Reconsidering the International Monetary System

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I am honored to have this opportunity to discuss prospects for strengthening the international monetary system. The topic is both timely and important. In many ways, the generally recognized sources of the recent global financial crisis involve factors that inevitably can be viewed—at least in part—as reflecting weaknesses in the existing international system. Moreover, many of the efforts under way to prevent future crises—especially those being pursued with the sponsorship and support of the G20 Leaders Summit process—are intended to enhance the resiliency and effectiveness of the international monetary system. In this context, it is sobering to recognize that the last comprehensive, broad-based discussions of international monetary reform were held nearly four decades ago.

Defining the International Monetary System

Before I go any further, it is reasonable to ask just what is being referred to as the "international monetary system." By this, I mean the policies and official arrangements related to the balance of payments. These include exchange rates, international reserves, current payments, and capital flows. A key purpose of the system—as described in the International Monetary Fund's (IMFs) Articles of Agreement—is: *To facilitate the expansion and balanced growth of international trade,*

and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all [IMF] members as primary objectives of economic policy.

It continues:

To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.

In addition, the system is intended to facilitate the orderly adjustment to shocks.

Successes Under the Current System

As is well known to this audience, the current system can be characterized as reflecting de facto dollar dominance, while allowing discretion for countries to choose their exchange rate regimes and international reserves policies, and encompassing broad but uneven capital mobility. That the current system can be subject to justifiable criticism is straightforward. Nonetheless, following the system's rocky reset in the 1970s following the collapse of the original dollar exchange standard, the current system has been successful in many ways.

In particular, the system has allowed countries to pursue their domestic policy objectives while underpinning an extended period of strong growth in global output and trade. At the same time, it has accommodated in the past two decades an historic emergence of a truly global system. As we know very well, that evolution has been accompanied—among other things—both by dramatic shifts in countries' relative economic weights—reflecting the rapid growth in many emerging market economies—and by significant systemic strains.

These strains were reflected in unprecedented payments imbalances and previously unimaginable buildups in international reserves. Of course, cross-border capital flows also reached amounts that had no equal in earlier times, often taking place in innovative formats. Many officials, international market participants and analysts have concluded that systemic strains contributed to the onset of the recent crisis. Although there are good reasons for holding such views, it also is worth noting that many prominently predicted problems—including warnings of systemically destabilizing swings in major exchange

rates—have not materialized. In broad terms, movements during the past few years among major market-determined currency cross-rates by and large have been supportive of reducing imbalances.

The crisis also has highlighted the adaptability of the global economic system itself. The rapid development of the G20 Leaders Summit process as a forum for economic and financial policy making, the rapid mobilization of increased resources for the international financial institutions (IFIs), the approval of new crisis-prevention facilities at the IMF, and the metamorphosis of the Financial Stability Forum into the Financial Stability Board—with an expanded membership—have facilitated the crisis response.

Systemic Problems

Of course, the onset in 2008/2009 of the most serious global economic and financial crisis since the Great Depression represents a *prima facie* indication of important systemic flaws, and a broad consensus exists that the system likely will face new challenges in the post-crisis environment.

I will highlight today three interrelated problems: (i) the system lacks an automatic and orderly mechanism for resolving the *buildup of real economic and financial imbalances* that are indicative of systemic fragilities; (ii) *the rapid and unabated accumulation of international reserves* has reflected the buildup of imbalances, but also the desire of individual country authorities to self-insure against potential international market disruptions; and (iii) *the large capital flows* that finance the imbalances, and that have the potential to put financial markets under significant pressure.

Successfully addressing these challenges will be crucial to achieving the global public good of economic and financial stability—by ensuring the orderly rebalancing of demand growth between deficit and surplus economies that will be essential for establishing a sustained and strong global recovery, while reducing systemic risk.

A Five-Pronged Approach to Systemic Reform

Although current multilateral reform efforts generally are not perceived in this way, in fact the IMF and its members—working with

the high-level political support provided by the G20 Leaders Summit process—are addressing the system's weakness in a reasonably comprehensive and collaborative fashion. These efforts primarily comprise:

i. Creating a new mechanism for enhancing the coherence of macroeconomic policy among the principal economies, while promoting medium-term structural reforms. This effort encompasses policy formulation and planning, but also strengthening the effective surveillance of policy implementation.

ii. Strengthening the global financial system.

iii. Making the *global financial safety net* more effective as a tool of crisis prevention.

iv. Improving the IMF's governance, such that it will be and be perceived to be legitimate and representative.

v. Looking forward toward improving the supply system for *international reserve assets.*

I will address briefly each of these themes.

Macroeconomic Policy Coherence and Effective Surveillance

Crisis lessons. One central lesson of the crisis has been that in the absence of any "automatic" mechanism, there is a need to enhance the coherence and consistency of macroeconomic policies among major economies. That is the goal of the Mutual Assessment Process (MAP) taking place in the context of the G20 Framework for Strong, Sustainable and Balanced Growth. The IMF, together with other international institutions, is providing technical support for this process, and the progress achieved to date is described in the MAP document prepared for the Toronto Leaders Summit in June, and that is accessible on the *imf.org* website. In Toronto, the G20 leaders committed to announce a Comprehensive Action Plan under the MAP at the time of the Seoul G20 Leaders Summit in November. Work is under way to meet that goal.

But plans alone cannot improve systemic stability and growth. Another central lesson of the crisis has been that the IMF's

economic and policy surveillance needs to be more rigorous, including enhanced coverage of financial sector issues and a better recognition of systemic risks and spillovers. Shocks can be transmitted rapidly by interconnected financial institutions pursuing complex asset and liability management strategies across markets and settling on a real-time gross basis. These interconnections can cause systemic risk to rise, and even relatively small events can have systemic ramifications.

Objectives. In principle, surveillance of the international monetary system—a responsibility assigned uniquely to the IMF—should provide concrete and analytically sound advice on achieving balanced and sustained growth in a context of global economic and financial stability, and it should facilitate effective multilateral collaboration. Moreover, it should incorporate monitoring and assessment of economic and financial interconnections, while providing insights regarding international policy spillovers.

The IMF is working actively to enhance both bilateral and multilateral surveillance. Our bilateral surveillance has been strengthened through increased attention to financial issues, including a deeper integration of financial stability assessments into regular country surveillance. Our joint work with the Financial Stability Board on a biannual Early Warning Exercise has sought to highlight key vulnerabilities for senior policymakers by examining potential risk scenarios for the global economy and by suggesting possible policy responses. We also are planning to develop several new multilateral tools on an experimental basis, including "spillover reports" analyzing the international impact of policies of systemically important countries, and cross-country reports on common themes.

Financial Sector Reform

Given the emergence in the past two decades of a historically unprecedented global capital market—and the systemic instability it exhibited in such a shocking fashion beginning in 2007—improving the international monetary system will require a more resilient financial system. This reform agenda is under way, but too often it is viewed as an issue of regulatory reform, and even more narrowly as a project of the Basel Committee on Banking Supervision.

In fact, the financial reform agenda rests on four pillars, of which regulatory reform is only one, albeit an important one. Of course, one of the key tasks under this pillar is a redrawing of the regulatory perimeter, such that all systemically important financial institutions will be regulated adequately.

The other three pillars encompass strengthening financial supervision, developing an adequate resolution mechanism and enhancing the independent assessment of financial sectors as a whole via the joint IMF/World Bank Financial Sector Assessment Program (FSAP).

With regard to supervision, IMF analysis indicates that weakness in supervision was as responsible for the recent crisis as were regulatory flaws (not forgetting that more than anything, the principal failings were those of financial institutions and market participants). At the same time, work on national resolution mechanisms remains incomplete, while work on a coherent resolution mechanism for systemically important financial institutions operating in multiple jurisdictions is just getting under way. As for the role of FSAPs, their frequency and usefulness are being increased. Clearly, much work remains on all four pillars.

Global financial safety net overview. The existence of instruments that permit policymakers to effectively counteract large economic and financial shocks and to restrict their propagation across countries—while limiting the risks of moral hazard or other distortions—are critical today to a well-functioning international monetary system. I would argue that until the onset of this crisis, insurance-like facilities simply did not exist that potentially could fulfill a crisis-prevention function in a world in which cross-border capital flows are increasingly important and increasingly take place via transactions involving marketable securities. Though the need for such facilities has been perceived clearly for some time, their design and implementation remains a work in progress.

Crisis prevention and crisis response. As I hope is well known to this audience, the creation last year of the IMF's new Flexible Credit Line (FCL) represented an important milestone in enhancing the system's crisis-prevention capabilities. By creating a pre-qualified,

precautionary credit facility, the IMF can provide contingent funding to members with strong policies but that face possible vulnerabilities from external market volatility. The goal is to avoid the emergence of perceived risk asymmetries deriving from external developments that could create systemically destabilizing capital flight from countries or economies that in fact are following sound policies. The IMF's membership made the application of such contingent facilities credible by agreeing to provide substantial amounts of contingent funding through the expanded New Arrangement to Borrow (NAB). While these changes allowed the IMF to be more effective than previously in limiting the damage from the global crisis, we are in the process of improving our crisis-prevention toolkit.

In particular, we are working to expand the IMF's set of insurance-like instruments in order to respond to the heterogeneity of countries' policies and circumstances. In addition to the FCL, which is available only to countries with strong policies, the IMF's Executive Board is discussing the creation of a Precautionary Credit Line (PCL) that could be made available to countries with sound policies that nonetheless do not qualify for the FCL. The PCL would carry strong qualification criteria, but also streamlined ex post policy conditionality.

There also may be good justification for the creation of a short-term precautionary IMF facility. The Federal Reserve's offer in late 2008 of swap lines to four emerging market countries helped to boost market confidence. But it may not be ideal to rely on such ad hoc offers in any future crisis, as systemic stability might be better served by a standing liquidity facility with well-understood conditionality and access rules.

Systemic crisis resolution. An enhanced framework to deal with systemic events also could contribute to a stronger global financial safety net. In this regard, a systemic crisis-prevention mechanism may be worth exploring. Activated during systemic events to mitigate contagion, this instrument could proactively channel support simultaneously to a group of IMF members—rather than one at a time—either through the existing FCL, the proposed FCL, or possibly through an eventual short-term facility.

International Reserves

Reserves and stable stores of value. The ongoing, rapid growth in international reserves to some extent reflects the failure of the international monetary system both to resolve imbalances in an orderly and credible fashion and to provide an adequate global financial safety net. With concerns rising about sovereign balance sheets, however, there may be limits regarding how far existing reserve assets will continue to meet the needs of reserve accumulators. Of course, there is nothing stopping countries from broadening their holdings of reserves assets. An inevitable question in this context is whether there is a prospective enhanced long-term role for the IMF's Special Drawing Right (SDR) as an international reserve asset.

Of course, there is no doubt regarding the dollar's dominant role for years to come. Moreover, as a basket currency (like the old European currency unit or ECU), and not a true fiat currency (like the euro), private demand for SDR holdings will be limited. But an evolutionary process toward increased SDR use could be feasible and worthwhile. More frequent SDR allocations would expand the pool of SDRs available for external financing. During systemic events, new SDR allocations could be considered. SDR allocations that are targeted to a subset of countries also could be considered, which would have as an advantage addressing potential moral hazard concerns but which would require an amendment of the IMF's Articles of Agreement. Over time, governments that borrow in multiple currencies also might consider issuing SDR-denominated bonds.

Global Governance Reform

Representation and involvement. In a highly interconnected world, multilateral decision-making must be representative if it is to be viewed as legitimate. The emergence of the G20 made global policy-making more inclusive then previously, but the contrast to the near-universal membership of the IMF remains striking. The IMF's 2008 reform put in place a rebalancing of representation through periodic quota reviews, while protecting the voice of the poorest. And as global economic weight continues to evolve, the IMF's membership has committed itself to agreeing this year to a new shift in voting

shares of at least 5 percent to dynamic emerging market and developing countries by shifting shares from currently over-represented to under-represented countries. At the same time that new voting shares are agreed, the overall size of the IMF's quota pool will be determined. The latter will determine the IMF's relative reliance on quota or borrowed resources if needed to fund lending.

Beyond voting shares and representation at the IMF's Executive Board, a long-standing issue for the effectiveness of multilateral decision-making is the need to focus senior political authorities—presumably at the ministerial level—on the process of effective policy collaboration, particularly in non-crisis times. It is during these times that coherent action, such as on international monetary and financial reform, can boost growth performance while forestalling sowing the seeds of subsequent crises. Several recommendations have been advanced to raise high-level political involvement in the IMF. But the similarities between the ministerial participation in the IMF's existing IMF Committee and the G20 Finance Ministers is striking, and will continue to inspire thoughts about enhancing the coherence of the governance of financial and economic policies.