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EDITORIAL

One issue must not overshadow another. Since 2008 the G20 has made a number of recommendations for improving banking and financial regulation in the wake of the global crisis. Some of these proposals have been implemented, but much remains to be done. Under the French presidency, the G20 has added ambitious topics to the agenda: international imbalances, reform of the international monetary system (or non-system in some respects) and commodity price volatility.

This paper brings together contributions on reforming the international monetary system. Several aspects of such reform are covered: the role of reserve currencies, exchange rate regimes, international liquidity supply, international imbalances and the distribution of adjustments between countries running a surplus and those with a deficit, multilateral supervisory systems and the rules applicable to 'deviant' countries.

Such issues –some of which have been under discussion for decades– cannot be resolved in the space of a few quarters. It is, however, important to accept the need for discussion and to make progress along the path chosen together, which will doubtless prove to be a long and tortuous one.

Christian de Boissieu
Chairman of the CAE

Reforming the International Monetary System

By Agnès Bénassy-Quéré, Emmanuel Farhi, Pierre-Olivier Gourinchas, Jacques Mistral, Jean Pisani-Ferry and Hélène Rey

Reforming the international monetary system ranks highly among the topics that the French presidency intends to address during its year at the helm of the G20. Over and above the 'crisis measures' taken in the midst of the recent financial turmoil, what is needed is an ambitious rethink of all the rules, agreements and international institutions that govern, the determination of exchange rates, international liquidity supply and international capital flows. The three contributions that comprise this report propose ways to launch this reform.

Why reform the international monetary system?

Why reform the international monetary system? Because it is a non-system, born out of the collapse of the Bretton Woods system, and because it seems to encourage a number of imbalances: excessive exchange rate volatility; sudden stops in private capital flows; persistent external imbalances 'in reverse' (net capital flows tend to go from emerging markets to rich countries); asymmetrical adjustment mechanisms between borrowing countries and lending countries; similar asymmetrical adjustment mechanisms between the United States –whose dollar remains the main currency in the current system– and the rest of the world; and excessive currency reserve accumulation by emerging market countries. Admittedly there is some disagreement about the link between these imbalances and the recent financial crisis. However, it is clear that the current non-system does not facilitate the necessary adjustment.

The non-system also seems out of step with the global economy, whose boundaries have been significantly enlarged by the growth of the leading emerging markets. The dollar's persistent dominance makes the current system a unipolar one, in contrast with the tripolar global economy, in which North America is no more important than Europe or Asia. As a result, an inevitable transition is playing out –and in some respects has already begun– towards a more 'multipolar' monetary system, whose mainstays could be the dollar, the euro and the yuan once the Chinese currency becomes fully convertible.

The contributions of Agnès Bénassy-Quéré and Jean Pisani-Ferry on the one hand, and Emmanuel Farhi, Pierre-Olivier Gourinchas and Hélène Rey on the other hand, both expound the prospect of a transition towards a multipolar international monetary system.

Advantages and disadvantages of a multipolar international monetary system

According to Agnès Bénassy-Quéré and Jean Pisani-Ferry, such a regime could prove to be the best or the worst of systems, depending on the degree of exchange rate flexibility it provides for and the extent of multilateral coordination. The transition could indeed be painful if carried out against a backdrop of a currency war or restrictions on capital flows... Therefore, the international community should start preparing for this transition and establish the conditions to ensure it is painless, by encouraging exchange rate flexibility (but not ruling out regional monetary agreements) and the internationalisation of the Chinese currency and possibly the euro. To achieve this, the authors recommend extending the IMF's mandate to supervising the financial account, setting up a code of conduct governing currency interventions and capital controls, reinforcing procedures for supplying liquidity in the event of a crisis and setting up a coordinated central bank framework to manage global liquidity. Such conditions would reap the benefits of the gradual move towards a multipolar system. Agnès Bénassy-Quéré and Jean Pisani-Ferry expect the transition towards a multipolar system to bring about improvements. In terms of economic efficiency, by encouraging the diversification of reserves, a multipolar system should limit the accumulation of reserves and enhance the circulation of capital both between regional blocks and within them, thereby improving the overall allocation of capital. Greater substitutability for the key currencies should also reduce currency imbalances in an environment of flexible exchange rates. This should mitigate the asymmetrical nature of adjustments, improving the fairness of the global monetary system. In terms of stability, short-term exchange rate volatility would probably rise owing to greater capital mobility, but in the medium term, the multipolar system could reduce the Triffin dilemma by sharing the problem between key currencies.

In short, the transition from a hegemonic system to a multipolar system would bring about improvements. But further improvements still need to be made to the structures that provide liquidity in the event of a crisis, over and above existing facilities. This should take the form of multilateral agreements that complement regional and bilateral accords. A structure for managing global liquidity is also needed. In this respect, Agnès Bénassy-Quéré and Jean Pisani-Ferry support the proposed extension and relaxation of the Special Drawing Rights (SDR), which were created in 1969 with the purpose of ensuring multilateral international liquidity management. This would require reform of the International Monetary Fund's statutes and close cooperation between the Fund and the central banks that issue currencies in the SDR basket, which could be extended to include the yuan.

The arguments put forward by Emmanuel Farhi, Pierre-Olivier Gourinchas and Hélène Rey also concern the emergence of a multipolar international monetary system. Their comments are based on two major questions:

• How can the emergence of a multipolar monetary system be encouraged?

• What strategy should be followed to open the financial accounts of emerging market countries?

Improving the liquidity guarantee

Taking a position on these issues requires a dual reflection. First, we need to consider how the international monetary system functions –or malfunctions– during a systemic crisis like the one we have recently experienced. By what mechanism did the system contribute to undermining the financial system and the global economy? What role did it play during the crisis? In other words, what are the systemic inefficiencies of the current monetary regime? Emmanuel Farhi, Pierre-Olivier Gourinchas and Hélène Rey answer these questions by focusing on an essential role that the international monetary system must fulfil during a crisis: supplying liquidity. In their opinion, the major weakness of the current system lies in the absence of systematic mechanisms that ensure a coordinated supply of sufficient liquidity. This insufficiency exacerbates countries' use of self-insurance policies –the accumulation of vast currency reserves– which are optimal at an individual level, but are socially ineffective.

The authors advance several specific proposals aimed at improving the global liquidity coverage needed to deal with individual or systemic crises, which would reduce demand for currency reserves:

• encouraging the development of alternatives to US treasury bills as the preferred reserve asset in order to accelerate the unavoidable transition to a multipolar system. In this respect, the issue of co-guaranteed European bonds would be particularly useful. Over the longer term, the opening of the Chinese capital account, yuan convertibility and the development of a yuan bond market will also be necessary;

• perpetuating the bilateral agreements between central banks to temporarily supply liquidity (swaps) which were successfully activated during the recent crisis;

• reinforcing and enlarging IMF facilities such as Flexible Credit Lines (FCL), Precautionary Credit Lines (PCL), and the Global Stabilization Mechanism (GSM) and extending IMF financing mechanisms such as the New Arrangement to Borrow (NAB). Alongside the NAB, it would be appropriate to give the IMF the opportunity to borrow directly on the markets;

• establishing reserve pooling facilities (for depositing currency reserves) with the IMF, which would provide better protection than self-insurance to participating countries, while secondarily enabling reserves to be recycled into more productive investments.

These measures, which reinforce the liquidity provision mechanisms that are essential to the functioning of the global economy, must necessarily be accompanied by prudential supervision by the IMF, in order to keep track of the main financial balances (by currency and by maturity), and to adjust the terms and conditions for accessing liquidity during a crisis. For Emmanuel Farhi, Pierre-Olivier Gourinchas and Hélène Rey, this overall supply of liquidity does not necessarily require the issuing of SDRs, or the pegging of the monetary system with a coordinated foreign exchange policy. In their view, the SDR is a complex tool that is poorly suited to meeting the global economy's liquidity requirements. As a result, the use of SDRs, which may be justified in certain specific circumstances, will not in itself resolve the structural inefficiencies of the international monetary system. A monetary peg would involve changing current monetary policy priorities –stability for prices and economic activity, financial stability– in favour of external objectives, which is not feasible, or necessarily desirable.

Controlling capital flows?

The second part of the analysis carried out by Emmanuel Farhi, Pierre-Olivier Gourinchas and

Hélène Rey concerns the mechanisms for regulating capital flows and the resulting exchange rate movements. The consensus on these issues has changed considerably, with institutions such as the IMF now recognising the usefulness of targeted capital controls, in particular during periods of massive capital flows. Alongside the problem of excessive volatility in capital flows, there is also the question of external adjustments while the global economy is still in a liquidity trap. Emmanuel Farhi, Pierre-Olivier Gourinchas and Hélène Rey recognise the usefulness of temporary controls on capital inflows in some clearly-defined cases, provided they are accompanied by a set of prudential and monetary measures.

There are, moreover, limited circumstances in which capital flows can be accompanied by negative externalities on the rest of the world, and must therefore be subject to mutual supervision. In this respect, the authors recommend extending the IMF's mandate to the capital account and improving cooperation in terms of financial regulation.

Lastly, these pathways to reform the international monetary system are seen as complementing the required reform of the regulatory and prudential architecture of the financial system, which is not the subject of this report. They in no way replace this necessary reform.

Comments

The first two contributions are both commented on by Benoît Cœuré, Daniel Cohen and Jean-Hervé Lorenzi. Benoît Cœuré emphasises the risks associated with the transition and questions whether a multipolar system would be more or less stable. He calls for a greater role for the SDR, which he sees as the ideal vector of multilateral liquidity, and stresses the need to carefully consider the composition of the basket of currencies that make up the SDR (currently dollar, euro, sterling and yen) and to stipulate the terms for integrating the yuan. Lastly, he explains the difficulties inherent in extending the IMF's supervisory mandate to capital flows. Daniel Cohen considers the Triffin dilemma, which he sees as the central theme of the first two contributions to the report. Jean-Hervé Lorenzi focuses on the proposal for a real international market for Eurobonds, which he sees as the most important decision for stabilising the international monetary system.

Political economy and international monetary issues

The report concludes with an analysis by Jacques Mistral, adopting a political economy approach to monetary issues while being attentive to the lessons of history, political situations and intellectual representation. The first part highlights the endogenous succession of the three principal monetary systems: the gold standard, the gold exchange standard and floating exchange rates. Globalisation, marked by the irruption of China, subsequently caused a shift towards a veritable non-system in which floating and administered exchange rates co-exist. Looking forward, Jacques Mistral outlines three possible scenarios in terms of international monetary relations: status quo, breakdown or reorganisation.

The second part of his contribution explores what could be the main pillars of this reorganisation, and successively looks at governance of the system, where a strengthened IMF would still be the main player, multilateral supervision, which needs to be afforded greater importance over national policy, the role of the last-resort lender in dealing with any serious international financial crisis, and the resurrection of the SDR, which could become a recognised international asset faster than is widely expected. Jacques Mistral concludes with a warning that there is a window of opportunity to launch this reform, that it needs to be addressed from all angles in the form of a policy packet, and that this could be the last opportunity to reach a settlement before a currency war breaks out.

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