

# General Discussion: Reconsidering the International Monetary System

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*Chair: Arminio Fraga*

**Ms. Reaser:** If these global imbalances, including the so-called savings glut, indeed are unsustainable, what do you think is the more likely solution? Will it be a political solution, or is it more likely to be a market solution, involving exchange rates and interest rates? And what are the implications?

**Mr. O'Brien:** There was an interesting omission from the panel. The words “capital controls” were never mentioned. And, yet, we’ve seen capital controls come back in a number of countries over the last couple of years. The rise of the G-20 versus the G-7 in global policy coordination is elevating countries that employ capital controls in the global economic and financial system.

So two questions: First, is there a role for capital controls in the global financial system? And, second, if there is, how could that be limited or controlled in order to protect the interests of global investors?

**Mr. Ingves:** On the issue of lender of last resort in different currencies, let me give you an example of what the world looks like as of today. I really agree with the reflection it’s not the textbook case anymore.

In our case, after the Lehman incident, we ended up doing swaps with the Federal Reserve and then on lending these dollars to

Swedish banks when the dollar market dried up. At the same time, we were involved in euro swaps, we used our own reserves with Latvia and Iceland—and then on top of that we also did Swedish kronor transactions with liquidity-strapped Swedish banks. That is saying this ended up being a completely new game very far from the textbook case.

What it points toward is basically that we need much more international cooperation than in the past when it comes to dealing with these types of issues. If that cooperation won't come forward, the other alternative is financial-sector, cross-border retrenchment. It becomes too dangerous to allow your banking sector to grow beyond your own jurisdiction or to finance itself outside your own market.

Along these lines, this points in the direction of what John Lipsky was talking about in terms of the need for new types of financial arrangements, creating more certainty when it comes to doing these types of transactions than what we have had so far.

**Mr. Heng:** John spoke about the financial safety nets and Maurice Obstfeld warned about national and regional arrangements. I would agree with a lot of what Mr. Obstfeld mentioned about those risks.

But I would also add there are advantages to having national and regional arrangements. And, more importantly, it is here to stay and perhaps the policy challenge for us is to think about a framework of preventing and dealing with crises that can link national, regional, and global arrangements. That framework should probably have two elements. One is the *ex ante* element of how to do the surveillance properly to prevent crises, and the second is the *ex post* element of how to activate the use of reserves in a crisis.

**Mr. Kim:** I would like to add a couple of points to the remarks John and Maurice made regarding the global financial safety net. It seems to me they are discussing these issues as a way to solve the current problem or the past. But I would argue it is needed for future policy in that we have to think in what direction we want emerging markets to move. In the case of Korea, I daresay Korea is one of the leading countries among the emerging economies in making efforts to liberalize its policies and open its market.

Let me very briefly give you a couple of figures. During the second half of this year, day-to-day exchange rate volatility turned out to be 0.92 percent in Korea. You may wonder whether this is high or low. For the U.K. pound, for example, for the same period it was 0.56 percent. For the Japanese yen, for the same period, it was 0.51 percent. So, we need a certain kind of instrument or tool that can prevent a currency on this scale. We didn't talk about the level and magnitude of a country's foreign reserves or the level of the exchange rate. But we want a way of avoiding a certain currency fluctuating too much.

Furthermore, as Professor Obstfeld explained, what happened to Korea right after the crisis was that Korea's foreign reserves—which ranked No. 6 in the world—shrank from a level of \$260 billion to \$200 billion within just a few months, but thanks to the currency swap lines agreed with the United States and also with China and Japan, the Korean financial market stabilized.

The lesson here goes something like this. Even though the scale of the currency swap lines we set up with the United States and with Japan and China eventually reached some \$80 billion, that was not large compared with the size of the foreign reserves. Foreign reserves were not that useful in stabilizing the financial market, but these currency swaps did the trick. Thus, the reason we have proposed establishing a global financial safety net is not to correct for wrongs or current problems, but the future direction in which the countries and currencies should be headed.

Let me add one more comment to what John Lipsky said about the facilities the IMF is considering as a means to a global financial safety net. Without explaining further due to the time constraints, I'd just like to mention that we want a stigma-free facility. FCL (Flexible Credit Line) and PCL (Precautionary Credit Line) are both useful tools, but what we want is one that is stigma-free.

**Mr. Frenkel:** The title of this session is "Reconsidering the International Monetary System." The answers are very different. I want to remind the old-timers here that about 25 years ago, we had the same session. The appetite for reconsideration of the system is highly correlated with periods in which there are great changes of exchange rates,

great volatility of exchange rates, and temptation that if something moves it should be stopped because somehow life is complicated. Indeed, in 1985 this was the mood. The resolution was a focus on the exchange rate, the Plaza Agreement, and shortly thereafter, everyone understood exchange rates are a manifestation of more basic stuff. It led to the 1980s and the early 1990s' focus on "policy coordination." Again, one realized policies are carried out at home, and it is going to be very difficult for one nation to tell another nation what needs to be done, especially for fiscal policy. And it failed. For a long period, there was the blanket approach that somehow coordination will solve the issue and the reality showed countries do whatever they believe and normally what is right for them.

With that, the gorilla that we spoke about earlier became untamed. Each nation has its own gorilla. Where is policy coordination appropriate? It is appropriate for areas in which the system is depending on the various policies—the level playing field issues. If we talk about financial regulation, that is where it is important they are harmonized, otherwise there is going to be regulatory arbitrage. When we talk about the trading system, that's when it is important it is coordinated and harmonized because that is the essence of it. When it comes to fiscal policy, we still have a problem. We still do not have the political penalties on the sinners.

This brings me to the question of the focus on regulation that John Lipsky mentioned. Yes, we are focusing a lot on regulation today, and I agree with you that supervision and the quality of supervision have to be focused on. Importantly, within it, where does the supervision rest? It had better be located in the place where the information is needed for timely reaction, and that is why I'm very strongly going to recommend it be located within the central bank. Otherwise, even if you have good supervision, if the information is not in the hands of those who need to act, it won't work.

Finally, the unintended consequences. As we deal now with the necessary and very important regulatory reform, it's very easy to say, "Yes, it's important it is being done." Only real economists can analyze properly the unintended consequences of those incidents where you press a button here and the reaction is elsewhere. How do we

know and how can we make sure that risk is not being shifted to the unregulated sector? That what needs to be done globally is indeed implemented? Here, speed is not the right approach.

**Mr. De Gregario:** In the first two presentations, there was a lot of criticism to accumulation of reserves because self-insurance is very expensive and there are much cheaper alternatives to insure countries against sudden stops or problems in financial markets.

The striking fact is in Chart 5 of Maurice Obstfeld's paper. The accumulation of reserves has been massive. That is one thing we need to explain. It is not simply that policymakers do not know about more-efficient insurance. What is missing in the first two presentations is that accumulation of reserves is also a way of intervening in the foreign exchange market. Self-insurance and the decision to intervene in the forex market are what explain this massive accumulation. We cannot separate both. And we cannot separate the cost of self-insurance without taking into account the fact that reserve accumulation has a lot to do with exchange rates.

In emerging markets (I won't go into the discussion), reserve accumulation has been stabilizing intervention. Also, policymakers prefer a somewhat weak currency than a strong currency, in order to promote export-oriented growth. But also, intervention is done to fight bubbles in the exchange rate. Bubbles in emerging markets are rapid, they are strong appreciations and many times beyond fundamentals.

This can explain why there is so much accumulation of reserves. It is not just self-insurance. Even in the peak of the worst crisis in many decades, reserve de-accumulation was very moderate. That is because we have to understand reserves in the context of exchange rates, especially when now there is also a concern of massive capital inflows into emerging markets and the discussion of which are the appropriate policy tools: exchange rate intervention or even capital controls to deal with massive capital inflows.

I agree there is a serious problem, and it is the global problem with exchange rates adjustments. But, the bottom line is that we cannot explain the accumulation of reserve as just self-insurance without taking into account exchange rate management.

**Mr. Johnson:** Two comments. One, John Lipsky emphasized the imperative of international financial regulatory development. When we look at the problem of “too big to fail,” I don’t think as a creditor, as an investor in the liabilities of large financial institutions, I can believe you will credibly shut them down unless cross-border bankruptcy regimes’ information systems monitoring the exposures mature a great deal because I wouldn’t expect the authorities to unleash unintended consequences. The result of that, of course, flows back to the budgets of the countries in question because if you can’t penalize creditors, you are going to rely on the taxpayers more in this anxious fiscal period we talked about during the last session.

My second thought pertains primarily to Maury Obstfeld’s comments, which is that when we are in a period where what you called the “appetite for self-insurance” is very large, the reserve currency countries then experience a pressure that leads to appreciation of the currency and a downward pressure on interest rates. Now in this particular reserve currency country, the question of being near the zero lower bound and how to alleviate the deflationary pressure comes to the fore. I know Alan Blinder spoke yesterday about many of the elements on the menu—suppressing term premia and risk premia—but if quantitative easing were invoked again it may now flow into the changes in the exchange rate as well.

I guess there is one other dimension of self-insurance reserve building. If you don’t rely on quantitative easing in exchange rate to stimulate the economy at the zero lower bound, it throws you back into the realm of reliance on fiscal policy. With concern about medium- and long-term fiscal dynamics and stability, any attempt to alleviate deflationary impulses resulting in fiscal expansion may actually make people anxious about fiscal health in the longer term and feed the demand for self-insurance.

I’d like to ask all the panelists: This appetite Maury spoke of and Ben Bernanke had written about as a savings glut earlier—what can be done to the international monetary system to alleviate those appetites and help the adjustment process?

**Mr. Soskic:** I have a question for all the panelists. Yesterday and today we have mentioned Hyman Minsky and his definition of speculative booms and the building up of highly leveraged speculators as the one to blame for the crisis. We have also mentioned deleveraging as a very important thing to prevent these events, like controlling the loan-to-value ratio. One could also argue you could control margins and futures and options trading. You could also impose capital buffers for instruments securing credit risk. It may be the type of securitization that is off-balance-sheet is also not really helping the reserve requirements serve the purpose of limiting credit expansion. My question would be, Is it time to think about measures to control leveraging globally?

**Mr. Mussa:** I'm actually skeptical on this discussion and its topic. We've had a major international economic crisis and financial developments have clearly played a key role in that. But it seems to me that with the policy adjustments that were made, the international monetary and financial system was not playing an integral role in the crisis itself. The United States had a large current account deficit going into the crisis, but it was *not* problems in financing that deficit that gave rise to the crisis, as we have seen in a number of other cases. There was international transmission of financial disturbances, but that was a consequence of the private financing flows that had occurred, not as a consequence of the exchange rate mechanism or other elements of the international monetary system.

Now, *if* leading central banks had failed to recognize their role as the lender of last resort in their own currencies for all important users of that currency—domestic and international—then we might well have had a disruption of the international payments system that would have seriously deepened the crisis. But policy responses avoided that outcome.

With respect to the movement of exchange rates, yes, exchange rates moved and often by substantial amounts, as they have done on other occasions. But it is very difficult to make the case that, on balance, the exchange rate adjustments that occurred were more destabilizing than stabilizing.

So, we want to focus attention on where the problems are and where the solutions are. Clearly some of the solutions that were found to prevent the international monetary system from complicating the resolution of the crisis need to be firmed up. But I insist this is not primarily a crisis of the functioning of the international monetary system. The problems lay elsewhere.

**Mr. Toukan:** Really I will just make one point. How do you alleviate this appetite for accumulating reserves? Clearly, we need confidence. What is missing in the world today is confidence and for good reason. Uncertainty was never at this magnitude. Therefore, central banks—as well as governments—should try to maintain credibility, and credibility comes from basically doing all the right things. It is reform measures across the board. Some of those reform measures are not popular but that is why central banks were invented—to do all the right things irrespective of whether the measures are popular or not. That’s my main point really.

**Mr. Obstfeld:** I can only respond to a few points, and I want to apologize for any questions I cannot address. Maybe John will pick up my slack. Three points:

First, a question was raised about capital controls. So, I want to point out that the last two words of my presentation were “financial protection,” and capital controls are mentioned in the text. If we cannot really progress on harmonizing international prudential regulations, we will see an upsurge in capital controls. Those would represent the second- or third-best solution, but could become necessary. For example, how do you insulate your system from regulatory arbitrage, which was indeed a factor in the transmission of the crisis, particularly between the United States and Europe.

Global markets need global governance. To extend the reach of markets and the integration of markets, we need to extend the umbrella of governance. We’ve seen this certainly in the sphere of international trade. It is also true in the sphere of finance. Negotiations toward this end are ongoing. But obviously the process is difficult.



Regional reserve arrangements and their link to global arrangements are also related to the issue of financial supervision. One of the problems with redundancy in the provision of these types of facilities is that it provides a means for some financial institutions to get away from their regulators and get liquidity support elsewhere. We did see episodes of that during the crisis.

Such episodes underscore that the lender-of-last-resort arrangement is intimately related to the financial supervision system. You can't discuss one without the other. Implicitly—I didn't talk about it much—we need to be considering how international supervision proceeds, if we also think about more structured international liquidity arrangements.

Finally, Jacob Frenkel mentioned and Michael Mussa alluded to the role of the exchange rate in crises and the fact that many years ago policy coordination focused on things like target zones. One of the very striking things about the recent crisis is that we saw some very large exchange rate fluctuations, without big negative consequences.

For example, the Korean won swung by about 60 percent in the crisis. This was not a huge problem, despite what one might have thought based on past experience. One could argue that the fluctuations in exchange rates allowed over recent years have strengthened financial resilience in some emerging markets by reducing the incentive to borrow in foreign currencies. These days we worry less about exchange rate stability, in and of itself, than in the past. That is a tribute to the floating exchange rate system.

**Mr. Lipsky:** I'll give some very brief and specific answers to some specific questions and then make some broad concluding remarks.

Let me start with the issue on capital controls. Of course, we've all perceived the risks, not just more broadly. We think of capital controls in emerging markets, and so forth. But, in general, there has been a tendency toward a response in financial markets under pressure to take actions that tended to isolate a ring fence on national markets. The point there is another reason why an international approach or a coherent approach to these issues is important.

Similarly, although I'll come back to one of the implicit issues raised by the attractions of capital controls, there is a role, but the appropriate role for controls is in a very special and limited context. We did create or publish what we call a Staff Position Note on capital controls. We tried to lay out very clearly under what circumstances—and I emphasize what *limited* circumstances—in which capital controls seem appropriate and, more broadly, the more appropriate policies, including potential exchange rate policies, fiscal policies, and others, as a response to surges in capital controls in less fully developed markets.

Turning to regional arrangements, to be clear the Fund, for example, is actively pursuing enhancing its cooperation and relationships with regional arrangements. We don't view those regional arrangements as in any way necessarily inimical to effective global coordination. In fact, you can say one of the results of the recent Greek crisis was a clarification of the role of the International Monetary Fund in the euro area. Something that had been ambiguous before and somewhat controversial has now been settled, hopefully in an extremely productive and supported way. This is not *prima facie* a problem, but rather an opportunity.

With regard to remarks of Governor Kim on the global financial safety net efforts, first of all I want to commend the Korean authorities for their leadership role as the host of the Seoul Summit in promoting progress in this important area. We see this—I hope I made clear in my remarks—as an important area for preparing the international system for the inevitable future.

With regard to remarks Jacob Frenkel made about supervision, let me just refer you to the Staff Position Note we published a few months ago on supervision. I think you will find it very interesting, if you haven't read it already. The title is "Learning to Say No," and it represents a detailed examination of the existing problems of supervision in the run-up to the recent crisis, based on the objective and detailed country-by-country analysis undertaken in the context of our FSAPs (Financial Sector Assessment Program). You will find it very interesting.

Also, with following Jacob's remarks, the lessons learned, implicitly what he was referring to was the importance of spillover effects and the need to understand spillover effects. This is something, as I mentioned in my remarks, we are trying to approach in a systematic way.

On reserves, it is really hard to generalize. It is too easy to generalize the phenomenon of huge reserve growth because it is so uneven. Some countries, as Maury mentioned, in some cases the amounts of buildup are so huge it is hard to relate them to self-insurance. Anyway, I think that is what Governor De Gregorio's remarks really intended to emphasize. It is a hard issue to oversimplify, given the difference in experience, but in broad terms it seems clear that a more effective global system would tend to reduce the buildup of reserves.

On the issue of cross-border resolution mechanisms and the importance of their credibility—or existence frankly and ultimate credibility in affecting the system—is a very important observation by Rob Johnson. As I said in my remarks, this is an area we saw in very concrete terms in the case of Lehman Brothers, which effectively at a global scale was a quite small institution, and how debilitating the resolution process has been and how complicating, because of a lack of a clear internationally coherent mechanism for institutions operating in multiple jurisdictions. Really, this is an area where work needs to be under way. We have published a paper in this area, I've given a speech on it, but this is an area in which I'm hopeful there will be some significant progress for an extremely complicated area.

One final word: Behind all this is the need for greater coherence in macro policy. I think that comes back in a way to what Mike Mussa and others were saying. Yes, the monetary system wasn't the source of this problem, but creating greater stability involves important efforts at international collaboration and policy coherence.

Underlying all the kinds of discussion we've had today and in this panel and other sessions, as I like to put it, "All issues lead to the G-20 framework." And a new effort at trying to see if policy coordination can progress in a more effective and efficient way than has been the case in the past.

It's easy to be skeptical, but the issues are very simple. Individual countries operating at partial equilibrium optimization will come up with a different solution than a general equilibrium solution. It's easy to imagine there are Pareto-superior outcomes in a global context, than if each country is left to its own devices to decide what to do. There is a fundamental prospect of Pareto-superior outcomes, but it requires collaboration and confidence everybody is going to do what they need to do to produce that outcome. Let's see what happens in Seoul.

**Mr. Hoenig:** I will be very brief. I do want to say just a couple of things. This conference, "Macroeconomic Challenges: The Decade Ahead," is really designed as a sense of optimism for the future. It reflects the fact we are confident that we will, if the right word is "slog" our way out of this recession and that is what we're in the process of doing. We need to be looking ahead. We need to be looking to this decade.

As I listened today and heard the discussions about reestablishing our monetary framework going forward and bringing more emphasis to the challenges we face globally around fiscal policy and the real need, and I think desire, to take that on now—in a central bank context because of its greater implications, if you will, for monetary policy and economic policy—that is critical we now be able to and willing to think ahead and to recognize we have to do it in a global sense.

Therefore I want to thank all those who presented papers here and discussed them, all the input from the audience itself and the chairs of the sessions as they recognized the stress of trying to get as much input as possible. I very much appreciate that, and I want to thank all of you.

The second point is I want to recognize Don Kohn, because he will be retiring at the end of this month after 40 years of service, not only to the central bank of the United States, but in many ways, since all of you know him, to central banks around the world. His service has been selfless. I know that from personal experience. So, Don, I want to personally thank you for being here at this session this year. Thank you.