Beyond the Dollar

Rethinking the International Monetary System

A Chatham House Report

Edited by Paola Subacchi and John Driffill

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Foreword

Does the international monetary system require fundamental reform? The question is not new. I can remember it being asked half a century ago, back in the 1960s, when the post-war dollar shortage turned into a dollar glut and Robert Triffin formulated his famous 'Dilemma'. It was posed again in the 1970s, after President Richard Nixon closed the gold window, suspending the convertibility of the greenback into gold, and the exchange rates of major currencies began to float. The question was back in the spotlight in the 1980s, when the Latin American debt crisis seemed to threaten the solvency of international banks. And it was asked again in the 1990s, following the Asian currency crisis, when everyone talked about the need to rebuild the global financial architecture. *Plus ça change, plus c'est la même chose.*

Today, once again, reform of the monetary system is on the agenda – and for good reason. In the past three years, the world has passed through its greatest economic challenge since the 1930s, and we are still not out of the woods. In many countries growth remains sluggish, financial markets stay fragile, and global imbalances are as serious as ever. Protectionism is a constant threat. Currency misalignments persist. And at the centre of the system, America's dollar continues to be undermined by large payments deficits and a swelling burden of debt. The theme of reform may not be new, but the need for reform has never been more urgent.

What can be done? The authors of this Chatham House report are right that the system is in flux. They are also wise enough to know that reform of the system is unlikely to come in one fell swoop. In the absence of a broad consensus among key governments, calls for a grand global bargain – a 'New Bretton Woods' – are naive at best. The original Bretton Woods system was born in exceptional circumstances that are unlikely to be repeated any time soon, if ever. Change, if it is to come at all, will emerge from a gradual process of incremental adjustment and adaptation. The world, in a sense, is always in transition. The coming years will be no different.

But that does not mean that we must limit our ambition. Quite the contrary, in fact, as this report suggests. Room exists for improvements on a number of fronts. Institutional arrangements can be strengthened to promote cross-border dialogue and policy cooperation. The surveillance role of the International Monetary Fund can be reinforced to address more effectively problems of exchange rates and payments disequilibrium. And perhaps most importantly, steps can be taken to safeguard the system against over-reliance on a weakened dollar, including expansion of the role of the IMF's Special Drawing Rights. The strategy laid down in this report is by no means timid. But it is doable and deserves to be taken seriously.

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Executive Summary and Recommendations

The international monetary system is a lightning rod for tensions in the world economy. Its shortcomings may fuel protectionist pressure. It is also a system in flux, no longer meeting the needs of a changing world economy. This is why Chatham House and the ESRC World Economy and Finance Programme have looked at the current system, assessed the goals and principles that underpin it and made some recommendations for the way forward.

Countries are responding in different ways, and the steps that some of them are taking signal tensions and changes ahead. In times of stress, when countries are trying to secure steady economic recovery, domestic policy goals may be in conflict with international obligations.

The United States, in particular, may find it difficult and burdensome to support the dollar as the primary reserve currency. Domestic policy goals – i.e. growth and employment – may lead the United States to 'benignly' neglect the greenback, but China and the Eurozone would undoubtedly not be happy.

This decade will certainly be one of transition. We do not expect a big bang, but a long, gradual process of incremental change and adjustment. However, whether this transition and the rebalancing of the world economy will be smooth remains to be seen.

In this context, dialogue and policy cooperation play an important role in helping the world's main economies and countries issuing the key currencies to coordinate their efforts and rebalance the world economy. Such dialogue should be informed by the recognition that the world economy is much more complex and integrated than in the 1970s when the Bretton Woods monetary arrangements were abandoned. As a result, the interests and requirements of the emerging economic powers should be taken into account.

Policy cooperation should aim to avoid any protectionist reaction to exchange rate movements. It should also help prepare the ground for a smooth transition to a more appropriate system by fostering the exchange of information and cooperation among the world's main trading areas.

There is an argument for moving towards a multicurrency reserve system in line with the multipolar world, as well as expanding the use of a supranational currency such as the Special Drawing Right (SDR) (see Box 1). The policy recommendations below not only propose the measures that we regard as necessary but also take into account the political and economic costs involved in the transition from the current inadequately functioning system to a more sustainable and functional one.

Recommendations for managing change to the international monetary system[1]

1. A multicurrency reserve system for a multipolar world economy

1.1 Develop a multicurrency reserve system that is appropriate for a world of regional trading blocs – Europe, Asia, the Americas – alongside a still pre-eminent dollar. The disadvantage of losing network externalities would be compensated by gaining stability. Historical experience has shown that two or more reserve currencies can operate simultaneously.

1.2 Encourage a more extensive use of Special Drawing Rights as a supranational currency alongside international reserve currencies that are issued by sovereign states or by sovereign states pooled together in a currency union, as is the case for the euro.

1 This list of recommendations has been drawn up by the editors based on the chapters in the report, discussions at the various workshops and other meetings. Not all contributors agree with all of the recommendations.

1.3 Promote cross-border dialogue and policy cooperation in order to manage the transition from a system based on the dollar to a multicurrency one. Institutional arrangements should be strengthened, with a clear mandate to avoid major imbalances.

2. Increase the use of the Special Drawing Rights

2.1 Expand the supply of SDRs in a frequent, predictable and politically independent way, so as to increase the existing stock at least in line with world GDP, gradually reducing the accumulation of dollars.

2.2 Establish a new committee (the 'International Monetary Policy Committee') to produce regular recommendations to the IMF board for new SDR allocations. The constitution of such a committee should be designed to ensure that its decisions are independent and fair. It might be chaired by the IMF managing director and composed of the heads of the central banks whose currencies make up the SDR, along with independent experts to allow independent decision-making on changes to the composition of the basket of currencies in the SDRs.

2.3 Establish a substitution account under the IMF into which member countries can deposit dollars, euros, yen or sterling, and receive the equivalent amount in SDRs in their account based on the exchange rate then prevailing. The size of this account should be limited initially and increased gradually, as experience is gained of its use by member countries and of the pattern of deposits and redemptions. Initially the substitution account might allow only one-way transfers, but it should work towards allowing both purchases and redemptions.

2.4 Take steps to increase the use of and demand for SDRs, beyond official circles, in international trade and finance:

2.4.1 The IMF should permit SDR accounts to be opened by private-sector actors.

2.4.2 The IMF or another suitable provider should create a settlement system, so that transactions denominated in SDRs can take place directly between buyers and sellers on a secure and transparent platform.

2.4.3 The development of SDR-denominated financial instruments and markets in which to trade them should be encouraged. In particular there needs to be a market-maker willing to buy and sell SDR bonds at bid/offer spreads that are competitive *vis-à-vis* those in existing bond markets. These measures would greatly strengthen confidence in the liquidity of SDRs (i.e. their marketability, acceptability by all countries, convertibility to the dollar and other currencies, and use as a unit of account and settlement for oil and other commodities).

3. Promote dialogue and policy coordination to provide stability, confidence and balanced adjustment

3.1 Foster greater efforts in the peer monitoring and assessment of the full range of economic policies that impinge on countries' balance of payments and exchange rates.

3.2 Encourage international dialogue between countries issuing a reference currency and individual or *groups* of countries using the reference currency. Consultation would pre-specify credible actions that would be taken in the case of growing imbalances and required change in reference currencies.

4. Strengthen the role and legitimacy of international institutions

4.1 Rebalance subscriptions to and voting rights within the IMF more rapidly and more radically than is currently taking place. These changes are needed to improve governance of, and increase international confidence in, the IMF. They are important in paving the way to wider use of SDRs. Without them the IMF risks becoming marginalized as an agent of a group of countries

with a dwindling global presence. Following the reweighting of the voting rights, the composition of the Executive Board should also be rebalanced.

4.2 Strengthen the IMF's 'score-keeping' capacity by allowing it to issue its own quarterly reports on exchange rate and other relevant policies. These would help in the evaluation of the full range of economic policies that affect exchange rates and the balance of payments, and establish a set of benchmarks against which countries' actual policies and policy commitments could be assessed. The IMF would thereby become more vigorously engaged in 'naming and shaming'. Both the management and the board must adjust the incentives for the staff to raise sensitive issues. IMF management, rather than the board, should have the authority to approve such surveillance reports, to further insulate the staff from political pressures.

4.3 Mandate the IMF to deal with currency misalignments and promote monetary coordination, or establish an institution for this purpose. Such an institution could start as a caucus of the countries issuing the reserve currencies – the United States, the Eurozone, the United Kingdom, Switzerland and Japan – and also include countries with the largest accumulation of reserves. This institution should eventually fulfil the function in terms of international monetary affairs that the World Trade Organization does for international trade.

Box 1: The Special Drawing Right

The Special Drawing Right (SDR) is an international reserve asset created by the International Monetary Fund in 1969. The SDR is largely used as a unit of account by the IMF, other international organizations (such as the Universal Postal Union), and agreements such as the Warsaw Convention and Montreal Convention. IMF member states can exchange the SDRs among themselves voluntarily. Private entities or individuals cannot hold SDRs.

The SDR is not a currency but a basket of currencies currently comprising the dollar, the Japanese yen, the euro and the pound sterling. The relative weights of these currencies are adjusted every five years. The next adjustment will take place in 2010.

The SDR was initially created to be a potential supplement to the dollar and gold under the fixed exchange rate regime of the Bretton Woods Agreement. However, the demand for SDRs declined after the suspension of convertibility of the dollar for gold in 1971 and the move by major economies towards a floating exchange rate system through the 1970s. More attention has been paid to the SDR recently after China, the largest holder of dollars as reserves, suggested that it might be an alternative international reserve currency.

There have been only four allocations of SDRs made thus far. The last two allocations of 161.2 billion and 21.5 billion were made in August 2009 and September 2009 respectively. The total amount of SDRs is currently 204.1 billion.

These SDRs are distributed to the IMF member states in accordance with quotas that are largely decided by the size of their economy and its openness. The quota determines each member's voting power in the IMF and its access to IMF funding as well as its financial obligations to the IMF. The Fourteenth General Review of Quotas is currently under way.

1. Introduction: No New Bretton Woods, but a System in Flux

Paola Subacchi*

Why the IMS?

It was cross-border, it was cross-sector, but the 2008–09 crisis was not a currency crisis. So why has the international monetary system (IMS) since been under the spotlight with suggestions – from President Nicolas Sarkozy of France and Governor Zhou Xiaochuan of the People's Bank of China to Governor Mark Carney of the Bank of Canada – that it should be reformed? Even if it was not at the heart of the financial crisis, the IMS is where tensions from globalization – and the conflict between domestic policy goals and international obligations – tend to coalesce. As the economic recovery kicks in – and we are no longer 'diving' together – the intrinsic asymmetry of the system becomes more evident. And the sense that the burden of adjustment is unfairly distributed may trigger protectionist responses in some countries.

But the IMS is also a system in flux. The steps that some countries are taking signal tensions and changes ahead. Indeed, the paths that the world's main economies – those of the United States, the Eurozone and China – are taking may be in contradiction, even if not in conflict, with each other. Domestic policy goals – i.e. growth and employment – may lead the United States to embrace an explicit policy of 'benign neglect' *vis-à-vis* the dollar. This may trigger tensions with both China – as the largest holder of dollars and dollar assets – and the Eurozone. China, on the other hand, may create tensions by keeping its currency undervalued while preparing for its internationalization. The Eurozone, in its turn, may try to avoid the burden of being the second reserve currency[1] and be tempted to respond to the upward pressures on the euro with competitive devaluations.

In this context, dialogue and policy cooperation play an important role in helping these countries to coordinate their efforts and rebalance the world economy. Policy cooperation should aim to avoid any protectionist reaction to exchange rate movements. It should also help prepare the ground for a smooth transition to a multicurrency system by fostering the exchange of information and cooperation among the world's main trading areas.

A systemic approach

Chatham House and the ESRC World Economy and Finance Programme have completed a joint project that takes a hard look at the current system and the way forward through a multidisciplinary approach. The aim is to close the gap in the debate on the IMS by providing an overview of the system – rather than some of its parts – and an assessment of the goals and principles that underpin it. Specialists from different areas of expertise have worked together, closely examining the current IMS in a systemic and interconnected way. The main conclusions of the project are summarized in this report. It should be emphasized that not all the contributors agree with all of the policy recommendations, or with the conclusions drawn in this introduction.

The contributions in this report range widely in approach and style, but several common themes emerge clearly and strongly. This introduction attempts to draw together the different strands of argument to offer a coherent overview. Such a summary, however, cannot

* I am indebted for comments on earlier drafts to Benjamin J. Cohen, John Nugée, John Driffill, DeAnne Julius, Vanessa Rossi, Mui Pong Goh and all the participants of the study groups..

1 As the ECB's President Jean-Claude Trichet stressed in an interview to the French daily *Le Monde* in November 2009, the ECB has no intention of strengthening the role of the euro as a global reserve currency (Delhommais and Leparmentier 2009).

replace the detailed and nuanced analysis in the individual chapters that follow.

The main conclusions of the project can be encapsulated in four key points.

- In a currency-based IMS, maintaining confidence in the primary reserve currency requires that the domestic policies of the country that issues that currency should not be in conflict with its international obligations, even if they cannot be aligned. In times of domestic stress, this can prove difficult and burdensome. When the issuer of the primary reserve currency is seen to put its domestic concerns first, as is almost inevitable, foreign holders of the primary currency become concerned about the consequences for and possible losses on their holdings.
- The erosion of confidence in the primary reserve currency and the availability of other international currencies point to the emergence of a multicurrency reserve system which could also include a supranational currency. Such a system would provide a more balanced counterpart to an increasingly multipolar economic order.
- We do not expect a big bang, but a long, gradual process of incremental change and adjustment. The steps taken by some countries, notably China's policy goal of making the renminbi convertible by 2020, suggest strongly that this decade will be one of transition. However, whether this transition will be smooth remains to be seen.
- The shape of the IMS for the twenty-first century will be significantly influenced by the views, interests and requirements of the emerging powers.

A *déjà vu* moment?

The history of the IMS is punctuated by recurrent debates and attempts at reform, especially in periods of turbulence when the confidence of both public and private actors is under pressure. Awareness of the system's limitations has always been acute, ever since the framework established in Bretton Woods in 1944 was discarded. Many commentators[2] remember the reform attempts by the Group of Thirty, the Committee of Twenty and the Plaza Accord, and they see very little new in the current debate. Is it correct to think that we have been here before?

> 'A fresher approach is needed, one that takes into account recent developments in the world economy'

From the early 1990s the world economy and international financial system have undergone such rapid and radical change that care is needed when making direct comparisons with earlier periods. Globalization and the rampant expansion of the world economy have resulted in worryingly large financial imbalances and a substantial accumulation of foreign exchange reserves by countries with a balance-of-payments surplus. The speed and magnitude of the recent crisis – greater than all previous crises in the post-war years – have added to international tensions. The IMS is deemed to be no longer adequate to meet the needs of a complex and integrated world economy. It may even exacerbate instability rather than contain it.

A fresher approach is needed, one that takes into account recent developments in the world economy. Such an approach should be systemic rather than just focusing on particular components of the IMS such as currencies and exchange rates. And the scope of the debate should include questions related to the changing dynamics of the global economic order.

Given that confidence in a single national reserve currency is what underpins the current IMS, we inevitably have to discuss the role of the dollar. Nonetheless, our focus is on the purpose and principles of the IMS. We start by asking whether the IMS can respond to the challenges

2 See, for instance, Cline (2005) and Truman (2010).

posed by the shift of the world economic order. In so doing, we bring in the view of emerging-market economies. These economies, China in particular, are concerned about the limitations of the existing system and the increasingly asymmetric burden of adjustment that it imposes.

The role of the primary reserve currency within the IMS

The IMS is the set of rules, tools, policies and institutions that govern the flow of money across the world economy. Providing the liquidity necessary to regulate and facilitate the international trade of goods and services and capital account transactions is its main purpose. We need currencies that can be used to invoice trade, that market players trust as means of payment and store of value, and that can be readily available to meet demand. Because money is also used by the official sector, we equally need currencies that can be used as a reference for central rates, as a means of intervention in foreign exchange markets and to form the basis for reserves holdings.

As John Nugée discusses in Chapter 2, the current IMS is currency-based. The demand for liquidity is met through the primary reserve currency – i.e. the currency most widely used in international transactions and held as a store of value. Such a system normally responds more flexibly than a non-currency-based system, such as the gold standard, to demand for liquidity.

The country that issues the primary reserve currency has a vibrant economy, deep financial markets and a range of short-term instruments for which there is strong foreign demand. As confidence underpins the whole system, this country must simultaneously maintain the stability of the currency's purchasing power and an inflation rate consistent with the preferences of the primary reserve currency holders. Ideally, from the point of view of the world, the supplier of the global reserve asset would behave in a public-spirited way and so exchange rate stability would take priority over domestic policy objectives such as employment and growth. For much of the time the two sets of objectives – domestic and international – may be compatible, and the balancing act sustained. But the risk is that in times of crisis or when the two sets are mutually opposed, the reserve currency country will put its domestic concerns and objectives first, with the result that confidence will be eroded.

Immediately after the Second World War the United States ran a current account surplus mainly thanks to its overseas investments. But over the years this proved increasingly difficult and the United States became a large net importer of goods and services while the rest of the world became its creditor. However, because there was no real competition to the dollar, confidence was never a pressing issue.

An inadequate system for a larger and more integrated world economy

Increased integration among the primary regions of the world – Europe, Asia and the United States – the expansion of global markets and the rise of the big emerging economies have contributed significantly to the expansion of the world economy since the early 1990s.[3]

Trade and capital flows have been the twin forces behind this expansion. Indeed they have grown at a far faster rate than world GDP and have outstripped growth in US GDP, which approximately doubled between 1993 and 2008. World trade expanded more than fourfold, from $3.7 trillion in 1993 to $15.7 trillion in 2008. Of this $12.3 trillion increase, $7.0 trillion came from growth of trade in the United States, EU, Japan and China.[4] During the same period financial integration also developed significantly, with a big expansion in capital flows and foreign exchange reserves, reflecting growing trade surpluses in Asia in particular. According to the available figures from the IMF, capital flows increased from just under $0.5 trillion in 1994[5] to $3.4 trillion in 2007. Of this, FDI rose from about

3 According to World Bank figures, between 1993 and 2008 it grew from $25.5 trillion to $40.3 trillion in constant 2000 dollars.

4 Figures from World Trade Organization.

5 This is the earliest IMF year for world total.

$0.25 trillion in 1994 to $2.2 trillion in 2007. Total foreign exchange reserves soared from just $1.5 trillion to $7.5 trillion by the third quarter of 2009 (IMF 2009). Two countries, China and Japan, accounted for $2.5 trillion of these reserves, a figure which further increased during 2008–09.

Globalization and the expansion of the world economy have boosted the share of international transactions, highlighting the limitations of a monetary system and policies that were designed for a less internationalized world economy.[6] A well-constructed IMS has two important functions. First, it should allow countries to run current account surpluses and deficits and accumulate net financial claims on each other. This is a mechanical clearing role, which the current IMS seems to manage well. Secondly, it should provide some form of mechanism to encourage a return to more balanced trading. This is where the current system seems to have problems, and it is also an area where policies matter.

A system under threat?

As Gianluca Benigno shows in Chapter 4, the dollar remains the primary reserve currency, representing about 60% of total foreign exchange reserves in 2008, higher than the level reached in 1995 when the IMF started systematic data collection. However, the persistent current account deficit of the United States has expanded in recent years, undermining the principle of confidence.[7] Even if the recession has contributed to reducing the US trade deficit and boosting the US aggregate savings rate – to nearly 9% in 2008, up from about zero in 2006[8] – it is highly likely that the trade deficit will simply pick up again if American consumers resume past patterns of behaviour.

Concern over the potential fragility of the current IMS is also widespread among holders of foreign exchange reserves. This is particularly true for China, which holds over $2 trillion in dollars and dollar-denominated assets as a result of its large current account surplus and FDI inflows.

As in the 1960s the Triffin Dilemma is kicking in.[9] The United States, as the main engine of growth for the world economy and the country issuing the primary reserve currency, runs a current account deficit and augments the world supply of dollars. The fiscal stimulus and bank rescues in response to the recession have already caused the deficit to balloon to record levels, and this has dramatically increased the volume of debt issuance. This high deficit could trigger a crisis of confidence in the dollar. There is reasonable concern – well expressed by John Nugée – that the United States may be approaching the tipping point at which over-issuance leads to the world community withdrawing its unquestioning faith in the dollar and dollar assets – and such a loss in confidence would damage the scope for the dollar to continue acting as the dominant reserve currency.

However, the end of the dollar as the primary reserve currency may still be some years away. As Benigno argues, this is due to the lack of strong contenders and also to the fact that the global crisis has served to strengthen the dollar's role as a safe-haven currency. More fundamentally, no other country is likely to achieve the dominance that the US economy acquired in the aftermath of the Second World War.

Whatever the final outcome, the short-term options are clearly limited. In Chapter 3 Catherine Schenk confirms this view by providing a valuable historical view of how sterling was gradually replaced by the dollar as the reserve currency. Contrary to popular conception that the dollar replaced the sterling at the end of the Second World War, Schenk found that the transitional process was much

6 Something that Peter Kenen stressed more than 20 years ago: '… stability cannot be achieved merely by endorsing it. Someone has to act differently' (Kenen 1988: 43).

7 It reached a peak in 2006 at 6% of GDP, to drop to just below 5% as recession struck in 2008.

8 Bureau of Economic Accounts, US Department of Commerce.

9 The Triffin Dilemma originally referred to the tension inherent within the gold exchange system of the Bretton Woods Agreement in which the dollar could be exchanged for gold. If the US stopped running balance- of-payment deficits, there would not be sufficient liquidity in the international economy. If the US continued its deficits, confidence in the dollar (or more specifically, the link between the dollar and gold) would be undermined. See also the discussion in Chapters 8 and 10.

longer, owing to the 'structure of the international monetary system and … collective global interest in its continuation'.

From a primary reserve currency to a multipolar reserve currency

The current system is structured in such a way that all players are locked by mutual interest in a form of stable disequilibrium. Disentanglement is likely to be long and complicated. This is evident in China's position as the largest holder of dollar reserves and hence its interest in maintaining the status quo.

There are few options for exiting the current system. One is a partial or total switch to a multicurrency reserve system. This would better respond to the need of a multipolar economy and provide the necessary liquidity without the constraints imposed by a single primary reserve currency system.[10]

Beijing seems to favour this shift. However, it has to be gradual so as to avoid undermining the value of existing dollar reserves. In Chapter 8, Gregory Chin and Wang Yong suggest two options that would suit China. The first is to establish a multicurrency regime in which the dollar, the euro and a regional Asian currency share the role of global reserve currency, backstopped by SDRs – a supranational reserve currency that could provide a new competitive mechanism to help discipline the issuing countries. The second option is the internationalization of the renminbi. Both options require time and a gradual approach, although the latter would probably precede the former. Moreover, domestic policies can have an impact on the internationalization of the Chinese currency; indeed, as Jim O'Neill suggests in Chapter 7, Zhou Xiaochuan, Governor of the People's Bank of China, may be highlighting to domestic policy-makers the need to bring forward the full convertibility of the renminbi[11] to pave the way for its inclusion in the basket of constituent currencies of the Special Drawing Right (SDR) in 2015.

Another possibility is to switch to the use of a supranational reserve currency. This is unlikely to take place in the near future. However, the greater use of SDRs might be an intermediate step in that direction. DeAnne Julius's proposal on SDRs in Chapter 6 eschews the radical 'big bang' approach, focusing instead on incrementally increasing the supply and demand of SDRs. She proposes two ways to expand the SDR supply: first, a regular allocation of SDRs via a new International Monetary Policy Committee which is linked to the IMF; and second, the creation of a substitution account whereby IMF member countries could deposit various currencies and obtain the equivalent value in SDRs. By only allowing one-way substitution in its initial stage – that is, countries are able to obtain SDRs by exchanging their currencies, but not vice versa – the issue of who bears exchange rate risk will be avoided. By allowing private agents to open SDR accounts with the IMF and by creating an SDR settlement system, these agents may find the use of SDRs more attractive. Julius's proposal takes into account the fact that private-sector actors rather than state actors will be the key determinant of the success of any migration from one reserve currency to another.

Cooperative solutions

From the above discussion it is clear that the current IMS is inadequate, but cannot be easily or quickly reformed or replaced, as the options currently available are either normatively undesirable or politically problematic. Any change to the current system and their implementation will take a long time. In the meantime, however, it is critical to ensure the sustainability of the old system and to avoid its collapse – with all the related shocks and costs that this might entail.

10 It would also 'free' the US from the burden of providing liquidity. For instance, Bergsten (2009) makes the argument that the dominance of the dollar is no longer in the United States' national interest because it has made it easier for the US to run large trade and current account deficits, thereby contributing to low interest rates, excessive liquidity and loose monetary policy and hence leading to the overleveraging and underpricing of risk that have characterized the current crisis.

11 The Chinese have announced that they will build Shanghai into an international financial centre by 2020, which suggests that the renminbi will be fully convertible by then.

The best interim solution, in everyone's interest, is for governments to work together to make the current IMS function as smoothly as possible. This means achieving some degree of policy cooperation, with countries exchanging information about current and future policy decisions while retaining their ability to pursue policies that are in their best interest.

Such a solution is elaborated in Christopher Meissner's contribution (Chapter 10), in which he argues for greater consultation and enforcement to ensure that the 'spillovers', which include the adjustment of asymmetric balance of payments and other imbalances, are minimized. He calls for mandatory dialogues between the reserve currency-issuing country and individual or groups of countries using this reserve currency, ensuring that the parties pre-specify actions to be taken to address the imbalances. This means, for example, engaging the two big surplus areas, the Middle East and East Asia, in devising a transfer of the burden of consumption towards surplus areas[12] – a task that Federal Reserve Chairman Ben Bernanke recently called 'extraordinarily urgent' (Guha 2009). Many believe that this requires intervention on both exchange rate flexibility, which involves monetary policy autonomy, and the level of the exchange rate itself.

For the realignment of exchange rates, which could help put the IMS on a more stable basis, policy cooperation is essential, especially where countries are largely engaged in international trade. As currency appreciation can damage the international price competitiveness of the country that implements it relative to that of neighbouring countries, one reasonable policy option is to agree on 'collective' currency appreciation *vis-à-vis* the dollar, which does not differentially affect individual countries' relative price competitiveness. Asia, once again, is the region where countries need to coordinate their exchange rate policies so as to avoid competitive devaluations against one another. This requires a convergence of exchange rate regimes. The existing policy dialogue processes among the region's finance ministers (such as ASEAN+3[13]) and central bank governors (such as the Executives' Meeting of East Asia-Pacific Central Banks) can play a critical role.

Institutions and the balance of power

Institutions are important in this context as a way to facilitate cooperation and the internalization of externalities through efficient bargaining among all players. This, in principle, does not require any form of supranational institution-building, but in practice transaction costs and distributional problems make such an outcome very difficult to achieve without the institutionalization of objectives, ways and means which is normally provided by a supranational framework.[14]

Unlike the international trade system with the World Trade Organization, there is no institution with the mandate for the governance and management of the IMS. And as long as the world's reserve currency was a national currency of one state, there was no need for such an institution.

The closest is the International Monetary Fund (IMF) in so far as its role in monitoring international macroeconomic and financial affairs includes issues related to the IMS. The recent upgrading of the IMF by the G20 as the main forum for international financial and economic affairs, and the willingness of some G20 countries to include reforms to the IMS in the future agenda,[15] signal that the IMF may become the key institution to deal with the functioning of the IMS. There are of course several problems with this, from the IMF governance – that has yet to change to match the different political and economic landscape – to the deep mistrust of the IMF that has built up over the years among developing countries, especially after the poor handling of the Asian financial crisis in 1997–98.

12 It can be argued that, like the country issuing the primary reserve currency, emerging countries face the dilemma and difficulty of putting what is good for the world ahead of what is good for themselves.

13 ASEAN +3 includes China, Japan and the Republic of Korea.

14 In policy cooperation/coordination the concept of public goods is central. These are goods that either are not supplied by the market or are supplied in insufficient quantity. They have two critical properties. First, it does not cost anything for an additional individual to enjoy the benefits of the public goods. Second, it is in general difficult or impossible to exclude individuals from the enjoyment of the public goods.

15 See Sarkozy's comments in Davos in 2010, which are cited in Bennhold (2010).

Mistrust of the IMF is in part also due to the perception that its surveillance is asymmetric, with the greatest attention paid to the weaker developing states or those in surplus, while the major deficit and surplus countries, the United States and China, are tolerated. In Chapter 9, Jeffrey Chwieroth provides several proposals which will enable the IMF to adopt stronger and more consistent surveillance. These proposals include the IMF issuing its own quarterly report on exchange rate policies with a set of benchmarks to assess each state's adherence to these; assessing a wider range of policies – including for the monetary, fiscal, exchange rate and financial sectors – instead of focusing narrowly on the exchange rate; and insulating the IMF staff from political pressures from their own board.

> "It is critical to restore and manage confidence, since it remains the key principle underpinning the IMS. Again, policy cooperation is essential"

This is not to say that the IMF has made no attempt to overcome some of the more severe criticisms. In Chapter 11, Christopher Adam, Paul Collier and David Vines show that the IMF has shifted from a 'presumption that countries in external difficulty must always adjust to this problem, and do so rapidly, to one that sees financing as a possible alternative to short cuts and rapid adjustment'.

The fall-back position and the way forward

Looking at the complexity of any plausible, albeit gradual, attempt to reform the IMS, there may be a case for doing nothing. John Driffill convincingly argues in Chapter 5 that the world has slowly been learning to live with floating exchange rates for more than three decades and individual countries have worked out a variety of arrangements for monetary policy, exchanges rates and financial stability to suit their own individual perceived circumstances and needs. Failed attempts to fix or manage exchange rates and unsuccessful experiments with policy coordination have shaken people's confidence in concerted action – we have been there before! Driffill suggests that the 'fall-back option' – 'business-as-usual, laissez-faire, muddling through' – is not such a bad thing.

But in the post-crisis world, where jobs and growth are dominating the policy agenda in many countries, the fall-back option carries the risk of leaving the system unmanaged and broadening the scope for governments to intervene by means of either uncompetitive devaluations or protectionist measures. The United States may be heading towards increasing difficulty in reconciling domestic policy objectives with policy settings that are consistent with global exchange rate stability. The governments of the Eurozone, on the other hand, may find it difficult to justify a strong euro with their constituencies. Such a context calls for some greater level of cooperation. Only through a coordinated effort can countries – 'new and old power centres' – share the task of exercising global responsibility.

It is critical to restore and manage confidence, since it remains the key principle underpinning the IMS. Again, policy cooperation is essential. In fact, as soon as the foreign exchange market regains confidence in the United States, the dollar may even begin to appreciate. This clearly risks triggering further problems with imbalances unless efforts are made to offset such a trend. A more desirable outcome is for China to return to its previous policy of steadily revaluing the renminbi once global growth looks more secure. Such a combination could help defuse current concerns about the imminent collapse of the IMS and dollar-based system, creating a breathing space in which to address wider reforms of this creaking system. For this it is important to ensure the sustainability of the system and avoid its collapse – with all the related shocks and costs that this might entail. Countries should become more engaged in reforming the existing IMS arrangements, a strategy that, according to Chin and Wang, China seems to have already embraced.

Table 1: Problems and possible solutions

Existing problem	Proposed solution	Knock-on problem	Responsible actors	Possible actions to be taken	Likely difficulties to be faced
Over-reliance on single national reserve currency	Greater reliance on SDR	Little demand for SDR	Private actors	(i) Open SDR accounts with IMF/suitable operators to clear transactions (deepen capital markets) (ii) Issue bonds in SDR	Will need to enhance liquidity in SDR markets to overcome resistance to their use
Over-reliance on single national reserve currency	Greater reliance on SDR	Little demand for SDR	National governments	Offer SDR-denominated financial products e.g. issue SDR bonds to develop capital markets for SDR	Will need to enhance liquidity in SDR markets to overcome resistance to their use
Over-reliance on single national reserve currency	Greater reliance on SDR	Lack of demand for SDR	IMF	Set up one-way substitution account	Governments may prefer flexibility of two-way substitution
Over-reliance on single national reserve currency	Greater reliance on SDR	Lack of demand for SDR	IMF	Set up two-way substitution account	Who will bear the exchange rate risk?
Over-reliance on single national reserve currency	Greater reliance on SDR	Lack of supply of SDR	IMF	Issue SDR regularly in line with world GDP	A rapid expansion of SDR supply may be necessary to achieve a significant impact
Over-reliance on single national reserve currency	Diversification of currencies	Non-convertibility of the Chinese renminbi, currency of a huge and growing economy	China	Make the renminbi convertible by 2015	The Chinese banking sector may not be ready
Over-reliance on single national reserve currency	Diversification of currencies	Governance of the Eurozone	European Central Bank	Harmonize fiscal policy in Eurozone	Will need a greater political appetite in the EU (not only in the Eurozone) than is currently available
Lack of confidence in the governance structure of the IMS	Changes to governance structure of IMF	Lack of confidence in the neutrality of IMF	IMF	Develop more multi-faceted indicators to review members' economic policies (rather than simply focusing on exchange rates and balance of payments)	Difficult to agree what these indicators ought to be
Lack of confidence in the governance structure of the IMS	Improved coordination between IMF and other multilateral institutions	Lack of confidence in the neutrality of IMF	IMF	Work more closely with the World Bank to ensure that both macroeconomic and microeconomic reforms are undertaken	
Negative spillovers	Promotion of cross-border dialogue and policy cooperation	Lack of accurate information	IMF	Improve surveillance	Difficult to get governments to agree on indicators and to submit to surveillance
Negative spillovers	Promotion of cross-border dialogue and policy cooperation	Lack of legal sanction	National governments	Improve peer review	Difficult to get governments to prioritize international needs over domestic ones

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2. Reconsidering the Reserve Currency Question

John Nugée

1. Introduction

The role of the dollar as the world's reserve currency has frequently invited debate and, for countries that have large dollar asset holdings, also caused concern. More than 40 years ago the then French finance minister Valéry Giscard d'Estaing referred to the United States' 'exorbitant privilege' of being the issuer of the reserve currency, and President Charles de Gaulle publicly worried about the value of France's dollar assets and sought to convert them into gold. But the debate was given added impetus in 2009, when various senior members of the Chinese government offered some observations on the question of the optimal reserve currency arrangements for the world's financial system. In essence they were seeking to open a debate on whether the current position, in which the dollar is the world's dominant international currency, was ideal either for themselves or for the world community in general, and invited comment from other governments and market participants.

This chapter contributes to that debate. The argument is developed over four sections. Section 2 explores the background to China's concerns, and considers the case for change in the current position of dollar supremacy. By analysing the position of the reserve currency issuer in history, the section considers why the dollar's period of hegemony might be nearly over and whether its decline is inevitable. Section 3 builds on the conclusion that no currency can expect to remain the world's sole or even dominant reserve currency for ever, but finds that there are no obvious alternatives to the dollar at present: the more dramatic reports of the dollar's demise are premature, and there is little prospect of any single currency supplanting the dollar in the near future.

Section 4 takes as its starting position that the dollar will continue to have a major role for a considerable time; it considers existing supplementary arrangements to the dollar, and how the current regime might be augmented and strengthened. It then looks in more detail at one of these suggestions, namely that there might be a larger role for the IMF's Special Drawing Rights (SDR). The section considers the mechanics of a supranational currency, and by drawing on lessons from the establishment of the euro, discusses a possible path for the SDR to gain wider usage. Section 5 concludes.

2. The case for change

2.1 China's concerns

The views expressed by China and other nations over the role of the dollar can be summarized very simply as a concern over future US inflation. The level of dollar issuance is high and has recently risen dramatically as the US administration seeks to counter the financial and economic crisis, and overseas holders of dollars (in particular in the form of fixed income securities) are naturally concerned that they may be holding a depreciating asset which will be subject to inflation. Creditor nations draw attention to America's current account deficit – the counterpart to their own surpluses – and are querying whether the political will exists in the United States to rectify the imbalances behind it, and therefore to stem the supply of dollars to the world's markets.

In effect, these nations are expressing fears that the United States might seek to defray its obligations to them by inflating them away. As well as harming America's creditors directly, this would also render the dollar less effective at performing one of the three main functions of a reserve currency, that of a reliable store of value. There

would be concomitant harm not just to current creditor nations but to anyone seeking to use the dollar for this purpose in future.[1]

While America's creditors are certainly entitled to debate how safe their assets are and the strength of the commitment by the United States to repay their borrowings 'in good coin', the existence of global imbalances, and in particular the large US current account deficit, is not new and the cause of them has been the subject of considerable debate for some years.[2] However, a more fundamental question is whether a reserve currency country can ever run significant surpluses over the long term, or whether something in the dynamics of a reserve currency prevents this.

It is not easy to address this question, not least because every reserve currency issuer is to a certain extent *sui generis*, but in order to shed some further light on the issue, and to see whether the United States has a specific case to answer over the imbalances that have prompted China's remarks, the next section explores in a little more detail some of the features of a reserve currency.

2.2 The dynamics of a reserve currency

The establishment of a reserve currency is seldom decreed by law or agreed by governments. Rather, it arises naturally as a result of choices made by a multitude of financial operators, and since one of the main qualities that those financial operators are seeking is general acceptance of the currency by other operators, the choice tends to be made on the basis of consensus and critical mass rather than anything more scientific or precise.

This has two general consequences. First, although there may be a number of international currencies at any one time, some of which may even reach the status of regional reserve currencies,[3] there is commonly only one global reserve currency at a time. Secondly, the process of changing the reserve currency is often a gradual one as adherents of the current reserve currency only slowly relinquish their use of it in favour of an alternative, until a final 'tipping point' when the critical mass switches to the new currency.

Neither of these rules is absolute. In particular, the end of a currency's reserve status can be quite sudden, as for example when the pound sterling ceased fairly abruptly after the Second World War to be either a reserve currency or even (because of exchange controls) an internationally traded currency at all outside the sterling area. But without major external factors such as war or the imposition of exchange controls, the decline of a currency's status as a reserve currency can be prolonged. And this raises the question of why, in the early stages of this process when the status of the existing reserve currency is still not seriously in doubt, the consensus of market participants should start to edge away from it.

The dynamics of a reserve currency mean that the issuing country has to ensure that other countries have easy access to an adequate supply of its currency. This is essential: international operators need to be assured that the availability of the medium of international exchange is not in doubt; and they need to be able to acquire it easily and at reasonable expense. The latter condition is not often a significant issue – it mainly requires the reserve currency to have deep and liquid markets open to international players – but the former can pose challenges. This is not least because the issuer of a reserve currency, at least when it first acquires that status, is almost by definition a strong country with a vibrant economy, and such economies often maintain significant current account surpluses.

This challenge – for a surplus country to ensure that enough of its currency is available to other nations – is by no means trivial; indeed it dominated the discussions at Bretton Woods as the post-war financial system was established. Since the United States emerged in 1945 as incomparably the most powerful economy in the world, the dollar was the only conceivable choice for the anchor currency for the global financial system. It is worth

1 Note that moderate inflation *per se* does not seriously undermine the effectiveness of the dollar's performance in the other two functions to which a reserve currency is put – that of a medium of exchange and of a unit of account. Indeed a currency is able to operate as an effective medium of exchange even when inflation becomes relatively aggressive; it is only in the later stages of hyperinflation that it ceases even to be usable for payments.

2 Including a series of conferences at Chatham House between 2005 and 2007 and a published study paper (Meade 2005) on the subject.

3 Most obviously the euro has this status in much of non-Eurozone Europe and (to a lesser but still significant level) in North and Francophone West Africa, for example. But some other currencies also perform this role; the South African rand is used as a regional reserve currency both formally in the Rand Monetary Area and more generally in Southern Africa.

recalling that one of the main questions facing the Bretton Woods negotiators was how other countries, many of whose economies were in ruins, were to acquire the dollars to be able even to form a part in the global economy. If the United States continued to run current account surpluses, it would drain the rest of the world of what tradable currencies there were, or end up stock-piling gold, or be forced to act as the creditor of last resort to other nations. The first two outcomes would have been highly deflationary for the world economy, while the last of the three was deeply unattractive to the US authorities.

Experience shows, however, that the problem is often self-correcting, and for a number of reasons the issuer of the reserve currency seldom remains a surplus country indefinitely. Partly, consumption tends to rise as the nation exploits its position of power and plenty. More significantly, the twin facts that the issuer of a reserve currency can pay for its imports with its own paper, and that demand for that paper is strong, remove the main balance-of-payments constraints faced by other countries: that of the need to finance imports with foreign exchange, and the need to persuade creditors to lend to them if their reserves of foreign exchange run short. In effect, while for ordinary countries both the foreign exchange reserves and the creditworthiness and ability to borrow to replenish them are assets in limited supply and in need of careful husbanding, neither constraint is binding on the issuer of the reserve currency.[4]

2.3 The current position of the United States

Over the last 60 years the United States has followed almost exactly the common trajectory of reserve currency issuers. A large current account surplus in the years immediately following the Second World War has given way to the present position, where America is a large net importer of goods and services, and the rest of the world is increasingly its substantial net creditor.

For many reasons, it was both understandable and desirable that the United States should turn from the world's major creditor nation in 1945 into the world's main consumer nation. The privilege of issuing the world's reserve currency both facilitated this transformation and in a way required it, and over the last 20–30 years the world has in general enjoyed a succession of longer periods of stronger growth because of it. Unfortunately every reserve currency issuer, going back to the Athenians in the 5th century BCE, has ultimately abused this privilege; every reserve currency issuer has over-issued its currency[5] and eventually found trust in its credit withdrawn by the rest of the world.

> 'The concern is that the United States may be approaching the point at which it too joins previous reserve currency issuers, and at which over-issuance of dollars leads to the world community withdrawing its unquestioning faith in the dollar and dollar assets'

The concern is that the United States may be approaching the point at which it too joins previous reserve currency issuers, and at which over-issuance of dollars leads to the world community withdrawing its unquestioning faith in the dollar and dollar assets. Many – not least in the United States itself – will hold the view that this concern is premature, but as history has shown, it is inevitable that the reign of the dollar will eventually end, and the only question is whether we are approaching that time. That is the issue the Chinese, as one of the main holders of dollars, have sought to raise.

4 Note that despite this analysis, we cannot in fact answer the question posed at the end of section 2.1. All we can say is that the evidence suggests that reserve currency issuing countries tend to move into current account deficit as their position matures – and that this is in passing beneficial for the rest of the world as it enables other countries to acquire holdings of the reserve currency.

5 In earlier times under precious metal-based monetary systems, the reserve currency issuer would 'overissue' by debasing its coinage (i.e. by mixing base metal with the precious metal from which the coins were meant to be minted), and relying on their coins' status as reserve assets to ensure their continued acceptance.

3. The alternatives to the dollar

The transition from one reserve currency to a successor usually requires both an acceptance among market participants that the current reserve currency is becoming unable to continue in the role, and a successor country able and willing to allow its currency to take up reserve currency status. Willingness is by no means a minor detail: when the status of the dollar was last seriously questioned, in the late 1960s and early 1970s, as America struggled to finance its military operations in Southeast Asia, there was no alternative country and currency both able and willing to take its place. Although both the other nations in the G3, Germany and Japan, were by then running successful economies with strong currencies, neither was keen to see an internationalization of its currency, especially if that implied a convertibility to gold; and it is also debatable whether their economies, vibrant though they were, were large enough to shoulder the burden.

In many ways the position is not wholly dissimilar today. The most obvious alternative reserve currency to the dollar is the euro. But while the Eurozone is a much larger economic unit than Germany alone was 40 years ago, and public speeches by the leaders of Europe's economies all purport to seek a larger international role for the euro, there remain question marks over the willingness of the European authorities to allow it to become the sole reserve currency, and even over whether Germany's traditional reluctance to internationalize its currency has fully abated. Moreover, the Eurozone economy is likely to stay in surplus for some time and also relatively slow-growing, and the long-standing question remains of how the rest of the world would acquire euros should it become the reserve currency.

The other G3 currency, the Japanese yen, is not a serious contender for global reserve currency status. The Japanese economy remains too small to support a reserve currency and it shares the position of the Eurozone of being slow-growing and predominantly in surplus – though there is at least a ready supply of yen-denominated government bonds for investors to buy.

The other possible alternative reserve currency is the renminbi. Here there is no doubting the Chinese authorities' long-term ambitions, and in due course it is very likely that they will both seek and facilitate an international role for their currency. But it is not even fully convertible yet, and it is therefore quite unable to act as an international reserve currency. The same is true of the other major emerging economies such as India, Brazil or even Russia, with the added disadvantage that these economies are an order of magnitude smaller than that of China today.

There are no thus obvious alternatives to the dollar at present and the more dramatic reports of the dollar's demise are indeed premature.

4. Alternative reserve currency arrangements

If, as the previous section has concluded, there are no obvious national currencies that stand ready to replace the dollar, how might the concerns of those who question its suitability be addressed? Three main alternatives have been discussed: a return to a non-currency base for the world's monetary system, a system of multiple reserve currencies, and the use of a supranational currency.

4.1 Non-currency base

This option is a clear harking back to the gold standard, when monetary gold underpinned the global financial system. Without here exploring in depth the full ramifications of a commodity or specie base for money, it is only necessary to recall the challenges posed by the gold standard (lack of ability to increase the money supply at will; difficulty of maintaining the liquidity and range of instruments in the specie base that modern markets need; settlement challenges) to realize that a specie base is not likely to prove a way forward. Indeed, the gold standard only really operated through the link between gold and the reserve currency of the day: it was underpinned by the convertibility of first the pound sterling and then the dollar into gold, and there is no appetite at all in Washington or indeed anywhere else for a return to the days when the dollar was convertible at the gold window.

4.2 Multiple reserve currencies

This system, alongside a still pre-eminent dollar, is a more possible scenario, and might indeed be how the world

develops. In a world of regional trading blocs (Europe, Asia, the Americas) it is by no means an unimaginable solution or an unworkable one. It has the disadvantage, however, that one loses economies of scale: each of the several reserve currencies will tend to have less liquidity and less deep markets than the present single reserve currency. And for this reason such a system has historically usually proved to be a temporary interlude, and a precursor to one of these currencies becoming dominant and the sole reserve currency.

4.3 Supranational currency

Again this would operate alongside rather than instead of the dollar. Such as system has been considered before – John Maynard Keynes proposed a global currency, to be called the bancor, as the centrepiece of his plans for stabilizing the global economy after the Second World War. There were many reasons for the failure of the bancor plan to gain any acceptance, not least the problem that America, as the then dominant creditor, would have ended up as the main holder of bancors, and that consequently the then US administration was unclear whose liability the asset would be or how it would be guaranteed.[6]

This lack of a fiscal authority to support a world currency remains a significant stumbling block. A fiat currency ultimately relies on the standing of the issuer, and it is far from clear who would issue a global currency, or with what authority or fiscal resources they would do so. Indeed, the same questions have at various times been asked of the euro, not least when problems in a number of European banks necessitated a call on fiscal resources to support them. The issues surrounding the euro – which for all the cooperation of the member states that use it and for all the technical excellence of the ECB remains a currency without a competent federal fiscal authority to support it – suggest that the challenge for any global fiat currency to supplant the dollar completely would be too large.

Nevertheless, this is not to suggest that there is no opening for a greater use of a global currency alongside the dollar. And given the existence of the SDR – now much augmented by the creation in August 2009 of some SDR 183 billion, which brought the total of SDRs in existence to 204 billion, or around $320 billion – it is a legitimate question as to how its use could be increased, and whether it could help solve some of the issues raised in the public debate earlier in that year.

However, there are practical obstacles to the use of the SDR as a reserve currency. Not the least of these is its availability: at the moment only members states of the IMF can transact in official SDR,[7] and only with each other across the books of the IMF. For the SDR to become a reserve currency there would have to be a significant increase in both supply and availability to non-official actors.

Other contributors to this report have commented on this at greater length and in more detail, but the history of the euro offers some guidance as to how this might be achieved. The euro started in the 1970s as the 'European Unit of Account', an untradable book entry unit for the European Commission, to enable it to facilitate payments between member states. In this it fairly closely resembled the current status of the SDR, and it was only when it was converted into the European Currency Unit (ecu), and then later when a private market in ecus started up, that the unit of account began to take on the form of a genuine currency – once private-sector agents could buy, sell and create obligations in ecus, a genuine two-way market in ecus arose.

This is a significant precedent for any greater use of the SDR: if it is to gain wider usage it will require either greater issuance and availability of the official SDR or the creation of private SDRs. The latter route may prove the more attractive, as it does not put the issuer of official SDRs (the IMF) at risk of balance-sheet exposures it may not want.

Other lessons from the ecu's history and its evolution into the euro also provide insight. First, in its later years there was a general presumption – held more strongly at some times than at others but never entirely lost – that at some stage the then European Community (now EU) would seek to

6 The United States put forward a counter-proposal to the bancor called the unitas, its main champion being Harry Dexter White, a senior US Treasury department official. The unitas was more a unit of account, and crucially as a result it did not create an extra supply of money for the world monetary system. It is perhaps not surprising that the proposals of the United Kingdom (as the main debtor in the developed world at the time) and the US (as the main creditor) should differ in this way, nor that it was the US view that prevailed, and when the SDR was eventually created in 1969, 25 years after the Bretton Woods conference, it had much more in common with the unitas plan than with Keynes' bancor proposal. The parallels between the UK and US position in 1945 and that between the US and China today will not be lost on the authorities in Washington and Beijing.

7 Plus a few supranational bodies, but their activities do not materially alter the general position.

introduce a common currency and would in doing so effect a merging of the official and private ecu. This 'convertibility end-game' helped underpin the value of the private ecu and hold it relatively close to the sum of its basket weights in 'real' currencies; without it, there would have been a significant risk that, as a 'currency' with no official issuer or fiscal backing at all, it could have ended up unwanted and worthless. Would a private-sector SDR without guaranteed convertibility into the underlying basket currencies have the same degree of underpinning, or would it be at risk of considerable volatility around its 'official' value?[8]

Secondly, use of the ecu only began to gather any momentum when private-sector operators promoted ecu-denominated securities, and private- and official-sector clearing systems and depositories made available settlement facilities in the currency. The same facilities would have to be established for a private SDR before any significant development of the market could take place.

The final lesson from the ecu's history is slightly more sobering. For all the enthusiasm of certain private-sector operators for the ecu and for the market in ecu securities,[9] it remained a niche product until it was transformed into the euro on 1 January 1999. Only then did general use of the currency, including its use as a regional reserve currency, become a reality.

5. Conclusion

Debates over the optimum monetary system for the world are not new, and the debate over the role of the dollar follows in a long tradition. But that does not detract from their validity or the urgency of addressing them. What may be different today is that there is no underlying asset such as gold into which dollars can be converted to safeguard the value of reserve assets (as there was in the 1960s), and there is no obvious alternative national currency to the dollar as a medium of exchange (as there was when similar concerns were expressed about sterling in the 1930s). It is in this light that the potential of the SDR to fill some of the gaps and alleviate some of the concerns expressed over the dollar is an interesting one.

Realistically speaking, for the SDR – or any other supranational solution – to gain significant traction and support will require a degree of international cooperation that has not been commonplace in recent years. However, with memories of the global nature of the financial crisis still fresh, and with the impetus at the G20 and in other fora for a global solution to our global problems, it is not impossible to see some progress being made. Ultimately, a world of nation-states must decide that it has more to gain from pooling its interests than from pursuing national objectives: if we are able to reach that point, it may be that, 40 years after it was originally created, the SDR is an idea whose time has finally arrived.

Reference

Meade, Ellen (2005), *Implications of External Imbalances for Monetary Policy-Makers: How Much Should the Fed Worry and What Can It Do?*, Chatham House Briefing Paper, IEP BP 05/05, May.

8 A useful analogy here is between shares in an exchange traded fund (ETF) and shares in an investment trust. The former has a convertibility arrangement allowing holders of its shares to switch them for the ETF's component securities, with the result that ETF shares stay very close to the underlying asset value. The investment trust does not, with the result that its shares can trade at considerable discounts (and, though less often, at a premium) relative to the underlying value.

9 Most notably Banque Paribas, but there were several other leading institutions promoting the use of the ecu at the time as well.

3. Lessons from History

Catherine R. Schenk*

Moving from one global currency to another

The global reserves system is coming under increased scrutiny both as a contributor to the current global crisis and as a threat to future stability. The conventional economic view is that the role of the dollar as primary international reserve asset, combined with the accumulation of substantial reserves in East Asia, contributed to America's ability to accumulate large balance-of-payments deficits and cheapened government borrowing. Depressed US interest rates fuelled the consumer and mortgage debt boom. Meanwhile the sustained decline in the value of the dollar from 2002 prompted a reconsideration of how long it could remain the world's primary reserve asset and if, when and how it might be overtaken by another currency such as the euro. The prospect that more countries will accumulate precautionary reserves in the wake of the crisis, thereby renewing the cycle, has prompted questions about the costs and benefits of issuing an international currency, how international currencies emerge and how they can be replaced without disrupting the global economic system.

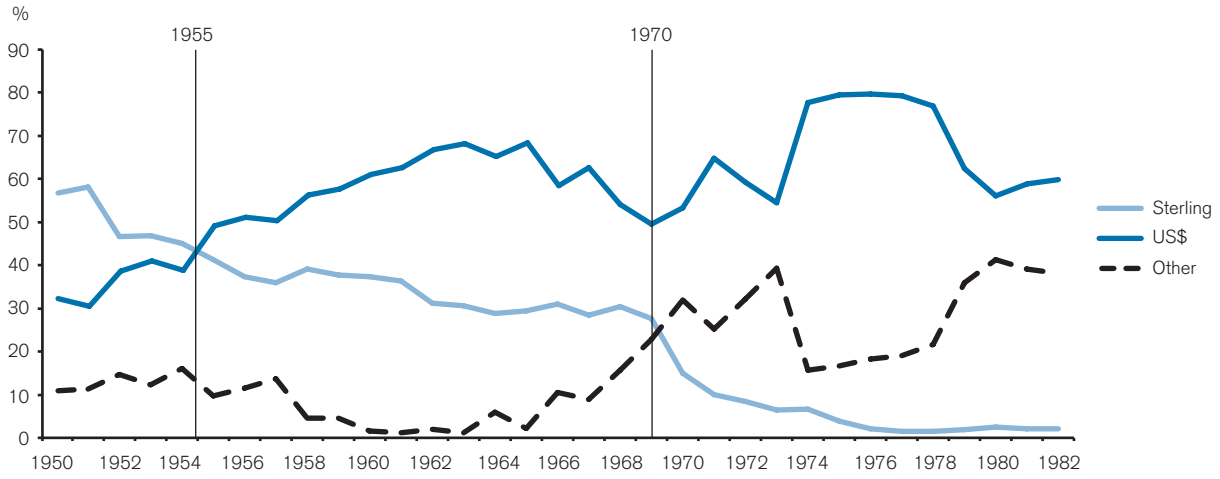
These questions are similar to those posed during the 1960s when the system appeared to be unsustainable owing to persistent American deficits and declining confidence in the dollar. In the 1960s these problems proved intractable and were in the end resolved temporarily by the advent of floating exchange rates (for core global currencies) and financial innovation, which together reduced the need for national precautionary reserves. In the process, the secondary international reserve currency, sterling, was retired. The case of sterling in the post-war decades provides an opportunity to examine the process of a reserve currency in decline.

Although the demand for reserve currencies can be modelled with a range of variables including issuing-country size, share of world trade and return on assets, these exercises have reinforced the importance of institutional rather than economic determinants. The important role of inertia is usually attributed to network externalities that prolong reserve currency status beyond the time predicted by economic fundamentals (Chinn and Frankel 2008: 49–73). These externalities suggest a tipping point or landslide effect should one major creditor switch its assets, so that the retirement of a reserve currency is likely to be non-linear. Examining the case of sterling in the post-war period helps to understand the determinants and timing of shifts from one major reserve currency to another. As in the case of the dollar today, the demise of sterling was widely anticipated but the process was more gradual than expected and its widely predicted abrupt collapse was avoided. A major source of inertia in this case was institutional support mechanisms to delay the tipping point for the pound. This analysis also supports Eichengreen's contention that more than one important reserve currency can operate at the same time, although this was artificially managed in the 1960s through exchange controls and bilateral agreements (Eichengreen 2009: 53–68).

At the end of the Second World War, it was clear that the dollar would be the dominant international currency in any global economic reconfiguration, and this became the core of the Bretton Woods system. Most rich countries pegged their currencies to the dollar, while the United States alone valued its currency directly in gold. Nevertheless, there continued to be a role for a secondary international currency to be used as a reserve asset, anchor currency and currency of settlement because the supply of dollar assets and gold was restricted in the immediate post-war period by US balance-of-payments surpluses.

* This chapter summarizes the argument in Schenk (2010).

Figure 3.1: Currency distribution of global foreign exchange reserves, 1950–82 (SDR valuation)



Source: Author's calculations

The system thus assumed that more than one major reserve currency could operate at the same time over a prolonged period. In the 1950s the sterling area (35 countries and colonies pegged to sterling and holding primarily sterling reserves) accounted for half of world trade, and sterling accounted for over half of world foreign exchange reserves. In the early post-war years, this share was even higher: the IMF estimated that official sterling reserves, excluding those held by colonies, were four times the value of official dollar reserves and that by 1947 sterling accounted for about 87% of global foreign exchange reserves.[1] It took ten years after the end of the war (and a 30% devaluation of the pound) before the share of dollar reserves exceeded that of sterling. This rather contradicts Chinn and Frankel's assertion that 'by 1945 the dethroning [of sterling] was complete'. Figure 3.1 shows the changing composition of foreign exchange reserves from 1950 to 1982.

How should the gradual nature of the decline of sterling be explained – what Paul Krugman (1984: 274) refers to as a 'surprising persistence'? Was this due to British government efforts to prolong sterling's role because it increased the capacity to borrow, because it enhanced Britain's international prestige, or because it supported London as a centre for lucrative international finance? These are the traditional explanations in the literature, but archival evidence shows that from the 1950s many British ministers and officials believed that the burdens of sterling's role in terms of cost of borrowing and confidence in the exchange rate outweighed the benefits of issuing an international currency, such as greater international demand for UK national debt. Krugman asserted that 'the preeminence of sterling and its displacement by the dollar [after 1945] were largely the result of "invisible hand" processes, ratified more than guided by international agreements' (1984: 261). Closer examination, however, shows that sterling's role was prolonged both by the structure of the international monetary system and by collective global interest in its continuation. As the market network externalities for sterling reserves were eroded, the retirement of sterling as a reserve currency was postponed through negotiated management among the developed and developing world, i.e. positive externalities in terms of global stability were identified and deliberately protected. In contrast, the retreat of sterling as a commercial currency was achieved unilaterally through exchange controls that encouraged the use of dollar and the offshore Eurodollar market, which led to the displacement of sterling as the

1 At this time foreign exchange was only about 30% of global reserves, but gold holdings were highly concentrated in the United States, so that foreign exchange made up about half of global reserves excluding the US.

currency of the City by the 1960s. The reserve role was less easy to shed. In 1971, UK accession to the EEC made it necessary for the UK government to be publicly explicit that sterling's reserve role would be eliminated as soon as possible. Still, this proved elusive.

During the early 1950s the UK Treasury devised various plans to discourage the use of sterling as a reserve currency by increasing exchange rate volatility or unilaterally suspending convertibility, but these plans were abandoned because they jeopardized Britain's political as well as economic relations with creditors, and because the retaliation and disruption to the international monetary system that would ensue threatened domestic priorities of full employment and price stability.

By the early 1960s, the future of sterling as a reserve currency became embroiled in global efforts to reform the international monetary system once it had become clear that the practice of using national currencies as international reserves in the pegged rate system was flawed. The accumulation of international reserves required persistent deficits to be run by issuing countries, and this ultimately undermined confidence in the value of those reserves. For sterling this was not such a threat since the value of overseas sterling reserves did not increase, although their geographical distribution shifted dramatically towards the Middle East and East Asia. Rather than managing an increase in sterling reserves, British proposals aimed at replacing existing sterling reserves with some other form of asset that would not be directly issued by the United Kingdom. This would reduce the liquidity of these UK liabilities and ultimately remove the strain of retiring outstanding liabilities when sterling reserves decreased, which they were expected to do. The weakness in the system was the apparently precarious ratio of outstanding sterling securities held in the reserves of other countries relative to the slim volume of United Kingdom's dollar and gold reserves (the ratio was 4:1 in the immediate post-war period). This exposed sterling to a collapse if there was a rapid switch to the dollar. British governments and central bankers were successful in using the threat that the collapse of sterling as a reserve currency would lead to systemic crisis to gather extraordinary credit from the United States, IMF, Bank for International Settlements (BIS) and G10 while the world debated how to replace reserve currencies.

The process of global reform was much more prolonged than expected and in the end the outcome (the SDR) was not radical enough to meet the task of retiring sterling. In the meantime, a multilateral support system was developed at the BIS that comprised three successive Group Arrangements in 1966, 1968 and 1977 whereby central banks pledged substantial lines of credit to minimize the impact of a tipping point away from sterling. These safety-net schemes aimed to forestall a rush away from sterling as a reserve currency by retaining market confidence and reducing the first-mover advantage from a flight from sterling. In 1968 (under pressure from G10 central banks) the United Kingdom also built a system of bilateral commitments with holders of sterling to limit diversification in return for a guarantee of the dollar value of 90% their sterling reserves. These Sterling Agreements were renewed three times before finally being allowed to expire in December 1974. This forestalled some diversification, although the minimum ratios were set lower than the *status quo ante* in many cases and the thresholds were rarely binding. Although sterling's share of international reserves fell sharply in the early 1970s to below 10% of the total, accumulations of sterling by oil producers left Britain vulnerable to diversification in 1976. This provoked a final scheme to replace sterling reserves with UK-issued foreign currency bonds, again underpinned by a line of credit from G10 central banks, marking a final end to sterling's reserve role. Sterling now comprises only about 3% of global reserves.

The shift from sterling to the dollar and the elimination of sterling as a major international currency did result in periodic crises, international tensions and conflict over British domestic economic policy. It was thus not a painless transformation, but it was tempered by the waning attractions of the dollar as an alternative safe haven and by the international commitment to avoid a damaging tipping point for sterling that would undermine confidence in the reserve currency system as a whole. But the persistence of sterling's reserve role was not just an artificial one. Many developing countries were willing to accumulate sterling assets during the 1960s despite the pound's

vulnerability because they denominated their trade and debt in sterling and because many currencies remained pegged to sterling.

Starting in 1971, however, most sterling pegs were replaced by pegs to the dollar or trade-weighted baskets, and sterling's commercial role declined rapidly relative to the dollar during the oil crisis. The sharpest fall in sterling's share of reserve assets took place at a time of dramatic expansion in global reserves during a global commodity boom and inflation. These factors eased the pressure on Britain from this final transition since inflation eroded the real value of liabilities, and the fact that the nominal value of global sterling reserves was quite stable meant that the falling share of global reserves did not require the presentation in London of sterling assets for exchange to dollar, gold or other currencies on a net basis. Rising international liquidity, inflation, geographical redistribution and international cooperation were the cornerstones that eased the retreat of sterling from global to national status.

> "Many developing countries were willing to accumulate sterling assets during the 1960s despite the pound's vulnerability because they denominated their trade and debt in sterling and because many currencies remained pegged to sterling"

The world is a different place now, with private finance far outweighing central bank resources and more freely floating exchange rates. The problems of sterling were also not identical to those of the dollar today. Nevertheless, the main lesson to be drawn from this case is that the decline of sterling was much more prolonged and less damaging than expected at the time, or portrayed in more recent analyses. The transfer was achieved without major implications for global stability because it was a deliberately managed process involving the world's richest economies as well as the formal cooperation of holders of sterling assets. Without the Cold War context that encouraged cooperation in the 1960s, it seems less likely that heroic efforts to postpone a tipping point for the dollar will be achievable. In this sense, the gradual decline in sterling's share of global reserves after 1945 should not give comfort to those who hope for a similarly unproblematic decline in the dollar.

Why did previous reform efforts fail?

As is the case today, in the 1960s most of the proposals for reform aimed to strengthen the role of the IMF either by hosting separate stabilization funds or by creating a new reserve asset distinct from national currencies. The Mutual Currency Account proposed by the British Chancellor of the Exchequer in 1962, for example, was a separate fund into which countries in surplus would contribute reserve currencies in return for claims on the account. These claims would form interest-bearing assets with a gold value guarantee that would be part of the donors' national foreign exchange reserves. In 1963, the influential economist Edward Bernstein proposed a new currency reserve unit (CRU) issued through the IMF with the value of a weighted basket of 11 major trading currencies. These plans did not initially gain the approval of either the United States or the IMF, both of which hoped to postpone any radical changes to the status quo in the hope that the global imbalance would resolve itself automatically over time.

By the mid-1960s both the IMF and the United States had come to the view that more fundamental reform could be desirable and the process began to gain traction in special policy committees set up among the G10 states. In the United States, Alfred Hayes, President of the Federal Reserve Bank of New York, preferred a scheme that would create reserve assets in the form of unconditional drawing rights on the IMF rather than a new reserve unit. Others disagreed and continued to hope for a new reserve unit representing a claim on a pool of currencies paid in by a group of advanced countries. A reserve unit did not

generate much support among the G10, particularly because of the challenges of governance over how and when it should be issued. Instead, IMF staff devised plans for reserve creation that would be open to all members; quasi-automatic drawing rights transferable through the IMF; and/or a new affiliate of the Fund (an International Reserve Fund) that would issue gold guaranteed reserve units transferable between countries as well as to and from the IMF.

From mid-June 1966 progress in the G10 seemed stalled and the forum was widened to include the IMF Executive Board. In the end, the breakthrough came in April 1967 when the EEC finance ministers agreed unanimously (although with varying degrees of enthusiasm) to support a drawing right scheme. In May, IMF staff quickly drafted outline proposals to put to ministers in time for public agreement at the IMF annual meeting in Rio in September. As late as the G10 ministerial meeting in August, there were still divisions over the governance and transferability of the proposed SDRs, but a vague compromise was reached that could be announced at the Rio meeting. The actual implementation and interpretation of the new SDR, however, remained a source of conflict.

In retrospect, the multilateral discussions on the reform of the international monetary system appear confused and inconclusive, partly because they lacked urgency or political will on the American side until 1965, and partly because they became embedded in disputes within the EEC in the following years. In the early 1960s the Americans refused to recognize that that there was a long-term problem, partly because of the risks to the dollar if plans emerged to replace it as an international currency. In addition to internal American dissention, globally there was no consensus on the nature of the problem and therefore no agreement on solutions. Instead, the negotiations in the G10 and in the IMF entrenched divisions between developing economies, Europe and the United States. In the end, the SDR was a triumph of ambiguity over clarity of purpose in order to meet expectations that had been built up for an announcement at Rio in September 1967.

These years of negotiations to seek a solution must be considered a failure since they did not prevent the gold anchor falling away in March 1968 or the pegged exchange rate system from crumbling in a series of crises between 1971 and 1973. The final compromise in the form of the SDR did not replace the use of national currencies as reserve assets, nor did it resolve the fundamental problem of the expansion of global dollar reserves backed by a shrinking ratio of gold, nor did it redistribute the burden of adjustment. When the SDR was finally activated in 1969 transfers were limited to the immediate balance-of-payments purposes and not to diversify reserve portfolios to reduce exposure to the dollar. After the first allocation of SDR 9.3 billion in 1970–72, the United States argued strongly that no continuous allocation should be made in the inflationary environment of the 1970s. However, the huge accumulation of dollar reserves from 1970 and the devaluation of the dollar against both gold and other currencies from August to December 1971 renewed enthusiasm for reform. Again, the framework was the IMF and the G10, and then from 1972 the Committee of Twenty or C20 (the Committee on Reform of the International Monetary System and Related Issues).

Most proposals, as today, involved extending the SDR through schemes to 'consolidate' reserve currency holdings by substituting them for SDRs. The United States suggested a trigger to signal the accumulation of 'excessive' reserves that would require a country to reduce its surplus, but got little support. By early 1973 (before the oil crisis) the United States was prepared to envisage a one-time conversion of a portion of existing dollar claims into SDRs, which would shift their liability to an IMF Stabilization Account rather than sundry national creditors, but the United States was wary of the financial obligations of exchange guarantee and interest burden. If the terms were too onerous, particularly considering the huge scale of the possible claims through the Stabilization Account, the United States would be unable to agree. If they were too generous, creditors would not participate. As today, without American support or at least acquiescence no arrangement to replace or supplement the dollar would be possible.

After two years of complex technical discussions the C20 submitted its report in June 1974. By this time the interna-

tional context had been transformed by the advent of floating exchange rates, the development of the European monetary system, the explosion of the Eurodollar market and the global imbalance associated with the oil crisis. These developments undermined collective interest in reforming the reserves system and the Committee's vague recommendations were not taken up. The C20 Report offered no agreed blueprint, but rather listed options, including a Stabilization Account, changing the name of the SDR to promote its development as a reserve asset, relaxing the restrictions on its use and determining an appropriate yield to make it more attractive. The one tangible outcome was to change the valuation of the SDR to a weighted basket of currencies rather than gold. The records of its meetings show that the C20 was too large and unwieldy a forum to achieve constructive reform.

Despite the failure to devise a blueprint for reform, the presentational attractions of a scheme to replace the dollar as a reserve currency were strong, and the Interim Committee of the IMF pursued the idea of a Substitution Account (SA) from 1979. By April 1980 the IMF Executive Board had come to a tentative agreement on some principles: on a purely voluntary basis all members of the IMF might be allowed to deposit dollar reserves (which would then be transferred to a special account at the US Treasury) in exchange for claims on an SA denominated in SDR. The SA would be operated as a trust administered by the IMF with an 'Assembly of Participants' who would manage and control it, although the voting rights and governance proposals were controversial. The SDR claims on the SA would be freely transferable among participants and also available to the private sector to develop a secondary market in SDR. If countries could not find partners to accept their SDR claims, these could be converted back to dollars as a last resort, although having a 'two-way' exchange through the SA raised fresh obstacles, particularly for the United States, and risked facilitating speculation. The maximum value of the SA in the first instance was set at SDR 50 billion (41% of official claims on the United States in 1980). The US Treasury would pay interest to the SA on its dollar liabilities and the SA would in turn pay interest to holders of SDR claims. The rates of return were controversial, as was the burden of exchange risk for variations of the dollar–SDR exchange rate. Any profits or losses could be shared between the United States and depositors and perhaps covered by part of the gold reserves of the IMF, but the balance of burden was not agreed. Developing countries also worried that the increase in SDRs through the SA would lead to a reduction of conventional SDR issues in the future. In the end, the plans were abandoned as the dollar exchange rate strengthened.

The failed discussions on reform reveal a range of obstacles to the use of the SDR as a primary reserve asset that persist today: the limits on transferability and liquidity, the lack of a private secondary market, and the valuation based on narrow currency weights which is inappropriate for some developing states. The major obstacle to the SA was how to distribute the burden of exchange rate risk among creditors and debtors. Ancillary concerns included the potential for speculation through a 'two-way' exchange with the SA, the desire among states to retain control over the portfolio distribution of their reserves, and a lack of commitment in the United States for an ongoing rather than one-off (and one-way) consolidation of a proportion of existing dollar reserves. As the momentum towards European monetary integration was renewed from 1979, the prospects of a future European currency pushed reforms over international reserve currencies further down the agenda of key stakeholders.

The problems of governance of any international currency have inhibited the usefulness of the SDR other than as a unit of account. The controversy over SDR governance is linked to the inertia and inflexibility of the IMF quota system as well as the waxing and waning of international confidence in the IMF's leadership. Nowadays, to reduce the dollar share of global reserves would require a huge amount of any new reserve asset: even after recent allocations SDRs now comprise only about 4% of total international reserves. Proposals to supplement rather than replace existing reserves require the SDR to be as attractive as the dollar in terms of liquidity, value and returns, but this poses a huge burden on the United States if it has to finance this through a liability to the Fund. Holders of SDRs must have confidence in their liquidity (marketability, acceptability by all countries, convertibility to the dollar as well as other

currencies) that will require a huge multilateral commitment to develop the market for SDRs.

The C20 of the 1970s also provides lessons for the process of reform. There was a clear trade-off between efficiency in policy-making and the breadth required for legitimacy of any emerging proposals. Similar challenges will confront the G20 as it adopts more policy-making responsibilities. In the 1970s, reform proposals were overrun by market solutions that reduced the need for precautionary reserves. Rather than focusing on how to manage such huge imbalances today, the emphasis should instead be on how to reduce the incidence of (or provide other forms of insurance against) the sudden stops that encourage the accumulation of owned reserves.

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4. Challenges for the Dollar as a Reserve Currency

Gianluca Benigno

Introduction

Following the recent financial market turmoil and its consequences for the world and the US economy in particular, a renewed focus on the status of the dollar as reserve currency has emerged. One of the reasons is related to the build-up of substantial global macroeconomic imbalances over the past decade. Indeed, the importance from the US perspective of maintaining the status of reserve currency for the dollar is relevant in so far as it allows the United States to finance easily and cheaply (at lower interest rates) its current account deficit.

> ‘Given that the world economy has suffered its most severe crisis since the Great Depression of the 1930s it is reasonable to ask to what extent such an event might lead to structural changes in the international monetary system’

Historically, shifts in reserve status between one currency and another are not abrupt events but occur slowly and reflect changes in different factors (e.g. economic and political influence, network externalities, use in trade and investment transactions and deepness of domestic financial markets). Discussions about the reserve status of the dollar have emerged in the past following the convertibility of West European countries' currencies in the 1960s, the introduction of the Special Drawing Right (SDR) in 1967 and more recently the introduction of the European currency in 1999 (Chinn and Frankel 2008).

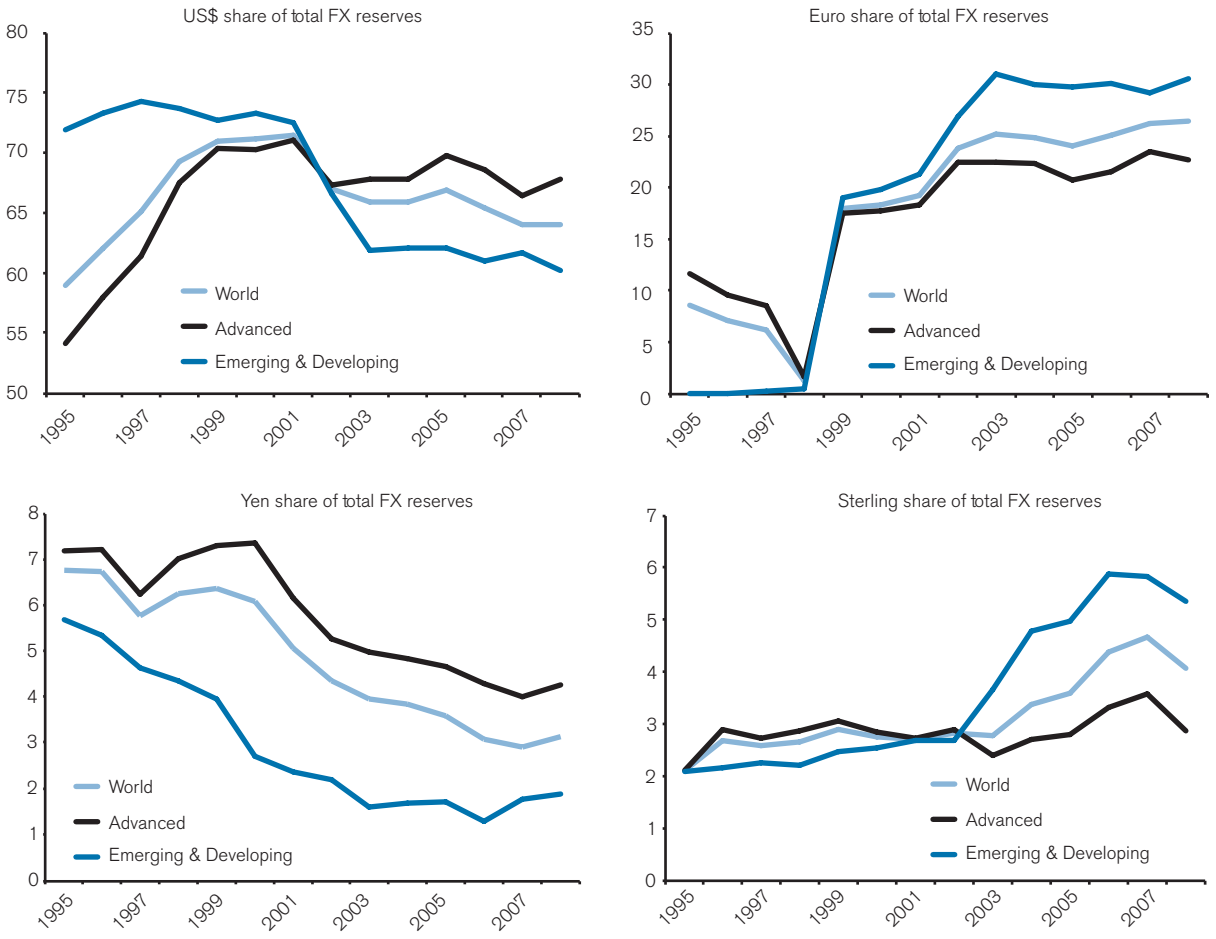
Why is this a good time to review the issue? What might be different now? Given that the world economy has suffered its most severe crisis since the Great Depression of the 1930s – the IMF has projected a fall in output for advanced economies by 3.4% and a decline in world trade volume of 11.9% in 2009 (IMF 2009) – it is reasonable to ask to what extent such an event might lead to structural changes in the international monetary system. These changes could be exogenous as policy authorities might redesign the international financial architecture, or endogenous as the consequences of current events might lead to a reshaping of economic powers and factors that are important in determining the reserve currency role.

This chapter starts by examining the extent to which the current financial crisis has undermined the role of the dollar as the main reserve currency, and goes on to discuss how the US current policy setting might affect such a role. It ends with a scenario analysis examining possible future outcomes along with some policy implications of this analysis.

The status quo: trends in reserve

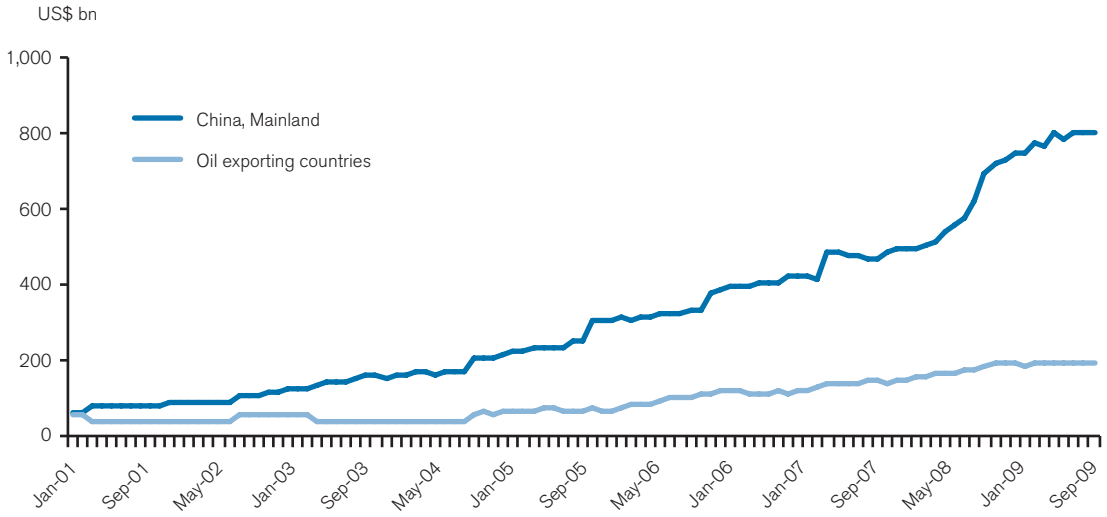
The IMF's currency composition of official reserves database (COFER) shows that there has been very little change in the shares that countries allocate to dollar reserves as opposed to other currencies. On the basis of this survey, the dollar accounts at present for more than 60% of total foreign reserves, higher than the level reached at the end of 1995 when the IMF survey begins (see Figure 4.1).

Figure 4.1: Currency distribution of global foreign exchange reserves, 1950–82 (SDR valuation)



Source: IMF, COFER database

Figure 4.2: Major foreign holdings of US Treasury securities, 2001–09



Source: US Treasury, TIC System

Even when one examines how this share has changed for different groups of countries, there is no evidence of any systematic trend in dollar claims. At most a slow decline in dollar claims by emerging and developing economies can be observed for the past five years, but the dollar share remains above 60%. The only notable trend in the past decade has been the rapid rise of the euro as a reserve currency, but more at the expense of other currencies (namely the pound sterling and the yen) than the dollar.

More indirect evidence on the desirability of dollar assets comes from Treasury International Capital (TIC) data. Figure 4.2 plots the holdings of US Treasury securities by China and oil-exporting countries and shows that, despite recent events, such holdings have actually increased markedly in the last year or so.

To summarize, the partial direct and indirect evidence that we have examined does not suggest any significant trend away from dollar assets until recent available observations.

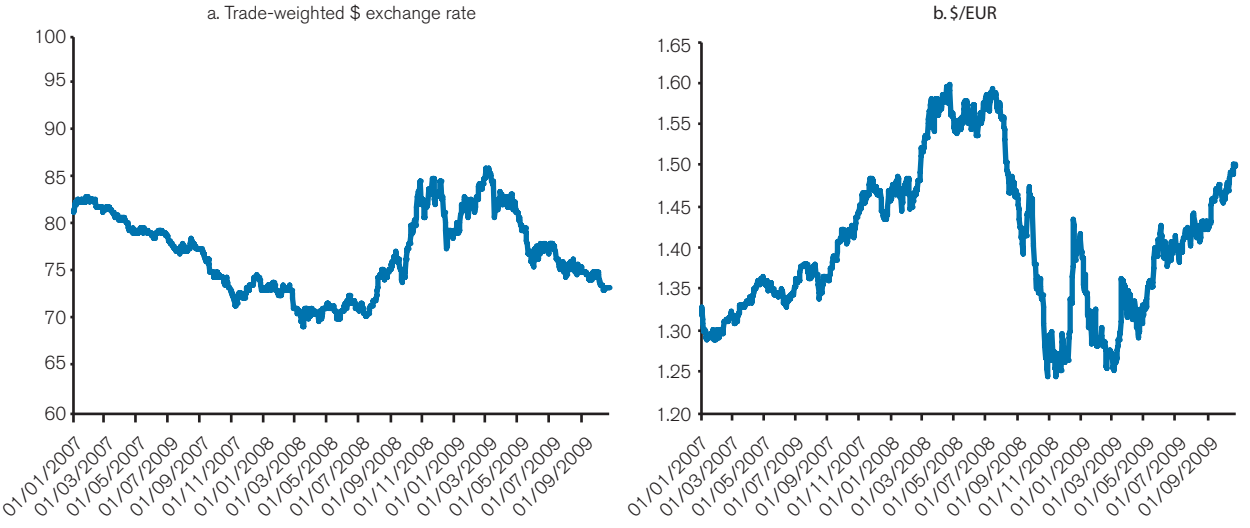
Role of the dollar during the current financial crisis

The current financial crisis offers an event study to examine the behaviour of the dollar. As it is difficult to gather data on high-frequency shifts in official reserve portfolios, we look at the (indirect) evidence coming from foreign currency markets and financial markets in the period from August 2007 to June 2009. Figures 4.3 and 4.4 show that, despite being at the epicentre of the financial turmoil in a period when the solidity and stability of the US financial system were questioned, the dollar has strengthened in value (Figure 4.3) and its role as safe-haven currency has been reaffirmed when tensions in international financial markets were at their highest (Figure 4.4).

It is clear from Figures 4.3a and 4.3b, showing the trade-weighted dollar exchange rate and the dollar–euro exchange rate, that the dollar was on a downward trend until July 2008 as the financial crisis started to become a global phenomenon, and then started appreciating, with peaks occurring at times of high tension in financial markets.

The preference towards dollar-denominated assets was measured by computing the difference between the TED spread and the LIBOR-OIS spread.[1] The results are shown in Figure 4.4. The TED spread measures the perceived credit risk in the economy while the LIBOR-OIS spread measures the risk and liquidity in the money market. Importantly, one of the factors that might determine an increase in the TED spread is lenders

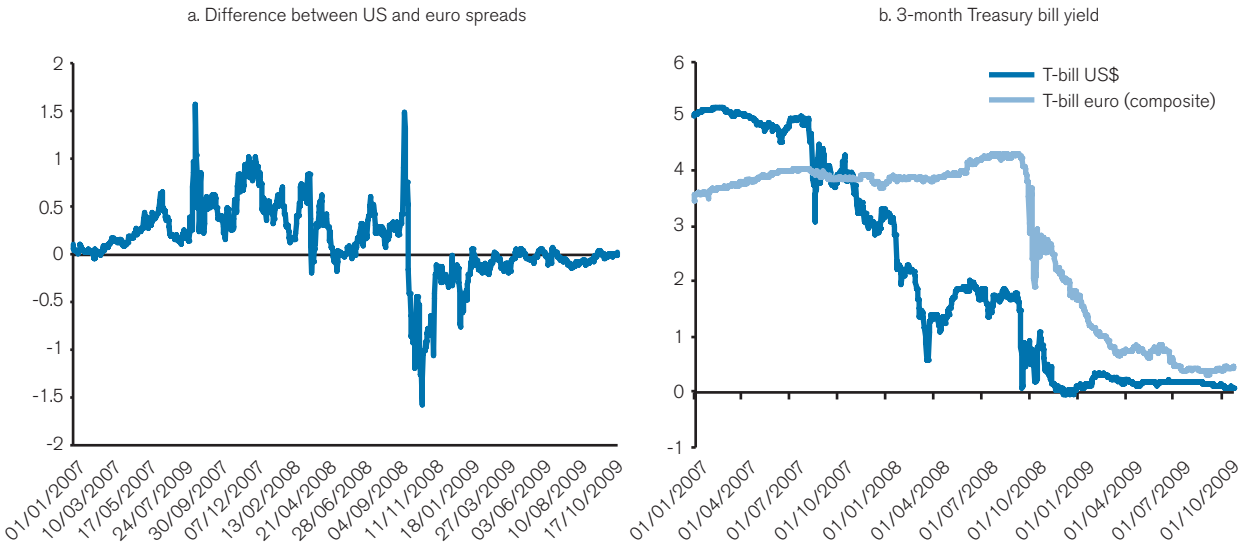
Figure 4.3: Dollar exchange rate



Source: Bloomberg

1 The TED spread is the difference between the interest rates on interbank loans (LIBOR) and short-term US government debt ('T-bills'). The LIBOR-OIS spread is the difference between the interest rate on interbank loans (LIBOR) and the overnight indexed swap (OIS) rate.

Figure 4.4: Difference between dollar and euro spreads, and 3-month Treasury bill yield



Source: Bloomberg

accepting lower returns on safe investments such as T-bills (Figure 4.4b shows the return on short-term US and German bonds). Generally the difference between these two spreads is negligible but in periods of tension in financial markets it might be amplified (a bigger difference would represent a 'flight to quality' event (i.e. a shift towards a less risky asset). To capture the preferences for short-term dollar claims, Figure 4.4a shows the difference between these spreads on US and euro assets. This difference becomes negative (i.e. the spreads diverge) in the most acute episodes of a financial crisis, mirroring the behaviour of the dollar and denoting a situation in which investors take flight towards short-term dollar assets.

Possible implications of current policies in the United States

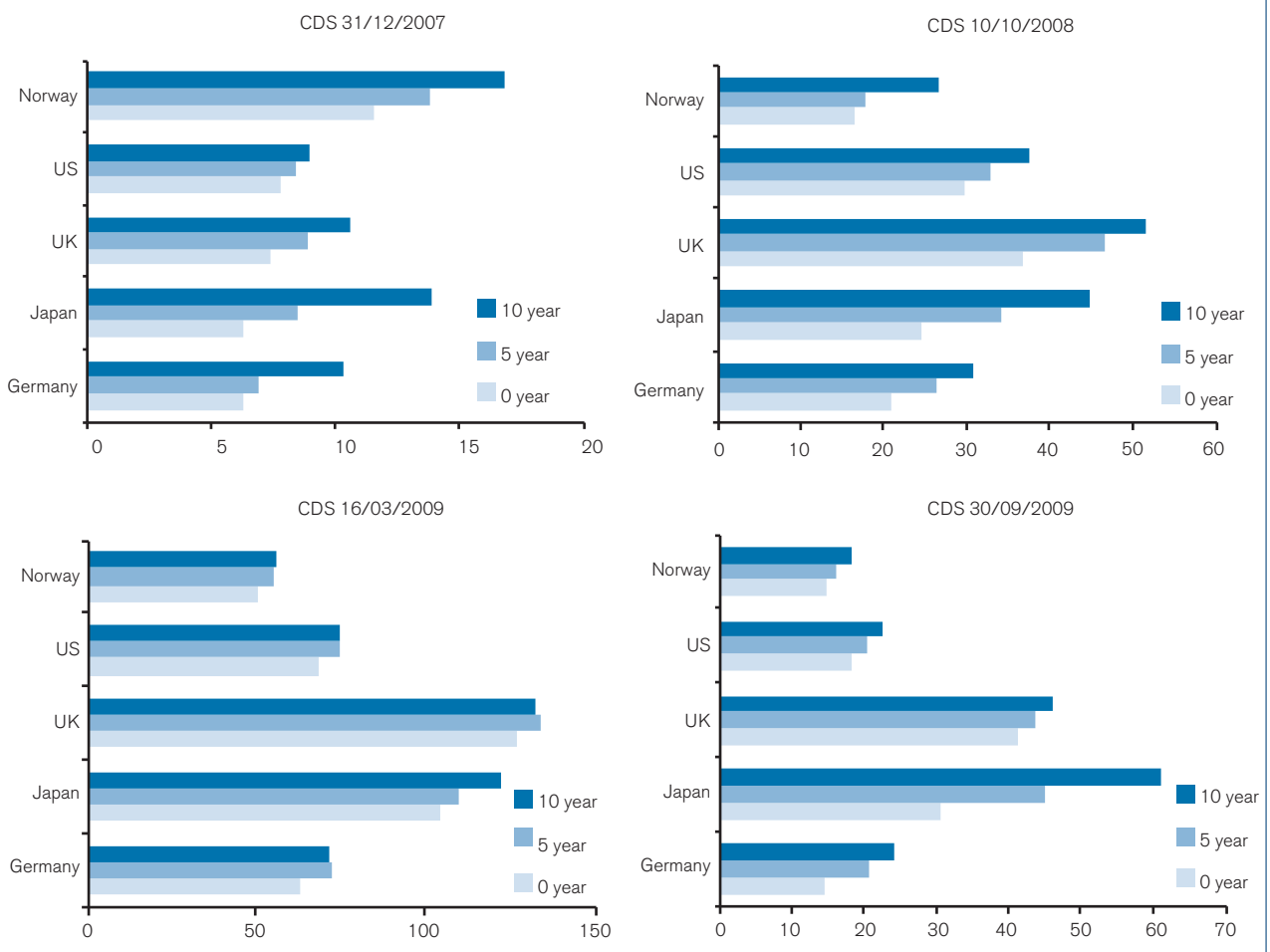
As financial market conditions have improved, the sustainability of the role of the dollar as a reserve currency has been questioned as a result of concerns about the possible consequences of current policy actions for the value of the dollar, from both a monetary and a fiscal point of view.

From a monetary policy perspective the Federal Reserve has implemented rate cuts, liquidity measures, outright asset purchases and bailouts to mitigate a credit crunch and avoid deflation. These measures are having some effect in resolving the credit crisis and recession. Indeed, the Federal Reserve has successfully fought expectations for deflation, but now there are some worries that its actions may lead to high inflation as the asset purchase programme could reach up to 15% of 2008 GDP.

So far, the increase in base money that has followed the quantitative easing programme has not been inflationary: monetary aggregates have not increased (money velocity has decreased) as banks have deposited their excess reserves with the Federal Reserve rather than expanding credit.

From the fiscal policy perspective the substantial increase in the fiscal deficit and its prospects in the near future have raised concerns about the sustainability of the fiscal position as well as its repercussions for the value of the dollar and its role as a reserve currency. In this respect the IMF projects the fiscal deficit to be 13.6% of GDP in 2009, 9.7% in 2010 and 4.7% in 2014. According to the Congressional Budget Office (CBO), the fiscal deficit will amount to $7.14 trillion over the next decade and remain above $500 billion (over 3% of GDP) during 2011–19.

Figure 4.5: CDS spreads



Source: Bloomberg, Datastream

Public debt is expected to rise from 54% of GDP in 2009 to 68% by 2019. In the long-term budget outlook, 'the budget remains on an unsustainable path. Unless changes are made to current policies, the nation will face a growing demand for budgetary resources caused by rising health care costs and the aging of the population would reduce long-term economic growth by lowering national saving' (Congressional Budget Office 2009).

This view seems to be consistent with market assessment of the US fiscal situation. One way to measure the market perception of the risks associated with the US fiscal position is to look at the credit default swap (CDS) market for government bonds for different time-horizons (3, 5 and 10 years) and different countries. This section considers CDS for bonds issued by the United States, United Kingdom, German, Norwegian and Japanese governments.[2] Norway is included because it has been one of the countries less exposed to the global slump and has relatively solid government finances: in this sense it can be used as a reference country.

The first thing to note about the evolution of the CDS spreads in the past two years is that there has been an overall increase (across countries, except for Norway) in market perceptions about the possibility of a government

2 A credit default swap (CDS) is a swap contract in which the buyer makes a series of payments to the seller and, in exchange, receives a payoff if a credit instrument (in this case the government bond) goes into *default*. The price or spread of a CDS is the annual amount the buyer must pay the protection seller (the institution selling the insurance contract) expressed as a percentage of the amount 'insured'. Some analysts argue that as a result of light trading and patchy issuance, sovereign CDS markets may not measure default risk perceptions. Market illiquidity, especially at the onset of the crisis, is probably the reason why higher spreads for CDS are observable on Norwegian bonds.

default. The peak for this perception occurred in March 2009 when fiscal stimulus discussions were on the policy agenda. Interestingly, the lowest spreads among the countries under consideration are those on Norwegian bonds. But what is more interesting to note is that, especially at short maturity, the gap between German and US bonds has increased relative to the pre-crisis period. This suggests that the market view on the US fiscal stance has deteriorated by comparison with the German one. These policy trends and the risks associated with them (at least from the market perspective) seem to be consistent at first pass with the weakening of the dollar since the end of March 2009 (see Figure 4.3).

Another important consideration in this respect is that the extent to which fiscal factors might affect the dollar's value depends on the currencies against which the dollar could weaken. As many of the advanced countries are running comparable large budget deficits, this reasoning suggests that dollar depreciation might be directed against emerging-market economies.

In general, however, despite the fact that signs of pressure might come from the current policy stances, it seems that a lack of alternatives, especially at the peak of the financial crisis, has reinforced the role of the dollar as a reserve currency.

Challenges ahead and policy implications

Most of the discussions on the reserve currency role of the dollar are centred on the possibility that the euro might provide a credible competitor (e.g. Galati and Woolridge 2006; Chinn, Frankel and Posen 2008). This section considers two possible alternative challenges. The first could come from current policy decisions that might affect the structure of the international monetary system. Indeed, the Chinese authorities have proposed reviving the role of the SDR and possibly also revising its composition by including the renminbi in the new basket. There is some suggestion that the Chinese would soon want to see the renminbi used as a means of payment in bilateral trade. China also sold its first batch of sovereign bonds in renminbi in October 2009, further signalling its intention to make the renminbi an international currency. These steps are consistent with China's rapid growth and potential, which resemble the pattern of the United States or Japan in their transformation to economic powers in the interwar and post-war periods. If anything, the size of the Chinese economy relative to global GDP is bigger now than for these comparable situations.[3] Nonetheless, at this stage the renminbi lacks many of the features that would make it desirable as a reserve currency: controls on inflows and outflows of capital are still in place, domestic financial markets are still underdeveloped and the Chinese bond market is not very liquid.

The second challenge to the dollar might come from the endogenous adjustment to the system following the crisis. At the heart of this adjustment lie the role of global imbalances and their eventual correction.[4] The scenarios associated with the maintenance of the status quo or the eventual corrections of the global imbalances are crucial for understanding the challenges for the dollar. Outlined below are two likely scenarios.

In the first, American consumers reduce their consumption and save to counterbalance public-sector borrowing. In this case a weakened dollar might provide the source of growth for the US economy. An orderly depreciation of the dollar would occur in so far as the Chinese authorities are willing to accept losses in the valuation of the stock of dollar reserves that they currently hold.

In the second scenario, American consumers resume their pre-crisis spending pattern. As long as the Chinese are willing to finance this by buying US Treasury bonds, the system could sustain such an equilibrium at possible higher interest rates. But if the Chinese authorities do not maintain the pace of such a spending pattern by accumulating dollar assets, the result could be a weakening of the dollar (not necessarily orderly) coupled with a US debt problem.

3 The size of China's economy is still lower than that of the US or the euro area, but as China is expected to grow faster than other developed economies its economic weight in the world is expected to increase.

4 For an interesting view on the origin of the global imbalances, see Quah (2008).

In both scenarios, a weakening of the dollar is the likely outcome, while the speed of the transition towards a regime in which it is not the only reserve currency could be accelerated, depending on the interaction between the behaviour of American consumers and the Chinese authorities.

As Rogoff points out, the crisis may have advanced the date when the dollar is no longer the leading reserve currency (see also the related discussion by John Driffill in Chapter 5). From a policy perspective, then, a welcome step would be to facilitate this development by improving the convertibility of the renminbi. At this stage, its limited convertibility is mainly related to the link between the development of financial markets and currency convertibility. Indeed, in general, a well-developed financial market increases the capacity of the domestic economy to cope with factors that affect the external demand for the domestic currency.

It is not unreasonable to think that the renminbi has the potential to play a role in international trade and investment transaction, given the pace at which the Chinese economy is expanding. This could create the necessary market discipline to limit global imbalances by allowing for an alternative reserve currency option.

To sum up, while the dollar has maintained and reinforced its reserve currency status during the crisis, there are elements that suggest the fragility of this status quo. In the medium run, the dollar's destiny might lie more in Chinese than in American hands. A diversification away from the dollar and the rise of a new international currency might imply, in the near or medium term, a regime with several reserve currencies, rather than just the dollar.

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5. The Fall-back Position

John Driffill

Introduction

While many people call for reform of the international financial architecture, and bold schemes are proposed, particularly following the global financial meltdown and recession of 2007–08, it is likely that nothing much will be done. The world will continue to stumble along with a mishmash of arrangements for monetary policy, exchanges rates and financial stability that individual countries have worked out to suit their own individual perceived circumstances and needs, and that various small groups and regional blocs have devised. This is the fall-back position: business-as-usual, laissez-faire, muddling through. Is it such a bad thing?

The world has evolved over the last hundred years or more from regimes of more or less fixed exchange rates towards one of greater flexibility. Now there is a system, or perhaps a non-system, of floating exchange rates among major currencies. In some regions there is a single currency, as in the Eurozone. Some groups of countries attempt to maintain fixed exchange rates, or to manage exchange rate movements, among themselves; one thinks in particular of the 'Bretton Woods II' arrangements among countries in East Asia. Many developing countries continue to peg or manage their exchange rates.[1] The dominant model for monetary policy has become the pursuit of a target for the domestic inflation rate by a (more or less independent) central bank setting short-term interest rates, with, on the whole, little attention paid to asset prices, including among them exchange rates (but also stock markets and housing prices), or paid to quantities such as measures of the money supply.

Managing exchange rates fails in the end

One of the lessons of the last century is that attempts to fix or manage exchange rates do not work, or at least not for very long. The gold standard collapsed because the disciplines it imposed were too severe in the face of shocks and secular changes such as the First World War, the Depression in the 1930s, the decline of the United Kingdom and rise of the United States. The Bretton Woods regime attempted to keep something like it – the gold exchange standard – alive after the Second World War, and it had a pretty good run, surviving from 1944 to 1971, and accompanying (or perhaps facilitating) the rapid growth of post-war continental Europe in the 'Golden Age' of the 1950s and 1960s. But it is a commonplace to observe that the limited flexibility (of nominal exchange rates) permitted by Bretton Woods came at great cost, and was only possible at all because of capital controls. Despite the institutions intended to make sure that deficit countries had time and resources to adjust gradually, the system had a deflationary bias. Surplus countries did not need to adjust as rapidly.

The brave new dawn that followed the sunset of Bretton Woods proved not to be the world of smoothly adjusting nominal exchange rates that Milton Friedman had long predicted and argued for. It took a long time for policy-makers (and possibly economists too) to learn that exchange rates did not move to offset changes in relative national price levels or to bring about trade balance. Instead they moved like asset prices, dominated by expectations of their future values, prone to speculation, bubbles and excess volatility. A world of floating rates may have removed the external balance constraint from fiscal policy,

1 A peg refers to the fixing of the value of one currency against another at a particular value. The term 'managing' is a looser and broader concept; it includes a managed float or a crawling peg or a target zone or a number of other less rigid controls on the movement of an exchange rate.

but it caused fiscal or monetary expansion to lead to higher inflation much faster than had happened under fixed rates. The launch of the world economy into these uncharted waters coincided with the oil price shocks of 1973 and 1979, and the productivity slowdown of the 1970s, the combination of which produced the 'Great Inflation' of that decade, a decade of stagflation: negative supply shocks, slow productivity growth, high unemployment and falling stock markets.

In the 1980s the shift in the West to monetary policies aimed at reducing inflation produced more unexpected and unwelcome exchange rate volatility. International macroeconomic policy coordination may have hit a high-water mark in the mid-1980s, with the Louvre Accord and the Plaza Accord aimed at lowering an overvalued dollar. Oil-exporting economies in Latin America which had borrowed heavily externally in dollars, ostensibly to finance development, were hit by rising interest rates, falling oil prices, a worldwide recession and a rising dollar, all by-products of Western anti-inflationary tight money policies. These countries defaulted repeatedly on loans, starting in 1982, with a succession of sovereign debt crises. They were not able to maintain their exchange rates in the face of tides of self-fulfilling speculation, raising the cost of servicing external debt. Their public finances had been undermined by a legacy of high spending from the boom years, undertaken to meet the demands of interest groups and prop up weak governments with fragile majorities. In this environment of serial defaults and crises, the IMF found itself fully employed in arranging bailouts and debt restructuring. It developed doctrines under which its loans became conditional on their recipients' following canons of sound fiscal and monetary policy and carrying out structural reforms along competitive free-market, deregulatory lines. The role of the IMF and the World Bank in promulgating the US view of sound policy gave rise to what John Williamson called the 'Washington Consensus'.

The normalcy of banking and exchange rate crises has been widely noted (Reinhart and Rogoff 2009). They still tend to come along every two or three years, even though in the 1990s, after nearly 20 years' experience, floating exchange rates appeared to operate in a more benign way. The shift to a regime of inflation targeting starting in the late 1980s and early 1990s was characterized by falling volatility of output and inflation among developed economies, although it is debatable whether this was due to good luck (and falling prices of Chinese exports) or good policy, and also the falling volatility of nominal and real exchange rates. Nevertheless, a succession of banking and exchange rate crises erupted, most notably perhaps the Asian crisis in 1997, striking for some similarities with recent events – the collapse of a property and investment bubble in the rapidly growing 'Asian Tiger' economies, which had grown in a climate of low interest rates and deregulated financial markets, with highly leveraged institutions and extensive foreign borrowing. The crisis was remarkable for its rapid spread to similar apparently sound economies in the region, for its spread from banking to exchange rates and the real economy, and for its widespread and disruptive effects. Unlike many previous crises, it afflicted economies that were pursuing sound fiscal and monetary policies, and did not have problematic public finances (at least until the crisis broke and undermined tax revenues and public spending).

"The Asian crisis has left a long shadow over the present, in the shape of large foreign exchange reserves accumulated by Asian economies, particularly China and the former 'Tigers'"

The Asian crisis has left a long shadow over the present, in the shape of large foreign exchange reserves accumulated by Asian economies, particularly China and the former 'Tigers'. For one reason or another, these countries have accumulated enormous reserves. Far from the Bretton Woods world of a chronic shortage of internationally acceptable means of payment, there now seems to be a glut. China's reserves alone exceed $2 trillion, mostly held in US government bills and bonds. They may have been accumulated for mercantilist reasons, to keep down the

renminbi, promote exports and growth, and restrain the widening income differentials in China between the booming east coast and the more rural interior. Olivier Jeanne (2007) claims that they cannot be a rational response to exchange rate and income fluctuations as a kind of a self-insurance policy. Marcus Miller and Lei Zhang (2006) propose an alternative explanation: an extreme aversion to a fall in income, owing to a 'sudden stop', a rapid fall in inflows of foreign investment. It may be an extreme reaction to the burdensome conditions imposed on borrowers by the IMF, in particular those imposed on the Asian Tigers after 1997, which appeared to be particularly inappropriate applications of a 'one-size-fits-all' policy of fiscal and monetary tightening and structural reform, plus maintenance of unrestricted trade and capital flows. It is notable that Malaysia, the country that most conspicuously rejected the conventional precepts and imposed capital controls to protect its currency, suffered a less severe recession and enjoyed a more rapid recovery than some of its neighbours.

Even a hard currency peg backed up by firm commitments is not immune from collapse. That of Argentina's currency board in 2001 is a case in point. Real appreciation of the peso through inflation, weakening economic growth and worsening public finances eventually led to collapse and chaos. The remarkably strong recovery three years later may have been aided by the tough line taken by the Argentine government following the largest sovereign default in history.

All or nothing

The success story for fixed exchange rates may be the Eurozone, though here the message is perhaps that these are still early days; and also that half-measures do not work. The only possibility is a move to a single currency. The euro has been a greater success than might have been expected. Having a single short-term interest rate for the Eurozone has not led to as widely divergent growth rates and unemployment as some feared. In principle, high-inflation countries in the Eurozone have lower real interest rates than low-inflation countries, and this causes growth rates to diverge and inflation rates to diverge further. This seems not to have happened. Ireland may be an example, but more likely it entered the Eurozone with an unrecognized competitive advantage (with its level of productivity and potential for future growth both greatly underestimated), which led to the boom. Ireland's dependence on the construction industry and property boom – and subsequent bust – has given it a particularly hard landing.

Ireland is one of several countries in the Eurozone with high government deficits and high and growing levels of public debt, whose situation was dramatically worsened by the global recession. Greece stands out as being in the worst position, and has attracted a frenzied response from financial markets, fearful of default on its government bonds. There has been speculation as to whether it may leave or be forced out of the Eurozone. With an independent currency, Greece could have allowed its currency to depreciate and used that to enhance its competitiveness, cut real wages, stimulate aggregate demand and deflate the real value of the public debt. Indeed, it is highly unlikely that a depreciation of the currency could have been avoided had Greece remained outside the Eurozone: there would have been sustained speculative attacks. Eurozone membership has transformed a currency crisis into a public debt crisis. While there may be default on the debt at some time in the future, it seems more likely that fiscal tightening plus possible financing from other Eurozone countries and the IMF will tide Greece over, and that real adjustment will take place through wage freezes or even cuts, and a painful period of high unemployment and slow growth. Portugal and Spain may find themselves in a similar position to Greece at some point in the future. Italy may also find its ability to borrow curtailed and the cost of borrowing raised by market fears of default if public debt is not kept under control. However, the remarkable feature of these developments is the resilience of the Eurozone.

The single currency removes the possibility of exchange rate adjustment to correct for overvaluation, and places a premium on gaining an advantage by holding down production costs. Germany and the Netherlands are credited with having used their corporatist structures to restrain wage costs and gain a competitive advantage within the Eurozone. Ironically, until recently Ireland was

one of the Eurozone countries that had benefited most from implementing a succession of corporatist national plans to promote growth and stability. While tensions and real exchange rate discrepancies between members may be growing, the euro is a short-term success in that its role as a global reserve currency is slowly growing, and countries of Eastern Europe are still queuing up (and trying to meet stringent conditions) to join.

China has tested the limits of successful exchange rate management by holding down the renminbi in the face of huge current account surpluses and capital flows. The cost is a $2 trillion accumulation of reserves which makes China's wealth sensitive to the value of the dollar, and leaves it unable to sell dollars on a large scale without incurring a capital loss. At the same time, high inflation (7–8% per year in recent years) resulting from high internal demand has partly achieved the necessary real exchange rate adjustment that China has sought to avoid.

Floating rates

So we are left with a world that has slowly been learning to live with floating exchange rates for more than three decades. Financial markets have developed in a climate of light regulation and absence of capital controls, to the point where most central banks feel unwilling and unable to stand in the way of speculative flows. Foreign exchange reserves, particularly among emerging Asian economies and oil exporters, have risen to all-time highs. The IMF and the World Bank have been largely sidelined. In 2007 the IMF had few borrowers left (Turkey, one of the few large borrowers of the preceding years, was repaying its loans) and was looking for a new role in the world, to supplement its data-gathering and surveillance function. The World Bank's lending, to Africa, for example, is dwarfed by investment and aid from China.

As China, India and other emerging economies grow relative to the United States and European countries, the funding arrangements and voting rights in the IMF and World Bank make these institutions increasingly irrelevant. The changes to IMF funding at the Pittsburgh G20 meeting in 2009 appear to be defensive measures to try to keep these institutions in the game. The scale of the changes in voting rights seems very modest. But in a world of floating exchange rates, awash in foreign exchange reserves, and with large emerging economies (mainly China at present) able to provide aid and trade links, their likely role looks marginal at best.

Although the dollar remains the predominant reserve currency, the role of the euro is growing slowly. China is beginning to take very tentative steps towards making the renminbi usable by its trading partners for payments to and from China. At the same time large surplus countries, including China, are diversifying reserves away from dollars. The renminbi, yen and euro may come to play larger roles as reserve currencies. Kenneth Rogoff has supposedly remarked that the 2007–08 crisis may have advanced the date when the dollar is no longer the leading reserve currency by 35 years.

One of the drawbacks of using the currency of one or more nations as international reserves is that those countries receive the seigniorage revenues, in the form of unrequited transfers of goods, but mostly as lower costs of borrowing internationally and higher returns on assets – the so-called exorbitant privilege of the United States, or part of the 'dark matter' that it exports; although, as Meissner and Taylor (2006) point out, this privilege tends to dwindle away over the course of time. It did so in the case of the United Kingdom in the late nineteenth and early twentieth centuries, and Meissner and Taylor's evidence points to its dwindling away now for the United States. Creation of SDRs by the IMF and their distribution to poor countries could allocate this revenue more fairly.

It is sometimes argued that global imbalances have contributed to the recent financial crisis, and that since the current international monetary system has allowed these imbalances to persist, it has in some way played a role. It is argued that the demand for low-risk dollar assets for foreign exchange reserves lowered the returns on these assets, and sent banks and other financial institutions off in search of other assets to invest in and make a return on – and that, as a result, they turned to the securitized mortgages and other complex products of financial inno-

vation. A parallel is drawn with the early 1980s, when the recycling of surpluses by OPEC oil exporters led to large amounts of sovereign lending, particularly to countries in Latin America. It is argued that this earlier 'global imbalance' laid the foundations for the sovereign debt crises that began in Mexico in 1982 and ran on through the 1980s. It seems rather an extraordinary indictment of the international monetary system that whenever there is a need to shift resources from one set of countries to another, disaster follows. A well-functioning international monetary system is intended to allow countries to run current account surpluses and deficits and to accumulate net financial claims on each other. There are many good reasons why these transfers should take place, without their presenting problems or reflecting any form of imbalance: they may be an equilibrium phenomenon that would arise in a well-functioning Walrasian world[2] (though not in a perfect one equipped with complete contingent claims markets). Backus et al. (2006) view them in this way. They note that the external liabilities of the United States amount to a small fraction of the total wealth of the country, and that there is no 'need' for US households, which are already very rich, to increase their saving rates. Blanchard and Milesi-Ferretti (2009) distinguish good and bad reasons why 'imbalances' might arise. They argue that distortions that cause imbalances should be addressed, rather than 'imbalances' *per se.*

Externalities and coordination

One of the arguments against a decentralized world with floating exchange rates is that some effects of each country's policies spill over onto others. Some form of coordination of policies can bring benefits. Nevertheless, in many of the models currently used in the central banks to model these interactions, the potential gains are very modest. In any case, in response to extreme events, as in the case of the 2008 global crisis, where a common shock affects demand in all countries in a similar way, an apparently coordinated response appears to have emerged largely spontaneously.

Excess volatility

Another frequent criticism of floating exchange rates is that they are excessively volatile. They are prone to bubbles, and move much more than fundamentals would dictate. And as asset prices they do not merely move so as to maintain the fundamental equilibrium exchange rates[2] that would balance markets for goods and services. It is commonly argued that these fluctuations are bad for income and growth. However, Aghion et al. (2009) find little evidence of such effects. Countries have adapted to fluctuating exchange rates. Financial instruments for hedging short-term volatility are now more widely available. The exchange rate disconnect puzzle identified by Obstfeld and Rogoff (2000) highlights how little the real economy affects the nominal exchange rate, and vice versa.

Conclusion

I conclude with the reflection on these issues that, after more than three decades, the global economy has learned to live with floating exchange rates. The need for a radically new international monetary architecture has diminished, because not only the benefits but also the possibilities of managing exchange rate movements have diminished. Emerging economies are learning to be more cautious about foreign borrowing in external currencies; after their bruising by bailouts and IMF conditionality they have for the moment been holding greater foreign exchange reserves. The prospective changes to the role, funding and power of the IMF and World Bank are likely to be incremental. From time to time widespread policy coordination may appear in response to common shocks. Some countries may from time to time want to peg or manage their currencies relative to others (like those countries aiming to join the Eurozone, China *vis-à-vis* the United States, and other Asian economies *vis-à-vis* the United States).[3] Aghion et al. (2009) note that real exchange rate volatility may have bigger costs for less financially developed economies. The current laissez-faire,

2 This generally means a competitive market economy with flexible wages and prices, no sources of market failure and continuously full employment.

3 For a definition and some recent estimates see Cline and Williamson (2009).

business-as-usual, mix-and-match international financial arrangements appear fairly robust, and seem to allow countries a fair degree of autonomy over their domestic policies without impeding capital trade flows. The UK government's proposals for the Pittsburgh G20 summit acknowledged these arrangements as part of the international financial architecture, while presenting them as if they were part of a consciously designed scheme (HM Government, 2009). The rise of China, India and others may eventually lead to challenges to the dollar as the primary international means of exchange and reserve asset. There could be merit in experiments to expand the role of alternatives such as the SDR which may allow for a more orderly transition when the time comes.

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6. A Roadmap for SDR Evolution

DeAnne Julius

Introduction

The financial crisis of 2008–09 has shaken the confidence of both public and private actors in the dollar-based monetary system that had supported world growth so effectively for the previous 35 years. It may prove to be the early tremor of a larger earthquake to come. There were many warnings about the build-up of global imbalances before the crisis as high saving nations – exporters of manufactured goods and commodity producers – generated huge surpluses which were balanced by a limited number of high consuming nations, most prominently the United States.[1] This fault-line between savers and consumers put increasing strain on the US economy, eventually causing it to buckle under the burden of household debt it had created. Much of that debt has been transferred to the public sector, but global imbalances have not been resolved and the next crash will find the public-sector balance sheets of the high consuming countries unable to take further strain.

The world economy, with the dollar as its anchor currency, may still be some years away from its tipping point. But the trends are clear enough, and the historical parallels are dire enough, that it is time to give serious thought to alternatives. No other currency is waiting in the wings to take the place of the dollar. More fundamentally, no other country is likely to achieve the dominance that the US economy acquired in the aftermath of the Second World War. Instead, a multipolar world economy is rapidly taking shape and it is time to design a multicurrency regime to support and sustain it.

This chapter develops one such design, based on an evolution of the Special Drawing Right (SDR) and an enhanced role for the IMF. This would build on existing foundations, while facilitating a gradual shift away from the dollar as an international store of value (for surplus countries) and unit of account (for OPEC and other commodity exporters). It would not turn the SDR into a global currency, nor the IMF into a world central bank. Rather, it would provide a bridge over the dangerous chasm that has opened up between global savers and borrowers and between fixed and floating currencies. It would be an important contribution to the G20 objective of balanced and sustainable world growth.

The difficult birth and current status of the SDR

The strangely named Special Drawing Right is a synthetic currency created in 1969 by the member countries of the International Monetary Fund in an attempt to avoid a breakdown of the Bretton Woods system of fixed exchange rates.[2] It failed in that task and during three turbulent years of international discussions, as the system of fixed exchange rates gradually collapsed, the original purpose for creating the SDR as a global reserve asset was largely overtaken by events.

Nonetheless, considerable progress was made in the early 1970s and the structure put in place then – to support fixed but adjustable exchange rates against the dollar – is actually quite well-suited to today's multipolar world economy with a mix of floating and fixed exchange rates. The SDR is currently defined as a basket of four currencies: the dollar (44%), the euro (34%), the Japanese yen (11%) and the British pound (11%). Each of these is a fully convertible currency with a market-determined (i.e.,

1 There were many contributing factors to the crisis, including US monetary policy, regulatory gaps and Chinese exchange rate policy. However, most commentators agree that the savings/investment imbalances were implicated as both cause and effect of policy choices.

2 For a brief description see Chapter 1, Box 1, above, and Williamson (2009a) for an excellent summary of the history and current functioning of the SDR.

floating) exchange rate. They are the four most widely used currencies in international trade and financial flows. The weights were chosen to 'reflect the relative importance of currencies in the world's trading and financial systems', although such a determination is not an exact science. Because most of the currency volatility that affects actual trade and cross-border financial flows takes place between these currency pairs, a basket that includes all of them will be more stable over time than any one of them. And, of course, stability of purchasing power over time is the *sine qua non* of a desirable reserve currency and unit of account.

This point is critical to understanding the attractions of the SDR. Under the current IMF rules, the SDR basket is rebalanced every five years using the market exchange rates of the three months preceding the end of the five-year period. One SDR is currently equal to approximately 63 US cents plus 41 euro cents plus 18 yen plus 9 British pence. These equate to the weights mentioned above at the last date of rebalancing (31 December 2005). Five years from then, suppose that the dollar had fallen against the euro by 20% while the yen and sterling had remained the same in relation to the SDR basket. Then, at the time of rebalancing and for the next five years, one SDR would require 76 US cents and just 34 euro cents to maintain the same currency weights in the SDR basket. A country holding its foreign exchange reserves solely in dollars would have lost value during that period, while a country holding its reserves in SDRs would have seen its value preserved.[3]

In terms of stability, a similar benefit would arise from denominating the price of internationally traded goods in SDRs rather than in dollars. This could be particularly important for commodity producers whose imports do not come predominantly from the United States. For example, if OPEC countries decided to price crude oil in terms of SDRs, and at the same time hold their foreign exchange reserves in SDR accounts, then they would effectively shield their economies from much of the volatility that a dollar-based oil price has created. Oil-importing countries – other than the United States – would also face a more stable oil price on which to base their domestic energy policies. The value of internationally traded oil and gas in 2008 has been estimated at $2.3 trillion, or roughly 16% of world merchandise trade.[4] Thus a change in the unit of account for this single sector could have a major effect on the international usage of the dollar, if coupled with further reforms to allow greater private use of the SDR.

At present SDRs are official reserve assets of governments, held in their accounts at the IMF. The allocation of SDRs to member governments has been sporadic, with the first new allocation since 1981 agreed at the G20 meeting in London in April 2009. As part of the package of emergency measures to restore confidence in financial markets and support global recovery, an SDR allocation of $250 billion was agreed. Although the amount of SDRs outstanding still makes up less than 5% of foreign exchange reserves, the willingness of key countries to act and the ease with which the IMF was able to implement the agreement show how the SDR could be used to take the pressure off the dollar as a global reserve currency and ease the transition to a multi-currency international monetary regime.

The next steps in SDR evolution

Although the Chinese central bank governor has called for reform to be 'guided by a grand vision' (Zhou Xiaochuan 2009), historical experience indicates that a more modest, step-by-step approach, with learning and adaptation along the way, is more likely to succeed. Another lesson from history is that the governance and voting structures of the IMF are exceedingly difficult to change even though they are poorly suited to the current pattern of global production or other measures of economic power. It is generally easier to graft new arrangements onto the old.

With these lessons in mind and within the constraints they impose, steps should be taken on two fronts: to expand the supply of SDRs in a predictable and politically independent way and to increase the demand for SDRs by allowing and facilitating their use in trade and finance.

3 Of course, a country could achieve the same result by holding its reserves in the four currencies directly, either according to their weights in the SDR or using weights related to its own trade patterns. The global stability advantages of the SDR stem from its further development and usage, as discussed later.

4 John Gault, independent energy consultant, in a private communication.

Expanding SDR supply

There are two routes to expanding the supply of SDRs and both should be pursued. The first is new allocations by the IMF to its member countries. Currently each new allocation of SDRs requires the agreement of 85% of the votes of IMF members. Both the United States and the combined Eurozone countries have sufficient votes for a blocking minority. Thus their agreement to new allocations would be critical. It is also justified in a practical sense because their two currencies together constitute 78% of the current SDR basket.

However, such a structure lacks both global legitimacy and political independence. Therefore it should be augmented by a new committee, perhaps called the International Monetary Policy Committee (IMPC), which would produce a regular recommendation to the IMF board for an allocation of new SDRs to member governments' accounts based on its independent analysis of the state of global economic growth, inflation prospects and financial stability indicators.

The IMPC should be chaired by the Managing Director of the IMF and composed of the heads of the four central banks whose currencies make up the SDR, along with four other term-limited individuals chosen on the basis of their economic expertise and, if possible, hailing from other G20 countries whose weight in the world economy is large or growing.[5] China and Brazil are obvious examples. Their membership on the IMPC could be a precursor to the eventual inclusion of their currencies in the SDR basket, at which point they would become permanent members.

The SDR basket would be reviewed every five years in advance of SDR rebalancing, with the economic criteria for inclusion remaining as they are today and the political decision left to the IMF board. Inclusion in the SDR basket requires that the currency be freely floating and have a substantial presence in cross-border trade or financial transactions. It is therefore possible that the Brazilian real could qualify in 2015 and the Chinese renminbi in 2020.

The IMPC would meet every six months in advance of the regular IMF board meetings. It would take decisions by majority vote and publish both its votes and its recommendation to the IMF board for a specific SDR allocation (which could be zero) based on its analysis. The IMF board could then approve or reject, but not alter, the IMPC's recommendation. In this way, the ultimate authority for SDR allocations would remain with the IMF board, while the pressures of transparency and expert advice from the IMPC would provide a counterweight to the threat of veto by the United States or the Eurozone countries.

‘Inclusion in the SDR basket requires that the currency be freely floating and have a substantial presence in cross-border trade or financial transactions. It is therefore possible that the Brazilian real could qualify in 2015 and the Chinese renminbi in 2020’

The remit of the IMPC would be to achieve a growth in international reserves over time which is consistent with the sustainable non-inflationary growth rate of the world economy (generally thought to be 3–4% per annum). Until SDRs make up a much larger share of international reserves, these small but regular allocations would have little effect on global liquidity. Initially, it is likely that they would be viewed as additional precautionary reserves, thereby reducing the demand for ever larger dollar holdings. As a private market in SDR use built up (as set out below), the global liquidity implications of SDR allocations would need to be considered by the IMPC in making its recommendation.

5 This structure of nine members including four 'independents' with published minutes and votes is loosely based on the Bank of England's Monetary Policy Committee, which has had over a decade of generally successful experience. A similar proposal was made by Sir Nicholas Stern for an independent international body to provide an early warning system for financial breakdowns, although his view was that it should be completely independent of the IMF (Stern 2009).

Even initially, however, the IMPC could use its published recommendation as a signalling device. It could vary the growth of SDR reserves in a counter-cyclical way by recommending lower or zero allocations when it judged that global liquidity was growing excessively and, conversely, larger than average allocations when a global output gap was developing.[6]

The second way to expand the supply of SDRs is to create a 'substitution account' whereby member countries could deposit dollars, euros, yen or sterling with the IMF and receive the equivalent amount of SDRs in their account based on the exchange rate then prevailing. Such a proposal was actively considered, but eventually rejected in 1978. At the time the United States would not agree to allow two-way substitution whereby it would ultimately bear the risk of converting SDRs back into dollars, if the owners so wished, at an exchange rate that might have moved against the dollar in the meantime. It is likely that today the European Central Bank would be equally reluctant to take on such risk with respect to the euro.

There are two options: either a one-way substitution account could be established, or the member countries of the IMF could collectively assume the risk of conversion out of SDRs. Such risk could be controlled both by limiting the size of the substitution account and/or by running it like a ring-fenced currency board, with redemptions limited in size and timing to maintain a buffer and avoid sudden runs during periods of currency market turbulence. For example, a six-month notification period between a redemption request and its execution could be specified.

The size of the substitution account could be limited initially and increased gradually as experience develops with its usage by member countries and the pattern of their deposits and redemptions. For example, its size could be limited at first to the total of outstanding SDRs. There could be an initial six-month window of time for countries to use the facility up to their individual SDR holdings. Not all countries would choose to exchange their reserves for SDRs up to their quotas, so beyond that time limit the remaining facility could be made available to those countries wishing to over-subscribe their quota for reserve substitution.

By tying the total size of the substitution account to SDR allocations, a potential doubling of the quantity of SDR reserve assets would be achieved. With the recent $250 billion equivalent of SDR allocation agreed by the G20, this would mean that SDRs could immediately grow to nearly 10% of global reserves. If all proceeded smoothly, the ceiling on the substitution account could then be raised, subject to approval by the IMF board.

If it proved impossible to negotiate even such a controlled two-way substitution account, then it could be established with one-way convertibility. Countries could exchange their foreign currency reserves for SDRs but not vice versa. That would limit the SDR's attractiveness to surplus countries, but it need not prove a major obstacle if at the same time private-sector uses of SDRs were facilitated, as set out below.

Expanding SDR demand

The dollar's role as a global currency stems both from its usefulness for international trade and from the deep liquidity of its capital markets for international financial transactions. These, in turn, rest on institutional and legal underpinnings that have evolved over decades. A similar long-term horizon is appropriate for considering how SDR use could be facilitated, not only as a reserve currency, but also for international trade and investments.

On the trade side, two relatively straightforward changes would be required to enable the SDR to play a bigger role. First, the IMF would need to agree that SDR accounts could be opened by private-sector actors. Second, a settlement system would need to be created either by the IMF or by an authorized provider to enable transactions that were denominated in SDRs to take place directly between buyers and sellers on a secure and transparent platform.

Initially the IMF could declare itself to be the monopoly holder of SDR accounts. As experience accumulates it would be entirely possible to allow private financial institutions to provide SDR accounts with regulatory supervision

6 Barry Eichengreen (2009a) has suggested such a counter-cyclical approach to regular increases in IMF quotas, which could be another route to the same end if SDR allocations were tied automatically to quota increases.

(just as many banks today provide multiple currency accounts to depositors who have need for such). In the initial stage the currency backing for SDR accounts should be 100% so that no risk exposure would be created. In effect, these accounts would be one-way substitution accounts for private as well as public depositors. A new account would be created by the depositor 'selling' convertible currencies to the IMF and 'buying' the equivalent in SDRs.

Along with allowing the private sector to open and hold SDR accounts, the IMF would need to establish (or outsource the creation of) a secure settlement system. This is where transactions denominated in SDRs would take place between buyers and sellers. For example, if OPEC denominated its oil exports in SDRs and its state oil companies established SDR accounts at the IMF, then the major purchasers of OPEC oil (chiefly the trading arms of the large private-sector oil companies) would find it useful to establish SDR accounts and clear their purchases directly through the IMF settlement system. The technology and know-how for settlement systems is widely available in central banks today.

There have been recent news reports that discussions are taking place between China and oil-exporting countries such as Iran and Russia to agree on a currency basket that could be used for some of their bilateral trade. That is likely to be an inefficient and cumbersome approach if the basket includes managed currencies such as the renminbi and rouble. Their objectives of dollar diversification could be achieved more securely and efficiently if a neutral settlement platform for the SDR were available.

In addition to facilitating trade denominated in SDRs, it would be important to develop SDR-denominated financial instruments and markets in which to trade them. There is nothing to prevent governments or indeed corporations from issuing SDR bonds and a few international organizations have done so. What is lacking is a market-maker willing to buy and sell such bonds at bid/offer spreads which are competitive with those in more liquid bond markets. John Williamson suggests that this may be due to an 'infant market' problem where benefits to the first mover would only materialize if and when the market became widely used (Williamson 2009). Barry Eichengreen has pointed out that the IMF is the obvious candidate to be the market-maker in SDRs (Eichengreen 2009a). However, this would require a change in its remit to allow it to transact with private investors and, potentially, to subsidize bid/offer spreads during the market's infancy.

The G20 summit in April 2009 agreed to increase the resources of the IMF by $500 billion, to be raised by issuing bonds. China and Russia have indicated their willingness to buy $50 million and $10 million, respectively. Both countries have also supported a greater use of SDRs and it is likely that a substantial portion of the $500 billion will be offered as SDR bonds. This would be an important step in expanding the supply of SDR-denominated assets. The next step should be for the G20 to request the IMF to prepare a working paper on becoming a market-maker in SDR-denominated bonds.

A global cost-benefit assessment

Who would be the winners and losers from SDR expansion? A fundamental feature of the evolutionary roadmap described above is its voluntary nature. No country is required to participate in any new feature, whether it be the substitution account, the settlement system or SDR bond purchase. In addition, the IMF board retains its current structure and voting distribution. The institutional changes proposed, such as the International Monetary Policy Committee, are additional to, not replacements for the current arrangements.[7] Since all participation would be voluntary, no country would lose directly or immediately from the introduction of new mechanisms. And indeed, all countries would benefit from regular new allocations of SDRs in line with their IMF quotas.

However, a more fundamental question is where the costs and benefits might settle over time. It is widely assumed that the United States would be the big loser from the replacement of the dollar as the world's reserve

7 This is not because the current arrangements are ideal, but simply that they have proved to be very difficult to change.

currency. However, a recent study by the McKinsey Global Institute has estimated that the so-called 'exorbitant privilege' enjoyed by the United States from seigniorage is now very small – equivalent to less than half of one per cent of its GDP (McKinsey Global Institute 2009). Fred Bergsten has argued recently that the international role of the dollar was a significant contributing factor to the US financial crisis because it undercut the ability of the Federal Reserve board to tighten monetary policy during the credit build-up – the 'conundrum' discussed by Chairman Alan Greenspan at the time (Bergsten 2009).

Surplus countries – such as Japan and China – would clearly benefit from the greater stability afforded by a composite currency as a store of value for their reserves. Deficit countries – such as the United States and the United Kingdom – would benefit to some degree from the additional option of issuing debt in more stable SDRs as that market developed. Large commodity exporters and importers would also benefit from the greater price stability of SDR-denominated commodity markets.

Smaller IMF member states would be beneficiaries both through their regular SDR allocations and through the greater diversification they could achieve in their own foreign exchange reserves if SDRs were more widely held and used. They would also benefit if SDR allocations were skewed towards the poorer countries to incorporate a poverty reduction objective.

Conclusion

Over the last 25 years the shape of the world economy has been transformed. The Asian countries have achieved rapid and self-sustaining growth. China has now become the world's largest exporter. The European Union has expanded to be larger than the United States in its total output and most of its members have adopted a common currency. The USSR has collapsed and Russia has become a large oil and gas exporter. The OPEC countries have grown on the back of higher oil revenues, much of which they have invested domestically. These developments have led to a multipolar world economy where the weight of the United States is in decline.

At the same time, the dollar has remained the dominant currency of international transactions and foreign exchange reserves, accounting for around 85% and 65%, respectively. There are efficiency gains to be had from a single world currency, but it also creates vulnerabilities.[8] The risks grow if the economic policies of the currency provider are inconsistent with maintaining a stable currency value, a steady growth of supply and a balanced pattern of world trade. This becomes ever more difficult if the currency provider runs a chronic balance-of-payments deficit. Such a situation eventually brought down sterling as the dominant world currency, albeit under a system of fixed exchange rates. Today's 'non-system' of both floating and fixed rates is subject to similar pressures when global imbalances mount.[9]

Fortunately, during previous periods of global currency crises, the groundwork was laid for bringing into use a basket currency, the SDR. This chapter has sketched out a roadmap for expanding its supply and putting in place the institutional infrastructure to facilitate its use by the private sector. The political obstacles to this route seem manageable, particularly if it does not require contentious changes in IMF voting shares and when the benefits of currency stability are shared by both surplus and deficit countries. An important step was taken at the London summit of the G20 when a major expansion of SDR allocations was agreed. The proposals in this chapter provide a roadmap to help sustain that momentum and prevent future crises.

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8 See Mateos y Lago et al. (2009) for a mapping of the trade-offs among nine criteria for international monetary systems.

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7. A Twenty-first Century International Monetary System: Two Scenarios

Jim O'Neill

Trying to develop a monetary system for the twenty-first century, in which the world's largest economies might include some that have quite undeveloped financial systems, is a major challenge. In 2010, China is likely to overtake Japan as the second largest economy in the world. In the next decade, along with other large emerging economies such as Brazil, India and Russia, the size of China's economy will probably be close to that of the United States. Within 20 years, the combined size of the so-called BRIC economies will possibly equal those of the United States and European Union together. What kind of international monetary system will be necessary for such a world, and can we start to devise one today for such an eventuality?

There appear to be two extreme scenarios that might emerge, but to plan for either is not easy. In the first, which is the presumption of many economic analysts and policy-makers from the more developed economies, as China continues to develop, becoming more wealthy and self-confident about the sustainability of its economy, it will eventually allow full convertibility of its currency, the renminbi. This will result in a floating exchange rate, as currently experienced with regard to the dollar and the euro. As China moves in this direction, other large emerging economies will presumably gradually move in the same direction, and the end result will be something approximating to today's Western monetary system. Under such a system, the renminbi, dollar and euro would all form the linchpin of the world's currency markets, and behind them would be the Japanese yen, pound sterling, Brazilian real, Indian rupee, and Australian and Canadian dollars. Perhaps one or two more currencies, such as the Korean won, Russian rouble and Swiss franc, would generally float. The currencies of most other economies might be under a managed float against those of the above.

The other extreme scenario is very different. Here there is a new currency, such as a revamped Special Drawing Right (SDR) which encompasses existing or future national currencies, closely controlled in their movements against it, with capital flows more restricted across borders than today.

> 'Unless each of the currencies is managed directly as a goal of policy by the respective central banks, how can the SDR be of any use as a world currency?'

When the Governor Zhou of the People's Bank of China wrote an article suggesting a broader role for the SDR in April 2009, many, including myself, initially found it hard to make sense of the proposal. Many have interpreted it more as a political statement to the United States and other developed countries: now that China had become a member of the G20 'elite club', it would be offering its own ideas but without trying to be very specific. Superficially, it does seem hard to see how the SDR can suddenly become of interest when it has existed since 1969 as a basket of major currencies; other than for accounting purposes involving IMF transactions, no one chooses to use it.

The SDR basket, which consists of the dollar, euro, yen and pound, can easily be replicated by investing or trading in all the component currencies, each of which has plenty of liquidity – so who really needs the SDR? Unless each of the currencies is managed directly as a goal of policy by the

respective central banks, how can the SDR be of any use as a world currency?

I have been intrigued by Governor Zhou's paper and have come to believe that his proposal might be viable in the future, even if not today. At the moment, the SDR basket is officially reweighted every five years, apparently on the basis of three criteria. Economic size appears to be of relevance, along with the size of exports of goods and services in each of the countries, and the amount of reserves invested in each of them by IMF member countries. It is also a condition that a currency needs to be fully convertible. The next reweighting is due in November 2010, and if the criteria remain the same as today, little is likely to change, other than perhaps a further reduction of the weight of the pound and the yen. Indeed, it is entirely possible that eventually, without changes in capital account usage in the emerging world, the SDR will effectively become a basket of two – the euro and the dollar.

But what if some key things change? Let us reconsider Governor Zhou's article, and explore other reasons why he might have written it. Perhaps it was not just aimed at overseas financial diplomats. It might also have been aimed at domestic political figures. In terms of two of the SDR inclusion criteria – economic size and share of exports of goods and services – China has a much stronger case for inclusion than the United Kingdom and, soon, Japan as it is about to overtake them. This fact is, of course, why so many policy-makers from around the world are constantly talking about the need for the renminbi to be more flexible and, in most cases, to have a stronger value. By raising the SDR topic so visibly, just ahead of the April 2009 G20 London meeting, Governor Zhou certainly achieved this. He knew it would result in a greater focus on this dichotomy, and many would write about it. It is interesting to note that China has occasionally announced that the renminbi will be used more for various purposes, including trade transactions with some of the other BRIC countries, and for some financial transactions in Hong Kong.

Why is the value of the renminbi not stronger? In 2005, in conjunction with a small revaluation against the dollar, China announced that going forward, its value would be determined on the basis of the movement of the currency against a basket of currencies. For a brief period, this did seem to be what was happening. The strengthening of the Chinese currency seemed to broadly reflect some combination of other currencies (presumed relevant to China) strengthening against the dollar. This stopped abruptly in July 2008, when the renminbi become virtually pegged to the dollar again, at around the 6.82–6.83 level. It stayed there when the dollar rose sharply soon after the global turmoil in autumn 2008, and at the time of writing remains there, despite the dollar weakening considerably against other currencies. Clearly, China has, at least for now, moved away from a basket system again. And it is repegging to the dollar. This seems to be a status quo which is not sustainable, and is obviously a growing source of frustration for many other policy-makers.

China has just announced that its 2009 growth rate was 8.7%,[1] at a time when G7 countries are reporting their biggest decline in GDP for many decades. Many policy-makers from the G7 countries, especially those with strengthening currencies against the dollar, see this as particularly 'unjust'. Europeans with a strong euro are at the forefront of this, and one wonders why Japanese policy-makers seem so relaxed.

Perhaps there is another, deeper and more complex issue at work. It could be that China wants to sit back now, especially as a G20 member, and think afresh after the crisis about how the world monetary system might evolve better, with fewer unpredictable, chaotic financial movements occurring. Until then, the Chinese may not want fresh movement of their currency adding to their problems. The countries that are recovering soonest from the recession are clearly the biggest emerging economies such as China, India and Brazil. They are not entirely alone, however. Within the developed world, some countries appear to have emerged relatively unscathed: Australia, Canada and also one or two within the euro area, perhaps France. Even if their GDP turns positive, the countries that appear to have some of the biggest challenges going forward include those that in the past have been keen supporters of very flexible and free financial markets, including floating exchange rates. This fact

1 http://www.stats.gov.cn/english/newsandcomingevents/t20100121_402615505.htm.

cannot be lost on developing countries, including China. There is some evidence that countries with more tightly regulated financial systems, including some in the developed world, have fared better in this crisis.

Could this evidence have influenced China? It may believe that the SDR could be revamped, perhaps not as soon as the next formal date in November 2010, but five years after that, under new criteria – specifically giving weight to only two of the current three, in which the absolute relative size of GDP (in either dollar or PPP terms) and the share of world exports are key. By 2015, the combined size of the four BRIC countries in global GDP (in current dollar terms) could well be approaching 25% – close to the size of the US and the EU economies. Under such criteria, the case for including the renminbi in the SDR would be overwhelming; and the case for including the currencies of each of the other three BRIC countries would certainly be rising close to that of the United Kingdom by then. Under such a scenario, the case for a new, more economically representative SDR would be obvious. Many exporting countries from elsewhere in the world, including oil exporters, might quite like to use such an SDR.

Of course, there would still be a major issue of free convertibility of the components of this new SDR, but perhaps the existence of a more globally representative currency might contribute to easing the opening up of capital and trade usage of these currencies.

8. China Debates: The Dollar System and Beyond

Gregory Chin and Wang Yong*

Introduction

The global crisis has reignited long-standing concerns about the functioning of the international monetary system (IMS). Some have drawn attention, once more, to the inherent weaknesses of the current hybrid system in which a dominant reserve currency issuer country runs fiscal and external deficits, and where there is also no effective mechanism for forcing reserve-issuing or surplus countries to adjust. Others focus on the sharp rise in the demand for reserves, which partly reflects the tendency of the emerging economies to self-insure against costly capital account crises. In a game-changing moment in late March 2009, China's leadership expressed its concerns publicly in a landmark speech by Zhou Xiaochuan, Governor of the People's Bank of China (PBOC), entitled 'Reflections on Reforming the International Monetary System'.[1] The speech – which asked what 'kind of international reserve currency we need to secure global financial stability and facilitate world economic growth' and pointed to the need to reform the international monetary system – elicited strong international reactions (Helleiner 2009: 28). Some observers saw it as a direct challenge to US power and a call to replace the dollar with a global monetary currency. Others dismissed it as an attempt to deflect international criticism of China's 'misaligned' currency, or to get other countries and the IMF to share the risks that China has assumed in accumulating massive dollar reserves (Cohen 2009: 28).

Inside China, the publication of Zhou's speech led to a wave of debate on the root causes of the global crisis, alternative reserve currency options, global imbalances, and the future of the international monetary system, as well as broader related themes such as Chinese currency internationalization, regional financial and monetary cooperation in East Asia, and financial collaboration between China and the 'BRICs'. The internal Chinese debate has received scant attention outside China. Yet China's evolving views on the monetary system and the dollar as the predominant reserve currency are bound to shape the international monetary order for the twenty-first century.

Reframing the problem

Chinese doubts about the dollar-centred IMS predate the current global crisis, and were brought to a head by the crisis. For China's top policy strategists, the financial crisis has laid bare the defects of the existing international monetary system, and they suggest that the world should look to diversify beyond the dollar system. Prior to the G8 summit in Italy in July 2009, Li Ruogu, CEO and President of the Export-Import Bank of China – one of the country's three policy banks – and former vice governor of the PBOC, stated that the financial crisis 'let us clearly see how unreasonable the current international monetary system is' (Rabinovich 2009). The 'institutional drawbacks' of the existing IMS have been a 'contributing factor' to the crisis, according to Wang Jianye, chief economist of Eximbank (and a former senior economist at the IMF). Chinese analysts suggest that the monetary policy of key reserve currency countries has serious global consequences ('externalities'), which the relevant national monetary authorities are not adequately taking into account, even though they may be pursuing legitimate domestic objec-

* We thank Benjamin Cohen, Andrew Cooper, Mui Pong Goh, Eric Helleiner and Paola Subacchi for their comments.

1 Chinese President Hu Jintao reinforced the Chinese leadership's concerns at the G20 London summit in early April 2009. See also Chapter 7 in this report, where Jim O'Neill suggests that Zhou's speech was more targeted at a domestic audience.

tives. The end result is policies that are globally destabilizing – and 'financial imbalances' on a global scale. The Chinese authorities note that the existing IMS is 'out of date.' It does not adequately reflect the profound changes in the world economy of recent years, and is simply no longer workable (Wang Jianye 2009). Wang highlights the fact that 'interventions from the G7 or G3 central banks were enough to move the key reserve currency exchange rates to facilitate international adjustment in the 1980s, but this is no longer the case.'

In addressing the root causes of the current crisis, as well as global imbalances and exchange rate challenges, Chinese analysts trace the *origins* of the problems to the dismantling of the Bretton Woods dollar-gold system in the early 1970s, and the transition to a dollar system.[2] Accordingly, the problem of imbalances is not about an 'artificially low' Chinese currency, which, in turn, has resulted in huge trade surpluses for China *vis-à-vis* the United States and the EU; these are but symptomatic issues that belie deep systemic problems. The current IMS is said to have allowed the United States to run consistent current account deficits, which, in turn, have led to its rising levels of external debt. Persistent net external debt eventually led to pressure on the US currency to depreciate. In turn, the depreciating global currency has 'wreaked havoc' on the international monetary and trading systems (Zhang Ming 2009a). Moreover, some Chinese commentators stress that the system suffers from the lack of a 'supranational institution' (i.e. the IMF[3]) that can effectively evaluate sustainable debt levels for the major currency-issuing countries, and enforce macro-policy changes when such transgressions have occurred. The IMF can only exert such influence over countries that borrow from it, but has been unable to do so over, for example, the issuer of the dollar (Chin 2009: 54).

Zhou's speech highlights the Triffin Dilemma. The governor's reading of Triffin, and that of prominent specialists such as Xiao Geng at Tsinghua University, is that when the currency of a single nation is used as the global reserve currency, the currency-issuing country faces the dilemma of taking decisions on domestic monetary policy that serve national interests but that may not contribute to global economic wellbeing. The PBOC's reading is that the root cause of the subprime crisis in the United States was excess liquidity throughout the world, which was the result of overly relaxed US monetary policy. Excess global liquidity pushed down interest rates in US financial markets over the long term, which, in turn, resulted in the real estate and derivatives bubbles. According to Zhou, 'Although [the] crisis may not necessarily be an intended result of the issuing authorities, it is an inevitable outcome of the institutional flaws.' According to Zhang Ming of the Chinese Academy of Social Sciences, whereas the gold standard system had an inherent tendency to cause deflationary pressure, the dollar standard system has a tendency to induce inflationary pressure (Zhang Ming 2009a). One way out of the Triffin Dilemma is a supranational or 'super-sovereign' international reserve currency.

Chinese commentators suggest that one of the most important differences between previous international monetary systems, i.e. the gold standard system and the Bretton Woods system, is that the dollar system suffers from an inherent systemic gap: there is no effective *multilateralized* check-and-balance mechanism to provide adequate international governance over the supply of key currencies. In other words, there are no supranational controls over the amount of currency issued by the country whose national currency also acts as the global reserve currency. Under the Bretton Woods system, the limit on dollar issuance was the dollar's peg to gold, and the threat that if the United States exceeded dollar-gold issuance limits, then other states could march on the US Federal Reserve to exchange their dollars for gold. A number of Chinese analysts believe that this disciplining measure on US money issuance was eliminated with the end of the dollar-gold peg and the shift to the current dollar-centred IMS. Excess liquidity in the international monetary system has thus led to a situation where boom-bust cycles in asset prices have become the systemic norm.

Chinese analysts note that problems of imbalances have been recurrent since the shift to the dollar system, and

2 The Chinese authorities see loose US fiscal and monetary policy as the main contributing factors of the past decade.

3 See Chapter 9 by Jeffrey Chwieroth, on surveillance.

have merely worsened since the late 1990s, rather than being a new phenomenon caused by China. Both Germany and Japan have run major surpluses *vis-à-vis* the United States, and have also had to deal with American pressure to revalue their currencies throughout the era of the dollar system. China is only the latest target. What has turned into 'normalized' behaviour, i.e. the United States running consistent current account deficits, has finally led to unmanageable external debt. Yu Yongding, one of China's most influential economists, suggests that the inherent flaws in the dollar system are easy to miss because the importance of dollar assets in the investment portfolio of international investors has meant that foreign exchange funds have flowed back into the United States through purchases of dollar-denominated financial products. This has allowed the United States to delay or deflect the necessary domestic adjustments to address its current account imbalance (Yu Yongding 2009). Now, the subprime crisis has dampened investor confidence in US financial products, and the US government's bailouts have triggered investor concern about medium- to long-term dollar depreciation.

Proposals for solutions

International commentators have noted that it was a major achievement in global crisis management to get all parties at the Pittsburgh G20 summit in September 2009 – particularly China and Germany – to agree to 'achieving balanced and sustainable growth' as a priority for the G20. Previously China would not agree to include the words 'global imbalances' in the official statements of the G20, as this could be taken as criticism of Chinese currency policy. However, its eventual support for the specific wording 'balanced and sustainable growth' allowed the host of the G20 Pittsburgh summit to claim a diplomatic victory. The tussle over including 'imbalances' was not merely about semantics. As discussed above, it reflects deeper differences between the trade surplus and deficit countries over the origins of the global imbalances, and on how best to address the problem. In this sense, even the rhetorical gains at Pittsburgh are noteworthy, as they reflect some degree of new convergence on the issue. It now appears that, at some level, Beijing has come to accept that addressing structural dynamics in the global economy between the surplus and deficit countries is needed, and that some unique and differentiated actions must fall to the former group. So far, the remedial actions have mainly taken the form of increasing domestic consumption in China through domestic fiscal stimulus – infrastructure and other public spending – but not exchange rate adjustment (Wang Yong 2008).

"Prior to the onset of the current crisis, senior Chinese officials were already speaking quite publicly about the 'irrationalities' of the existing monetary system, and the changes needed over the medium term to reform it"

While many international observers see fixing the issue of imbalances as the priority, what does Beijing see as pivotal? For the near term, Governor Zhou's speech calls for appropriate policy and institutional measures to ensure that the monetary policy of the key reserve currency countries takes into account their global effects. In this regard, the IMF must not only accelerate its own governance reforms (e.g. changes in voting shares to reflect shifts in the international balance of economic power), but take appropriate responsibilities in crisis prevention and resolution, and inescapably the responsibility of ensuring that the fiscal and monetary policies of the key reserve currency countries are not leading to 'unsustainable financial imbalances' (Wang Jianye 2009).

Prior to the onset of the current crisis, senior Chinese officials were already speaking quite publicly about the 'irrationalities' of the existing monetary system, and the changes needed over the medium term to reform it.[4] As early as 2003, the Chinese authorities called on the IMF to

4 For example, see Li Ruogu's remarks at the Lujiazui Forum in Shanghai in summer 2008 (Lujiazui Forum 2008: 10)..

'tighten its surveillance of the macroeconomic and financial policies of the major industrial countries' (Li Ruogu 2003). They emphasized that 'overcoming the problem of imbalances required the establishment of a new equitable and reasonable economic and financial order' and that 'the IMF needs to continue to examine the flaws in the existing IMS, and gradually establish a new IMS that more fully reflects the interests of the many developing countries, and provides institutional safeguards for the sustainable growth of the global economy'. In 2003, the then assistant governor of the People's Bank, Li Ruogu, also called on the IMF to 'actively promote the general allocation of SDRs; in particular, that the IMF needed to complete the special one-time allocation of SDRs as soon as possible to strengthen the capacity of member countries to withstand crises' (Lujiazui Forum 2008: 10).

Zhou's March 2009 speech, delivered right in the middle of the global crisis, has galvanized international attention and elevated the internal Chinese debate by laying out some technical options for reforming the international monetary system, especially reserve currency options. To mitigate the effects of the Triffin Dilemma, and reduce the world's dependence on the dollar as the global reserve currency, Zhou suggested expanding the scale of issue and scope of circulation of the SDR over the medium term. Chinese analysts have made a number of suggestions on how best to implement Zhou's SDR proposals, as the official speech itself was short on details.

While the Chinese authorities have been cautious about discussing the (Chinese) currency implications of Governor Zhou's proposals, some scholars have run ahead of the official position. Zhang Ming, for one, proposes a greater international role for the renminbi in relation to an expanded role for the SDR as a reserve currency, suggesting that the SDR currency basket (currently consisting of the dollar, the euro, the pound and the yen) should be expanded to include currencies of the major emerging economies, led by the renminbi (Zhang Ming 2009a). He also proposes three other SDR implementation measures:

(1) encouraging the use of the SDR for pricing international trade transactions, commodities, investment and corporate accounting, and including consideration of the SDR in calculating the market value of a country's foreign exchange reserves;
(2) expanding the use of the SDR in global trade and investment, by extending its use beyond the settlements of governments and the major international organizations, to private-sector and corporate cross-border settlements;
(3) launching SDR-denominated financial assets in order to promote the attractiveness of the SDR as a reserve currency, with the IMF issuing bonds for using SDR as a pricing medium, and establishing open-ended funds that use the SDR as a pricing tool.[5]

Beyond the dollar system

It is important to recognize that the Chinese SDR proposals are part of a medium- to long-term strategy for reforming the IMS. At the same time, the Chinese debate on international money is underpinned by a strong dose of *realpolitik*. Analysts note that even if the transition from the dollar system began immediately, it would be a while before a super-sovereign reserve currency were in a position to replace the dollar as the global reserve currency. While most published Chinese accounts appear to favour the SDR proposal, senior officials and many analysts are cautious about its prospects – for the immediate future. Li Ruogu notes that despite the 'irrationalities' of the current dollar-centred IMS, 'it would be difficult to find and implement a feasible replacement plan in the short term, so we will still have to travel a relatively long road for reform of the international monetary system' (Rabinovich 2009). Lu Qianjin at Fudan University points out that the 'world is still far away from leaving the dollar standard system, because of the overall strength of the United States, the greater level of risk in other investments, and the political opposition to dollar depreciation even among the creditor nations' (Lu Qianjin 2009). Others note that the United States is

5 IMF members could then use their foreign exchange reserves (specifically their dollar holdings) to purchase the SDR-denominated funds.

unlikely to want to see a dilution of its monetary power, and would be likely to resist attempts to strengthen the role of SDRs. Huang Xiaopeng, an editor at the newspaper *Securities Times*, believes that 'rule-less bilateral or multilateral coordination of monetary affairs will be the norm for the near future' (Huang Xiaopeng 2009). Although the subprime crisis has weakened confidence in the dollar, many of the rival currencies that are already established as reserve currencies, such as the pound and the yen, have also been weakened by the fallout from the current global crisis (the euro is the exception).

The above reservations notwithstanding, the broadly held view in the Chinese discussions is that a fundamental shift is not only needed but also now imminent. A number of Chinese observers believe that the current crisis could well turn out to be a turning point for the dollar as the supreme reserve currency, and for the dollar system. Huang Yiping of Peking University notes that the dollar may no longer be as dominant on emerging from the crisis, and that the future of the dollar system does appear less certain over the medium term (Huang Yiping 2009: 20–25). Yu Zhonghua, of Liaoning University, suggests that it is in China's strategic interests to promote the shift away from a 'dollar hegemony' scenario (Yu Zhonghua 2009). Lu Qianjin (2009) adds that the best option for China is to be 'pragmatic'; to support a gradual move to a 'more diversified international monetary system with more currencies, acting as reserve, trading and pricing tools' and calls for 'letting different currencies compete and balance against each other'.

Chinese government representatives and commentators appear unanimous in supporting a gradual shift to a more multipolar international monetary system. One vision is a monetary system in which the dollar, the euro and a regional Asian currency share the role of global reserve currency, backstopped by SDRs – a *multipolar* reserve currency that could provide a new competition mechanism to help discipline the key currency-issuing countries[6] (Zhang Ming 2009b: 33). Others encourage moving ahead with the efforts to internationalize the Chinese renminbi (Yu Zhonghua 2009).

Currently, Beijing does not appear to favour institutional alternatives to a *global* monetary system that is anchored in the IMF and the Bank for International Settlements – although monetary and financial integration in the East Asian region does appear to have reached a new plateau since the onset of the global crisis. For now, China's interests in the dollar-centred IMS are so great that the rational strategy appears to be to engage more fully in reforming the existing international monetary system, and repositioning the IMF, while simultaneously supporting a gradual shift to a multipolar reserve system.

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6 Li Yang, Director of the Institute of Finance and Banking at CASS, the Chinese Academy of Social Sciences, urges pushing ahead with Asian regional currency development as a crisis-prevention mechanism, and Zhang Tao, Director General of the Financial Survey and Statistics Department of the PBOC, calls for strengthening financial cooperation between emerging economies and East Asian countries. See the remarks of Li Yang and Zhang Tao (Lujiazui Forum 2008).

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9. IMF Surveillance: 'Getting Tough' on Exchange Rate Policies

Jeffrey M. Chwieroth

The persistence of undervalued exchange rates in some major economies, particularly in Asia, has been a leading cause of global macroeconomic imbalances and has helped create the underlying conditions for the current financial crisis. Moreover, since the onset of the current crisis the world economy has witnessed the return of 'dirty floating' as various governments have pursued 'hard' and 'soft' intervention to hold down the values of their currencies. In short, as Chapter 10 by Christopher Meissner makes clear, these exchange rate policies have the potential to generate negative spillovers and therefore create the need for *ex ante* coordination, cooperation, and enforcement. In this context, the current chapter argues for the need for further reforms to IMF surveillance to help it 'get tough' on exchange rate policies.

Efforts thus far

The IMF was established to discourage competitive depreciations and beggar-thy-neighbour exchange rate policies. When the Fund's Articles of Agreement were amended in the 1970s to reflect the emergence of generalized floating, the revised Article IV created new obligations with respect to exchange rate policy for the Fund and its member states. Specifically, the Articles state that each member country shall 'avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members'. The Fund in turn is to 'oversee the international monetary system in order to ensure its effective operation, and […] oversee the compliance of each member with its obligations' and it 'shall exercise firm surveillance over the exchange rate policies of members, and shall adopt specific principles for the guidance of all members with respect to those policies.'

In a 1977 Decision, the Fund specified a series of principles and procedures for how it would conduct this task. The board identified a number of 'pointers' that 'might indicate a need for [a special ad hoc] discussion with a member of the Fund'. Listed first among these pointers is 'protracted large-scale intervention in one direction in the exchange markets'. But over the past three decades the G5/7 countries have kept the IMF largely on the sidelines in their discussions of exchange rate policies. Developing and emerging-market countries also did not welcome IMF surveillance of their exchange rates. A 'pact of mutual non-aggression' (Mussa 2007: 2) among the IMF membership meant that exchange rate issues rarely received much substantive consideration. In fact, the IMF has initiated these special ad hoc considerations on only two occasions.[1]

Over the past decade, the exchange rate policies of major economies have been discussed largely in the context of concerns about large and sustained global macroeconomic imbalances. Starting in 2004, G7 communiqués began calling for greater flexibility in the exchange rates of major economies whose exchange rate regimes lacked such flexibility. China, which had been intervening heavily to sustain the hard dollar peg it had operated since 1994, was the clear target of such calls. Some observers argued that large-scale exchange rate intervention on the part of China and other Asian economies was inhibiting adjustment and violating the rules of the international monetary system (Bergsten 2007; Goldstein 2006).

In early 2005, the US Congress began drafting legislation that would have imposed punitive tariffs on China. Later that

1 With Sweden in 1982 and South Korea in 1987.

year China shifted management of the renminbi from a hard dollar peg to an unspecified basket of currencies, and permitted a slow and steady appreciation over the next three years. But since July 2008 China has, in effect, re-pegged its currency to the dollar. Undervaluation of the renminbi (and other Asian currencies) thus remains a source of considerable controversy (Goldstein and Lardy 2009).

Despite its mandate, the IMF, for its part, has shown little inclination to get much involved in specifying what is and is not acceptable exchange rate policy. To be sure, over the past decade the Fund has raised concerns about the macroeconomic risks emanating from large imbalances, specifically the risk that a shift in portfolio preferences of official and market actors could result in a rapid and disorderly depreciation of the dollar. But the IMF, while endorsing arguments for greater exchange rate flexibility, stopped short of identifying certain countries as engaging in manipulation, and, until 2006, refrained from arguing for the need for an appreciation. Rodrigo Rato, IMF Managing Director from 2004 to 2007, resisted pursuing more aggressively countries that were engaging in prolonged exchange rate intervention, partly out of concern that acting as an 'umpire' would conflict with the Fund's role as a 'trusted advisor,' and partly owing to deep divisions among major economies on the issue.

Nevertheless, in 2004 Rato did include multilateral consultations and a review of the 1977 Decision as part of his Medium-Term Strategy for reforming the Fund. Launched with much fanfare in 2006, the multilateral consultations brought together major economies in an effort to help broker agreement on policy actions that could be taken to unwind global imbalances. Yet rather than gaining firm policy commitments backed up by some enforcement mechanism, the Fund could only manage vague policy plans. Although it did offer a set of benchmarks against which progress could be assessed, it has since downplayed the importance of the consultations.

Great importance was also attached to the review of the 1977 Decision. Over the years, the actual practice of surveillance diverged significantly from what is outlined in the 1977 Decision, and it required updating. Some advanced countries, notably the United States, argued that the Fund had failed to fulfil its mandate to exercise 'firm surveillance' over exchange rates and accused the IMF of being 'asleep at the wheel on its most fundamental responsibility' (Adams 2006: 135). But developing and emerging-market countries feared that updating the Decision would entrench a perceived asymmetry in which IMF surveillance, while having little impact on advanced countries, would infringe on the sovereignty of developing and emerging-market countries because of their actual or potential need for the Fund's resources or seal of approval.

In 2007, in the face of a seriously divided membership, a decision was reached to overhaul IMF surveillance. The 2007 Decision set the stage for a more rigorous scrutiny of exchange rates. It introduces 'external stability' (a balance-of-payments position unlikely to generate disruptive exchange rate movements) as the organizing principle of surveillance. It also revises the list of principles and 'pointers' contained in the 1977 Decision. Mirroring some of the language in US Congressional draft legislation aimed at China in 2005, it introduces 'excessive' accumulation of reserves, 'fundamental exchange rate misalignment' and 'large and prolonged' surpluses as developments that would warrant a special ad hoc consultation. The Decision also specifies in detail what is meant by the obligation prohibiting members from manipulating their exchange rates. Although China expressed reservations about whether the Decision would result in surveillance being applied in an even-handed manner, the Decision did go a long way towards satisfying US demands for the Fund to play a more aggressive role more along the lines of an 'umpire'.

Yet despite the hype surrounding the 2007 Decision, the record on implementation has been at best mixed. Although the Decision has significantly improved the quality of exchange rate surveillance, the IMF has failed to 'get tough' on exchange rates. Candour, which was to have been improved through specific findings of 'misalignment' and 'manipulation', has been lacking. For instance, since the adoption of the 2007 Decision, a very large proportion of exchange rates has been assessed as 'broadly in line with fundamentals' despite large current account imbalances. There has also been a tendency among the staff to point to temporary factors to explain away large imbalances rather than focusing on the possible need for exchange rate adjustment. These tendencies to some extent reflect the technical

challenges involved in estimating equilibrium exchange rates, which have large margins of error, and assessing them against exchange rate levels. But a far more critical determinant of these tendencies has been what a 2008 internal IMF review calls a 'fear of labelling' (IMF 2008: 18). This fear stems partly from organizational imperatives to maintain good relationships with country officials and partly from the perception among the staff that if they were to take an aggressive stance, they would not receive sufficient support from management or the board.[2] The unwillingness of some countries to discuss exchange rate issues, and management's concern that forcing the issue, particularly with respect to China, could heighten tendencies toward creating regional reserve pools, also served as a constraint. As a result, annual consultations with some country officials, notably China, encountered extensive delays.[3]

Given these difficulties, management issued revised guidelines to the staff in June 2009. These revisions eliminate the requirement to use specific labels and, in practice, reserve findings on non-compliance with the 2007 Decision for only the most egregious cases. The revisions also allow the assessment of exchange rate policies to take into account the 'intentions' of country officials.

More recently, in September 2009 the G20 agreed to a new framework for balanced global growth that will seek to tackle global imbalances. The new framework will involve G20 officials setting the goals and receiving reports from all members detailing how their policies meet these goals, and it will be monitored by the IMF. There will not be any formal sanctions for non-compliance, and policy commitments will be enforced through a system of 'mutual assessment' (peer review). The G20 communiqué directs the IMF to monitor the framework by providing 'candid, even-handed, and balanced analysis of our policies'. In essence, the G20 have asked the IMF to play the role of 'scorekeeper,' 'umpire' and 'ruthless truth-teller'.

Yet there is a palpable sense among many observers that we have been here before. Indeed, the multilateral consultations were launched in 2006 with similar fanfare and then the initiative soon fizzled out. Will it be different this time? At the time of this writing, it is too soon to tell. On the one hand, it is troubling that despite the importance the G20 have attached to the framework, their most recent communiqué makes no mention of exchange rates. It also remains to be seen whether peer review will be an effective mechanism to encourage compliance. At the IMF many governments find little value-added from this process, and one recent high-level report on governance reform has proposed eliminating it (Committee on IMF Governance Reform 2009). Furthermore, given the concerns of surplus countries about signing on to the framework, it remains to be seen whether countries will be willing to act on unpalatable advice from the IMF.

On the other hand, there are some indications that this time could truly be different. Perhaps most importantly, there is widespread recognition among the G20 that the United States will, in all likelihood, not return to its role as consumer of last resort as it did following the Asian financial crisis. Thus, this time around, countries that rely on undervalued currencies to stimulate export-led growth face stronger incentives to reform their ways. The IMF has also started to take a more aggressive stance on imbalances, warning in the October 2009 *World Economic Outlook* that 'Many economies that have followed export-led growth strategies and have run current account surpluses will need to rely more on domestic demand – notably emerging economies in Asia and elsewhere and Germany and Japan' (IMF 2009: 32). The current IMF Managing Director, Dominique Strauss-Kahn, has also become increasingly vocal in urging greater appreciation of the renminbi and other Asian currencies.

Proposals

Such actions, while unpopular in surplus countries, should be welcomed. But the IMF can do more to build on its new-found assertiveness on exchange rates and shore up its capacity to engage in ruthless truth-telling. Toward these ends, the following proposals are offered.

2 In a 2008 internal staff survey, almost one in five IMF mission chiefs considered the 'need to preserve quality relationships with the authorities' had – to some extent or more – acted as a constraint on candour (International Monetary Fund 2008). See also Independent Evaluation Office of the International Monetary Fund (2007).

3 The year 2009 was the first since 2006 in which the IMF board had discussed the Chinese economy.

First, *the IMF should strengthen its 'score-keeping' capacity by issuing its own quarterly report on exchange rate policies*. These quarterly reports would help to define the range of acceptable (and unacceptable) exchange rate practices, thus establishing a set of benchmarks against which country policies and policy commitments could be assessed. The G20 should signal their support for these reports by incorporating them into their peer review exercises.

Second, to combat the perception that there is an asymmetry in surveillance, *the IMF, in keeping score, must rigorously assess the full scope of policies (monetary, fiscal, exchange rate and financial-sector) that the 2007 Decision specifies as having a direct effect on external stability*. Because some G20 governments have a strong revealed preference for exchange rate stability, the risk is that by getting tough on exchange rate policies without equal treatment of other policies the Fund could end up reinforcing the perception that surveillance is asymmetric. However, developing and emerging-market countries are more likely to view surveillance as credible and legitimate if they perceive the IMF to be giving equal treatment to advanced countries, most of which have floating exchange rates. Therefore, a dialogue about the full scope of policies that contribute to external stability, along with more rigorous treatment of the policies of advanced countries, should accompany the Fund's current shift away from the tacit presumption that the main risks to external stability lay with developing and emerging-market countries.[4]

Third, *the IMF must serve as a more effective umpire*. The basic problem is that the Fund lacks leverage over countries that do not require its resources or seal of approval. Yet the Fund does possess an 'epistemic authority' that can enable it to engage in 'naming and shaming'. Although labelling has proved to be difficult in the past, there are signs, such as in the recent *World Economic Outlook*, that the IMF may now be more willing to call country officials to task. Management and the board must build on this by adjusting the incentives for staff to raise sensitive issues. A clear signal needs to be sent to the staff that they will be supported when they have a potentially controversial message to convey. Performance appraisals should reward staff not only for ensuring effective dialogue but also for increasing candour, with a balance needing to be struck between the two goals.

Fourth, *to shore up its 'truth-telling' capacity the IMF needs to establish an overall framework to guide its assessment of exchange rate policies*. John Williamson has proposed the use of reference exchange rates to guide IMF surveillance (Williamson 2006: 157–70). This seems to be a good starting point. With due regard for the uncertainty surrounding such work, the staff should be required, rather than advised, to make use of the range of estimates currently produced by the Fund's Consultative Group on Exchange Rates. Not surprisingly, in past cases where IMF staff have employed such estimates, they have often encountered significant dissatisfaction from country officials. To help stiffen the resolve of the staff in the face of such resistance, the IMF should open up staff reports to external debate before they are submitted to management and the board. Input from a diverse range of academic observers, market participants and think tanks would provide a valuable check on the temptation to be less candid for the sake of preserving good relations with country officials.

Fifth, *to further insulate the staff from political pressures from the board, authority to 'complete' (approve) surveillance reports should be transferred from the board to management.* Under these new procedures, the relevant country director could be given the opportunity to voice doubts about the staff assessment, but final authority on whether to revise the staff assessment, and thus ultimate accountability, would rest with management. This proposal, along with others currently being considered that seek to clarify the roles and responsibilities of management, the board and cabinet ministers and to shift the board away from its current focus on operational issues and towards more strategic oversight,[5] should help to strengthen the independence, candour and credibility of surveillance.

4 Conceptually speaking, it also makes little sense to presume tacitly that it is only through exchange rates and balance of payments that domestic policies and developments can affect external stability. The primary impact of the US financial crisis on the rest of the world has been through the financial sector, with the dollar and the balance-of-payments position remaining relatively stable. On this point, see Lavigne and Schembri (2009).

5 The Fund is currently considering corporate governance reforms proposed in reports from the Independent Evaluation Office, the IMF board (the Moser Report), the Committee of Eminent Persons (the Manuel Report), and civil society.

Sixth, *the IMF should eliminate the new 'intentions' language from the surveillance guidelines*. Because IMF staff (and country officials) have in the past used policy intentions as an excuse for inaction, dropping such language will strengthen incentives for the staff to speak more candidly about the need for reform.

Finally, *the IMF's Strategy, Policy and Review department must do more to ensure consistent advice from staff across the Fund in their work on surveillance*. As I have written elsewhere, contrary to popular depictions, intra-organizational debates often lead the IMF to offer a diverse range of views to its membership (Chwieroth 2010). Within the Fund, area department staff responsible for bilateral surveillance have tended to take a less aggressive stance toward exchange rate policies than staff in research departments responsible for multilateral surveillance. While intellectual diversity within the Fund has its virtues, when projected externally it can undermine the impact of surveillance and lead to less candour. The Strategy, Policy and Review department must therefore be more proactive in resolving internal debates, and it must receive clear and strong support from management to do so.

Conclusion

With many governments likely to be tempted to rely on undervalued currencies and export-led growth to fuel their recovery from the current crisis, it is vital for the IMF to 'get tough' and reform the way it conducts surveillance of exchange rates. Moreover, to help strengthen its credibility and legitimacy it is equally vital that the IMF take steps to combat the perception that there is an asymmetry in the way it conducts surveillance. Taken together, these proposals should help to strengthen the IMF's ability and capacity to serve as a score-keeper, umpire and truth-teller.

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10. Systemic Changes in the International Monetary System and the Need for Coordination, Cooperation and Enforcement

Christopher M. Meissner*

The international monetary 'system' serves to facilitate significant gains from trade and investment in the international economy. The last 130 years of economic history illustrate that large changes to the basis of such a system, for instance when one key currency is replaced by another, are typically associated with significant negative shocks to the global economy. Although these changes have been fairly infrequent, they are currently of interest as the dollar faces challenges to its hegemony in the next few decades. A long-run view helps provide insight here.

This chapter considers how to deal with spillovers during such challenges to the hegemony of key currencies. Better coordination is needed to deal with spillovers which arise in an interconnected world. These spillovers also encompass 'imbalances' and the perennially difficult issue of asymmetric balance-of-payments adjustment which the IMF was intended to ameliorate.[1] The chapter focuses less on imbalances and more on the issue of changes to the key currency in the international system, and aims to show that there are significant external and systemic effects during such changes and that coordination, consultation and enforcement could limit such negative effects.

In particular, the international monetary system seems to display excessive inertia and lock-in over the choice of key currencies owing to transition costs and strategic complementarities.[2] The proposal put forward here is not to substitute national currencies with an international currency basket such as the SDR or a new global money: national currencies (or a set of them) are no less suitable than other plausible alternative models, and alternative models have their own drawbacks and complexities. Rather than wholesale reform, several modifications to the governance of the international monetary system are proposed that could reduce the negative spillovers in the current system. These include improved international coordination, consultation and enforcement with regard to exchange rate policy. Multilateral action is of course the theoretically endorsed solution whenever policy spillovers exist. The goal of this chapter is to demonstrate that such spillovers do exist and then propose remedies.

We are not starting from scratch. This approach has been common, and useful, in monetary unions, but such formal self-enforcing mechanisms either do not exist in the realm of exchange rate policy or need to be enhanced.[3] Moreover, while in the sphere of international trade, nations have consented to enforcement by the World Trade Organization, no such

* I thank, without implicating, Michael Bordo, Catherine Schenk and other participants at a workshop at Chatham House for comments on an earlier draft.

1 Frieden (2009) provides an excellent analysis of imbalances as the key spillover in the international monetary system. Frieden 'makes the case for systematic inter-governmental cooperation on international monetary affairs', as I do here for ancillary reasons.

2 Strategic complementarities are situations when it is beneficial to imitate the policies and choices of other countries. For example, the larger the number of countries pegging to the dollar the more beneficial it may be for any other country to do so as well.

3 In the case of monetary unions within quasi-political unions (e.g., the European Monetary Union or the sterling area after the Second World War), significant coordination at the international level has taken place. Veyrune (2007) discusses extensive cooperation between France and other nations in the 'franc zone' from 1956 to 2005. In the case of the dollar and its clients rather less coordination and cooperation have been evident.

consent currently exists in monetary affairs. This is surprising given that the gains from international monetary stability are arguably as important as those derived from open international trade. An instructive comparison can be made with the mechanisms already in place in the European Union. Outside the EU, however, although the International Monetary Fund is the most obvious body for enhancing cooperation, it lacks the capability both to deal with multilateral issues and to enforce its decisions. The articles of agreement, at best, only implicitly recognize spillovers as a problem to be solved. Exchange rate misalignments are perhaps the exception – but even here enforcement procedures leave much to be desired.

The proposal here is that there should be mechanisms mandating international dialogue between countries issuing a reference currency and individual countries or *groups* of countries using this reference currency. Consultation would pre-specify actions that would credibly be taken not only in the case of imbalances but where there was *required systemic change* to the currency (or currencies) acting as the reference currency (or currencies) within the system. The status quo alternative – weak surveillance, ad hoc forums for cooperation and non-credible commitment – is likely to yield further instability, large shocks and abrupt systemic changes. The timing of these shocks is usually uncertain, although quite disruptive, and the aim should therefore be to minimize their likelihood and/or to reduce the costs associated with them.

This chapter surveys the historical record on the births and deaths of international currencies, discussing how international monetary arrangements matter and the nature of spillovers in such events. It concludes with a specific discussion of the weaknesses of the current system in the presence of spillovers and recommends a framework for greater stability based on a long-run perspective.

Anchor currency choice and stability

The discussion here focuses on a particular dimension of international monetary relations: the *decision* about which currency to use as an anchor or reference currency. When several countries choose to peg their exchange rate to the same currency, *blocs* of countries that have fixed exchange rates to each other are created; by creating nominal exchange rate stability, these blocs strongly determine trade patterns and investment flows.[4] They also generate their own reserve demand patterns. Further, these choices help determine invoicing patterns, the currency denomination of foreign borrowing, foreign market entry decisions and expected inflation rates. Monetary and fiscal policy in key currency nations can affect and be affected by policies abroad. Although decisions are taken at the national level, international strategic considerations (i.e. spillovers) are a major feature of the structure of the international monetary system.

A key determinant of national decisions is what other countries – especially trade partners – are doing. The larger the number of significant trade partners using a particular currency, the more likely other countries are to use this as a reference currency. Countries' gains from any particular anchor policy are larger when important trade partners have a similar policy. Research has shown that these *network externalities* help explain the configuration of the international monetary system (Meissner and Oomes 2009).[5]

A general feature of repeated games of coordination is that history can matter and inefficiencies may arise. Lock-in around a particular set of international arrangements inherited from the past is entirely possible. Such lock-in can persist but may be inefficient for many reasons. Changing trade patterns and changing the policy orientation of reference countries are two possibilities. Without an internationally coordinated policy to change the system's configuration of pegs, nations may find it individually more beneficial to adhere to a particular exchange

4 See Klein and Shambaugh (2009) on trade flows and pegged rates, and Rose (2000) on trade flows and monetary unions. Historical evidence is presented in López-Córdova and Meissner (2003).

5 This is an extension of Optimal Currency Area theory. The size and nature of shocks, labour mobility, currency denomination of debt and the size of financial markets also influence outcomes. In the larger discussion of the appropriate exchange rate regime, these domestic factors matter too. Space constraints prevent these issues being discussed here.

rate arrangement they have inherited – even when they and other countries involved might all be better off in an alternative arrangement. Potential transition costs include capital losses on reserve holdings and loss of network benefits when unilateral changes are made.

One example is the pound sterling, which maintained an international role, especially in some of its former colonies, well into the 1960s. Once sterling's demise was negotiated, countries moved in geographically concentrated groups to dollar-based systems in the late 1960s and early 1970s, further enhancing trade and capital market integration with the dollar bloc and the United States.

The history of the nineteenth century shows that such changes, if completely uncoordinated, can also give rise to a rapid transformation of the status quo and sudden destabilizing realignments. This occurred in the 1870s when silver – which up to that point had been used as much as gold in Europe as a basis for domestic monetary systems – lost out to gold. Silver had traded at a ratio of 15.5: 1 for the 30 years prior to 1873, but then depreciated by over 20% between 1873 and 1879 (15% in 1876 alone). The shock further enhanced the difference in borrowing costs between those inside and outside the gold system and also further reoriented trade into the gold bloc.

> "Issuing countries may also worry about external use of their currencies, especially in cases where foreign countries are large enough to have an impact on the monetary sovereignty of the issuing entity"

The UK devaluation in 1931 and the US devaluation of 1933 led to many other nations leaving the gold standard *en masse*, a race to secure the limited supply of monetary gold, deflation and extreme exchange rate realignments. Trade collapsed much faster than output in the Great Depression because of numerous barriers to trade which were both a cause and a consequence of exchange rate revaluations.[6] The period also witnessed seesaw demand for sterling and dollar assets which complicated economic policy in the reserve nations (Eichengreen and Flandreau 2008).

Countries considering a peg also worry about monetary policy in the country supplying the anchor currency. Although the Triffin Dilemma is not an issue in the float, unexpected inflation in the key nation can lead to capital losses on reserve assets and may affect the desirability of using its currency as a key currency. However, the US experience of the 1970s and early 1980s illustrates the point that inflation need not be devastating for key currency status. Rather, the amount of trade and the depth of financial markets may also be important determinants of key currency status. Larger trade flows and deeper financial systems are necessary to achieve key currency status.

Issuing countries may also worry about external use of their currencies, especially in cases where foreign countries are large enough to have an impact on the monetary sovereignty of the issuing entity. The European Union, for example, has discouraged adoption of the euro abroad. Non-EMU nations in the EU must abide by various policy limits. Accession countries are discouraged outright from unilateral adoption of the euro. Japan, prior to the 1980s, also attempted to restrain international use of the yen. For the most part, the United States has recently operated a policy of benign neglect towards dollarizers, although unofficially there has been a preoccupation with China, and expressions of discontent, since at least 2005.

The Japanese yen and the euro are also examples of how size and low, stable inflation rates are insufficient criteria for understanding how to achieve international status. The protracted financial crisis and economic slump of the 1990s in Japan surely contributed to the lack of further interest in the yen. But in the 1980s, coordination problems are likely to have existed. Nations already locked into the dollar bloc together might have found the transition costs to a yen bloc prohibitive.

6 See Eichengreen and Irwin (2009) on why overvalued gold-based currencies were more likely to opt for tariffs in the 1930s.

A long-run view of systemic changes in key currencies

From its inception in the 1870s, the classical gold standard represented the choices of individual countries acting in an uncoordinated way to arrive at an 'equilibrium' outcome. The wealthier countries of the time found that the incentive to join gold increased as other trading partners did so. The gold bloc emerged spontaneously in Europe in the 1870s many years after a world gold-based system was envisaged. Such a bloc was actually initially proposed in 1867 at Europe's first International Monetary Conference in Paris, where all the participating nations had already agreed they were in favour of a gold-based system.

As noted above, the flip side of gold's rise was silver's demise as a monetary standard in Western countries and eventually in parts of Asia and Latin America. It has been argued that silver's depreciation *vis-à-vis* gold from 1873 onwards created a panic and drove countries away from using silver instead of gold for monetary purposes. In reality, trade and investment patterns and preferences on monetary autonomy were more decisive. The decline of silver was more a symptom of the rapid transformation of monetary regimes in many important countries after 1873. Also, France attempted to maintain silver's price as late as 1876 and could have done so, especially if the United States had maintained its use of silver after 1873 instead of abandoning its historical commitment to bimetallism (i.e., a silver and gold system). However, by 1876, most countries had moved to gold and France realized that monetary coordination might have benefits (Flandreau 1996) given the new international circumstances. International monetary conferences in 1878, 1881 and 1892 attempted to revive international bimetallism but failed, probably because it was a system that was vulnerable to Gresham's law.[7] Limited international enforcement meant that any one country could defect from bimetallism, setting up laggards for large capital losses on silver holdings.

Tellingly, not every country adhered to gold throughout the period. Even in the heyday of gold orthodoxy, nations opted out of fixed exchange rates and altered the shape of the international monetary system. However, this occurred mainly on the periphery, which was not of systemic importance. During emergencies such as wars and financial panics, important nations too temporarily suspended gold convertibility, but this rarely occurred after 1870. On the other hand, even later on many smaller, peripheral and less systemically important nations facing balance-of-payments problems frequently opted for devaluation and subsequent long periods of floats to allow for export growth and rebalancing (Catão and Solomou 2005). Italy floated from the mid-1880s, Portugal from 1891, Spain from the 1880s and Austria-Hungary from the 1870s. Greece went on and off gold, Japan did not join gold until 1897, Brazil did so only in 1907, and Argentina had numerous spells of floating exchange rates. These national cases illustrate that although the contours of the international monetary system depend on international pressures, they are also in part shaped by domestic forces. The stability of the classical gold standard in the larger core of countries was founded upon credibility and cooperation (Eichengreen 1992).

Prior to the First World War, the pound sterling was the key international currency for financing trade and investment. Britain had steadfastly been on gold since 1821. From the 1870s, sterling's international status was generated by the eminence of London's financial industry and the absolute size of its international trade transactions. It took almost 60 years from 1870 for a serious challenge to the key status of sterling to arise, mainly from the dollar.

In 1914 the Federal Reserve was created in the United States. One of the aims was to establish the dollar as an international currency to compete with sterling. Despite having the requisite absolute economic size and fiscal credibility, and the relative monetary stability during the First World War, the dollar struggled to attain international status. The dollar competed with sterling throughout the 1920s and 1930s with ups (late 1920s) and downs (post-1933) measured in terms of the value of reserves held in dollars by the world's central banks (Flandreau and Eichengreen 2008).

7 Essentially any country that offered to trade silver for gold at a fixed ratio less than the world market value of silver per unit of gold would face heavy inflows of silver via arbitrage. Arbitrageurs could get more gold per unit of silver in such countries than on the open market. Such bimetallic countries could raise the mint ratio to avoid this but such an action would defeat the goal of maintaining stability.

Despite all these efforts, it was still gold that mattered for monetary relations in the 1920 and 1930s. The re-emergence of the gold standard, this time in the guise of a gold exchange standard, was the hallmark of the international monetary system in the late 1920s. Britain's return to the gold standard in 1925, at the overvalued pre-war parity, signalled the rebirth of the international gold standard. US and British assets helped to back the monetary liabilities of the rest of the world and gold was supposed, in turn, to have backed sterling and the dollar. Nations returned to gold in the order that trade patterns, capital flows and domestic concerns would suggest. Those countries that were most integrated with the gold bloc joined earlier, and as the gold bloc grew, the relative value of the trade-creating benefits of fixed exchange rates increased.

A key problem for the interwar gold exchange standard was insufficient liquidity provision because of the limited availability of gold and the convertibility commitment of key nations. This was a precursor to the Triffin Dilemma. The demise of the gold standard occurred when Britain abandoned its peg in September 1931 in favour of a more expansionary monetary policy and reflation. The uncertainty about the pound's devaluation and subsequent floating made sterling reserves become less attractive from 1930, and the dollar experienced a similar reaction in 1933 after it was devalued. The 1930s produced exchange rate instability, fractured trade and volatile economic activity.

The post-war Bretton Woods system established a system of fixed exchange rates. However, many countries with convertible currencies were indirectly pegged to the dollar but actually used currencies such as the French franc, pound or Deutschmark as an anchor (Reinhart and Rogoff 2004). Sterling ceased to be a reference currency in the 1970s. Use of the Deutschmark increased slightly after 1971 and the French franc held steady. The proportion of countries using the euro as an anchor has increased only slightly since it replaced the Deutschmark and franc in 1999, hovering around 30%, while roughly 50% of countries are attached to the dollar.

The post-Second World War data reveal that a world of multiple international currencies is possible and quite natural. Non-systemic nations have, by and large, chosen the exchange rate policy option best suited to their patterns of integration and other constraints. The overall stability of such arrangements suggests that currency blocs reflect deep and slow-moving economic and political characteristics. Also international currency status does not appear to be lost easily, even when policy performance is poor.

Conclusions and recommendations

There is considerable stability over the long run in the percentage of countries adhering to any of the several key international currencies, which have not changed a great deal in 130 years. Sterling, the dollar and eventually the euro (replacing the Deutschmark and franc) are the only major key currencies the world has known. What changes there have been illustrate that international spillovers in regime choice are crucial in understanding the orientation of the international monetary system.

History suggests that international currency status is neither gained quickly nor lost easily. The dollar's rise, dating from the second decade of the twentieth century, was not solidified until after the Second World War, which altered economic fortunes considerably. The dollar's status was dented but not lost after 1971 when the closing of the gold window emphasized significant uncertainty about whether future US monetary policy would ever again be constrained by the exigencies of gold convertibility. Also, sterling's demise occurred in stages. Despite a major devaluation in 1931 and a loss in reserve shares, sterling partially regained reserve use after 1933 when its nearest competitor, the dollar, faltered. The final curtain was drawn on sterling in the late 1960s but despite several significant balance-of-payments problems it had maintained international status for decades after the Second World War, in part because the transition away from the status quo involved significant cost and complications. Chapter 3 by Catherine Schenk illustrates what role concerted international cooperation – as proposed here – might have played. It could arguably have alleviated the fear of capital losses on sterling assets in any number of mutually beneficial ways.

The big picture of stability in arrangements since the 1950s may also hide net gains from coordinated moves to alternative arrangements at the systemic level. What can be done in the face of such lock-in? Can the transitional costs of capital losses on reserves and accumulation of new reserves be avoided or lessened?

Greater formal multilateral coordination regarding monetary and exchange rate policy could help. Typically these problems have been viewed as bilateral or country-specific issues rather than systemic ones, and Article IV of the International Monetary Fund is written in these terms. Forward-looking analysis at the outset of a peg between the anchor currency country and all others using such an anchor could lay out credible contingency responses in the event of imbalances and systemic shocks. Coordination among nations contemplating a mutually beneficial peg could enhance the network externality benefits from a shared reference currency. Coordinated simultaneous adoption of a new standard and exit from an old standard could maintain these benefits.

Institutional and permanent insurance mechanisms aimed at compensating involved parties could smooth the losses from such a transition. The scenario one might imagine here is a dialogue between, say, China and others in the 'dollar bloc' in the early 1990s and the United States. Formal mechanisms that could support the reserve currency after a predetermined level of reserve accumulation, the point at which a parity change would take place and mutually agreeable principles on who would pay to resolve such imbalances could eliminate much of the uncertainty within the international monetary system. Of course, credible enforcement mechanisms would have to be agreed at the outset; this would minimize subsequent disputes about which country should bear the burden of adjustment. Such a mechanism could be extended to a multilateral environment, as it is in Europe, and may even be the more salient case. The success of the Eurozone during the ongoing crisis attests to the benefits of ground rules and ex ante cooperation. Finally there are considerations regarding the impact of market forces. Perhaps these could be compensated for through the imposition of capital controls, trade policy changes or temporary fiscal and monetary policy measures, but this is not the main focus of this chapter.

Anchor currency countries have an incentive to participate in changes to the reference currency since these ideas could save them from a surprise shock to borrowing costs. This is a very likely outcome when decentralized decision-making leads to an attempt to be the 'first to the exit', creating a systemic change. It is in the interest of the issuing country (whether it is a debtor or surplus country) to prepare and participate in planning for such situations.

In addition to an insurance fund akin to an equalization fund, issuing countries could pre-commit to adjusting public borrowing appropriately or using monetary policy to keep yields on assets stable and to avoid sharp rises in borrowing costs. Non-issuing countries could pledge not to engage in a fire-sale exit strategy. This would yield an obvious gain relative to a decentralized and disorderly exit. Since spillovers are, by definition, part of the problem, enforcement could be ensured via trade sanctions or other means.

Stability improves economic outcomes and is therefore a worthwhile goal. The world needs a monetary regime that maintains maximum systemic stability. As global integration proceeds apace, such needs will become more urgent.

Larger schemes for new international currencies to replace domestic currencies as the basis of an international system are potential long-run solutions for economic and logistical reasons. For non-systemic players (countries whose policies and actions do not require reaction by or make an impact on other countries), the world's international monetary system suits the needs of the global economy relatively well. When national choices could have systemic impacts, further formal mechanisms for coordination and enforcement must be created. These can be mutually beneficial and should be striven for in the coming decades.

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11. Small Developing Countries in the International Monetary System

Christopher Adam, Paul Collier and David Vines

Introduction

This chapter comprises four sections. The first section reviews the history of the relationship between small, very poor economies and the International Monetary Fund, while the second discusses the current situation in this relationship. The third section discusses what the IMF has done for these countries during the global financial crisis, and the chapter concludes by suggesting some ways forward.

Background

Until the mid-1970s, the IMF's work, in its role as coordinator and monitor of the international monetary system, was concerned mainly with monetary, exchange rate and trade issues.[1] To the extent that the IMF also functioned as a credit union for countries in balance-of-payments difficulties, its lending focused on the provision of short-term, self-liquidating loans to buttress central banks through temporary balance of payments difficulties. The Fund's cornerstone principle of equal treatment of member countries dictated that financing to low-income countries was provided largely under stand-by arrangements on the same terms as those approved for emerging markets and industrialized countries. The oil crises of the 1970s, however, made it increasingly clear that intractable structural issues in many low-income countries needed to be tackled if balance-of-payments difficulties were to be addressed. As a result, the 1970s saw the advent of lending on concessional terms, with lower interest rates, to low-income countries. This created some tension between the Fund's essential focus on short-runs stabilization and an emerging role in the provision of longer-term resources in support of broad macroeconomic adjustment in developing countries, a tension which has never been fully resolved (see, for example, the report of the Meltzer commission, IFIAC 2000).

The obstacle to financing concessional lending posed by the Fund's Articles was overcome in the 1970s by creation of the IMF Trust Fund which, financed from profits from the sale of a portion of the Fund's stock of gold plus direct contributions from major donors, provided a concessional lending window to low-income countries. Against a background of falling commodity prices and deteriorating external conditions in the 1980s, the Fund moved to reinvigorate its concessional lending with the creation in 1986 of the Structural Adjustment Facility (SAF) and, in the following year, with the Enhanced SAF (ESAF). Through the SAF and ESAF, which allowed the Fund to send billions of dollars to the world's poorest counties on concessional terms with longer maturities than was possible under its previous facilities, the IMF rapidly assumed a decisive leadership role in the debate on stabilization and adjustment in low-income countries. The Fund's engagement had a powerful catalytic effect on lending from other official creditors, and IMF collaboration with the World Bank and the regional development banks, as well as with, *inter alia*, the UN, UNICEF, UNDP and bilateral donors, all appeared to improve under the ESAF process (Boughton 2001). In addition, IMF technical assistance to many developing countries on monetary, fiscal and trade policy, as well as debt management, also

1 This section draws upon House et al. (2008).

expanded substantially in order to help countries achieve their programme commitments. This increase in technical assistance has been very valuable.

By the 1990s, the Fund's engagement in low-income countries had become the target of a rising chorus of concern. Some civil society organizations and academics, as well as some low-income governments themselves, contended that IMF conditionality and programme design in low-income countries tended to prioritize adjustment over poverty reduction, growth and income distribution concerns. This criticism is summarized by Easterly (2005). It arose despite the fact that the Fund has been helping to produce, in many low-income countries, a marked stabilization in macroeconomic indicators, and in some cases, the beginning of sustained periods of growth. In response to critics' concerns, and in a further step in the evolution of Fund lending, IMF Managing Director Michel Camdessus advocated a fresh model of engagement with low-income countries in which there would be a renewed role for the Fund in reducing global poverty and in promoting high-quality growth in developing countries.

This new strategy, which was crafted on the basis of a highly influential critical external review of the ESAF (IMF 1998), featured three main elements. The first was much deeper and wide-ranging debt relief than had hitherto been achieved. The Heavily Indebted Poor Countries (HIPC) Initiative and its successor, the Multilateral Debt Relief Initiative (MDRI), agreed at the Gleneagles G8 summit in 2005, provided a framework for the write-off of nearly all HIPC country debts to the IMF, World Bank and African Development Bank. The second element was to link debt relief, in particular the spending of debt-service savings, as well as new donor commitments, to an explicit programme of poverty-alleviating social expenditure. From 1999, these plans were articulated in country-based Poverty Reduction Strategy Papers (PRSPs) which were in turn anchored to the achievement of the UN Millennium Development Goals (MDGs). The PRSP was intended to form the basis of the targets and policy conditions in programmes supported by the IMF's Poverty Reduction and Growth Facility (PRGF). This was the successor in 1999 to the ESAF and formed the third element of the Fund's new approach to low-income countries.

The current situation

Since its introduction, the PRGF regime has been the subject of intense scrutiny by the IMF staff (IMF 2002, 2005) and the Independent Evaluation Office of the IMF (IMF 2004, 2007a), as well as by civil society and the NGO community. On paper these reviews have been mixed, finding that while PRGF-supported programmes have become more accommodating to higher public expenditure, in particular pro-poor spending, there is less robust evidence that they have led to significantly enhanced support to low-income countries or to notable improvements in per capita incomes.

But the picture from the ground looks rather different. The two decades since the ESAF was launched have seen a radical transformation in the conduct of macroeconomic policy in low-income countries, and much credit should be given to the IMF for guiding this transformation. Although a small number of countries remain in the grip of severe macroeconomic instability, the majority have moved to a position where there is much less pressure on central banks to accommodate large domestic fiscal deficits, where exchange rate flexibility is the norm rather than the exception (highly distorted multiple exchange rate regimes are now virtually extinct) and where there is a strong domestic political consensus in favour of fiscal discipline and macroeconomic stability. As noted in the *Africa Regional Economic Outlook* for both 2007 and 2008, growth and macroeconomic performance in sub-Saharan Africa's growth performance during the middle of the last decade has been the best in more than three decades (IMF 2007b, 2008).

As a result, the Fund's relationship with most low-income countries has been transformed, from one of conflict in the 1980s when it was locked in protracted wars of attrition over public expenditure, stabilization and macroeconomic management and was viewed with suspicion and hostility, to one of cooperation today. By and large the IMF is now treated as a valued development partner (see also Bevan 2005).

The nature of the IMF has changed as well. There is much greater transparency and intellectual flexibility in the way in which the Fund deals with low-income

countries. The decentralization of the research function in the Fund, through the creation of regional policy departments (responsible for, among other things, the *Regional Economic Outlook* companions to the IMF's regular *World Economic Outlook*) has not only improved engagement and communication but also reinvigorated the intellectual debate on macroeconomic management in low-income countries. There was a time when the Polak model[2] constrained all of the Fund's country analysis. Nowadays, though this basic model still underpins the financial framework used to guide analysis in many countries, it is now employed in the context of a richer and more nuanced intellectual debate and, increasingly, alongside alternative, and arguably superior, macroeconomic models.[3]

> "The decentralization of the research function in the Fund, through the creation of regional policy departments has not only improved engagement and communication but also reinvigorated the intellectual debate on macroeconomic management in low-income countries"

New instruments have also made a difference. Previously, the IMF had only engaged substantively with low-income countries on the basis of a lending programme, and then often in the role of an enforcer of conditionality. Now that substantial debts have been written off under the HIPC and MDRI initiatives and the returns from a generally more conservative macroeconomic stance are being garnered, the need to borrow from the Fund has decreased. The Policy Support Instrument (PSI), introduced in 2005, has thus enabled the Fund to continue to engage with countries in detail, to support policy analysis and formulation and, critically, to provide a signal on macroeconomic performance to other development partners, without requiring the country to access the Fund's resources. The PSI allows the Fund to fill the role of development partner, assisting in the construction of good policies, and policy regimes, in which conditionality emerges as the codification of agreed policy measures rather than as an enforced contractual arrangement designed to maintain the flow of resources in the presence of a conflict of interest between the Fund and the country concerned.

The global financial crisis

In its dealings with low-income countries, the IMF has had a 'good crisis'. Low-income countries were largely isolated from the first-round effects of the crisis – those operating through the financial system – but were hit hard by the generalized jump in emerging market bond spreads, the reversal of private FDI flows and the drying up of trade credit. The main (short-run) effects, however, were felt most powerfully, through the current account as global demand shrank, primary export commodity prices fell and remittance flows withered. But countries' favourable initial conditions – themselves the consequence of almost a decade of good macroeconomic performance combined with debt relief – meant not only that for many countries the full range of policy instruments was on the table but that a rapid and relatively unencumbered engagement with the IMF was an option.

The Fund responded decisively and much more rapidly than expected to the emerging problems in low-income countries. This response was made both through the

2 Published in 1957 and named after its developer, Jacques Polak – one of the first staff members of the research department of the IMF – the Polak model was an early version of the monetary approach to the balance of payments, linking external balance (the primary concern of the IMF) to domestic fiscal choices, represented by choices over the level of domestic credit expansion. The model not only reflected the realities of the early Bretton Woods period where private capital accounts were effectively closed, but was intentionally simple to allow its application by IMF missions in the field in environments where data were scarce.

3 The April 2008 edition of the *Regional Economic Outlook: Sub-Saharan Africa*, for example, carries an extensive discussion of the conduct of monetary policy when capital accounts are open *de facto* but domestic financial markets remain thin.

exogenous shocks facility (ESF)[4] and the SDR allocation approved by the G20 at the London summit in April 2009. As a result of IMF funding, as well as a degree of 'front-loading' by the World Bank of its highly concessional lending through its International Development Association (IDA) window, many low-income countries were able to avoid the painful real exchange rate adjustment that might otherwise have been required. This shift by the Fund away from a presumption that countries in external difficulty must always adjust to this problem, and do so rapidly, to one that that sees financing as a possible alternative to short cuts and rapid adjustment, providing such actions are part of a coherent policy response, has earned the Fund a reputation in the crisis as a flexible and responsive development partner, one that has proved substantially more flexible than many bilateral donors.

As the immediate crisis passes, the Fund faces the important task of supporting low-income countries in unwinding fiscal stimulus programmes and re-establishing the fiscal and monetary anchors that were so successful in establishing their commitment to macroeconomic stability in recent years. It also faces the task of supporting the restoration of the investment, both public and private, on which sustained growth depends.

Looking forward

The reforms of the past 15 years, described above, have been macroeconomic reforms. The fundamental problem of the poorest emerging-market economies, particularly those in Africa, is now not so much macroeconomic policy regimes as the underlying microeconomic difficulties. To correct this requires much greater investment in physical and human capital, particularly in infrastructure. Yet in Africa, not only is the capital stock old and inefficient, the investment rate is very much lower than in many other countries, especially in emerging-market economies in Asia.[5] The overriding challenge in the next 15 years is to raise the investment rate and the efficiency of investment. Without this, growth will remain only marginally above that required for capital deepening, and the gains already posted in terms of hitting the MDGs will prove temporary.

While incomes remain low, the financing of investment will not come from domestic sources. Nor is it likely to come from the private sector in advanced countries in the next few years, considering how risk-averse the international financial system has become – something which has happened of necessity because of the need to clean up the financial balance sheets of so many local banks. Nor indeed is it likely to come from concessional aid, particularly considering the strapped fiscal position in which many G20 economies will find themselves in the coming years. By the same token, it is unlikely that a further SDR allocation will be sanctioned by the G20.

What is required is a very great increase in lending to such countries by the International Bank for Reconstruction and Development (IBRD). It is essential, however, for such lending to be protected somehow from any new move for further debt forgiveness. Any entanglement of the two risks destroying the IBRD process, which currently provides large sums ($30–40 billion) to middle-income, emerging-market economies. IDA was designed to be separate from IBRD lending, and until now it was only IDA lending that was forgiven. Since no such increase in IDA lending is likely to be forthcoming, any extension of IBRD lending to the poorest emerging-market economies must be designed in such a way that does not confuse it with the (valuable) process of debt forgiveness.

Devising such a new funding-for-development strategy for the poorest emerging-market economies presents a big challenge for the IMF. It must do this in collaboration with the World Bank, since such IBRD lending must come from the Bank, not the Fund. It is clear that PSI lending is not the kind of lending appropriate to the task. A working version of such collaboration would require three things. First, the IMF will need to play the role of advising countries about the underlying macroeconomic framework which should be in place to enable such finance to be effectively absorbed by the recipient countries and used well. This will require much further work on the circumstances in which the accumulation

4 Revamped in 2008, the ESF is a quick-disbursing high-access facility designed to assist member states, principally low-income ones, to adjust to exogenous external shocks, typically those arising from movements in global commodity prices, conflict or natural disasters. The ESF is highly concessional and conditionality tends to be light.

5 The problem is actually worse than it appears, in that many African economies are depleting a finite stock of assets in the form of natural resources.

of debt is sustainable.[6] The second, related, requirement is that this advisory role must support countries' engagement with 'non-traditional' donors, most notably China and India. Both countries hold out the prospect of a substantial increase in resource flows to low-income countries but the form and contractual nature of such flows are likely to be radically different from those with which countries are familiar. This raises a range of important macroeconomic management and governance issues that will need to be addressed. Finally, the World Bank must be in a stronger position than it is now to give good advice on the required microeconomic reforms. This will inevitably require the World Bank to move away from its emphasis on poverty reduction, towards a focus on the microeconomic foundations of absorptive capacity. The Fund has already embarked on a programme of work on questions of the macroeconomics of absorption in low-income countries. This analysis must go hand in hand with the development, by the Bank, of its skills in this area, if it is to become possible for the poorest countries to absorb more finance, increase their investment and grow more rapidly.

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6 Recall that any increase in finance will be in the form of loans – which must of course be repaid – rather than in the form of aid.

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