The International Monetary System at a Crossroad*

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1. Introduction

The recent international economic crisis has intensified the debate about a reform to the international monetary system. The pressure for a change in the system increased in March 2009, when the Governor of the People's Bank of China, Zhou Xiaochuan, made a proposal calling for the replacement of the US dollar as the world's main reserve currency. Governor Xiaochuan argued for a stronger role of the International Monetary Fund in the new world monetary order, and, in particular for the IMF´s special drawing rights (SDR) as an alternative reserve currency.

Could the dollar lose its role as the world's reserve currency? Which currency would replace it? This debate is very important. The international monetary system is (or must be) the basis for the adequate operation of trade and financial transactions in a globalized world, providing stability in exchange rate markets, avoiding chronic external deficit or surplus in particular countries or regions, and granting credits to adversely hit nations in episodes of financial distress. In this essay we review the current situation of the international monetary system and explore some proposals to reform it.

2. Reserve Accumulation as Insurance Against Shocks

The world has witnessed a significant increase in the demand for official international reserves in recent years. The growing trade and financial integration provides many benefits to countries, but also makes them more exposed to external shocks. This is reflected on macroeconomic volatility, measured below as the standard deviation of GDP growth, which has increased significantly in developed and emerging economies over the last three decades, as shown in Figure 1.

* Essay prepared for the first meeting of the International Monetary Advisory Group of the Asian Development Bank, held in New York at the University of Columbia, September 16-17, 2009. I am grateful to Sebastian Claro, Jeffrey Sachs and Rodrigo Vergara for useful comments, and Juan Bravo for helpful assistance.

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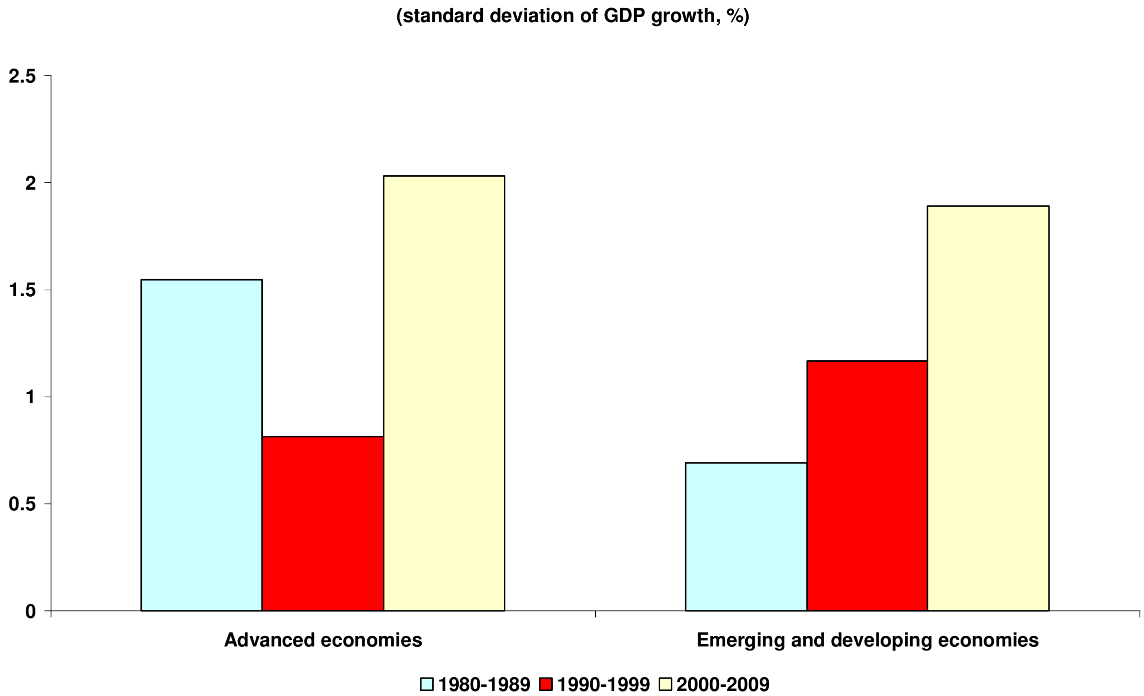
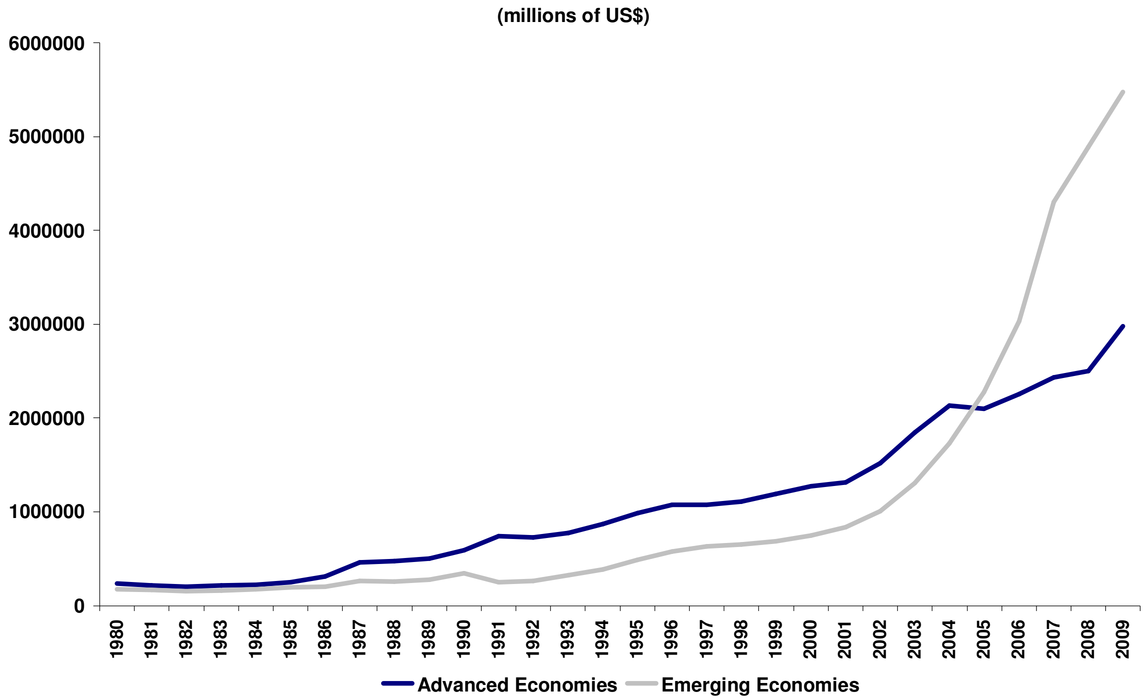
Figure 1



Source: IMF

Higher macroeconomic volatility, and the terms of trade improvements experienced by emerging economies in recent years have led to an explosion of international reserve accumulation. During the current decade and for first time in history, emerging economies hold more international reserves than advanced economies, as can be seen in Figure 2. The People's Republic of China (PRC) has played a key role in this change, with nearly US$2.5 trillion in international reserves in 2009. By itself, PRC holds some 30% of total world reserves or almost 80% of the international reserves held by the advanced economies.

Figure 2



Source: IMF

Thus, international reserve accumulation is a natural consequence of the will of countries to insure themselves against shocks, in an environment of vastly increasing volatility. (Another, complementary reason for reserve accumulation is the fact that countries may regard the terms of trade improvement as transitory, thereby saving a large part of the windfall). Indeed, Obstfeld et al (2009) have shown that countries with large reserves (as a proportion of M2) did not suffer significant currency depreciations during internationally unstable periods (and even some appreciated). Reserves, thus, have been a useful buffer.

To insure against shocks, however, an alternative is the existence of an adequate international lender of last resort (ILLR). It may be argued that the ILLR is a more efficient way of insurance, but not any ILLR will do. In principle, two conditions must be met: (i) that the ILLR makes available a credit line of sufficient size; (ii) that drawing on this credit line has no conditionality or only has ex ante conditionality for countries to qualify for it, but once a country qualifies, funds are made automatically available.

A prime candidate to organize such line is the IMF, though other international institutions may also do it, probably as complements to a main ILLR. However, this will require increased funding for existing international financial institutions. Also, the current system has been improved through swap agreements among central banks, as done by the FED, the People's Bank of China, the BoJ and the ECB during the recent crisis to help stabilize global financial markets and ease liquidity. These swap arrangements have added up to about US$1 trillion, and have no doubt helped, but they suffer from several shortcomings: (a) they benefit a few countries which are politically or economically close to the country/region whose central bank provides the swap; (b) they are limited in size. In fact, empirical evidence shows that large central banks tend to extend swap facilities only to those countries with which they have strong financial and trade linkages; thus, for a majority of developing countries, swap lines cannot substitute for reserve accumulation (Aizenman et al., 2010).

Some authors (Calvo, 2002, 2008) have proposed the creation of an Emerging Market Fund, to avoid the spread of the crisis to other emerging economies, though I am skeptical that such a fund may work.

Table 1

(billion of US$, swap arrangements since December 2007 to March 2010)

FED	People's Bank of China	European Central Bank	Bank of Japan
Australia 30	Argentina 70	Denmark 15	PRC 3
Brazil 30	Belarus 20	Hungary 5	Indonesia 12
Canada 30	Hong Kong, China 200	Iceland 1.5	Malaysia 3.5
Denmark 15	Indonesia 100	Poland 10	Philippines 6
ECB 240	Malaysia 80		Singapore 3
Japan 120	Rep. of Korea 180		Rep. of Korea 20
Mexico 30			Thailand 6
Norway 15	Total CNY 650	Total EUR 31.5	
New Zealand 15			
Singapore 30			
Rep. of Korea 30			
Sweden 30			
Switzerland 60			
United Kingdom 80			
Total 755	**TOTAL 95.2**	**TOTAL 39.5**	**TOTAL 53.5**
TOTAL SWAP ARRANGEMENTS 943.2			

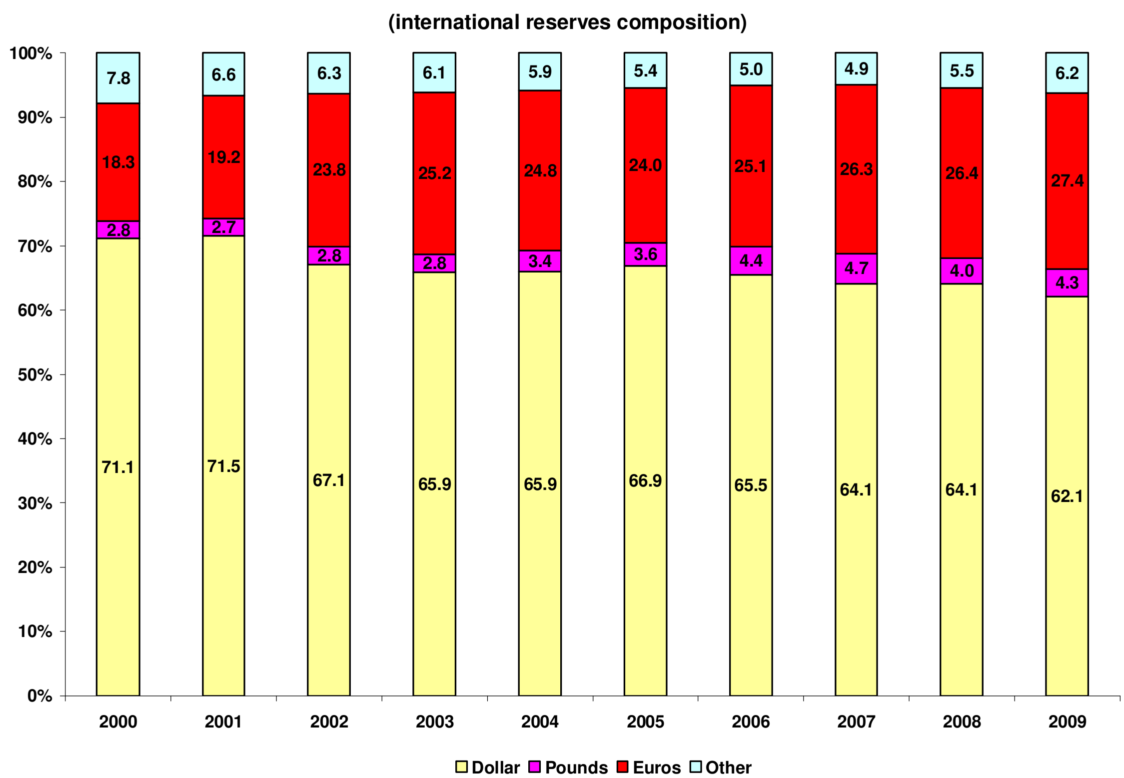
Source: Central banks and Aizenman, J. et al (2010)

The key part of the trick is to make an ILLR credit line as close a substitute to reserves as possible. Currently, there is no line that provides automatic credits for countries in large enough sums; funds are not readily available and require conditionality. Of course, the other problem with the lender of last resort is the moral hazard issue, as such a facility could stimulate countries to excessive risk-taking. Therefore, unless drawing from this international lender of last resort is truly expeditious, automatic on the fulfillment of ex ante objective criteria, it will be less than a perfect substitute for reserve accumulation.

3. Large U.S. and Global Imbalances: a Threat to the Current, US dollar centered International Monetary System

The current international monetary system is under strong tension. About 62% of world international reserves were in dollars in 2009 (see Figure 3), but the United States (US) represents only 20% of world GDP (measured at PPP in 2009) and there are huge global imbalances. In 2009 the US had a current account deficit of US$420 billion, although several European economies have significant deficits, too. As the world as a whole is a closed economy, so others have a large current account surplus, such as the PRC, oil exporting countries of the Middle East, Germany, Japan and Russia.

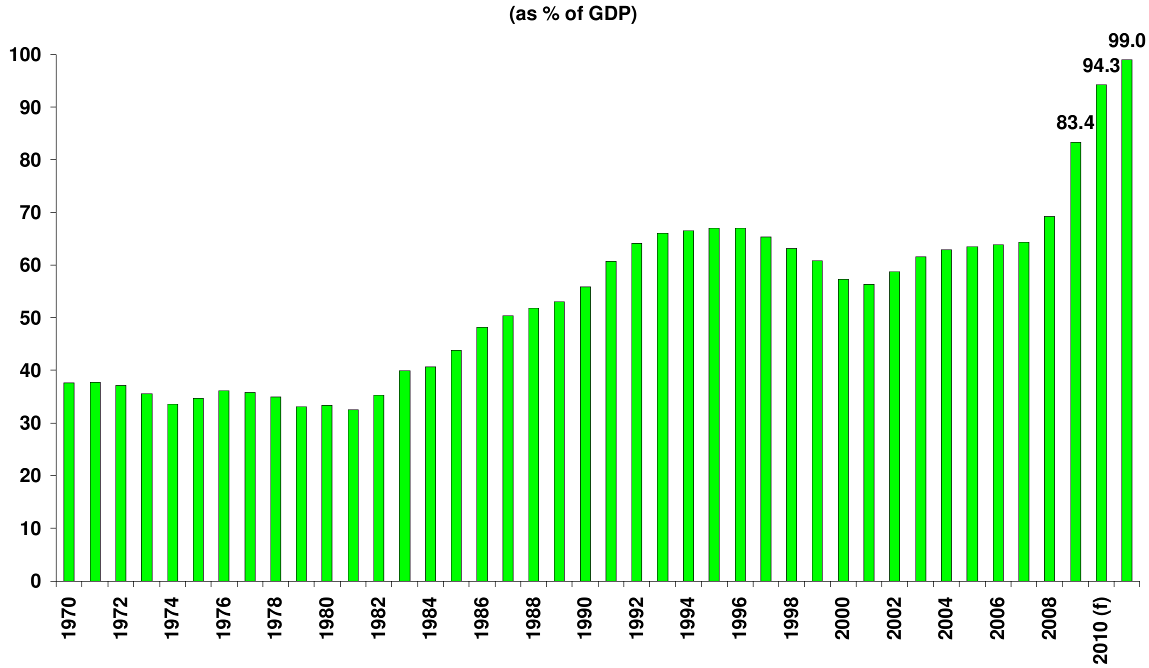
Figure 3



Source: IMF

In this scenario, the probability that the dollar loses its current dominant role in the international monetary system has increased because of several concerns in the current macroeconomic environment. With the outbreak of the recession and the stimulus policies, the US monetary base more than doubled in 2009, and the fiscal deficit reached 9.9% of GDP that same year and could reach - according to the latest forecast of the Congressional Budget Office 9.2% of GDP in 2010. This will contribute to further increase the already high U.S. public debt (see Figure 4), which topped 83% of GDP in 2009 and is likely to increase to 94% of GDP in 2010 and almost 100% of GDP in 2011, according to the Office of Management and Budget.

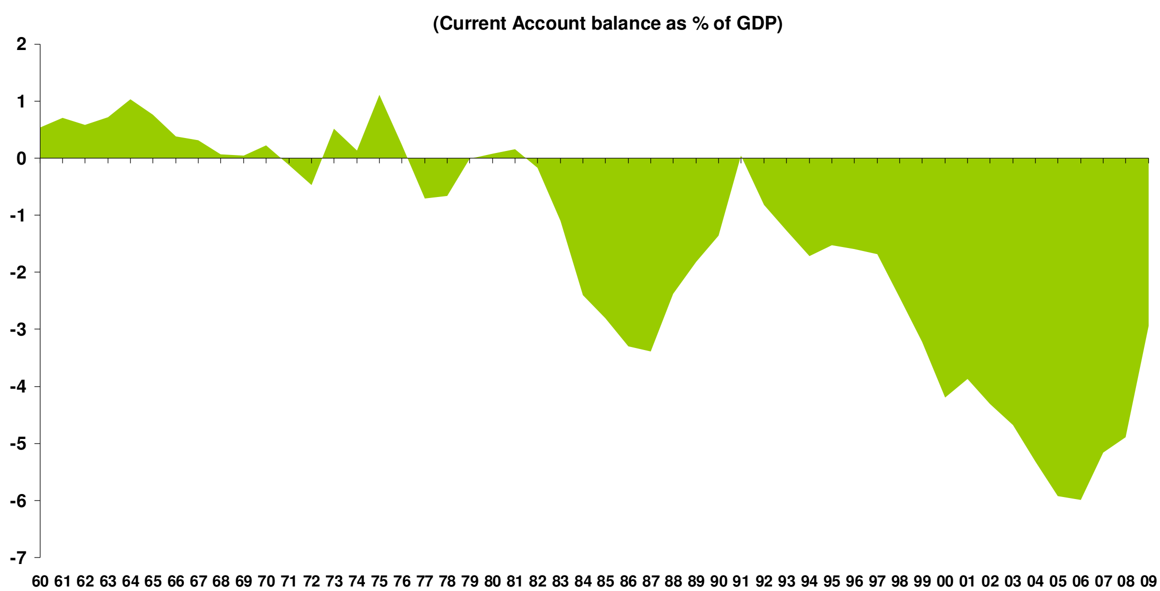
Figure 4



Source: Office of Management and Budget

On the other hand, though the current account deficit has moderated from its peak of 6% of GDP in 2006, it still reached 2.9% in 2009 (see Figure 5).

Figure 5



Source: Bureau of Economic Analysis

Eliminating global imbalances require two mechanisms: growth rebalancing and exchange rate realignments. The empirical evidence indicates that growth rebalancing cannot do the job by itself, and needs significant currency realignment (see, for example, Edwards, 2007).

Thus, the dollar centered system is under siege. The dollar is likely to reduce its current share of the market as an international reserve over the medium term. It is difficult, however, to gauge the speed of this process.

4. Alternatives to the current system

There are basically 2 alternatives to the current, U.S. dollar centered system:

1. Increased competition from other currencies, including, in the limit, replacement of the dollar by another national currency. The growing competition among national currencies as international reserve has increased in recent years. In 2000, more than 70% of international reserves were held in dollars, but that proportion has fallen every year, reaching 62% in 2009, as Figure 3 shows. The euro has gained from the reduction of dollar holdings, with euro assets going from a little over 18% of world reserves in 2000 to more than 27% in 2009. Nonetheless, the recent problems in the Euro area have posed strong doubts about the potential of the Euro to pose additional competition to the U.S. dollar as an international reserve currency. Other currencies like the yuan, the Australian and New Zealand dollars, and other strong emerging market economies could play a larger role in the future, but only gradually and starting from a very low base.

On the other hand, another national reserve currency will have similar problems to the dollar, i.e. conflicting objectives between monetary policy at the service of the national economy and of the international monetary system; under any national reserve currency, a national authority will privilege the local effect of its monetary policy over what is best for the international monetary system. Moreover, increased demand for reserve currency can generate inflationary bias under this system.

2. A supranational currency. The IMF's Special Drawing Rights (SDRs) have the potential to act as a supranational reserve currency. The main advantage of a supranational currency is that it is uncontaminated by a country's local policies. However, in order to implement the SDR (or other alternative) as a global reserve currency, several issues should be considered before. The scope of use of the SDR is very limited at the present, and hence, it is necessary to expand and promote its use through financial instruments, and commodity pricing, among other mechanisms. On the other hand, it would be desirable to enlarge the basket of currencies used to determine the value of the SDR, particularly with commodity currencies, such as the Australian and New Zealand dollars, the Norwegian krone, or the Chilean peso[2]. Furthermore, it is necessary to find ways to discipline both deficit and surplus countries; a "tax" on chronic surpluses, for example, has been proposed by Greenwald and Stiglitz (2006).

The alternative of replacing the dollar by another national currency suffers from 2 important shortcomings: a) it does not solve the conflict of interest between domestic

[2] In the speech of March 2009 Zhou Xiaochuan proposed that the basket of currencies forming the basis for SDR valuation should be expanded to include currencies of all major economies, and suggested the GDP to be included as a weight.

monetary policy goals and the provision of a world reserve currency; and (b) the main rivals for the dollar have still a long way to go to displace it as international reserve currency.

The euro has usually been considered the main candidate to compete with the dollar., like the US, the Euro Zone has strong institutions, respect for property rights, and sound macroeconomic policies relative to the rest of the world (Eichengreen, 2005). On the other hand, the Eurozone and the U.S. are economies of roughly the same size. Nonetheless, the European Union is expanding at a faster pace than the dollar area. Consider only the enlargement of the EU over the last decade, compared to only 2 quite small countries dollarizing in the same period (Ecuador and El Salvador). If all 11 EU members who are not currently in the European Monetary Union (EMU) join it over the next decade, the EMU area will become considerably larger that the dollar area. This is a point in favor of Euro expansion. A key point, however, is whether the UK also joins, as it will bring in not only economic size but also deep financial markets (Chinn and Frankel, 2008), though this seems unlikely. According to Galati and Wooldridge (2009) the euro financial markets are becoming as liquid as those of dollar markets. But the debt problem in several countries of the Euro Area has endangered the existence of the common currency because the fiscal problems are deep and Europe is divided on how to support highly indebted countries.

The yen is probably a lesser rival because Japan is a much smaller country and has a serious demographic problem. On the other hand, the PRC has financial markets that lack depth, a non convertible currency, and its institutional infrastructure is still shallow. Consequently, the yuan is only a long term option.

The second alternative, with SDR as the global currency reserve is a significant potential competitor to the dollar. The idea of a supranational currency is not new. Keynes formulated the Bancor Plan in 1942 with the purpose of improving the financial stability of the world. Keynes proposed the creation of an International Clearing Union, based on international bank money (the bancor), to be accepted as the equivalent of gold by all members of the Union with the purpose of settling international balances. The Bancor Plan provided mechanisms to avoid excessive current account deficit or surplus. This plan is the base for the current proposals for the SDR as a supranational currency. However, the main limitation for the SDR is its very limited use in trade and financial transactions. It seems hard for the SDR to displace the dollar, though it is likely to provide increased competition.

5. Role of the IMF

The IMF is the international institution best suited to have a larger role on the international monetary system. The origin of the IMF is the Bretton Woods Agreement of 1944 to international economic cooperation and came into formal existence in 1945 based on multilateral principles, in contrast to the rising unilateralism and barriers to trade applied in the world after the Great Depression. The mandate for the IMF is basically to promote international monetary cooperation, facilitate the expansion and balanced growth of international trade, promote exchange rate stability, and assist in the establishment of a multilateral system of payments[3].

[3] The purposes of the IMF are available in http://www.imf.org/external/pubs/ft/aa/aa01.htm

The IMF has today 186 member countries and hence, country representation is a very important issue to consider. Each country is allocated a quota based approximately on its relative size in the world economy. When a country joins the IMF, it is assigned an initial quota in the same range as the quotas of existing members that are comparable in economic size and characteristics. The IMF uses a quota formula to guide the assessment of a member's relative position. Quotas are denominated in SDRs. The largest member of the IMF is the US, and the smallest member is Palau. The quota determines a country's financial contribution to the IMF, its voting power, and ability to access IMF financing. Each IMF member has 250 basic votes plus one additional vote for each SDR 100,000 of quota. Thus, the US has 371,743 votes (16.77 percent of the total), and Palau has 281 votes (0.01 percent) [4].

The IMF will have a different role according to which system emerges. It will have the largest role with an SDR based system and less prominence in a national currency system, mainly as an expanded lender of last resort.

A more useful IMF needs a stronger role as a lender of last resort. Thus, the increase in SDR allocation of 250 billion in August 2009 (and the special allocation of about SDR 33 billion in September 2009[5] is a step in the direction of both expanded use of SDRs and of a stepped up LLR role. Nonetheless, only 40% of the total (100 billion) is allocated to developing countries; thus, for example, a country such as the Republic of Korea (Korea) is allocated only about 3.5 billion. This allocation is available to all members, but it is very limited in size relative to international reserves. The PRC may be an extreme example, but its SDR allocation is less that 0.5% of the country´s international reserves; for Brazil and Russia, it is less than 2% of reserves.

The flexible credit line (FCL) introduced by the IMF in March 2009 seems a more promising route. This is a truly contingent credit line that requires country prequalification, but not conditionality; thus, when a country prequalifies, drawing from it is completely automatic. The FCL may be opened for 6 months to 1 year, and requires a commitment fee of 25 bps for 500% to 1,000% of quota; its repayment period is 3 and a half to 5 years. A few countries have prequalified for the FCL, including Mexico with 45 billion, Poland with 21 billion, and Colombia with 11 billion.

Not any country can have access to the FCL, but the resources that can be drawn for those who can are relatively large in size. The moral hazard problem of this credit line is partly resolved with the prequalification process based on economic criteria. Nonetheless, the FCL is still a relatively far substitute for international reserves because of the prequalification process, the limited period that the line is available, and the still limited amount of funds that can be drawn from it. An FCL with an expanded period of prequalification, maybe permanent qualification for the line with periodic evaluations based on strictly economic criteria, looks more attractive. Premia can also be made variable so that the acceptance/rejection for the FCL is not so extreme, thus making it available to more countries. A recharged FCL along these lines will make progress in solving the

[4] More information about the IMF's quotas system in http://www.imf.org/external/np/exr/facts/quotas.htm

[5] The special allocation was designed to enable the allocation of SDRs on a more equitable basis and correct for the fact that countries that joined the Fund after 1981—more than one-fifth of the current IMF membership—had never received an SDR allocation.

needs of countries at times of crises and deepening the LLR role of the IMF, though it will still be far from a perfect substitute to national reserves.

Going further, for the SDR to provide a bigger challenge to the U.S. dollar, some fundamental changes in financial architecture may be needed. The SDR may be delinked from other currencies and issued by an international institution acting as a world central bank (Lipsky, 2009), then it becomes a full international currency; but these SDRs would be very different from those we know today. And the issuing institution may be the IMF only with a significantly transformed status.

In any case, a more central IMF role requires changes in IMF governance. A necessary reform is the voting system. There are two possible types of voting: one, according to quotas in the IMF (the current functioning system); the other is one country, one vote. Emerging economies are increasingly important in the global economy, and therefore, should have a bigger role than currently in the decision making process. A two-vote majority (one based on the current quotas, the other per country) is a possible scheme for some issues. A change in the quota allocation is now in the cards, with emerging markets increasing significantly their weight.

6. Conclusion

In the most likely scenario the US dollar will remain as the main reserve currency in the foreseeable future, but will face growing competition over the medium term from other national currencies, such as the euro, the BRIC currencies, the yuan, etc., and a supranational currency such as the SDR. Therefore, the dollar will probably lose weight in time as a share of international reserves. However, this process is likely to be slow and gradual, particularly due to lingering doubts about the future of the euro following fiscal problems in several countries of the Euro area.

The SDR is likely to gradually win greater importance as a reserve currency if it can play a larger role in trade and financial transactions in the global economy, and if it can substantially increase its liquidity and use as an ILLR currency. The increase in 2009 of the SDR allocations and the flexible credit line go in that direction.

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