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The New Multi-polar International Monetary System

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Abstract

Backed by rapid economic growth, growing financial clout, and a newfound sense of assertiveness in recent years, the BRIC countries—Brazil, Russia, India, and China—are a driving force behind an incipient transformation of the world economy away from a US-dominated system toward a multipolar one in which developing countries will have a major say. It is, however, in the international monetary arena that the notion of multipolarity—more than two dominant poles—commands renewed attention and vigorous debate. For much of its history, the quintessential structural feature of the international monetary system has been unipolarity—as American hegemony of initiatives and power as well as its capacity to promote a market-based, liberal order came to define and shape international monetary relations. As other currencies become potential substitutes for the US dollar in international reserves and in cross-border claims, exchange rate volatility may become more severe. There are also risks that the rivalry among the three economic blocs may spill over into something more if not kept in check by a strong global governance structure. While the transition will be difficult and drawn out, governments should take immediate steps to prevent financial volatility by enhancing cooperation on monetary policies, currency market intervention and financial regulation.

This paper—a product of the Development Prospects Group, Development Economics—is part of a larger effort in the group to analyze the implications of the ongoing shift in the balance of global economic power on the management of international monetary system. Policy Research Working Papers are also posted on the Web at http://econ.worldbank.org.

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Produced by the Research Support Team

The New Multi-polar International Monetary System

by

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The New Multi-polar International Monetary System

For the first time in modern history, leading emerging nations have a real chance to shape the evolution of the international monetary system. Key actors in this scenario are the BRIC countries—Brazil, Russia, India, and China—whose growing presence on the global stage has been the defining feature of the world economic landscape of the early 21st century. Backed by rapid economic growth, growing financial clout, and a newfound sense of assertiveness in recent years, the BRICs are a driving force behind an incipient transformation of the international monetary system away from a US-dominated system toward one that is more regionally based and in which developing countries have a major say. Meanwhile, increasing economic cohesion in Europe---particularly within the 16 member states of the euro area--- is a separate source of pressure on the international monetary system to adjust. Both the BRICs and the euro area will contribute to the evolution of the international monetary system, as they work to strengthen their relative position and mold the system to their purpose, reinforcing the underlying shifts in the global economic relations and how they will come to be managed. The global governance structure defined for much of the post-war era by the dominant position of the United States, its liberalism, and its support for multilateralism, is now undergoing some important changes, as the underlying power distribution is shifting toward multi-polarity. What implications this shift may have for the evolution of the international monetary system and its management are issues of paramount importance to academics, policymakers and market practitioners. Addressing these questions is the main objective of this paper.

Multi-polarity, of course, has different implications when applied to different spheres of contemporary international relations[2]. In politics, where much of the discussion has been focused, the debate centers on non-polarity, in which numerous concentrations of power exist with no single center dominating—a viewpoint forcefully argued by Richard Haass[3]. In the realm of trade, multilateralism reigns, notwithstanding the failure of the current Doha Round of the World Trade Organization. In fact, multilateralism in trade has been the greatest achievement of the post-war international negotiations that launched the Bretton Woods consensus of "embedded liberalism"—a compromise solution favoring trade expansion at the expense of a liberal financial order. Greatly influenced by the experience of the Great Depression and World War II, the architects of the Bretton Woods system supported the use of capital controls by governments as a tool for preserving control over national macroeconomic policy, and as a means of defending stable exchange rates and liberal international trade. By contrast multilateralism has been absent in the treatment of international investment flows, where bilateral investment treaties (BITs) have constituted the dominant international vehicle for the promotion and governance of FDI transactions. Since the 1960s, the number of BITs has grown rapidly, reaching more than 2,500 by 2007, and encompassing 176 countries across the globe.

Yet, it is in the international monetary arena that the notion of multi-polarity—more than two dominant poles—commands renewed attention and vigorous debate. Some, such as Barry Eichengreen, argue that there is

[2] For an analytical definition of multipolarity, see Edward D. Mansfield, "Concentration, Polarity, and the Distribution of Power" *International Studies Quarterly, 37(1)*, pp. 105-128, Mar. 1993

no substitute for the US dollar at the top of the international monetary system[4]. This position, however, ignores the recent dramatic shifts in relative economic power and the deep interdependencies between the United States and other major players. Broadly speaking, important decisions regarding the international monetary system must now account for the interests of Europe and fast-growing emerging markets (the BRICs for certain, but for some purposes also such countries as Korea, Mexico, and Saudi Arabia).

Nonetheless, the three poles—the United States, the euro area, and the BRICs—share a common interest in maintaining financial stability and facilitating trade and economic growth. Trade and investment flows between the three entities account for a large part of their respective global flows. About one-quarter of US exports go to the euro area and one-quarter to BRIC countries, while 16 percent of the total exports of BRICs go to the United States and 29 percent go to the euro area. Dense cross-border foreign direct investment transactions have created strong mutual interests and interdependencies. American multinationals hold more than one-third of their total direct overseas investments in companies located in the euro area, and European banks have established a strong presence in BRICs through extensive networks of subsidiaries and branches. Combined, the three poles account for 61 percent of world output, 51 percent of world trade, and 63 percent of world stock market capitalization.

Going forward, the international monetary system is likely to become a more managed system. In this regard, the BRICs have proposed a greater role for the International Monetary Fund's quasi-currency, the Special Drawing Rights (SDR), in providing a multilateral substitute for the dollar. In support of this stance, China, Brazil, and Russia have signaled their intention to purchase a combined $70 billion of forthcoming IMF bonds, which are to be priced in SDRs. In principle, cooperation such as this could reduce the risk of crises as well as accommodate the wishes of the rising powers. But there are risks that the rivalry among the three economic blocs may spill over into something more if not kept in check by a strong global governance structure. For instance, if the global economy faces a severe energy price or supply shock, a trade war, or a financial crisis, uncoordinated responses may be inadequate or perverse.

Challenging the Global Order

Meeting for the first time as a fraternity of rising powers in the Russian town of Yekaterinburg on June 16, 2009, leaders of the BRIC countries reiterated, this time collectively, their demand for a new multi-polar world order. Longstanding dissatisfaction with how the world is managing its international monetary affairs is an important factor underlying the BRICs' challenge to the international monetary system created in the aftermath of World War II, even though they have been among the main beneficiaries of the system. For much of its history, the quintessential structural feature of that system has been uni-polarity—as American hegemony of initiatives and power as well as capacity to project a liberal order came to define and shape international monetary conduct and structure. While the system has been generally credited for the early post-war successes in securing currency convertibility of the Western European currencies and launching a multilateral trading system, there remains much controversy about its structural bias against developing countries, assigning them a peripheral role in the process of making and remaking the international financial architecture. It is, thus, of

[3] Richard N. Haass, "The Age of Nonpolarity: What Will Follow US Dominance" *Foreign Affairs*, May/June 2008.

interest to remember that the first loan extended by the World Bank in its early days of existence was not to a developing country, but to France in May of 1947 ($250 million reconstruction credit), followed by similar reconstruction loans to the Netherlands, Denmark, and Luxembourg. It was not until March 1948 that the first loan to a developing country was approved---to Chile for $16 million in support of financing a hydroelectric plant and production of agricultural machinery. It was indeed after the US had taken over the task of reconstruction of Western Europe through the Marshal Plan that the architects of the Bretton Woods system turned their attention to matters of development and financing the developing world.

Though the international role of the dollar has evolved over time, US monetary policy has set the tone for global monetary conditions for most of the post-war era, while US balance of payments deficits have served as the engine of global liquidity expansion, determined endogenously in a complex interaction with the operation of offshore Eurodollar markets. Between 1944, the year the Bretton Woods system was established, and 2008, the United States has run a deficit on its current account of the balance of payments for 36 years and for every year since 1992. This has led to amassing liabilities to the rest of the world totaling $7.37 trillion (according to some estimates), with about 50 percent accumulated over 2003–07 alone--- years when the world economy experienced an economic growth boom fueled by high credit expansion and liquidity. But until the mid-1960s, the US current account remained broadly in balance, as the combination of a healthy trade surplus and income on US overseas investments provided the necessary resource space to pay for the three key levers of US international monetary power: overseas military expenditure, foreign aid, and private investment abroad (see Figure 1). However, this balance between resource availability and commitments to foreign economic relations began to unravel in the mid-1970s as the trade account turned negative and continued to grow in a big way, reaching $840 billion in 2006. It has been only the financial crisis of 2008 and its fallout of deep economic recession that has served to narrow the US trade deficit over the past two years to an estimated current level of $406.5 billion[5].

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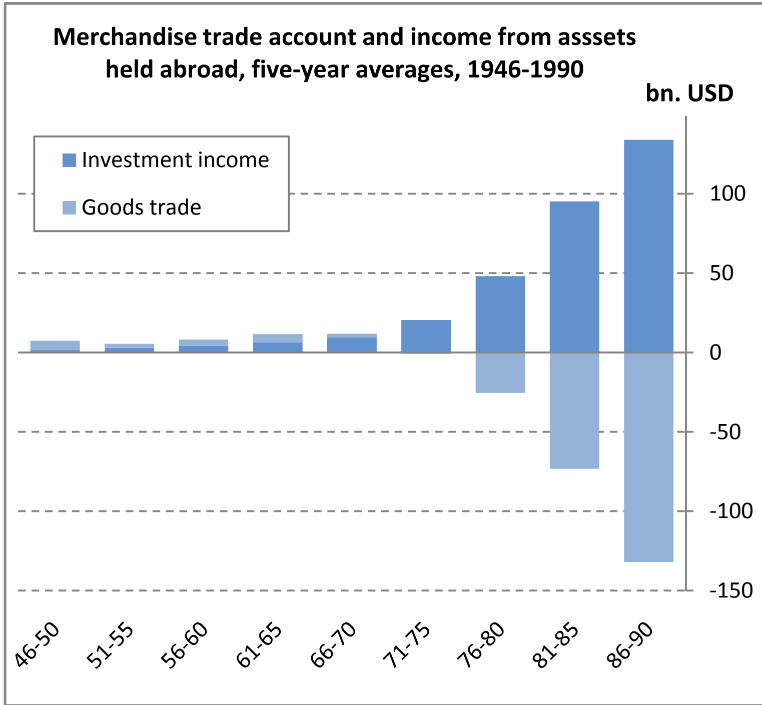
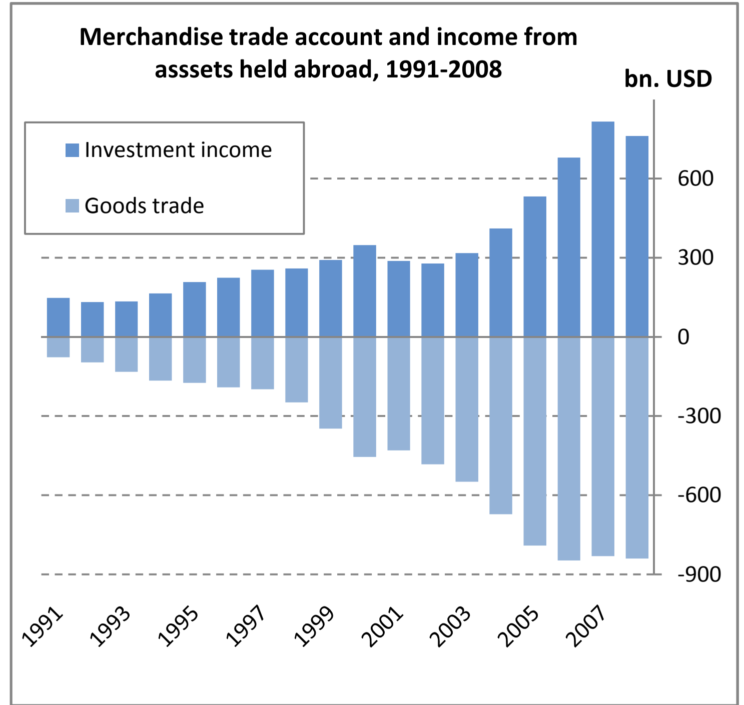
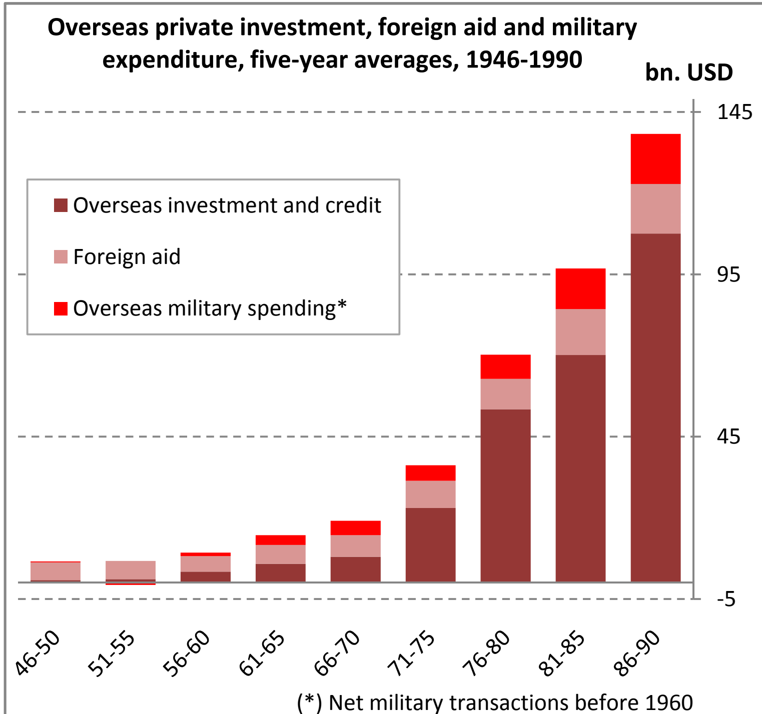
[4] Barry Eichengreen, "The Dollar Dilemma" *Foreign Affairs*, September/October 2009.

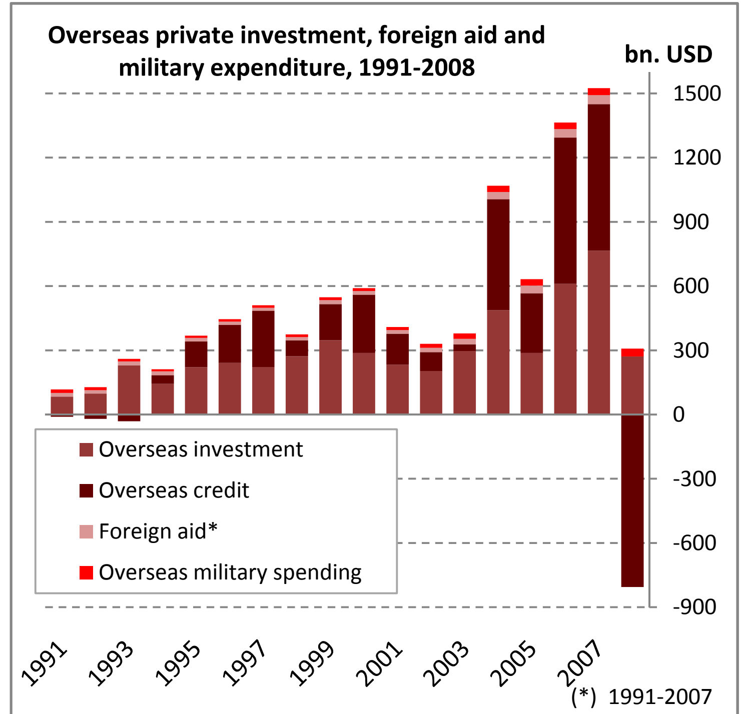
[5] Based on 2009:H1 data of $ 203.25 bn. reported by BEA.

Figure 1: The evolution of the US external payments position: 1946-2008







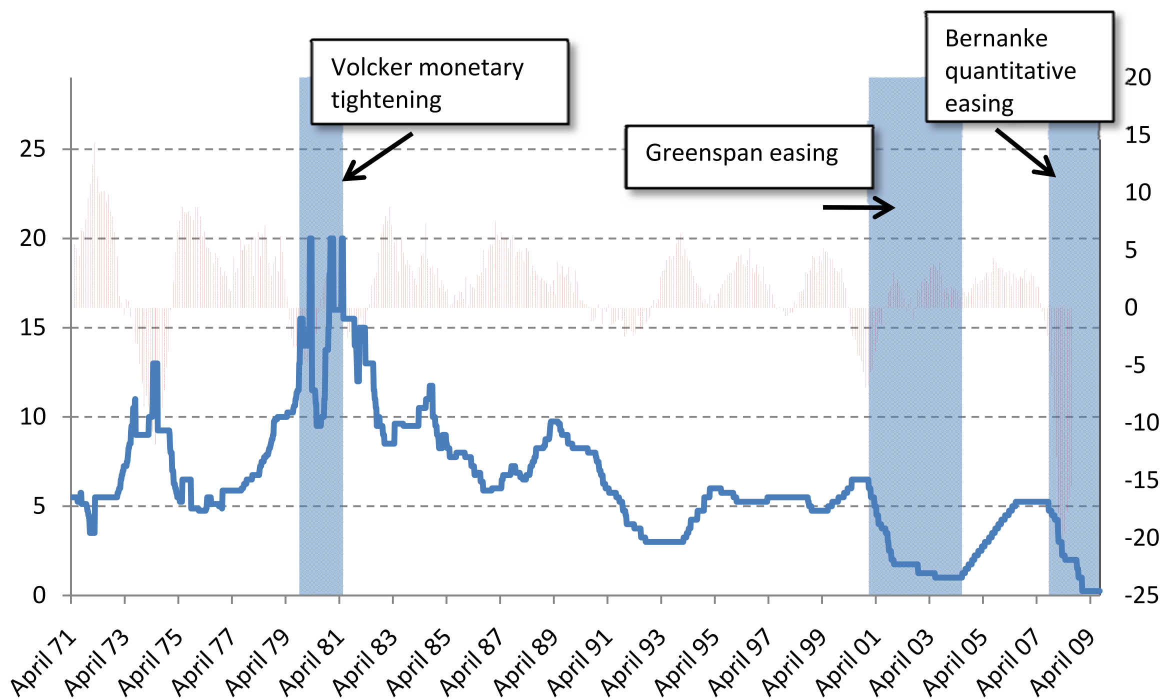


Source: Compiled from HSUS (2006)[6], Bureau of Economic Analysis (International Economic Accounts), and US AID Greenbook (2007)[7]

[6] Historical Statistics of the United States, Millennial Edition On Line, Carter S. et al., eds., Cambridge University Press 2006.

Even more important for global economic outcomes than the US current account position is the stance of US monetary policy, which is understandably tailored to US economic realities. Thus, monetary policy changes in the United States, even if appropriate from a domestic US standpoint, can cause economic distress elsewhere. The sharp increase of US interest rates in the early 1980s, for example, helped precipitate the emerging market debt crisis of the 1980s—whose primary cause was the excessive borrowing of recycled petrodollars. Tightening of US monetary policy in 1994 no doubt contributed to the problems facing the Mexican economy, which in turn led to the collapse of the peso at the end of that year. Monetary easing in the United States has also had important consequences on the rest of the world, contributing to booms in commodity prices in the early 1970s and again in the lead-up to the current crisis. Figure 2 below highlights the relationship between movements in the United States federal funds target rate and changes in global industrial production.

Figure 2: US monetary policy geared towards domestic objectives, but with global implications



Fed Funds Target rate and developed countries' IP y-o-y growth (12-month lag)

While a multi-polar monetary system is not necessarily a bad thing in itself—there is no reason for a monopoly of power in international finance, and as Barry Eichengreen argues[8], competition may lead to better policies—it has intrinsic dangers that require a strengthening of global institutions. But the nascent institutions

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[7] U.S. Overseas Loans and Grants: Obligations and Loan Authorizations, Jul 1, 1945-Sep 30, 2007, U.S. Agency for International Development.

[8] Op. cit.

that have emerged from the current crisis with enhanced powers, in particular the G20 and the Financial Stability Board (formerly the Financial Stability Forum) are not adequate in their current state to serve as permanent fora for cooperation in international finance. Bodies with global membership, and hence greater legitimacy, are needed to institutionalize the recognition that international cooperation is essential to mitigate further crises. Without enhanced cooperation, the fundamental causes of the current crisis—inadequate coordination of macroeconomic policies leading to global imbalances and a "race to the bottom" in prudential regulation, as well as laissez-faire monetary policies—will not be addressed.

Economic Power Realignment

As dramatic as the 2008 financial crisis has been in shaking public confidence in US stewardship of global finance, the BRICs' challenge of the established global order has been in the making for many years. Four striking shifts in global economic relations over the past decade contributed materially to this evolution. First, a major realignment of economic power has occurred, as emerging market countries and oil exporters have accumulated vast claims on the United States (and, to a lesser extent, on other "rich" countries). Second, the euro, launched on January 1, 1999, has become an important player in the international monetary system—more in some areas than others, but to an extent that means that there is now a viable alternative to the dollar. Third, there has been a general decline of multilateralism in a number of areas. Fourth, strong economic growth, improved economic policies, and increasingly mature institutions have led to an expanded international role for the emerging market economies. All of these developments, meanwhile, have played a role in the dilution of US power and the emergence of regional poles and ad hoc groupings such as the BRICs. Taken as a whole, these shifts will mean that important decisions regarding global economic reform in the years ahead can no longer be made solely by the United States and its allies, or even within the G7.

It is widely accepted that global imbalances associated with a low rate of saving in the United States and a high saving rate in Asia, combined with upward pressure on natural resource prices, have led to a massive accumulation of foreign assets by emerging market and oil exporting countries. China now holds about $2.3 trillion in official foreign exchange reserves, almost 50 percent of which has been accumulated since 2004 as the country runs a large current account surplus, both with the United States and globally. Assets under management by sovereign wealth funds are estimated to be in the order of $3.9 trillion as of the end of 2008, nearly two-thirds of which are funded by earnings from commodity exports, mostly oil and gas. As of end 2008, the foreign financial assets of all petrodollar investors are estimated by McKinsey Global Institute to be $5 trillion, despite some losses incurred as the result of the financial crisis.

The significance of the launch of the euro, on the other hand, is often underestimated. For the first time, a multilateral currency was created as the outcome of voluntary, international negotiations rather than as a projection of hegemonic power. Indeed, it is what John Maynard Keynes envisioned at Bretton Woods but which never emerged at the global level. The SDR, by contrast, is defined in terms of a basket of existing currencies (US dollar, British pound, euro, and Japanese yen) and has never functioned as a full-fledged currency. In its ten years of existence, the euro has indeed emerged as a legitimate rival to the dollar. In some years, global international debt issuance in euros has surpassed that in greenbacks. Absorption of an ever-expanding set of currencies into the euro area has created a regional economy with a large pool of capital and has dramatically

lowered transaction costs and currency volatility for investors in member countries, while the euro serves as anchor or reference point for a large swath of neighboring countries. The fraction of global foreign exchange reserves denominated in dollars (of those reserves whose currency has been publicly identified), at slightly less than two-thirds, has declined steadily over the past decade. Though commodities—in particular oil—are still priced in dollars, the dollar's supremacy in this area is also being questioned.

With a weakening of US economic power there has also been a weakening of multilateralism in favor of strengthening regional integration and asserting regional interests. There are several causes for this. One is that the process of European integration has become a model for other regions. Mercosur, the Gulf Cooperation Council, and several groups of African and East Asian countries are planning, or at least discussing, the creation of regional currencies and pooling of financial resources. Another cause is the growing doubt about the capacity of global financial institutions—principally the IMF— to respond to large-scale global financial crises. The Asian response in the aftermath of the 1997 crisis was to self-insure—i.e., to accumulate vast foreign exchange reserves in order to weather future crises without having to resort to IMF lending and contingent policy advice. In addition, East Asian countries have pursued regional monetary cooperation, in particular through the Chiang Mai Initiative.

As the shift in global foreign asset holdings has diminished the strength of the United States and the G7 in the international monetary system, emerging market economies, exemplified by the BRICs, have gained maturity and respectability. China has been tremendously successful in gradually transitioning from a centrally planned to a mixed economic system without a serious economic crisis, along the way becoming the world's second-largest economy and the third-largest exporter. India – which, after decades of sluggish economic growth, finally opened up to the outside world – is now growing quickly and beginning to become a global power. Brazil, after taming hyperinflation through a dollar peg, successfully moved to a floating exchange rate and "made at home" monetary policy based on inflation targeting while simultaneously curbing endemic fiscal deficits. Brazil, like Russia, also benefited from the sustained rise in commodity prices that accompanied the global boom.

As a consequence of this and other reforms, emerging markets have become an investment-grade asset class. At the same time, the financial crisis has severely tarnished the reputation of the United States and other developed-country financial markets, since they were at the origin of the crisis. The crisis has uncovered the gaps in financial regulation in those countries and called into question the supposed sophistication of their financial institutions. Moreover, the aftershocks of the crisis are likely to continue for some time, since many developed countries have incurred large debts (which will need to be paid down through increased taxation and spending cuts) and taken ownership of banks and nonfinancial companies whose management and eventual re-privatization will absorb not only fiscal but also political resources.

In sum, rather than a world in which decisions on the international monetary system are made primarily by the United States, as has been the case during much of the post-war period, the next few decades are likely to see at least three major power centers —the United States, the euro area (or EU more widely), and the BRICs (along with other large emerging markets and oil exporters with sufficient influence and power to assert their interests). Regional integration is likely to develop further. The BRICs are not regionally based and are a loose grouping, but individually they participate in different regional integration initiatives. Regional integration is

likely to continue to be strongest in Europe. East Asia, where manufacturing is already very integrated across borders, is poised for a decision on regional monetary integration. Meanwhile, monetary integration around the US dollar in the Western Hemisphere is unlikely to make much progress.

Power Centers with Very Different Strategies

Divergences in past and prospective power and in regional cohesion mean that the emerging power centers will likely have very different strategies for addressing global problems and with regards to international monetary reform. In turn, these differences will probably lead to difficulty in agreeing upon and implementing major reforms, even when such reforms are generally recognized as desirable. In particular, reform of governance at the international financial institutions, creation of an international reserve asset, and initiatives to strengthen financial regulation will pit the various blocs against each other.

The fact that the United States faces a decline in its relative economic power means that it will have to brace for greater policy interdependency and market linkages in shaping its domestic and foreign economic policy. In the immediate post-war years, the United States had the luxury of embracing multilateralism and the reduction of trade barriers because of its position as the world's strongest economy, at the same time making it beneficial for other countries to follow its lead by providing generous financial assistance. The United States is no longer in that fortunate position. In order to mitigate an abrupt loss of power, the United States is likely to be selective in its support for multilateral institutions, and will concentrate instead on the bilateral relationships in which it can best project and maintain its economic power. This may take the form of bilateral trade deals or currency swap arrangements with other central banks—as the Federal Reserve has done with Brazil, Mexico, South Korea and a number of other countries over the course of the crisis. While supportive in principle of the BRICs' desire to expand their voting power at the IMF, which would come at the expense of Europe, the United States will resist any reform that would jeopardize its own veto power within the institution. Similarly, it will seek to retain its close relationship with Middle East oil producers and to play a key role in global energy markets.

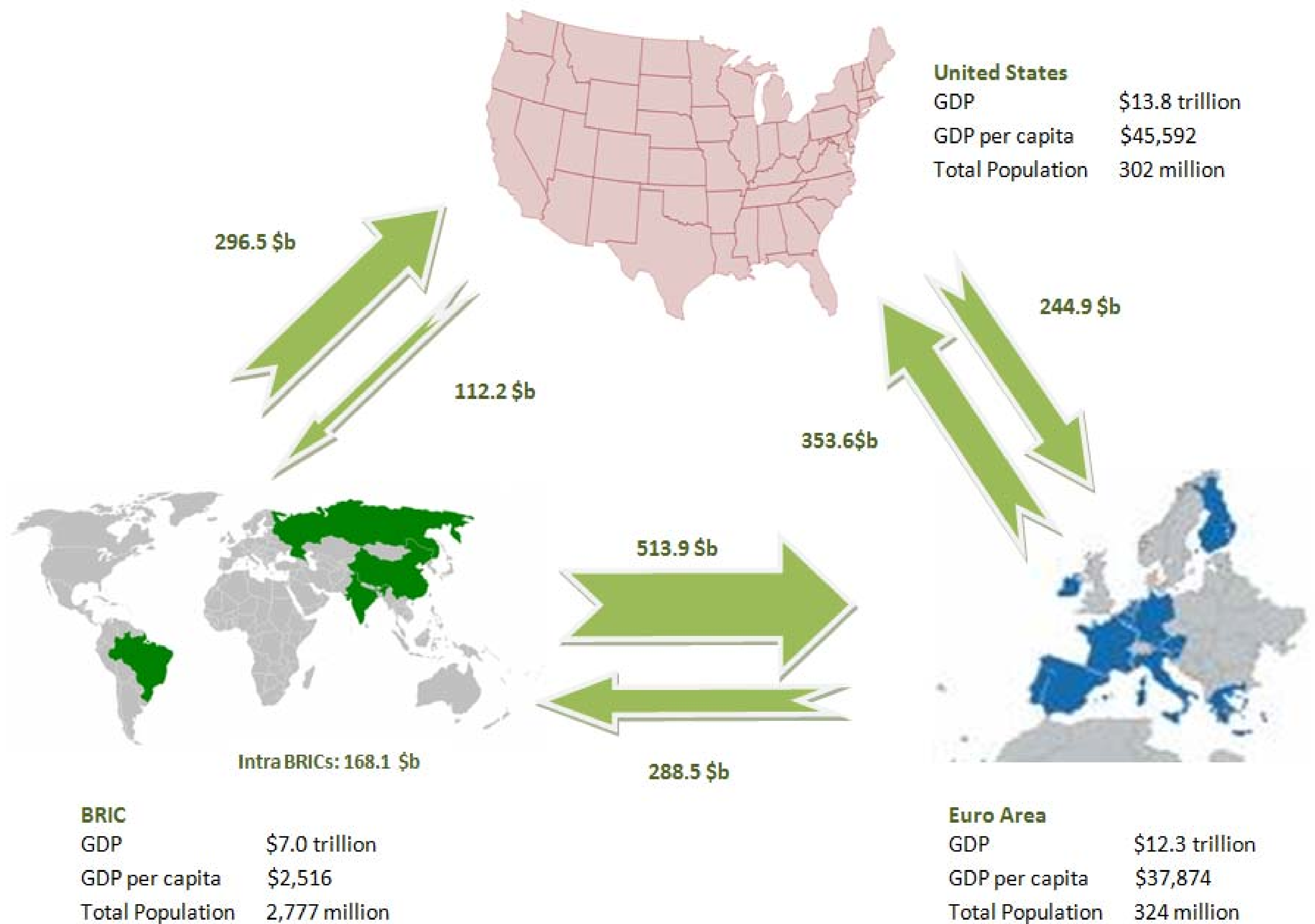
The BRICs, despite their diversity in political structure and economic development, are likely to support reforms that help to maintain the real value of their newly acquired wealth, while at the same time remaining critical of existing institutions and a division of power that is a holdover from World War II and the Cold War. Thus, they are likely to come together on the need to move away from the US dollar as the linchpin of the international monetary system, provided some guarantees are given for the value of their dollar assets. With official holdings of $1.95 trillion in dollar denominated assets, and total merchandise trade of $1.9 trillion, they have a strong interest in ensuring that the transition to multi-polarity is not at the cost of high financial market volatility or disruption in the flows of world trade, investment and capital. As articulated by Zhou Xiaochuan, Governor of the People's Bank of China, the fundamental issue " is to create an international reserve currency that is disconnected from individual nations and is able to remain stable in the long run, thus removing the inherent deficiencies caused by using credit- based national currencies" (March 23, 2009, www.pbc.gov.cn). Part of the solution has been to enhance the role of the SDR through increasing its supply, promoting its use in international trade and debt issuance, and expanding its use beyond the current official circle, by making available SDR-denominated bonds to qualified private investors, such as pension funds and insurance companies

that would be attracted due to portfolio diversification as well as the natural currency hedging embodied in the structure of the SDR.

In this context, the Chinese proposals to increase SDR issuance and promote its market appeal are clear areas of common interest to the BRICs. But in other areas the BRICs have very different objectives, and more rivals than partners. Whether measured by geography, political structure, or level of economic development, the BRICs are a deeply diverse set of countries. A tour of the four capitals of the BRICs, for example, requires traveling 22,000 miles, almost five times the distance between Washington and Brussels. Likewise, GDP per capita in the BRICs covers a broad range, from approximately $12,000 in Russia to $1,000 in India, with Brazil at $8,400 and China at $2,700. Both China and Russia, for example, have geopolitical ambitions, while Brazil and India are less concerned with projecting global political power than consolidating their economic achievements and rebalancing global institutions toward developing countries. Meanwhile all four countries will face tough competition in the global corporate M&A market, as they provide support to their blue chip companies to help them expand abroad and globalize.

In many ways, Europe will continue to be inwardly focused in the coming years, as the European Union (EU) continues to enlarge and address the fault lines exposed by the financial crisis. While the transition of the former satellites of the Soviet Union from planned to market economies and the expansion of the EU to include many of these countries has been an extraordinary achievement, the work is not yet finished. The heterogeneity of views on the future of Europe, as well as the unwieldiness of governing by agreement among more than two dozen countries, makes it essential to hammer out a new constitution that can be sold to the public of all member countries. Additionally, the European Central Bank needs to be supported by a strengthening of other EU institutions, the democratic deficit needs to be addressed, and the EU bureaucracy streamlined. In the financial arena, the lack of Europe-wide regulation and a common supervisor has led to problems—fumbled responses to failing banks and inadequate knowledge of cross-border exposures. As for dealing with the BRICs, the EU is in a position of weakness given its energy dependence, in particular on oil from the Middle East and gas from Russia, giving these countries the potential to exploit their market power and strategic position.

Figure 3: Trade Flows between Blocs



Dangers of a Multi-polar World

Except for occasional joint interventions by ad hoc groupings of major powers, the current international monetary system is largely uncoordinated, presciently described some three decades ago by Max Corden as a "nonsystem[9]." Instead, countries generally attempt to keep their own monetary policy houses in order (with varying degrees of success) by targeting inflation, while letting their exchange rates fluctuate. The main exception among major economies, of course, is China. Despite Chinese authorities' formal move toward greater exchange rate flexibility in July 2005, the renminbi has experienced limited appreciation against the US dollar in the face of Chinese current and capital account surpluses that remain large, reflecting the importance of

[9] Max Corden, "The Logic of the International Monetary Non-System" in Fritz Machlup, Gerhard Fels, and Hubertus Müller-Groeling, eds., *Reflections on the Troubled World Economy: Essays in Honour of Herbert Giersch* (London: Macmillan, 1983), pp. 59-74

underlying structural saving-investment imbalances. There is no anchor, however, to the system as a whole, and global liquidity is the result of the actions of individual central banks, multiplied by the operation of offshore - currency markets.

Though the international monetary "nonsystem" continues to revolve around the dollar, the currency of the world's largest economy with the most liquid financial markets, the rise of the euro and other currencies have made measuring global liquidity in terms of only dollar liquidity inadequate. Still, whether considered in terms of the dollar alone or in terms of multiple currencies, there is nothing that ensures that the amount of liquidity is appropriate for the global economy.

Advocates of floating exchange rates, such as Milton Friedman, traditionally have maintained that exchange rate flexibility combined with sound domestic macroeconomic policies would insulate countries from inappropriate policies abroad[10]. The experience of floating exchange rates since 1973, however, has belied that line of thinking. Exchange rates do not always adjust in an appropriate direction. Monetary independence is not absolute, even with a freely floating exchange rate. And US interest rates do have transmission effects to other countries, even those with flexible exchange rates. Thus, claims by economists such as Andrew Rose that floating exchange rates and inflation targeting preclude the need for policy coordination[11] do not ring true. Asset price bubbles and crashes, along with their contagion effects across countries, cause excess volatility in foreign exchange and other asset markets that are best addressed by joint policy action. That said, policy coordination may be more difficult in a multi-polar system when compared to a hegemonic one.

Moreover, an unmanaged international monetary system will not prevent one of the blocs from using exchange rate undervaluation to stimulate economic growth, or overvaluation to achieve "competitive disinflation" in response to a global supply shock. In addition to China, even the United Kingdom and Switzerland have been criticized for their acceptance of currency depreciation in response to the severe economic downturn currently afflicting them. When exchange rates are deliberately manipulated, or fortuitously do not adjust, there is the danger that global imbalances will develop, as has occurred over the past decade. Present mechanisms for macroeconomic policy surveillance, primarily the responsibility of the IMF, are inadequate, in particular policies influencing the exchange rate. Countries not beholden to IMF borrowing—which in practice means all developed and major emerging market countries—blithely ignore the IMF's advice.

Another problem with the current international monetary nonsystem is exchange rate volatility, which will be exacerbated by the usage of multiple major reserve currencies. As Robert Triffin argued five decades ago with respect to the US dollar, reserve currencies are subject to crises of confidence when they run balance of payments deficits[12]. While such deficits may be essential to augment global liquidity, the associated increase in claims on the anchor country can raise doubts about its ability to honor them. In a world with a single reserve currency, the possibilities of substituting away from that currency are limited. Thus, despite concerns about US monetary policy and large US current account deficits in recent decades, the dollar has not faced a disorderly fall—the dreaded "hard landing." In a multiple-reserve-currency setting, however, credibility problems can have

[10] Milton Friedman, "The Case for Flexible Exchange Rates" in *Essays in Positive Economics* (Chicago: University of Chicago Press, 1953), pp. 157-203.
[11] Andrew K. Rose, "A Stable International Monetary System Emerges: Inflation Targeting is Bretton Woods, Reversed" *NBER Working Paper No. 12711*, November 2006.

an immediate impact as holders of one major currency easily shift to another, exposing the disfavored currency to quick, sharp depreciation and the favored currency to rapid appreciation. In this regard, the BRICs' calls for a shift away from the dollar could trigger a crisis of confidence in the currency, causing massive losses in the value of dollar-denominated assets. Without coordination of the transition away from a dollar-dominated system to a multi-polar or true multilateral monetary system, there are dangers of financial instability with consequences for economic activity and development in all countries.

Need for Better Governance

The international monetary system faces a major challenge in accommodating the reality of multiple power centers. Already, the importance of the BRICs has been acknowledged in the creation of the G20, the current hub for international discussion about policy measures to address the current financial crisis, and in the Financial Stability Board, a grouping of financial officials with similar membership. However, the G20, like the G7, faces a problem of legitimacy .While it is more representative of the realities of global power than the G7, it excludes many middle-size and smaller countries, and thus does not satisfy the universality principle of multilateralism entrenched in the post-war economic order. Neither the G20 nor the Financial Stability Board is a global institution, and neither has a secretariat that is thus able to lay the groundwork for important decisions by the member governments and guarantee follow-through. Such a role would normally be assumed by multilateral financial institutions, in particular the IMF and the World Bank. Alternatively, multilateral organizations with more restricted membership—e.g., the Organization for Economic Co-operation and Development and the Bank for International Settlements—could be expanded to take on a global role, or new institutions created to do so. However it is achieved, it is imperative that the institutions of global financial governance be strengthened in advance of the occurrence of further major global shocks.

Ultimately, the instabilities associated with the coexistence of major reserve currencies must lead to either dominance of one of them or agreement to create a more managed international monetary order. The current monetary nonsystem embodies serious risks, however. Without international cooperation, the prospects for early resolution of the rivalry among currencies seem extremely remote. The euro may rival the dollar, but it is unlikely to take over its preeminent role. Among the BRICs, there is no candidate for the title at present. While the renminbi might become an important international currency at some time in the future, China first needs to further develop its financial infrastructure and make progress with other economic reforms. Thus, there is renewed interest in managing the international monetary system, such as the Chinese proposal to revive the SDR as a reserve currency, and in moving away from the nonsystem. But the SDR in its current form—a basket of currencies—does nothing to solve the problem of multiple reserve currencies. Rather, it simply allows some hedging of exchange-rate risk. Even with increased use of the SDR, global liquidity would still be the result of uncoordinated actions of major central banks. International regulation of liquidity would require the creation of the equivalent of a global central bank. Creation of such an institution would not only require agreement on how to manage decision-making powers, but its effectiveness and legitimacy would have to be supported by other global institutions. Thus, the advent of a global central bank is in the distant future, if at all.

[12] Robert Triffin, *Gold and the Dollar Crisis: The Future of Convertibility* (New Haven: Yale University Press, 1960).

What progress can be made in the meantime in order to reduce instability? In the short run, the risks of dollar devaluation on the major reserve holders can be mitigated by providing some guarantee relative to the SDR, either by the United States or through a multilateral institution. A substitution account—an idea that dates back to the breakdown of the Bretton Woods system—could be created to enable the orderly switch by reserve holders from the dollar to the SDR or the euro. At the same time, major central banks should swallow their reservations and agree to more active and coordinated intervention in foreign exchange markets. While the effectiveness of unilateral interventions is doubtful, a demonstrated willingness to counter disorderly movements through appropriate actions by both the appreciating and depreciating country would prevent the large swings that might otherwise occur. Thus, the major reserve currency nations need to cooperate much more closely, and expand the scope of their monetary policy objectives beyond domestic inflation to include global financial stability.

The deficiencies of nationally-based financial regulation have also been recently highlighted by financial globalization. However, the reality of jealously-guarded sovereignty in this area and the desire of the major financial centers to maintain their competitive advantage guarantee that a global financial regulator will not emerge from the current crisis. The more limited goal should be to enhance cooperation and information sharing across borders and to move to greater harmonization of regulation, while keeping supervision at the national level where it can be most effective.

Summing Up

The history of the international monetary system suggests that there is a large degree of inertia in currency use. Thus, moving away from the dominance of the US dollar could be expected to be a gradual process. Creation of the euro and the growing economic clout of the BRICs over the past decade, however, have led to a new environment in which a multi-polar international monetary system is beginning to emerge. For the first time in 65 years, there are genuine international alternatives to the dollar. A multi-polar monetary environment, however, is likely to exacerbate currency instability, leading to shifts into and out of the major reserve currencies, which in turn is likely to lead to increasing demands for a managed international monetary system and a move away from the “nonsystem” that emerged after the breakdown of Bretton Woods in the 1970s. The substantial economic power that the euro area and the BRICs are now able to exert will make it impossible for the United States to successfully resist a reshaping of the international monetary system toward a more multilateral and managed one. While the transition will be difficult and drawn out, governments should take steps to prevent financial volatility by enhancing cooperation on monetary policies, currency market intervention and financial regulation. The new Framework for Strong, Sustainable and Balanced Growth adopted by the G 20 leaders in Pittsburgh in September 2009, embodying a process of mutual assessment of each other’s policies, provides a promising approach to international cooperation and policy coordination.