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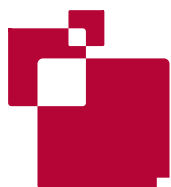
Highlights

- Reform of the international monetary system is under discussion after three decades of apathy. However, in the short term, there is little chance of a grand redesign. Nevertheless, concrete steps should be taken.
- First, consensus is needed on exchange rates, capital flows and reserves. This consensus is closer than often assumed, and should be codified in some form of soft law, with provisions for surveillance agreed on.
- Second, financial safety nets must be improved so that countries do not have to self-insure by accumulating reserves. The least difficult route could be a new regime for deciding on Special Drawing Right allocations that would facilitate more frequent use of this instrument.
- Third, a change in the composition of the SDR should be planned for, to strengthen the multilateral framework by including the renminbi. These reforms would be a partial move, and would prepare the ground for further developments.

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REFORM OF THE INTERNATIONAL MONETARY SYSTEM: SOME CONCRETE STEPS

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THE POSTING OF Governor Zhou Xiaochuan's famous paper¹ in 2009 awakened the debate on the international monetary system (IMS) from a three-decade long state of apathy. In the run-up to the 2011 French presidency of the G20, many ideas were floated about reforming the international monetary system, through reports, papers and conferences. These contributions pointed out in particular the deficiencies of the present system: dependence on a key reserve currency, which in turn leads to asymmetries in the process of adjustment; inability to provide incentives for surplus countries to adjust; disregard for spillovers effects of national monetary policies and, as a result, the possible inadequacy of the global monetary stance; the costly reliance on self-insurance through reserve accumulation on the part of developing and emerging countries; inability to channel net capital flows from low-return, advanced economies to high-return, emerging countries; and significant real exchange-rate misalignments, sometimes leading to 'currency wars'. Old policy dilemmas, such as that of Triffin, have been revisited, and old ideas, such as the expanding the role of the Special Drawing Right (SDR), have been intensively discussed.

The need for a change in the international monetary system – what Keynes famously called the “rules of the game” – is accentuated by tectonic shifts in the balance of international power. These shifts were already visible in the last decade, but the financial crisis and its asymmetric effects on advanced and emerging countries have accelerated them. By 2020, the balance of economic power globally will be more equal than at any time over the last two centuries, and there is therefore a strong case for moving towards a multipolar monetary system whose main planks are likely to be the US dollar, the euro and the renminbi.

In the short term however, there is no hope of rebuilding the international monetary system according to any of the grand designs on offer. The weaknesses of the euro and the renminbi are too apparent for these currencies to constitute alternatives to the US dollar. To reform the rules of the game is an ambitious enough endeavour. To rewrite them entirely, as some proposals suggest, is not on the agenda. We are not in 1944.

It is therefore time to focus the debate on what is possible. Already, official working groups have been tasked with providing concrete proposals for the G20, to be discussed at the finance ministers' meetings, in readiness for decisions to be taken at the heads of states and governments G20 summit in Cannes, in November.

So what could the concrete steps be? What are the reforms that would both help address fundamental deficiencies and command a sufficient degree of consensus? We suggest three avenues:

- First, to create consensus on policies on capital inflows and provide a framework for international surveillance of national capital controls, reserves and exchange rate policies. This would help tackle the risk of 'currency wars'.
- Second, to draw on the results of the Korean G20 presidency in 2010 and strengthen financial safety nets so that countries do not have to self-insure by accumulating reserves or to rely on possible bilateral swap lines to access liquidity when confronted with sudden stops.
- Third, to prepare and plan for a change in the composition of the SDR, that would strengthen the multilateral framework while favouring evolution towards a more multipolar system.

1. Zhou Xiaochuan (2009) 'Reform the international monetary system', available in *BIS Review* 41/2009, <http://www.bis.org/reviwer/r090402c.pdf>.

‘Exchange rates, capital flows and reserves are highly controversial. But it is apparent that the crisis has had highly asymmetric effects that call for a real exchange rate realignment between the advanced and emerging worlds. This realignment will take place one way or another.’

EXCHANGE RATES, CAPITAL FLOWS AND RESERVES

The first topic seems highly controversial at first sight because it touches on the sensitive issue of exchange-rate policies. But it does not need to be controversial. To start with, it is increasingly apparent that the global crisis has had highly asymmetric effects that call for a real exchange-rate realignment between the advanced and emerging worlds. This realignment is going to happen one way or another, either through nominal exchange-rate changes or through divergent inflationary developments. Higher pressure on consumer prices will reduce the willingness of emerging country governments and central banks to oppose exchange-rate appreciations through reserve accumulation and/or capital controls.

For the same reason, the controversy about capital controls is abating. The International Monetary Fund is less reluctant than in the past to make room for such controls in the policymakers’ toolbox. At the same time, it is increasingly recognised by policymakers in emerging countries that capital controls are only one instrument among several. They are part of a broad range of macroeconomic and macro-prudential tools that can be used to limit the detrimental impact of large, volatile capital inflows.

Policy consensus may therefore be within reach. What will be more difficult is to agree on institutional arrangements. To start with, the emerging international consensus should be written down in some sort of soft law, such as a code of conduct. Second, the joint monitoring of capital controls and exchange-rate policies, with the aim of separating macroeconomic and financial stability motives from mercantilist motives, would need to be allocated to an international body. This body should provide assessments and policy suggestions, as well as technical assistance when

required. A natural candidate for this task would be the IMF. However, this would require amending the Fund’s statutes (since the IMF presently has no legitimacy to review financial-account policies). Hence, a formal approval by 85 percent of the board of governors would be needed. This is not impossible, but is demanding in view of the continuing lack of trust in the institution in significant parts of the emerging world.

FINANCIAL SAFETY NETS

To put in place financial safety nets, two different routes may be taken: a strengthening of bilateral central bank swap lines, and an extension of multilateral schemes. During the crisis, swap lines generously extended by the US Federal Reserve (and, to a lesser extent, other key central banks) proved instrumental in providing US dollar liquidity to national central banks. However these were unilateral, discretionary initiatives, the benefits of which were reserved to some partners and whose repetition may not be taken for granted, should another crisis hit.

One idea would be to institutionalise the network of swap lines under the supervision of the IMF. There would be a risk of losing in the process the flexibility demonstrated during the crisis. Understandably also, and perhaps more importantly, this project is vigorously opposed by central banks, whose independence has already been brought into question because of their role in keeping ailing banks (or, in the European case, states) afloat, the threat of a return of fiscal dominance, and the extension of their mandates to macro-prudential surveillance. Formal commitments from central banks to extend swap lines to countries designated by an international institution are unlikely in these circumstances.

The institutionalisation of bilateral swap lines would also amount to the creation of a two-tier

system in which countries would explicitly depend on the support of regional partners. Such schemes may be attractive to some countries where cooperation around a regional hub has developed, but it can hardly provide a global solution.

This leads to consideration of potential multilateral schemes. It is necessary here to distinguish three variants:

- i The pooling of central banks' foreign-exchange reserves, possibly with a transformation of part of them into SDR reserves;
- ii The creation of new IMF facilities;
- iii A more active policy of SDR allocation, through more frequent, possibly counter-cyclical and/or targeted allocation by the IMF.

The pooling of official reserves has already been practised at regional level and could conceivably be extended to the multilateral level. While efficiency-enhancing, this raises difficult questions about the sharing of the exchange-rate risk and about the use of the reserves. Reserve pooling would require rules on how each member could use these reserves, which would be difficult to do ex-ante. Furthermore, access rules would make reserve pooling inferior to unconditional self-insurance through reserve accumulation.

IMF facilities are a way to channel reserves to countries hit by capital outflows. The recent evolution has been towards the creation of no-conditionality (the Flexible Credit Line – FCL) or low-conditionality (the Precautionary Credit Line – PCL) facilities that aim at crisis prevention rather than crisis management. Further proposals have been put forward such as the Fund's Global Stabilisation Mechanism (GSM), a new mechanism that would activate the provision of liquidity to systemic and vulnerable countries in case of a systemic shock. The problem with such facilities, however, is that potential beneficiaries might

remain unsure that they will get access to them in times of need, which makes them partial substitutes to reserves only.

New SDR allocations would not have this shortcoming. They would provide countries with SDR reserves that they could exchange for reserves denominated in the currency of their choice. If provided in limited volumes and in response to increases in the demand for reserves only, such allocations would be unlikely to have far-reaching consequences for global liquidity while providing a welcome buffer for vulnerable countries. But to make them a recurring feature of the provision of liquidity, a revision of IMF statutes would be needed (since currently an 85 percent majority within the board is needed to decide an SDR allocation). This avenue cannot be considered closed but it presents serious hurdles.

A NEW SDR

Several SDR-based proposals are on offer. One aims at addressing a different shortcoming of the IMS, namely the lack of safe assets at global level. The idea is to create a new investment vehicle by allowing international financial institutions, including the IMF, to issue debt securities denominated in SDR. The liquidity of the SDR market could be enhanced by developing the private use of the SDR, through commodity invoicing and subsequent demand for SDR-denominated bonds.

This is certainly not the only way to expand the range of safe and liquid assets that is needed at the global level. Another, which should be encouraged, would be the development of national-currency bond markets.

Although consistent with the initial purpose of the SDR, from 1969, the promotion of SDR-denominated securities through IMF borrowing is likely to encounter a number of obstacles: notwith-

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standing technical problems related to the initial liquidity premium (estimated 80-100 basis points by the IMF staff) and to the need for market infrastructures for SDRs, IMF members are likely to be reluctant to surrender to the oversight of the IMF resources they currently enjoy.

Rather than trying to create an SDR market from scratch, we suggest adapting the existing SDR to the new global environment through more frequent allocations, and by planning the inclusion of the renminbi in the SDR basket (which presently only includes the dollar, the euro, the yen and sterling), in the context of an opening up of China's financial account and a move towards a flexible exchange-rate regime in China. Such a reform would be consistent with the rapid shift of the global economy in favour of China. It would put the largest reserve holder at the centre of the SDR liquidity-provision system and would create a natural venue for monetary-policy dialogue and possibly coordination between the five countries involved in the SDR – a G5 circle.

Interestingly, the renminbi need not be immediately included in the SDR, and China need not immediately open up its financial account, for

China to play a part in providing financial safety nets. The People's Bank of China has already started extending swap lines to a number of foreign central banks in renminbi, in addition to the Chiang Mai initiative. It could also provide liquidity in dollars in exchange for a number of listed currencies – say the currencies of the G20 – and provide SDR-denominated loans. This would be a way for China to diversify its reserves smoothly while providing international liquidity in times of stress, without having to wait for a move to free convertibility and integration into the multilateral liquidity-provision scheme.

IN BRIEF, the most workable deliverables today seem to be (i) guidelines on and surveillance of capital controls, (ii) a new regime for deciding on SDR allocations that would facilitate more frequent use of this instrument, and (iii) the inclusion, after some delay and against financial opening up, of the renminbi into the SDR basket.

Would these three reforms be conducive to addressing the shortcomings of the international monetary system? Only partly. But they would represent concrete steps towards change and would pave the way for longer-term developments.