy is still sorely lacking. Taking into account the participation of the EU, some 40 countries are effectively represented in the G20. The UN, meanwhile, includes 205 member countries. For the G20 to be able to adopt recommendations or rules that are enforceable everywhere, the makeup of the G20 would need to be reformed along the lines, for example, of the Bretton Woods institutions and their regional constituencies. This would give all countries the opportunity to have a say in decisions that concern them.

A mechanism to regulate global liquidity

Two types of measures appear necessary to regulate global liquidity:

- The first ought to be self-evident. It would consist of the creation of a high-level group charged with overseeing global liquidity. A group of central bank governors should be invited to report periodically—every six months, for example—to the IMF's International Monetary and Financial Committee (IMFC). This committee, the former Interim Committee, should become the ministerial organ of the G20 and bear ultimate responsibility, inter alia, for calibrating global liquidity. In this context, it helps that central banks are becoming more independent, and Stanley Fischer usefully points to the benefits of this (Fischer 2015). But, ultimately, the system needs the ministerial authority that will be provided by the IMFC.
- The group of governors tasked with this oversight could usefully comprise the governors of the central banks whose currencies are included in the SDR currency basket, which now includes the RMB, and, eventually, presumably the Indian rupee. Through this recognition of its dimensions, the SDR instrument could be thoroughly overhauled and—this is the second measure—able to

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Excellent suggestions toward this end were recently formulated by the experts brought together by the Triffin Foundation (Triffin International Foundation 2014). In particular, they proposed specific measures that need to be taken for the new SDR instrument to be promptly issued if needed and, just as rapidly, mopped up, to stabilize the global liquidity situation. These measures include steps to give the SDR much more visibility in the operations of the IMF and other institutions in the official sector, thereby building its potential to become competitive with other internationally used currencies. Above all, the currently flawed definition of this instrument should be reviewed and full monetary status granted to it, as an effective condition for it to become the principal reserve asset in the international monetary system, as originally envisaged in the IMF's Articles of Agreement. In this context, two other changes of unequal importance should be considered:

1. Reform of the irrational present regime of allocations, which consists of providing supplementary SDRs to countries less in need of them than others;
2. Changing the 'anachronic' denomination of this instrument.

The adoption of these measures would constitute a major step forward in modernizing the current system. It would then be time to take the third step in the reform of the international monetary system. It is already clear that the global system is evolving in the direction of a new multi-polar monetary universe, differing markedly from that faced by the Bretton Woods conference. In all likelihood, this will require a new set of negotiations just as ambitious as those the "founding fathers" of the Bretton Woods institutions had the vision to undertake at the end of World War II.

Toward a new Bretton Woods?

Why?

In concluding their work amidst the last great crisis, the members of the Palais-Royal Initiative issued a clear warning:

> "The crisis heralded, indeed accelerated, a transition to a new world where emerging market economies play a role on a par with advanced ones in driving global growth; a world that will be fundamentally multi-polar and in which global monetary problems must be dealt with cooperatively. The international monetary system to which we aspire is one that preserves the gains of the past sixty-five years without succumbing to its own instability. It is a system that maintains freedom of trade and current payments and that allows sharing more widely the benefits of financial globalization, appropriately regulated. It is a system where all countries recognize their stake in global stability and accept that near-term national objectives may, if needed, be constrained by the global interest. International cooperation is, in the long run, a necessary ingredient in the search for national prosperity. This should lead every country to look with a renewed sense of responsibility and discipline to the system as a whole. The opportunity for the emergence of a fully-fledged international monetary order is here at stake" (Boorman & Icard 2011).

Regrettably this pressing call was received by ears deafened by the roaring of the European debt crisis. Several stakeholders also saw in it the risk of failure or of sparking further instability, while struggling to see the opportunities it presents.

It is, yet, a major opportunity, which we cannot afford to continue to ignore, whatever the difficulty of the task and the arduous negotiations it will require. Leading this change will be up to those nations or group of countries

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who recognize that, in an increasingly interconnected world, the need for stability of the international monetary system is becoming a global public good of the highest importance requiring much closer cooperation between the system's members. At a time, for instance, when a currency—the RMB, long considered a minor player—could begin to challenge the dollar's hegemony, it will be elementary wisdom for the leading countries to plan for the transition--substituting a genuinely cooperative global monetary management to disorderly and mutually damaging competition. This new framework could also offer a useful way to ensure adequate regulation of global liquidity.

Looking back, global liquidity has long been hostage to the vagaries, first, of fluctuating output from gold mines, then of the balance of payments of the dominant economy and, more recently, of international capital flows. It is time that its stability becomes the responsibility of an institution designated to do so by the entire global community. Setting up such an institution and equipping it with the necessary monetary tools is an ambition that will require a new Bretton Woods conference (Bretton Woods II), which will need to be planned with the utmost care. For now, the major monetary powers could show their intention to move in this direction by implementing a number of preliminary measures.

Even if constructed, as recommended by the Palais-Royal Initiative, on the basis of a revamped IMF, the necessary negotiations should be launched in time for the new institution to be up and running, if possible, during the 2020s. It is therefore important to settle urgently on an agenda for these negotiations and to adopt the preliminary measures likely to pave the way for its success.

From these considerations emerge the contours of an agenda for a Bretton Woods II. This could consist of the following:

1. Completing ongoing negotiations on the reform of the IMF;
2. Concluding parallel work on the governance and collaboration with other organizations in the global monetary and financial system (such as the World Bank, FSB, BIS, WTO); and
3. Developing the new role of global liquidity management and regulation entrusted to a new IMF.

Let us for now focus on the last point.

Toward a new IMF

The transformed Fund should be charged, in cooperation with the national or international central banks, with continuously monitoring global liquidity flows, and preparing the regulatory decisions that would need to be taken to manage it. Empowered by this mission and set up with a fully-fledged monetary asset, the governing body of the Fund would decide, if necessary, to add or withdraw liquidity depending on the state of the markets. This would not be far removed from the mechanism outlined by Keynes at the start of the 1930s, when he wrote:

> "The ideal system would surely be in the foundation of a supranational bank that would have similar relations with the national central banks to those that exist between each central bank and its subordinate banks" (Keynes 1930).

A century later, what may have appeared visionary, even utopian, in the 1930s could soon appear simply logical in light of the problems inherent in an increasingly integrated world. Nevertheless, the political reality is that—barring a fresh major crisis—the global community could be reluctant to commit to such a groundbreaking project. Hence, comprehensive analysis and discussion of the issue should be launched, preferably under the aegis of the IMF and the world's main central banks in association with academia and international research centers. The challenge, at that stage, would be to make international public opinion more aware of the ongoing risks of instability inherent in the current system, leading possibly to a new, large-scale crisis, and then of the need for a new global mechanism properly equipped to prevent it or to face it in credible fashion.

In the present turbulent context, for several years now, China has shown keen interest in these questions, and

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the Governor of the People's Bank of China has formulated bold proposals to this end.[9] Europe, on its side, could reiterate its long standing interest for international monetary system reform and also demonstrate its desire to contribute to strengthening the efficiency of the IMF's governance structure, for instance, by expressing its readiness to accept a further reduction in its representation in the Bretton Woods institutions through the merger of two of its constituencies, perhaps followed, sooner or later, by establishing a single Euro group constituency. Such a move would have the merit of making clear the need for a far-reaching reform, as well as Europe's desire to play a full part in it.

In the current climate, it would be highly desirable for major stakeholders to take this initiative as soon as possible, so that such work could lead to concrete proposals and to the convening of a conference mandated to propose the needed changes to the Articles of Agreement of the IMF. One option is for China and/or for a number of major emerging countries, which are increasingly aware of the risks of the current system for Europe and other countries or group of countries, to launch a joint initiative to this end.

Conclusion

The world toward which we are heading in the next 30 years will be dominated not by one large hegemonic power but by several monetary poles along continental lines. In order for international monetary relations to evolve as harmoniously as possible in such a context, it is vital that the central structures be seen as legitimate and equipped with the necessary legal and financial instruments. This could be best done through a global monetary institution, centered in a transformed IMF, with a stronger mandate for surveillance, stabilization of exchange rates and global liquidity, effective mechanisms for reducing the risk of disorderly spillovers, and for dealing with debt restructuring. But the ambition behind this reform does not stop there. It should also contribute to creating better conditions so that the global community can achieve, despite all the obstacles it faces, especially those from conflicts, inequality, and climate change, truly sustainable development.

9. People's Bank of China Governor Zhou Xiochuan has written frequently about reforming the international monetary system, for example, see Xiochuan (2009).