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Challenges in IMS Reforms A Global and Emerging Markets' Perspective

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Abstract

The current global financial crisis has reopened an old debate on the international monetary system by baring weaknesses and flaws that have long been known. The debate is centred on both stability and equity. International co-operation is necessary to resolve a complex interplay of several interrelated problems. The G 20 seems to be better positioned than the IMF arrive at some international consensus on these issues. However, while there has been some progress, the big issues of moral hazard and inequities deriving from the global reserve currency seem intractable. With the macro-economic framework under great strain, we may indeed be poised for a leap into the dark going forward. Since solutions seem elusive, even as everybody is agreed that there is a major problem, discussion and debate are crucial.

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A Global and Emerging Markets' Perspective

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1. Introduction

The subject of reforms in the international monetary system has in recent years seen perhaps the most intense debate since the inception of the Bretton Woods system. Policy-makers from both developed and developing countries, intergovernmental organizations and prominent academics are proposing a number of reforms to the international monetary system to maintain financial and price stability, and to ensure economic growth going forward. The French Presidency also placed the subject high on the priority of the G 20 agenda.

Why is this the case? Weaknesses in the extant international monetary system, including those of the "non-system" in place following the breakdown of the Bretton Woods system that are now being highlighted, have long been known1. The system had nevertheless served the global economy reasonably well, ensuring price and financial stability, and also delivering on global growth. Indeed, the post war period was a period of unprecedented prosperity and growth sustained over a long period – half a century to be precise. Is there now a lurking fear that this is coming, or has come, to an end, and that a major overhaul of the international monetary system is, inter alia, necessary to get the global economy back on a sustainable track?

I will not even pretend that I have an answer to this question. I would instead try to put some questions on the table by looking at the issue from two perspectives, namely stability and equity.

The question of stability derives from the intellectual debate on the origins of the current global financial crisis. I say current, rather than recent, a phrase I had been using till recently, for good reason. While the US subprime housing problem is by consenus the trigger that ignited this crisis, its ultimate causes are usually traced to mounting global imbalances and underlying weaknesses in the financial and monetary systems.2 Global imbalances generated a flood of liquidity that drove down interest

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[1] Vijay Joshi and Robert Skidelsky, ***"Keynes, Global Imbalances, and Internal Monetary System Reform, Today",*** in Ed. Stijn Claessens, Simon Evenett and Bernard Hoekman **Rebalancing the Global Economy: A Primer for Policymaking** Chapter 24. http://www.voxeu.org/index.php?q=node/5219 Centre for Economic Policy Research, 2010.

[2] **The Turner Review**, UK Financial Stability Authority, March 2009. www.fsa.gov.uk/pubs/o**the**r/**turner_review**.pd *G 20 Finance Ministers and Central Bank Governors*

rates, and thereby encouraged excessive risk taking. The lax supervisory and regulatory structure in the financial system in advanced countries, and the extant monetary policy framework, translated risky behaviour into investment in risky financial instruments across the world.

2. The Role of IMS and Its Limitations

So where does the international monetary system come into all this? One of the main objectives of a well functioning international monetary system is to prevent the buildup of large, unsustainable external imbalances in the first place. The weakness of the extant international monetary system lies in the fact that it does not have institutional or market mechanisms for preventing or correcting certain kinds of imbalances. The issue is no doubt complex, with several interrelated problems, and I will mention four that come to my mind.

First, the market forces only deficit countries to adjust, and not surplus countries, something pointed out by Lord Keynes decades ago. [3]

Second, there is little pressure on both deficit and surplus countries within currency unions to adjust because the exchange rate between them is fixed. Thus the Euro zone can be seen as a microcosm of the global economy, with the north-south imbalances mimicking the US-China imbalances.

Third, reserve currency issuing countries also have little pressure to adjust, as they can continue financing large internal and external deficits with seeming impunity, particularly when most required during crises as there is a flight to safe reserve currency assets. This is the equity issue. Indeed, it was noted quite some time ago by Robert Triffin that reserve issuing currencies may need to run larger and larger deficits to meet the needs of global liquidity. This problem has since been made more complex by the increasing importance of the liquidity multiplier through a sophisticated financial system. [4]

Fourth, the capacity of the G 20 and other multilateral fora such as the IMF to address the reserve currency issue is limited as policy based solutions need to find market acceptance.

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had identified these root causes in Sao Paulo, Brazil on November 8-9, 2008. http://www.g20.org/Documents/2008_communique_saopaulo_brazil.pdf

[3] Vijay Joshi and Robert Skidelsky, ***op.cit.***

[4] Lorenzo Bini Smaghi,***"The Triffin dilemma revisited"***, **European Central Bank Conference on the International Monetary System: sustainability and reform proposals,** October 3, 2011, 100th birth anniversary of Robert Triffin, Triffin International Foundation, Brussels. **http://www.ecb.int/press/key/date/2011/html/sp111003.en.html**

Following the break up of the Bretton Woods system it was expected that floating exchange rates would prevent the buildup of large imbalances, as current accounts would tend to move towards balance through appreciation and depreciation of currencies. The impact of exchange rate movements is however hotly contested and frequently misunderstood because of the disproportionate attention showered on the nominal exchange rate. Thus, although Japan's fixed nominal exchange rate may have contributed to its large current account surplus in the period leading to the Plaza accord, the subsequent appreciation of its nominal exchange rate did not abate its large current account surplus.

How could this have happened? One way of looking at the issue is through relative shifts in productivity. Let us suppose that a country's current account is balanced to begin with. Ceteris paribus, an improvement in productivity relative to other countries would tend to move its current account into surplus, and vice versa. Counterpart capital flows should over time move the current account back towards balance through adjustments in the nominal exchange rate. The ceteris paribus condition, alas, rarely holds in the real world. This self-correcting mechanism may not work if real wages do not keep pace with productivity gains. To take another scenario, if capital flows exceed the level required to balance the current account in the event of a relative downward shift in productivity, the nominal exchange rate could even appreciate. What matters, therefore, is not the nominal exchange rate, but the real effective exchange rate, that takes into account relative movements in productivity and inflation. Movements in the REER are however notoriously difficult to compute.

Adjustments in the nominal exchange rate therefore may not correct imbalances.[5] The latter are really the counterpart of the savings, investment and consumption equations in different economies, captured in the national income equation in which external balances play a key balancing role. These equations in turn are linked to stages of development and cultural differences. Thus savings rates tend to increase in young societies undergoing rapid growth; they tend to decline as societies age; they are generally higher in developing Asia than in developing Latin America; and within OECD countries, the savings and consumption behaviour of the Swabian housewife in Germany is very different from that of the stylized American housewife[6].

It is also possible to argue that the development of global imbalances was inherent in the pattern of globalization based as it was on international mobility of capital, goods and services combined with relative immobility of labour. This lowered returns to

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[5] Robert I. McKinnon, ***"Why Exchange Rate Changes Will Not Correct Global Trade Imbalances"*** in Ed. Claessens, Evenett and Hoekman **Rebalancing the Global Economy: A Primer for Policymaking** , op. cit, Chapter 12. Fred Bergsten, "***The Dollar and the Deficits: How Washington Can Prevent the Next Crisis",*** **Foreign Affairs**, Volume 88 No. 6, November/December 2009. http://www.iie.com/publications/papers/paper.cfm?ResearchID=1312

[6] Ms. Angela Merkel, the German Chancellor, has drawn attention to the thrifty the Swabian housewife who always balances her budget by force of habit. http://www.ft.com/intl/cms/s/0/21dddea4-7d60-11df-a0f5-00144feabdc0.html#axzz1gmIUE17m

labour relative to capital on the one hand, even as capital moved to areas where productivity gains, and therefore returns, were highest. On the flip side, real wages failed to keep pace with productivity increases,[7] depressing consumption and increasing reliance on external sources of demand. Since income from labour rose relatively modestly, global growth increasingly relied on investment (in developing countries) and leveraged consumption (in OECD countries, especially the US which emerged as the global consumer of last resort) enabled by a combination of financial innovation and lax regulation. Excessive consumption would ordinarily lead to rising current account deficits which should have been self-limiting through markets. However, since markets didn't penalize current account deficits of reserve issuing currencies under the extant international monetary system, it is hardly surprising that these deficits were concentrated in the United States and within the so-called 'Club Med 'Euro zone countries, both of which had access to cheap capital derived from the reserve status of their domestic currencies.

The picture drawn may appear complex and confusing, but serves to illustrate that global imbalances are nothing new, and their determinants are complex. Therefore, they may not be easy to correct through some silver bullet, such as adjustments in the nominal exchange rate, as is sometimes argued.

3. Reforming IMS: Alternative Approaches

What, then, should our level of ambition be in the circumstances? Should we try and reform the international monetary system which can prevent the accumulation of imbalances through market mechanisms? Alternatively, should we try to innoculate the financial system through regulatory reform and monetary policy by reforming its framework in such a manner that imbalances cannot destabilize the global economy? Or do we rely on institutional mechanisms to keep imbalances within reasonable limits, which would need to be defined, consistent with financial stability? Let me turn to each of these three options in turn, beginning with the last.

The IMF was expected to be the institutional mechanism for making the adjustments to prevent the build up of large global imbalances. Under Article IV of its Articles of Agreement it has an internationally agreed mandate "to exercise firm surveillance over the exchange rate policies of members" to "assure orderly exchange rate arrangements and to promote a stable system of exchange rates". This surveillance was mostly done through a process of bilateral consultations, with limited multilateral surveillance as a relatively late entrant. Be it as it may, the IMF and other eminent economists had clearly sounded strong warnings of a possible financial crisis emanating from a

[7.] **Jared Bernstein and Lawrence Mishel,** *"Economy's Gains Fail to Reach Most Workers' Paychecks"*, **Economic Policy Institute, April 30, 2007,** http://www.epi.org/publication/bp195/
Trends in the Distribution of Household Income Between 1979 and 2007, Congressional Budget Office, The Congress of the United States,
http://www.cbo.gov/ftpdocs/124xx/doc12485/10-25-HouseholdIncome.pdf

disorderly unwinding of global imbalances leading to a collapse of the dollar.[8] The predicted financial crisis did occur, and global imbalances also had something to do with it, but not in the manner prognosticated. As a result, the current crisis has only strengthened rather than weakened the dollar. This rather counter-intuitive phenomenon largely derives from the dollar's status as the global reserve currency, an issue to which I shall turn presently.

It is however clear that IMF's surveillance mechanism to prevent and correct imbalances did not work well. The Independent Evaluation Office of the IMF has identified analytical and organizational weaknesses within the IMF for this failure.[9] I would however like to highlight three major reasons. First, there was too great a focus on nominal exchange rates for abating imbalances. We have seen that this problem is complex. Secondly, the IMF had limited leverage with major countries in enforcing its policy advice, as this is usually done through conditionalities imposed on countries that borrow from the IMF. Major countries that accounted for the big imbalances never felt the need for IMF financial support. But perhaps the most important reason was IMF's crisis of legitimacy. Its governance and ownership structure remained basically the same as it was at the time it was set up at the end of World War II. Its major shareholders never felt the need, let alone urgency, to adjust its governing structure to accommodate the rising emerging economies whose weights in the global economy was rising dramatically. There was therefore always the feeling that IMF's policy advice was not even handed, and that this reflected the viewpoint of its majority shareholders. This perception prevails to this day, despite the marginal shift in quota in favour of EMEs following a push given in this direction by the G 20.

The emergence of the G 20, which has a more balanced governing structure in which major advanced and developing countries are equally represented as equal partners, as the premier forum for global international co-operation now appears to be taking over the IMF's mantle as the institutional mechanism for making the adjustments to keep global imbalances within the limits necessary to ensure strong and sustainable growth going forward. The IMF plays an important role in this process, initiated at the third G 20 Summit at Pittsburgh[10], but as a technical advisor. The new process is purely multilateral and is owned by the G 20 countries themselves who take decisions through

8 The IMF had sounded a warning on the build up of unsustainable global imbalances as early as in its 2002 ***World Economic Outlook***, even prior to the large Chinese current account surpluses, and more specifically In its June 29, 2007 ***Staff Report on the Multilateral Consultations on Global Imbalances with China, the Euro Area, Japan, Saudi Arabia and the United States.*** http://www.imf.org/external/np/pp/2007/eng/062907.pdf. See also Maurice Obstfled and Kenneth Rogoff, ***"The Unsustainable US Current Account Position Revisited".*** **NBER Working Paper 10869**, October 2004. http://www.nber.org/papers/w10869

9 **IMF Performance in the Run-Up to the Financial and Economic Crisis. IMF Surveillance in 2004–07** http://www.ieo-imf.org/ieo/pages/IEOPreview.aspx?img=i6nZpr3iSlU%3d&mappingid=dRx2VaDG7EY%3d Independent Evaluation Office of the IMF, 2011.

10 **Leaders' Statement, Pittsburgh**, September 25, 2009. http://www.g20.org/Documents/pittsburgh_summit_leaders_statement_250909.pdf

mutual consultations and assessment. Indeed, the G 20 Mutual Assessment Process has come to occupy the centre stage within the G 20, and is often described as its heart and soul, as though the latter's entire image depends on the outcome of the mutual assessment process.

The G 20 mutual assessment process has featured prominently in the last three G 20 summits at Toronto, Seoul and recently at Cannes.[11] In the Cannes Action Plan for Growth and Jobs, countries have committed to specific, and indeed measurable, short-term and medium term policy actions. This is still work in process, and we have still to see how this new Framework would work, and to what extent countries are willing to harmonize country and multilateral frameworks. The benefits of policy coordination are manifest. Apart from policy spillovers, in an increasingly integrating global economy, it is apparent that an un-coordinated rebalancing of the global economy, such as rise in savings in one part of the global economy in the absence of a rise in consumption in some other part, would lead to lower growth in the aggregate. Through the WTO it has been possible to arrive at globally agreed and enforceable agreements on trade, so could the same happen in the case of macro-economic policies? Welfare gains from trade can however be symmetric, since most countries have at least some comparative advantage. However, gains from macro-economic policies may be asymmetric, on account of the inherent advantages accruing to issuers of global reserve currencies. A working agreement on macro-economic policy coordination within the G20 may be more difficult and hinge on the overhaul of the reserve currency system.

The second option is reform of financial regulation and monetary frameworks. Consumer price deflation was one of the chief features of the 'Great Moderation' preceding the current global financial crisis.[12] This was largely on account of the downward pressure on real wages in a fast globalizing world with large productivity gains through the entry of big developing countries like China and India, as goods and services increasingly moved freely across borders. As a result, instead of overheating, or excessive demand and liquidity relative to productive capacity in reserve issuing currencies translating into consumer price inflation, this spilled over into asset markets. This dramatic decoupling of consumer and asset prices should have rung alarm bells for financial market regulators and central banks alike, but they did not.[13] As a result, since

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[11] The **G20 Toronto Summit Declaration**, June 26-27, 2010, http://www.g20.org/Documents/g20_declaration_en.pdf

the **G20 Seoul Summit Declaration**, November 11-12, 2010, http://www.g20.org/Documents2010/11/seoulsummit_declaration.pdf

Cannes Summit Final Declaration, November 4, 2011. http://www.g20.org/Documents2011/11/Cannes%20Declaration%204%20November%202011.pdf

[12] Claudio Borio and Andrew Filardo, "***Globalisation and Inflation: New Cross-Country Evidence on the Global Determinants of Domestic Inflation"*, Bank of International Settlements, Working Paper # 227**, May 2007. http://www.bis.org/publ/work227.pdf?noframes=1

[13] US Urban CPI rose by just 10% between June 2000 and March 2004. The US Case Shiller Housing index rose by 60% during the same period. The US FED serially lowered the Fed Funds rate from 6.5% to 1% over this period.

monetary policy responded to consumer prices rather than to asset prices – because, as famously articulated by Alan Greenspan, central banks cannot call asset bubbles and so should only clean up afterwards[14] – US Federal Reserve's monetary policy remained unusually accommodative even by its own yardstick of the Taylor Rule[15]. In retrospect at least, Alan Greenspan's argument does not seem convincing. Quite apart from the decoupling in prices, returns on financial assets also far exceeded returns in the real economy. This was easily measurable through a comparison of returns in financial and non-financial companies and assets. This unusually loose monetary policy encouraged risky behaviour, innovation that sought to drive up yields, and ultimately the excessive leverage that the world is still struggling to unwind. Central banks lost control of liquidity management by the emergence of a lightly regulated shadow banking system.[16] The question now is whether a shift in the monetary framework to cover both consumer price and asset inflation might abate the deleterious impact of global imbalances by reining in shadow banking.

The deleterious impact of global imbalances was amplified through the financial system by risky innovations that gave rise to what is often described as the 'shadow banking system'. This resulted in a dangerous build up of leverage and opaque and risky financial instruments. Much of the spurt in growth during the 'Great Moderation' was based not on rising labour incomes, which remained stagnant in real terms, but on leveraged, and therefore unsustainable, consumption enabled by financial innovation and regulatory and supervisory forbearance. Major financial regulatory reform is being attempted by through the restructured Financial Stability Board under the aegis of the G 20 to address these flaws. It is however still unclear whether this will go far enough to keep leverage and asset booms in check, especially since the Basel II 'mark to market' accounting standards are not being revisited. No distinction is still being made between leveraging for investment in the real economy, and leveraging for investment in financial assets and for consumption. The shadow banking problem is also still to be addressed head-on. Moreover, while regulatory reforms might ensure that leveraged private consumption booms are kept in check, there seem to be few constraints on public sector leveraging to plug in the gap in leveraged private demand. There is already talk of the unsustainable Bretton Woods II international monetary system

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[14] Popularly known as the "Greenspan doctrine". See his ***Remarks at the Economic Club of New York, New York City***, December 19, 2002. **http://www.federalreserve.gov/boarddocs/speeches/2002/20021219/default.htm**

[15] John B Taylor, ***"Does the Crisis Experience Call for a New Paradigm in Monetary Policy?",*** **CASE Network Studies and Analyses # 402/2010** http://www.case.com.pl/strona--ID-publikacje,publikacja_id-30086909,nlang-710.html ***The Economist*** of October 18, 2007, carried a graph showing just how much the Fed Funds rate deviated from the 'Taylor Rule' in the run up to the crisis. The Taylor Rule itself was deduced from an evaluation of past policy decisions of the US Fed that had worked well.

[16] Alan Greenspan, **The Age of Turbulence. Adventures in a New World**. Allen Lane, 2007, p. 381. Greenspan was specifically referring to the impact of cross-border capital flows. We now know that much of this mobility was on account of the shadow banking system.

giving way to an equally unsustainable Bretton Woods III, where private leverage is replaced by government leverage.[17]

This brings me to the third option of the reform of the international monetary system itself, which is closely linked to the issue of equity. The G 20 has so far reached some sort of consensus on a number of issues relating to reform of the international monetary system, [18] such as policy approaches on handling large volatile capital flows, enhancing the capacity of developing countries to absorb capital inflows, coping with sudden stops of capital in developing countries, and reviewing the composition of the SDR basket. No consensus however has been reached on the bigger issues relating to the international monetary system, namely the measurement and metrics of global liquidity, accumulation of reserves and exchange rate management, and the reserve currency question itself.

4. Issues in Reforming IMS

I will handle the issue of reform of the international monetary system in two parts. Firstly, the issue of capital flows, and secondly the issue of the international reserve currency.

a. Issues of Capital Flows

From the viewpoint of the widely accepted Mundell-Fleming open economy model,[19] a country can have only two of the following as part of its macro-economic framework: an open capital account, a stable exchange rate and monetary independence. While several developing countries, including India, have at times tried – with little success I may add – to get around this impossible trinity, countries have mostly adopted different solutions to this equation. Thus, the United States has an open capital account, independent monetary policy but a floating exchange rate (India's solution most closely resembles this model). China has adopted a stable exchange rate, independent monetary policy but a closed capital account. The euro zone solution to the equation was to have a fixed exchange rate, an open capital account, while its countries sacrificed monetary independence.

From the perspective of national macro-economic balance or stability, any of the three solutions may be equally valid; however, this is less clear from a multilateral perspective or from the viewpoint of global stability. Is one of the solutions likely to

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[17] Jörg Bibow , ***The Global Crisis and the Future of the Dollar: Toward Bretton Woods III?*** Levy Economics Institute of Bard College and Skidmore College, Working Paper No. 584, February, 2010. http://www.levy.org/pubs/wp_584.pdf

[18] **Cannes Summit Final Declaration**, November 4, 2011. http://www.g20.org/pub_communiques.aspx Paragraphs 9-21.

[19] Maurice Obstfeld, ***"International Macroeconomics: Beyond the Mundell-Fleming Model"*** , **IMF Staff Papers**, Vol. 47 Special Issue, 2001 http://www.imf.org/external/pubs/ft/staffp/2000/00-00/o.pdf

lead to a greater build-up of global imbalances? By focusing on adjustments in nominal exchange rates in its recent surveillance reports the IMF seems to have made clear its preference for the combination of flexible exchange rates, open capital account and monetary independence to prevent the build up of global imbalances.[20] The Mundell-Fleming trilemma however indicates that there are other tools through which external adjustments can be made. Indeed, those countries that adopted a model with floating exchange rates were never in a position to use the exchange rate tool at all to correct imbalances.

From the IMF perspective, global imbalances kept rising under Bretton Woods II because some developing countries adopted other combinations of the impossible trinity, such as a fixed nominal exchange rate, closed capital account and monetary independence. The IMF however seems to have overlooked the equally destabilizing impact of a fixed nominal exchange rate, open capital account and monetary dependence followed by Euro zone countries. At any rate it did not sound the alarm bell on intra-Euro zone imbalances with the same shrillness as it did in the case of US-China imbalances. In retrospect it does not seem in the least bit coincidental that the two countries with the largest trade surpluses, namely China and Germany, have fixed nominal exchange rates – the first relative to the US dollar, and the second within the Euro Zone. Therefore, an open capital account may not in itself prevent the build up of external imbalances.

From a developing country perspective, the IMF prescription may well have worked had capital flows remained merely the counterpart of current account imbalances. However, with greater integration, openness and sophistication of financial markets, capital flows gradually decoupled from the current account. This led not only to greater volatility in such inflows, but to excessive inflows in times of plenty, and outflows when external capital was most needed. This at any rate has been India’s experience, which needs foreign capital on account of a structural current account deficit. This volatility can make the nominal exchange fluctuate sharply over relatively short periods, with a very damaging fall out on the real economy. Thus starting out from the mid forties to the US dollar, the last three years has seen the rupee appreciate all the way down to the mid thirties, then depreciate sharply to exceed fifty, before falling back again to the mid forties, and now once again threatening to break into the mid fifties. The G 20 consensus at the Cannes Summit on developing local currency bond markets needs to be seen in the light of developing countries’ own initiatives at developing their own financial markets and economy to increase their absorptive capacity of capital flows in times of plenty.

This excessive volatility has repeatedly tested the Central Bank’s resolve to stick to its solution to the Mundell Fleming equation and try to beat the impossible trinity by intervening in foreign exchange markets. Good macroeconomic management was no

[20] IMF, **World Economic Outlook**, Sept. 2011, p 25. http://www.imf.org/external/pubs/ft/weo/2011/02/index.htm

guarantee of stable flows, as a crisis in one part of the globe spreads rapidly to other parts of the world through financial markets, leading to safe haven flows. Since capital flows were in reserve currencies, this meant capital flight to the reserve issuing countries. This happened even in cases where the source of the crisis itself lay in reserve issuing countries, such as following the collapse of Lehman Brothers, and again following the credit downgrading of US long-term debt, and now yet again in the midst of the Euro zone crisis.

Even in non-crisis situations, however, reserve issuing countries can influence the direction of capital flows through their domestic monetary action which can impact the cost of capital in developing countries. From this perspective it can indeed be argued that open capital accounts are supportive of monetary policy frameworks of reserve issuing countries, who are also the major shareholders of the IMF. It is easy to see why the IMF has a crisis of legitimacy. It is also easy to see why the IMF has now relented on the issue of capital account convertibility[21], and why the consensus on 'coherent conclusions' arrived at by the G 20 at Cannes in the matter of managing capital flows retains the option of imposing capital controls in certain circumstances.

There was of course always the IMF that was expected to provide liquidity support to developing countries in just such an eventuality, when liquidity was a problem. However, the experience of several developing countries with IMF programmes has not always been happy – although I may add that India has little ground for complaint in this regard -- procedures were tardy, the structure of the programmes reflected the interests of creditors or the majority developed country shareholders, leading to contractionary policies in times of stalling growth – or the exact opposite of what it is now recommended for developed countries in crisis currently – and the stigma attached by markets to approaching the IMF. Many countries have complained that as soon as markets got wind of their intention to even engage the IMF on standby arrangements, this was interpreted as the first sign of crisis and they started penalizing them for their foresight! In these circumstances is it surprising that developing countries turned increasingly to building their own financial safety nets through accumulation of reserves? Countries with such large reserves also seem to have fared better during the current crisis. The other response has been to develop regional financial safety nets, such as the Chiang Mai initiative, and now the EFSF in the Euro zone. The effectiveness of such regional safety nets however has still to be tested. Accumulation of large reserves by developing countries, of course, is not simply the outcome of a self-insurance policy. In several cases it is the byproduct of a policy to manage large destabilizing capital inflows.

[21] Jonathan D. Ostry, Atish R. Ghosh, Karl Habermeier, Marcos Chamon, Mahvash S. Qureshi, and Dennis B.S. Reinhardt, *"Capital Inflows: The Role of Controls"*, **IMF Staff Position Note SPN/10/04**, February 19, 2010. http://www.imf.org/external/pubs/ft/spn/2010/spn1004.pdf

b. Issues of International Reserve Currency

Lastly, I come to the issue of the international reserve currency itself. I have already referred to the perception that the issuer of reserve currencies has certain inherent advantages. There has therefore been talk of negating this advantage by moving to a multi-currency system, or to a new currency, such as the SDR, which is not linked to any nation state. Apart from rhetoric, however, these suggestions have led nowhere, and the G 20 has even stopped discussing this aspect. We therefore need to explore this issue a little deeper, even at the cost of covering some basic, well known territory, including the very nature of money itself.

Trade and exchange are amongst the most ancient of human transactions. Money emerged as a form of universal exchange that enabled human societies to move beyond barter that was very cumbersome as you needed to trade in a large number of articles to eventually get what you wanted to consume.

Different forms of money, or currencies, were until recently local phenomena, because bulk trade, and society itself, was local until major technological advances following the Industrial Revolution. Despite poor communications, however, there was always a flourishing long-term trade, such as the overland silk trade, or the maritime Indian ocean trade, in luxury goods for which there was stable demand from the ruling classes of opulent empires. The currencies issued by big empires were generally acceptable across borders for trade and financial transactions, especially since these were not fiat currencies, and there was always a relationship between its extrinsic value and the intrinsic value of its scarce metal content, such as gold, silver, copper, etcetera. No sophisticated financial, monetary or legal system was required to back up currencies issued by major empires, such as the Roman and later the British, which could be considered to be the original global reserve currencies.

Reserve currencies always had a strategic and extra-economic dimension, which is the case even to this day. The US dollar has been the world's reserve currency since as far back as most people can remember, and certainly since the end of the British Empire. Its continuing resilience has long been an unexplained macro-economic puzzle, as its relative value does not seem to respond to current account and fiscal deficits in the manner other currencies do. Indeed, a number of intrepid theories have been floated to explain its continuing strength, such as that by the economists Hausmann and Sturzenegger[22] who invoked the 'dark matter' analogy from quantum physics. The fact of the matter is that in a globalised world the macro-economic rules of the thumb applicable to other currencies do not apply to the reserve currency as the latter has a strategic and safe haven status that cannot be captured in financial models.

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[22] R Hausmann and F Sturzenegger, ***U.S. and Global Imbalances: Can Dark Matter Prevent a Big Bang?*** Harvard University, November 13, 2005. http://www.cid.harvard.edu/cidpublications/darkmatter_051130.pdf

It is this unfair advantage devolving on the reserve currency that has time and again led to calls for either competing reserve currencies or for replacing the dollar by a currency at arms length from Nation States, such as the SDR, and even for a return to the gold standard.[23]

However, the same economic logic that gave rise to money itself as a form of universal exchange makes it likely that as economies integrate further and become seamless, a single reserve currency would become the measure of universal international exchange and value. The reserve currency itself might change in future with shifting geo-political and economic fortunes, just as it transited from the pound sterling to the US dollar in the inter-war period. However, a shift to a more legitimate multi-currency system would run against the tide of history. Arguably, a fast globalising world has space for just one reserve currency. The problem of the reserve currency advantage, attendant moral hazards and legitimacy issues will not go away.

However, it is still possible that one reserve currency could be replaced by another, just as the pound sterling yielded to the dollar in the first half of the twentieth century as the US economy became the biggest economy and trading nation, and also the dominant technological and military power.

The only currency area that comes even close to the US in size is the Euro area. Even before the Euro zone crisis, however, trend growth in the latter was slower than in the US. The relative size of the US economy was therefore actually increasing with respect to the Euro area, and the technological and military gap was also widening. It could however be argued that a further expansion of the Euro area could in future have dwarfed the US economy, and the Euro could have replaced the Dollar going forward. All such thoughts have perished at a time the survival of the Euro itself is at stake.

The large Chinese and Indian economies are growing much faster and rapidly bridging the gap with the US, but are still a small fraction of the latter at market exchange rates. China would moreover need to move away from its mercantilist policies and float its currency. Besides, economic and convergence is not matched by technological convergence. In the foreseeable future these look as unlikely candidates to replace the dollar.

While the G 20 at Cannes asked the IMF to take a re-look at the current SDR basket, even the unlikely event of a major recast of the SDR basket is unlikely to amount to much since the SDR is currently simply an accounting unit and not a payments currency accepted by markets. It could make a transition to becoming a currency only if there was a market maker on a monumental scale to negate the first mover advantage of

[23] One of the most publicised recent statements was a speech by Zhou Xiaochuan, Governor of the Bank of China, at the **Bank for International Settlements** on March 23, 2009. http://www.bis.org/review/r090402c.pdf

the dollar, with all associated risks and costs.[24] This appears unlikely. The most likely candidate, the IMF, is unlikely to be given the powers of an international central bank with full discretion to print SDRs at will. There is no good reason for the reserve currency issuer to give up its enormous advantage in the matter of financing internal and external deficits at low costs, especially when it appears that no other currency has the market depth or intrinsic strength to take over the mantle of an alternative reserve currency from the dollar. The inescapable conclusion therefore appears to be that there is no alternative currency that can rival, let alone replace, the US dollar as the international reserve currency in the foreseeable future.

5. Summary and Conclusion

So where do we go from here? I should have really stopped here at what appears to be a dead end, since the remaining option of reverting to the gold standard did not seem practicable since governments and central banks would lose flexibility in use of monetary and fiscal policies to stabilize the economy. It may be recalled that the origins of the Great Depression are often traced to the absence of these macro-economic tools[25]. The current debate on the international monetary system has also not treaded on this dangerous territory. While I am no longer so sure, I would nevertheless have kept these doubts to myself had this not been an academic seminar where ideas are expected to germinate and struggle for survival.

The reason why I raise this rather subversive thought is that extant fiscal and monetary frameworks developed alongside the fiat currency system since the seventies are under undue strain. The chief economist of the IMF is also on record to confessing that we are no longer sure what parts of the extant macro-economic framework still works.[26]

The seventies saw an unbridled use of fiscal policy to counter what was a permanent rather than a cyclical demand shock deriving from the severe oil price shock, leading to stagflation. This was tamed through aggressive monetary action. It was soon recognized that fiscal policy is too political a tool to be used optimally in macro-economic management. The burden of stabilizing growth therefore passed on to central banks through monetary policy, which in turn became increasingly rule based.

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[24] Barry Eichengreen, ***"The Dollar Dilemma. The World's Top Currency Faces Competition"***, **Foreign Affairs**, September/October 2009.

[25] This was the view of both Milton Friedman and the current chairman of the US Federal Reserve, Ben Bernanke, http://www.federalreserve.gov/boarddocs/speeches/2004/200403022/default.htm. Liaquat Ahmed's recent study of the policies of three central bankers during the Great Depression arrived at a similar conclusion that "for all of Norman's enormous prestige and Schacht's creativity, they were both hamstrung by the dictates of the gold standard", Liaquat Ahmed, Lords of Finance. 1929, The Great Depression, and the Bankers Who Broke the World, William Heinemann, London, 2009, p. 503.

[26] Olivier Blanchard, Giovanni Dell'Ariccia, and Paolo Mauro, "***Rethinking Macroeconomic Policy"***, **IMF Staff Position Note, SPN/10/03**, February 12, 2010.
http://www.imf.org/external/pubs/ft/spn/2010/spn1003.pdf

The ageing of Western societies however continued to strain the fiscal framework, while the great moderation, as we saw, had features, such as "good deflation" and "shadow banking" that strained the monetary framework. Policy spillovers were also making the task of macro-economic management enormously complicated. Now a sovereign debt crisis in western economies alongside near recessionary conditions is making monetary policy unusually accommodative and innovative through quantitative and credit easing to the point that the divide between fiscal and monetary policy has all but collapsed, as private deleveraging has yielded first to government leveraging and finally to central bank leveraging without addressing the underlying problem of excessive leveraging that lay behind the current crisis.

Macro-economic policies and the international monetary system now seem to be at a historic tipping point, just as they were during the Great Depression. Reshaping them are the great challenges for the future. How might this be done? Does the past provide some guidance? How can monetary and fiscal tools be reshaped?

If both fiscal and monetary policies have been debased within just 40 years of the end of the gold standard, the question may soon be asked, as it indeed was by the World Bank President, Robert Zoellick, a short time back,[27] and if it is not already being implicitly asked by markets, as to whether the gold standard was no worse than, and arguably superior to, fiat money?

The gold standard imparted a degree of inflexibility to using macro-economic policies to stabilise growth, since money could not be created at will. Fiat money, however, suffers from the obverse problem that has seen policy-makers succumb to moral hazards inherent in excessive policy flexibility. The gold standard at least delivered on price stability over the long term. Since the stock of gold is limited and finite, its value could not be eroded significantly. The stock of fiat money, on the other hand, is potentially unlimited and policy-makers cannot be trusted to use it wisely.

A return to fiscal and monetary rectitude may well entail re-anchoring fiscal and monetary tools, and with it money itself, to gold (or some other scarce natural material) in some manner. How this re-anchoring could be done is not clear at this stage. However, the concept itself might not be entirely fanciful. The market response to the debasement of macro-economic policies since the onset of the recent financial crisis seems to be to turn to gold as an alternate safe haven alongside the US dollar.

If gold is now behaving more like a currency than a commodity, this could be a classic illustration of the age-old Gresham's Law that bad money drives good money out of the market. The question is whether this is a temporary trend or a structural shift. Be it as it may, some long-term damage has been done. The gold standard and its variants have been around for millennia, outliving several disastrous monetary experiments. Fiat

[27] Robert Zoellick, ***"The G 20 must look Beyond Bretton Woods II",*** **Financial Times**, November 7, 2010. http://www.ft.com/cms/s/0/5bb39488-ea99-11df-b28d-00144feab49a.html#axzz14dKEeR16

money has been with us for just four decades. Why should this time be different? The experience of the last four decades makes the historian in me fear for the future of fiat money.

To conclude, the current global financial crisis has reopened an old debate on the international monetary system by baring weaknesses and flaws that have long been known. The debate is centred on both stability and equity. International co-operation is necessary to resolve a complex interplay of several interrelated problems. The G 20 seems to be better positioned than the IMF to arrive at some international consensus on these issues. However, while there has been some progress, the big issues of moral hazard and inequities deriving from the global reserve currency seem intractable. With the macro-economic framework under great strain, we may indeed be poised for a leap into the dark going forward. Since solutions seem elusive, even as everybody is agreed that there is a major problem, this conference is very timely. I am confident that it will be a fertile breeding ground for new ideas to take root.

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