The International Monetary System: Too Big to Fail

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I am extremely honored to be asked to speak on such an important topic and before such a distinguished audience, and I wish to thank Tom Hoenig for giving me this opportunity. I am also very proud to be on this panel. Some years back, and throughout my dissertation work, which was under the able guidance of Frederic Mishkin, Maurice Obstfeld went beyond the call of duty to respond to my many inquiries. I wish, once again, to express to Professor Obstfeld my feelings of gratitude. John Lipsky has been giving me valuable advice on matters of monetary policy and bank supervision in my country, and I wish to thank him and his team at the International Monetary Fund (IMF).

There is no shortage of justifications to the call for the reform of the international monetary system (IMS). The justifications referred to can be sorted out under two categories: the macro policies of member countries and the imperfections of the Bretton Woods system. Macro policies of member countries include such policies as running massive deficits or intervening in foreign exchange markets. On the other hand, commentators agree that the Bretton Woods system did not function as originally planned. After 1973, the IMS seemed to have reverted to a more market-oriented, hybrid and voluntary system as opposed to a system characterized by IMF surveillance and supported by IMF facilities. In my remarks today, I will attempt to

relate the above mentioned issues to three sets of interrelated but at times conflicting considerations: 1. national vs. international considerations; 2. political vs. economic considerations; 3. public policy vs. market considerations.

Given that seven countries are currently dollarized or have currency boards using the dollar, and 89 countries have pegged exchange rates using the dollar as an anchor[1], it is clear that the macro policies of the main reserve currency country have a huge impact not only on the countries just mentioned but also on the rest of the developed world. It is equally important to appreciate the perception of vulnerability by the countries whose currencies are pegged to a major reserve currency and the consequent need to accumulate reserves as self insurance.[2]

The global current account imbalances and the resulting volatility of capital inflows did have several serious consequences, some of which were blamed for the recent global economic and financial crisis.[3] Considerable volatility in capital flows and the associated "*liquidity shocks*" can create a strong need to accumulate reserves. Commentators generally agree that, in the case of oil exporters and China, reserve holdings exceed conceivable precautionary needs and reflect more the state of the still-developing financial markets in those countries as well as the desire to boost policy credibility.[4]

The move to a flexible exchange rate regime by advanced economies was expected to help clear global imbalances. That expectation has not been fully met for several reasons. First, public policy choices for some countries continue to put off important structural adjustments. Furthermore, a number of emerging economies did not allow their currencies to float freely and continued to defend their peg at an undervalued exchange rate. Those modes of behavior beg the issue of how to deal with protectionist sentiments.

We have a light-hearted question in our region that asks: Why did God choose to send the prophets of all three religions to the Middle East? And the answer is: It was impossible to get them a Schengen visa. Divine wisdom aside, protectionism, in its broadest sense, continues to be a major challenge to global coordination. Anecdotal evidence suggests that, last year alone, 450 "*low intensity*" protectionist

measures were taken by the G20 members.[5] With fiscal consolidation in many countries and an almost jobless growth, countries may continue to resort to increasing exports to create jobs. Consequently, the risk of competitive devaluations, through intervention or otherwise, may be growing. The plausible assumption for the persistence of protectionist sentiments is that countries who take protectionist measures do so to protect their "*national interest.*" Similarly, one may also assume that the competitive devaluations of the 1930s were intended to protect the national interests of the countries concerned. The outcome of the events of the 1930s and their aftermath clearly do not support the fine objective of this line of reasoning; neither do the present imbalances and the present market volatility. And it is not only public policy that tends to overvalue national interest and undervalue international interests but also the market mechanism seems to produce a similar outcome. An interesting argument in support of this view was presented in the Per Jacobsson lecture last June in Basel[6], and I quote "*…there is a nationalist bias in the pro-market revolution…* ." Given the dominance of globalization and the interdependence of financial markets, it may seem paradoxical that there is still that much difficulty in reconciling national and international interests.

To sum up on this point: I think the Bretton Woods institutions and, indeed, the United Nations system were designed to reconcile national interest with global interests and to ensure the mutual consistency of national policies.[7] The fixed, but adjustable, peg and later on the floating, or managed, exchange rate regimes were supposed to take care of imbalances in the current account. The prevailing hybrid system of exchange rates could not clear the current account, and imbalances continue to persist. The good news is that IMF surveillance proved to be invaluable in the case of deficit-developing countries. Since the late 1980s, we have introduced several key structural reforms in Jordan based on IMF surveillance and IMF consultations. More recently, the Financial Sector Assesment Program (FSAP) reviews helped us introduce several key reforms in the financial sector. Other developing countries may have gone through the same exercise. In this regard, the IMF can play an important role in the ongoing regulatory and financial reform efforts on both sides of the Atlantic. Furthermore, the call for more legitimacy in representation

or quotas may enhance the multilateral role of the IMF and meet the concerns regarding IMF governance. More importantly, I suggest that enabling the IMF to provide international liquidity when needed with schemes that establish a "*Global Financial Safety Net*" and expanding its mandate in the light of the recent global crisis to include macro-financial surveillance and spillover analysis should be seriously considered. In general, I would suggest that strengthening the IMF with some *enforcement mechanism*, such as Keynes' original idea of a global clearing bank, would restore to the international monetary system some needed ownership and credibility. I believe it was the late Charles Kindleberger[8] who said that the international financial system will not work unless somebody takes responsibility for it. Finally on this point, it is also essential for the IMF to enhance its collaboration with the Financial Stability Board (FSB) as well as the Bank for International Settlements (BIS).

A major criticism against the Bretton Woods agreement of 1944 is that it separated economics and politics in "*water tight*" compartments, according to Richard Gardner in his very interesting book *Sterling Dollar Diplomacy*.[9] In this regard, *political* policy choices can continue to put off adjustment in surplus countries. How any reformed international monetary system can bring about the needed consistency between *economic* and *political* considerations will be a major challenge for the global community in the coming years.

The global crisis and the fact that it started in the United States may have led some to believe that the current IMS model of using the dollar as the global key currency has been undermined. Moreover, recent sovereign debt problems in Europe raised doubts about the euro and whether a single currency, with limited political integration, and little fiscal coordination among member countries, could be sustainable. In this regard, I suggest that most of the concerns are not totally justified. The dollar is backed by trust in the U.S. political and economic system, the liquidity and depth of the U.S. financial markets, and the outstanding infrastructure for payments' settlement. Moreover, and although the euro has been around for only 10 years, it is today associated with price stability. In this regard, I think major credit should go to the European Central Bank (ECB) and to

President Trichet also for his consistent stand on the independence and integrity of the ECB. By definition, only currencies that can be freely convertible for trade or investment purposes have the potential to achieve the status of an international currency. Furthermore, the international use of currencies is a market-driven process that is determined by independent decisions of private agents and public policy. The criteria for central banks' decisions on their foreign currency portfolios often differs from the considerations of private savings, which may be more related to standard *portfolio choice* criteria.

When the present international monetary system in its original form was agreed upon in 1944, it was expected that the dollar would be the main reserve currency. More than 60 years on, the dollar is still the main reserve currency. Any shift by central banks from holding dollar reserve assets risks large accounting losses. Structural reforms, in particular, in the area of medical care and entitlements, as well as addressing what is often described as a *savings glut* or *investment drought*, are essential to restore balance to the global economy. Major reserve currency governments are responding to the calls for fiscal balance, higher savings and more-balanced investment spending at home. Other countries could also introduce more flexibility to the exchange rate of their currencies and allow relative prices to change. Fiscal policy in some emerging markets can also stimulate domestic demand away from exports and toward more consumption at home. This is all well known, but I think it bears repetition.

Before I conclude, I would like to present a quotation from a book about the history of the BIS in Basel[10], when during one cold, snowy December night in North Carolina, the author woke up during a power failure, which, in his words, took him back to the 19th century, and he realized that we take for granted so many things in life, and I quote: "*…the payments system is yet another example of a highly complex network technology. We take it for granted that our checks clear, ATMs instantly provide cash anywhere in the world, imports are paid for in the required currency, and the desired amount of liquidity is available to us any time at the lowest cost. In fact, we should marvel at the ordinarily smooth working of the international payments system rather than be surprised at its occasional malfunction… .*"

Clearly, the global crisis of the past two years is hardly an occasional malfunction. However, I would like to suggest that the Bretton Woods agreement and subsequent reforms did serve the global economy well since World War II. Furthermore, markets do work, and even when they become dysfunctional, as we saw during the past 18 months or so, markets were sending a clear message for corrective action. Of course, the *coordinated,* non-conventional measures taken by major central banks, in particular the Federal Reserve, the Bank of England and the ECB, as well as action taken by governments, did save the global economy from a meltdown. The managing director of the IMF suggested last spring that one-third of the effectiveness of stimulus measures was due to global *coordination.* Those same measures taken individually may not have produced the same result. A quick review of all statements by ministers at the IMF meetings last spring would reveal that the terms *"multilateralism,"* "*coordination*" and "*surveillance*" were the most frequently used terms. At least one minister called for "*compulsory multilateral coordinated surveillance.*" The minister's remarks were reflected in the "*G-20 Framework for Strong, Sustainable and Balanced Growth,*" which emphasized the mutual assessment of members' monetary, exchange rate, fiscal and financial policies with the assistance of the IMF and other international financial institutions.

I started my remarks by referring to several inconsistencies that need to be reconciled by the global community, and I would like to end my remarks by going back to basics. Central banks should continue to adhere to their medium-term objective of price stability, and governments should adhere to fiscal consolidation or the unwinding of fiscal deficits. Furthermore, an international agreement on a framework for financial sector reform should be arrived at. Maintaining central bank credibility as well as fiscal and regulatory credibility is essential to restore confidence to the IMS. However, it is still not clear how any reform mechanism can impose adjustment on surplus countries. Furthermore, it is not clear either, under any reformed system, how an international body can impose fiscal discipline on member countries. I would therefore fully subscribe to the view that "*achieving a better balance will require lasting shifts in spending, production, saving and borrowing around the world.*"[11] It would be ideal if

the *political-economic* mix in public policy, especially in major economies, would be consistent in allowing the *market* to produce those shifts and for the countries concerned to conceive those shifts as being in their national interest. After all, if anything is too big to fail, it should be the IMS.

Endnotes

[1]Reinhart and Rogoff, 2004.

[2]Aizenman and Sun, 2009.

[3]Kohn, 2010.

[4]Obstfeld, Shambaugh and Taylor, 2009.

[5]Saccomanni, 2010.

[6]Tommaso, 2010.

[7]Carney, 2009.

[8]Landau, 2010.

[9]Gardner, 1980.

[10]Toniolo, 2005.

[11]Kohn, 2010.

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