Reinventing Bretton Woods Committee Workshop—Summing-Up

The International Monetary System: Old and New Debates
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Reinventing Bretton Woods Committee Secretariat

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Executive Summary

The conference's proceedings were marked by a wide variety of viewpoints on the case for reform and possible approaches to reform. Participants expressed the view on the one hand that the current system had succeeded in promoting sustained international economic integration while on the other hand significant external imbalances and exchange rate volatility had revealed inherent weaknesses. Participants indicated that the problem of asymmetric adjustment remains the main weakness of the system. The discussion seemed to suggest that the case for reform may be at least in part conditional upon identifying realistic reform options. Participants outlined as possible reform approaches: targeting of international reserves, strengthening of obligations under Article IV, guidelines for international reserve diversification, bank capital regulation, and an expanded role for the SDR. Participants stressed that most such reform proposals had been discussed in the past but had failed to command international agreement and that reform priorities varied through time.

The Reinventing Bretton Woods Conference "The International Monetary System: Old and New Debates" brought together policy makers, leading academics and market participants to provide an assessment of the case for reform of the international monetary system and ideas about how that might be achieved. Proceedings were divided into eight panels with individual presentations followed by questions and answers. The summing-up aims to group panellists' remarks into broad but not necessarily comprehensive sets of topics.[1]

Causes of crisis

The relationship between the global financial and economic crisis and the international monetary system remains ambiguous. Some panellists warned that unless a clear causal relationship can be established there is a risk that reform initiatives will not receive sufficient political support. However, other panellists saw in persistent imbalances and currency misalignment major sources of instability that strongly contributed to if not caused the crisis. Participants also argued that exchange rate volatility caused bank failures in the U.S. Several stated that the crisis has therefore given new urgency to the need for reform.

Purposes of an international monetary system

The international monetary system was viewed essentially as allowing free international exchange and an efficient international division of labour while providing a framework for monetary relations between monetary institutions. Panellists argued that the system

[1] Remarks are reproduced mostly verbatim. The term panellist is used generically and does not indicate any consensus among remarks unless stated.

should be macro-economically neutral, that is, neither inflationary nor deflationary. Panellists stressed that the ultimate success of a system will be judged by its ability to generate global economic growth.

Case for reform

The case for reform rested largely on the persistence of large external imbalances and exchange rate fluctuations. Recent announcements of relocations of production facilities by corporations due to exchange rate fluctuations were seen as illustrating deficiencies of the current system. Panellists stressed that the current international monetary system resting on an obligations framework had failed to induce sufficient policy coordination. Panellists remarked that the existing institutions governing the international economy had been established by and were largely run by advanced economies and that despite some reforms these required further institutional change. Panellists warned that economists tend to deal always with the last crisis but many felt that continuation of the current system would lead to recurrent crises.

Global imbalances

In the view of many participants, savings and investment imbalances is the main cause of persistent external imbalances. However, other panellists stressed that external imbalances are just manifestation of other underlying imbalances induced by national policies, in particular fiscal imbalances. Panellists stated that net-savers will continue to accumulate assets and net dis-savers will de-accumulate assets. The relationship between the balance of payments and the exchange rate is not always clear. Some participants argued that exchange rate changes are often unlikely to have a significant impact on the current account. However, the exchange rate may affect savings behaviour. Panellists indicated that the Plaza accord was possible at the time because there was consensus that the dollar was overvalued but that no such consensus existed today. Current account imbalances can persist for prolonged periods and imbalances are often a reflection of the diversity of economies and distribution of income.

The nature of the imbalances differs, often reflecting differences in underlying uses of capital inflows and concern arises where imbalances feed asset bubbles. Panellists argued that the structural nature of imbalances might equally require structural policies to address them effectively. Political tensions were feared likely to continue as U.S. unemployment remains at 10 percent while China grows at 10 percent. Panellists stressed that a fundamental issue lies in the fact that policy makers are not ready to subordinate policies to external objectives. Panellists also argued that it is often difficult to persuade policy makers that spillovers of their policies can have negative feedback on their own economies as well as on others.

The asymmetry of payments adjustments remains a central concern. Some panellists argued that such an asymmetry led to the collapse of Bretton Woods and that there was a need for the burden to be shared equally between deficit and surplus countries. The notion that global imbalances would be solved by either generalised floating or by reducing domestic imbalances was contested. Some panellists argued that floating was no solution and that current policy interdependencies required additional coordination. The burden of adjustment remained central and some panellists argued that if the world overall is in depression, pressing surplus countries to adjust is sensible but when economic performance across is mixed, sharing the burden of adjustment is more problematic.

Reserve accumulation

The accumulation of foreign exchange reserves is seen as likely to continue. Panellists saw such reserves growth being mostly demand driven. Panellists indicated that there was growing uncertainty about the supply of quality reserve assets. The increasing concentration of reservable instrument in the hands of the official sector also raised

questions about the sustainability of continued reserve accumulation. The large amount of reserves raised concerns about their systemic impact. Panellists argued that the excess demand for reserves may be deflationary.

Reserve currencies

The role and status of reserve currencies remains controversial. Some panellists felt that the Triffin dilemma remains valid, though application today may differ from its original formulation. Some panellists argued that the U.S. could maintain large external deficits due to the reserve currency status of the dollar. However, panellists also indicated that reserve currency status does not allow the reserve currency country to devalue its currency to improve its trade competitiveness. Some panellists saw no threat of massive capital outflows from the U.S.

SDRs and SDR substitution account

The future role of the IMF's SDR in the international monetary system remains debatable. Panellists commented on the fact that the objectives of adopting and promoting the SDR had always differed among its proponents; it could be viewed for example as a world currency, or as an official reserve asset, or as a vehicle to transfer aid and that this ambiguity may have been the main reason why the role of SDR has not grown as hoped for. Panellists pointed out that agreement had not been reached despite several earlier attempts on setting up a SDR substitution account amid unresolved difference on meeting possible valuation shortfalls.

China

The level of the RMB exchange rate and impact of the exchange rate on China's balance of payments continued to be controversial. Many participants argued that the RMB exchange rate might have a substantial impact on China's current account. Other panellists argued that wage increases would make a major contribution to correcting imbalances. China remains concerned about the post-Plaza developments in Japan which may affect its decision to allow greater exchange rate movements. Some panellists accused China of not playing by the rules amid its large external imbalance but other panellists claimed that the RMB is not undervalued. China was also seen as wanting to assume a greater stake in the international monetary system and to be interested in contributing to change. Panellists voiced concern that China may no longer be able to sterilise large capital inflows sufficiently as management of nominal exchange rate may unduly exert inflation pressure and that China therefore should focus on the real effective exchange rate. Panellist indicated that China continued to pursue a policy of gradual RMB liberalisation.

Eurozone distress

Persistent difficulties and market uncertainties in the Eurozone were viewed with concern. Some panellists saw Spain as being too big to save but this was strongly disputed by others. On the question of resolving imbalances within the Eurozone, panellists were not able to offer a solution. The Eurozone was urged to support its member countries in distress. Debt default was not seen as a viable alternative also due to domestic debt complexities and the view was expressed that countries could generate sufficient primary surpluses needed to restore debt sustainability.

Emerging markets

The rise of emerging markets implied a structural transformation of the international economy and relationship with advanced economies. Panellists emphasised that the centre of gravity of the international economy had shifted towards Asia and that this is not a transitory phenomenon. Economic power and demographics were also identified as key parameters to determine international relations. Panellists stressed that the notion of

periphery to describe emerging markets is “insulting.” Panellists emphasised that the integration of emerging markets currencies into the international monetary system constitutes one of the most important reform challenges.

Capital flows and capital controls

The impact of capital flows on policy independence and importance of capital flow volatility remain contested. Participants stressed that the trilemma (impossible trinity) remains binding (one cannot have monetary policy independence, capital account openness and a stable exchange rate). However, participant contested that the trilemma really is dilemma as one cannot have fixed exchange rates and independent monetary policy. Participants argued that capital flows to emerging markets rested on positive fundamentals and are not necessarily a function of accommodative monetary policies in advanced economies. The volatility of capital flows was viewed with concern but volatility was also attributed to underlying economic policy volatility. While panellists argued that capital flows to emerging markets are more permanent in nature, other participants indicated that it is difficult to distinguish between transitory and more permanent capital flows. Panellists indicated that FDI are hard to reverse but other panellists indicated that the associated cash flows can easily be reversed; FDI does not necessarily constitute a more stable source of capital. Panellists called into doubt the positive contribution to economic growth of capital flows.

The introduction of capital controls was not seen in principle as problematic. However, panellists argued that capital controls should constitute only a last resort and after correcting for excessively loose monetary policy and implementing prudential measures. The unpredictability and volatility of capital flows was seen with concern as its does not allow the market to adjust. Panellist citied the unintended consequences of capital flows by directing flows disproportionately to other countries. Controls should distinguish between controls that address market imperfections (prudential) and others. Panellists argued that coordination of capital controls would be difficult. Panellists also suggested of whether advanced countries should not consider controls on outflows. The promotion of capital outflows is seen by other as an alternative to a control on inflows.

U.S. monetary policy and quantitative easing

The conduct of U.S. monetary policy and its external spillovers remained controversial. Some panellists argued that the Federal Reserve does not take due account of the external effect of its policy conduct while other panellists pointed out that the Federal Reserve fully recognises its international obligations. Panellists indicated that by disregarding the exchange rate, the Federal Reserve loses an important price signal, as inflation is too slow to react. Some panellists argued that QE2 has unduly fuelled capital outflows from the U.S. and /or that QE2 would prevent U.S. adjustment through deflation. However, panellists had not readily identified alternatives to QE2. Others were quite comfortable with QE2.

Reform options

Several options had been discussed in the past but had failed to gain general acceptance.

- Reserve targeting: it was proposed that countries should declare and discuss their objectives for reserve growth to cap external imbalances, with estimated additional reserves to be announced ex-ante and possibly supplied through SDR allocations. Countries would be accountable for reserves exceeding established caps and be subject to possible penalties.
- SDRs: Panellists proposed expansion of the SDR as a reserve asset to be used for transactions with the IMF. Some panellists argued that valuation of the SDR basket should be changed to a real basket made of a commodities and/or goods to serve as nominal anchor and for issue of such SDRs to be conducted in ways similar to the

rules governing a currency board. The opening of the SDR basket to include other currencies in particular the RMB was proposed. SDR could also be used to guide more orderly reserve diversification. However, other panellists indicated that despite the initiative of the Governor of the People's Bank of China, few other policy makers had much interest in either SDR or in a SDR substitution account. Other panellists argued that the features of the SDR, as at present constituted, do not make it a sufficiently attractive asset.

- Multiple-currency regime: Panellists discussed currency diversification to foster competition among currencies and some felt this might be conducive to greater payments discipline. To be credible new reserve currencies would have to consist of regional currencies and may therefore require some form of further regional integration. A multiple currency regime would reduce dependence on key currencies and might therefore reduce the susceptibility of the system to currency-specific shocks. The adoption of such a regime would also facilitate the integration of emerging markets currencies into the system and as such take into account their "aspirations." One participant argued that the system already consisted of multiple currencies. Panellists argued that negative externalities (first-mover problem) associated with the adoption of new currency constituted a major obstacle but that this could be overcome by agreeing on a common framework – which could also guide orderly reserve diversification. Panellists indicated that the earlier transition from sterling as a major reserve currency occurred within a framework of gradually managed diversification supported by coordinated agreements between central banks.
- Strengthened surveillance: Panellists proposed a revised surveillance framework where countries adhered to a set of strengthened obligations and norms based on countries' policy practices where failure to meet policy obligations triggers possible penalties including financial ones. Panellists also proposed use of a set of indicators to gauge the adequacy of payments positions with emphasis on the direction of movement rather than the position at any time. Panellists argued that surveillance needed to be multilateral to be effective and that certain automaticity should be established based on the notion of "yellow and red cards." Panellists stressed that, contrary to some media reports, the U.S. had not proposed current account targets and caps. Other panellists argued that a system cannot be based just on rules; but it will be difficult to enforce any discretionary elements in such a framework. Peer pressure may not be enough to exercise sufficient discipline.
- Bank regulation: Panellists proposed adoption of a more proactive and country specific bank capital regulation regime to affect more directly leverage amid the assumed interdependence between bank credit, leverage and exchange rates where capital adequacy will be aligned with exchange rate considerations.
- Stabilisation of euro-dollar exchange rate: some panellists proposed to establish a band for the euro-dollar exchange rate as an essential anchor for other currencies.