

Fabrizio Saccomanni: The global crisis and the future of the international monetary system

Speech by Mr Fabrizio Saccomanni, Director General of the Bank of Italy, at the Chinese Academy of Social Sciences, Beijing, 15 April 2010.

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The global crisis that hit the world economy since August 2007 has revived the long dormant debate about the adequacy of the institutional arrangements required to ensure stability in international economic and financial relationships on a global scale.

The financial roots of the crisis have been widely analysed. Here, I intend to focus more on the macroeconomic drivers. I will try to argue that they are ultimately connected to a number of long-standing features of the international monetary system such as it has evolved since the demise of the Bretton Woods regime. I will then review the main options available to reform the international monetary and financial system.

1. The global crisis and its macroeconomic roots

There is now a broad consensus that, even though the global crisis was triggered by dysfunctions in the financial system, unbalanced global macroeconomic conditions contributed to the accumulation of large financial vulnerabilities (Visco, 2009 and 2010).

The proximate cause of the crisis was the US housing boom, financed by an unprecedented expansion of mortgage lending. Regulators' failure to correct the incentive distortions introduced by financial innovation can largely explain the deterioration of lending standards, the widespread use of opaque financial instruments and the excessive risk-taking on the part of many international banks. Excessively easy monetary conditions contributed to encourage the rapid growth in mortgage borrowing and fed the rise in house prices.

An easy monetary policy in the US and Japan – and, to a lesser extent, in the euro area – translated into a loose global monetary stance. Very low interest rates in main financial centers encouraged capital flows to economies with higher interest rates, which were induced to ease policy in turn, in order to avoid an excessive currency appreciation. Countries that pegged their exchange rate to the dollar effectively adopted the US monetary policy stance, and absorbed capital inflows by accumulating large official reserves.

The investment of official reserves in US Treasury securities financed the growing US current account deficit and, at the same time, contributed to keep Treasury bond yields low. Investors turned increasingly toward riskier assets in their “search for yield”, leading to a compression of risk premia on a broad range of financial assets, from equities to corporate and sovereign bonds, thereby boosting asset valuations. National housing price cycles, usually mainly driven by country-specific factors, became highly synchronized globally.

For several years this financial market exuberance went hand-in-hand with sustained global growth and price stability, thus feeding the illusion that the conduct of economic and especially monetary policy could reduce underlying risks, and that whatever risk was left could be easily diversified or shifted to those in a better position to bear it by efficient and sophisticated financial markets. The “speed limit” for the global economy appeared for a while to have been permanently raised, as the entry of China and other emerging economies in the global trading system effectively increased the world's labour supply. At some point, however, bottlenecks emerged in commodity markets and global inflation picked up sharply. As monetary policy was tightened and housing markets peaked, also the degree of risk diversification turned out to be more limited and the risk management practices of financial intermediaries much less sound than it had been previously assumed.

As the initial turmoil evolved into a fully-fledged crisis, the sharp fall in consumer and investor confidence translated into a dramatic and simultaneous contraction of demand, output and international trade, not only in advanced but also in emerging economies, which had hitherto been largely immune from the crisis' fallout. The severity and the highly synchronized character of the world recession can only be fully understood by considering that the financial crisis had hit what had been until then the keystone of global economic growth, i.e. the ability of US consumers to continue borrowing and spending. Without that "consumer of last resort", the whole edifice crumbled.

2. Flaws in existing international monetary arrangements

There is a close connection between the macroeconomic imbalances that paved the way to the global crisis and some key features of existing international monetary arrangements.

The Bretton Woods regime of adjustable exchange rate pegs collapsed in 1971–73 under the combined pressure of increased capital mobility and conflicting policy objectives among the largest economies. It has since been replaced by a "non system", which is simply the result of individual countries' choices among a broad menu of exchange rate regimes, ranging from monetary unions and hard pegs to freely floating rates. Market pressure resulted in the gradual removal of capital controls, first in industrialised countries and then, from the 1990s, in emerging ones, paving the way to global financial integration. At the same time, increasing trade integration continued to provide a strong motive for countries to try to avoid excessive exchange rate fluctuations, since large and persistent exchange rate movements are difficult to hedge against and discourage the establishment of trade relationships that require substantial long-term investment.

Thus, contrary to predictions that increased capital mobility would lead to a polarization of exchange regimes around the extremes of either "hard pegs" or flexible exchange rates, many countries still adopt intermediate regimes, including various types of crawling pegs or managed floating. Individual countries' exchange rate preferences can reflect a variety of structural factors and policy objectives. The result of these individual choices is a situation where a large number of countries *de facto* peg to the US dollar or actively manage their bilateral exchange rates with it; a smaller number of countries peg to the euro or to a basket; and several countries (mostly industrialized ones) allow exchange rates to float.

This non-system lacks a mechanism capable of ensuring the global consistency of national objectives. The consequence has been a recurrent systemic instability (see Saccomanni, 2008):

- since the 1970s ***exchange rates among the major currencies have experienced very large fluctuations*** with serious consequences for the real economy. Periods of US dollar overvaluation have entailed the demise of important US manufacturing sectors and have been accompanied by strong protectionist pressures; on the other hand, when the dollar was weak, upward pressures on the yen and on European currencies destabilized the respective economies and greatly complicated the conduct of policies. For example, in Japan in the late 1980s the easy monetary stance to counter the yen's appreciation allowed a huge speculative bubble to develop; the subsequent phase of yen appreciation in the early to mid-1990 exacerbated the economy's slide into stagnation.
- the last thirty years have seen ***repeated episodes of currency and financial crises in emerging economies*** (the Latin America debt crisis of the early 1980s; Mexico in 1994; South-East Asia in 1997; Russia in 1998; Argentina in 2002). Although the proximate cause of each crisis could be identified in specific policy errors and structural/political weaknesses of the countries in question, a clear pattern recurs through all of them: a protracted underestimation of risks on the part of lenders, followed by an abrupt change in perceptions and a "sudden stop" in

capital flows. The excesses of market optimism were usually connected to easy global monetary conditions, and the trigger of the crisis was often a monetary tightening in the United States.

- the past 10–15 years have seen a sharp **widening of current account imbalances**. The US deficit widened from 1.7 per cent of GDP in 1997 to 6 per cent in 2006 with, as a counterpart, growing surpluses in Japan, China and the oil exporting countries. The external imbalances largely reflected unbalanced domestic conditions: a sequence of asset price bubbles in the United States (the dot-com bubble in the late 1990s, the housing bubble after 2000); a sharp rise in saving and fall in investment in several Asian economies in reaction to the crisis of 1997; an extremely high saving propensity in China. A widely shared concern has been that current account imbalances could be at some point be regarded by the markets as unsustainable, triggering a sharp reversals of capital flows with destabilising consequences for the exchange rates of major currencies.

Underlying these manifestations of global instability are some fundamental weaknesses of the existing international monetary arrangements.

First, a well-functioning international monetary system must impose some form of **discipline on national economic policies**. In its original conception the Bretton Woods system assumed that the discipline would be based on a set of rules enforced collectively through the International Monetary Fund. Now the enforcement of discipline is entirely left to the markets and this poses several problems. First of all, its enforcement is far from uniform and symmetric: unsustainable current account surpluses are not sanctioned in the same way as deficits, and the country issuing the dominant reserve currency is largely immune, since it can finance deficits in its own currency as long as other countries are willing to accumulate reserves. Moreover, financial markets do not always sanction unsustainable policies consistently, because their perceptions of fundamentals can vary over time and are often overshadowed by other drivers of capital flows. After long phases of disregard for mounting risks, markets often react “too much – too late”, resulting in sharp “boom and bust” cycles. Thus, market reactions often encouraged authorities to act in highly pro-cyclical ways.

Secondly, the international monetary system, like a domestic monetary regime, needs to provide **a global anchor** to stabilize inflation expectations, by ensuring that the monetary stance is appropriate on a global scale. The anchor, in earlier times provided by a link to gold, is now in practice dependent on the monetary policy frameworks of the major economies. However, even when these countries adopt a sound monetary stance, this does not automatically ensure an appropriate stance at a global level, since policies conducted with a narrow national focus may overlook global sources of inflationary pressures: the recent commodity price boom, driven by buoyant global demand, is a case in point. Moreover, countries that peg their currencies to the dollar (or otherwise shadow US monetary policy) effectively adopt the US policy stance. When many countries do this, the US monetary stance effectively becomes the prevailing stance in a large part of the world. This can lead to global monetary conditions that are either too easy or too tight for the world economy.

A third important feature of the international monetary system is how it influences the **demand for official reserves** and how that demand is met. The global demand for reserves has increased enormously over the past 10–15 years: foreign exchange reserves rose from about 1.4 trillion US dollars in 1995 to 7.5 trillion in 2009. An important motive for reserve holding has been precautionary: official reserves allow authorities to offset capital outflows in the event of “sudden stops”, avoiding exchange rate depreciations or the need to seek conditional financing. Reserve accumulation could also be the by-product of an export-led growth strategy, as in the case of China. The accumulation of reserves by individual countries can, however, involve some important negative externalities for the global economy, as well as for the countries themselves. In order to accumulate reserves countries

need either to run current account surpluses or to attract (and then usually sterilize) substantial capital inflows. To this end, they will compress domestic demand by implementing tight monetary and/or fiscal policies which may result, in the aggregate, in a deflationary bias on the world economy.

In summary, the present arrangement is not able to enforce an effective discipline on national economic policies in a reliable, timely and symmetric way; it cannot ensure that the global monetary policy stance is appropriate to global conditions; and by encouraging countries to accumulate huge official reserves, which finance the current account deficits of the reserve currency country, it tends to feed large and persistent global imbalances.

3. The options for reform

In reviewing the potential alternatives to the present “non-system”, a first necessary step is to clear the ground from seemingly “simple” and “automatic” solutions. A return to a regime of fixed exchange rates or a move to full and universal exchange rate flexibility are the two polar cases most frequently considered. I would argue that neither is feasible or desirable.¹

3.1 Exchange rate-based reform options

A system of rigidly fixed exchange rates would be impractical (unless there was a political willingness to establish a single world currency) and would not be viable without a return to generalised restrictions on capital mobility. Capital controls would need to be very pervasive to have any effectiveness, implying prohibitive costs and setting back financial development by several decades.

The option of free floating has in theory a number of advantages: *i)* it would not require to accumulate reserves to stabilize the exchange rate; *ii)* it would preserve monetary policy autonomy; *iii)* it would protect each country from external monetary shocks; *iv)* markets would enforce an effective and symmetrical discipline on national policies across all countries; *v)* it would avoid imbalances and instability as long as each country maintained its own house in order.

The real world is, however, far from the idealized representation of the theory. When the hypotheses of perfectly flexible prices and costless adjustment are abandoned, and we consider the actual working of the financial system in a world of imperfect information and incomplete markets, the presumption that exchange rates will smoothly adjust to reflect changes in fundamentals soon appears unrealistic. In practice, changing market perceptions may make exchange rates volatile and lead them to diverge from fundamentals, especially where markets are thin and uncertainty high, as it is often the case in emerging economies. This experience explains why so many countries have displayed in practice a strong “fear of floating”.

If we exclude the two “pure” exchange rate regimes, the only option available is that of a “managed” system based on international cooperation. However, it would be misleading to suppose that the starting point of any reform must be the choice of the exchange rate regime. There are other important features that deeply affect the functioning of the international monetary system: the role and effectiveness of international institutions; the multilateral surveillance process; the available mechanisms for creating international reserves; international trade rules and the mechanism for resolving trade disputes; and the regulatory framework for international financial markets. Not surprisingly, much of the recent discussion in the G20 on how to improve the functioning of the system has centered on these issues.

¹ For a detailed review of these issues, see Padoa Schioppa (2010).

3.2 Towards an SDR-based international monetary system?

Before turning to the G20 strategy, I would like to review a proposal by Zhou Xiaochuan, the Governor of the People's Bank of China (Zhou, 2009). After identifying a fundamental problem of the present international monetary system as stemming from the fact that a national currency is used as the main international reserve asset, Governor Zhou suggested that one of the goals of its reform should be creating “an international reserve currency that is disconnected from individual nations and is able to remain stable in the long run”. Indeed, “a super-sovereign reserve currency managed by a global institution could be used to both create and control global liquidity”. More specifically, he argued that the SDR, issued by the IMF, has the potential to become such a super-sovereign currency and that its role should be more actively promoted in the future, both through further increases in SDR allocations and by enhancing its use in international trade and in financial transactions.

A proposal to increase SDR allocations has already been approved last year by IMF member governments; the new large SDR allocation, the first after many years, has effectively multiplied by a factor of 10 the outstanding amount of SDRs. Nevertheless, even after the latest increase, SDRs still represent less than 5 per cent of global foreign exchange reserves.

The proposal that the IMF and the international community should actively promote the use of the SDR in trade and financial transactions is equally stimulating, and has been echoed by several academics and policy-makers.² At present, the SDR can be regarded as an international currency only in a limited sense of the term, because it is a basket of currencies, is not issued by a central bank, and its use is restricted to “authorised” institutions of the official sector. Countries cannot use SDRs directly to intervene in the exchange market, but need first to convert them into a “true” currency. In any case the possibility to use SDRs directly in interventions would require, first of all, the existence of a private SDR market. This, however, has never taken off in practice, even though no technical obstacles to it would seem to exist.

In this regard, it is interesting to contrast the case of the SDR with that of the ECU, the basket of currencies introduced in 1979 in the context of the European Monetary System which eventually merged into the euro. While the use of ECU, much like the SDR, was restricted to transactions among official holders, during the 1980s and 1990s a large *private* market of ECU-denominated financial instruments developed. Substantial amounts of ECU-denominated bonds were issued and an interbank market in ECU deposits developed, supported by an agreement among a group of private banks to establish an ECU clearing arrangement, as well as markets in a wide array of ECU derivative instruments. In this context European central banks acquired reserves in private ECUs, which could be used to carry out interventions directly in ECU. The rapid growth of a private ECU market benefited from the support of Community institutions and some national official institutions (including the Bank of England), which issued debt denominated in ECU, thus providing the critical mass that helped the market to take off. Moreover, EU institutions assured legal certainty of the definition of the ECU basket and its continuity.

As in the case of the ECU, instruments denominated in a basket – like the SDR – that included all the major currencies would represent a natural hedge for companies whose business is global. Once a liquid market for SDR instruments existed, it should be attractive for such companies to manage the bulk of their financial operations in SDRs rather than in the individual currencies. The crucial difficulty, however, is reaching the critical mass that would allow the development of a deep, diversified and liquid market, where transaction

² See for example Williamson (2009), Kenen (2010) and Padoa-Schioppa (2010). For a discussion of the issue of reforming the international monetary system, see Greenwald and Stiglitz (2008), Bergsten (2009), Eichengreen (2009), Cooper (2009), Mateos y Lago et al. (2009).

costs would be sufficiently low that the natural advantages of the SDR can emerge. Given the inertia that comes with network externalities and economies of scale and of scope, reaching such a critical mass would be virtually impossible unless public policy plays an active role. The type of actions that were used to foster the development of the ECU market could be a starting point.³ Over time, the SDR could become widely used in trade transactions. Producers of internationally traded commodities may want to set prices in a unit that is a much better proxy than the dollar of the composition of their imports. This, in turn, would encourage trade invoicing in SDR, creating a further inducement for countries to hold reserves in SDR. It is likely that for the SDR, incentives to its use as a unit of account, means of payment and store of value would be mutually reinforcing.

Enhancing the role of the SDR may require, at some point, revising the composition of the SDR basket in order to make it more representative of the world's main economic regions. Two elements should, however, be kept in mind: first, for operational reasons, it would be preferable to continue to restrict the basket to a limited number of major currencies; second, all the component currencies should be fully convertible and have well developed financial markets with full capital mobility, since by allowing arbitrage to keep the valuation of SDR-based instruments in line with that of instruments in the component currencies, this would facilitate both their development and their acceptance. This implies that the inclusion of the Chinese renminbi in the SDR basket, highly desirable on economic grounds, may nonetheless need to be postponed until sufficiently developed and open renminbi financial markets exist.

It is important now to ask in which ways an enhanced role of the SDR could contribute to address the fundamental flaws of the existing international monetary system. This is a complex question and I have only some tentative answers. First, once the SDR becomes a true reserve asset, there would be an incentive for countries with a broadly diversified set of trading partners to manage their currencies with reference to the SDR, while those that are closely integrated with one particular region could continue to maintain a link to a regional currency (the dollar, the euro and, in the future, the renminbi). Countries that peg or manage exchange rates vis-à-vis the SDR would presumably choose to accumulate reserves in SDRs rather than in US dollars. Second, regular IMF allocations of SDRs, and the fact that these would be regarded as “true” reserves, would help diminish the pressure for countries to try to accumulate other currencies by maintaining undervalued exchange rates and sterilizing capital inflows, which in the recent past has been a driving factor behind the widening of global imbalances.

I think these effects would be important contributions to a more balanced and stable system, although they would be felt only gradually as the SDR increases its role. Still, two important issues would remain unresolved. First, exchange rates among the major currencies may continue to undergo wide fluctuations, even though these may have less destabilising effects on third currencies to the extent that many of these would be linked to the SDR. Second, since the SDR would remain a currency basket without its own central bank, the “global monetary stance” would continue to be a “weighted average” of the stances of the major economies. Although IMF decisions on SDR allocations and cancellations could potentially influence the stance, the complex and politically-charged decision making process on SDR allocations may not be suitable for conducting an efficient monetary policy on a global scale.

³ For example, national governments and multilateral institutions could start issuing SDR-denominated debt on a regular basis. Once a sufficient volume of debt instruments at different maturities exists, the market itself can be expected to develop derivative instruments based on them. Moreover, it should not be too difficult for international institutions, working with private banks, to foster the establishment of a clearing arrangement for private SDR deposits. Ways could also be found to connect the private and the official SDR market (something that did not exist in the case of the ECU), either by easing the legal restrictions on the use of official SDRs or through an institution acting as a clearinghouse.

In order to facilitate the transition to an SDR-based system, it may in any case be necessary to set up at the IMF SDR-denominated reserve accounts where members could deposit their currency reserves and obtain in exchange SDR deposits, as suggested by Governor Zhou. This closely resembles the idea of a “Substitution account”, which has a long history in international monetary reform negotiations in which I was personally involved (Micossi and Saccomanni, 1981). In the broader context of Governor Zhou’s proposal, this could be seen as a way of smoothing the transition to an SDR-based system, avoiding the uncertainty and potential currency instability associated to the shift in the composition of global reserves (Kenen, 2010).

The rationale for establishing a “Substitution account” is twofold. First, it would allow countries to rebalance their reserve composition through off-market transactions, thus avoiding undesirable exchange rate effects of the liquidation of large amounts of dollar reserves. Second, it would also be possible to share or shift the exchange rate risk from the original holders of dollar reserves to other parties. This second result, however, would depend on the specific technical arrangements.⁴

Clearly, the financial implications of the alternative risk-sharing arrangements would be very different, and would depend crucially on how exchange rates are expected to move after the reserve transfer. The negotiation of any arrangement of this kind should therefore presumably be part of a more general agreement on a reform of the international monetary system. To the extent that such a reform would remove the underlying structural roots of the dollar’s weakness, it could also help make the exchange rate risk more acceptable (see Williamson 2009; Kenen 2010).

4. The G20 reform process

A crucial test of the commitment of policy-makers in the major countries to address the weaknesses of the existing global monetary and financial system and to set the global economy on a sustainable growth path will be the outcome of the ongoing efforts to rebalance global demand through enhanced policy coordination. This effort is currently centered around the so-called “Framework for Strong, Sustainable and Balanced Growth” launched by the G20 last year in Pittsburgh (Saccomanni, 2010). It envisages the identification by each G20 country of detailed policy measures aimed at achieving the agreed common objectives, with a mutual assessment process, assisted by the IMF, where the adequacy, consistency and effective implementation of those measures will have to be evaluated.

The choice of the G20 as the leading forum for cooperation was dictated by the need to strengthen the legitimacy of the process, recognising that a global readjustment could not be treated as a bilateral affair between a few major countries – no matter how big – or that it could be left to the interplay of foreign exchange markets. Every effort must be made to ensure that the G20 process is successful. A failure would have serious implications for the growth prospects of the world economy and might set in motion renewed tensions in the global financial system and in exchange rate relationships.

Europe is deeply committed to play its role in the adjustment process. Although individual countries within the euro area have non-negligible surpluses or deficits, the area as a whole runs an approximate balance and it has been able to absorb the impact of a dollar depreciation of 45 percent vis-à-vis the euro between early 2002 and mid-2008, only partially

⁴ For example, if the dollar reserves were simply transferred to the IMF and the deposits acquired by reserve holders were denominated in SDR, the exchange risk would be shifted to all IMF members according to their quotas. If, however, the resulting IMF claim vis-à-vis the United States were also denominated in SDR, the US would then bear the risk (effectively giving an SDR guarantee on its dollar liabilities). The risk sharing problem is not regarded by most authors as insuperable. See Alessandrini and Fratianni (2009) and Kenen (2010).

compensated by the dollar appreciation recorded since then. Since the crisis, the need to take measures to deal with its internal imbalances and to restore growth and competitiveness of its members has become an important policy priority for the European Union, as reflected in the EU 2020 Economic Program recently presented by the European Commission. A firm commitment has been undertaken at the highest political level to take “determined and coordinated action to safeguard financial stability in the euro area as a whole”.

In the G20 strategy, the process of rebalancing and sustaining global growth is expected to be supported by complementary efforts to liberalise the trade system and to strengthen financial regulation.

A commitment to maintain an open multilateral trading system has been strongly reaffirmed in every G20 statement, together with the objective of reaching “a successful conclusion of the WTO’s Doha Development Agenda with an ambitious and balanced outcome”. But progress in this delicate area has been mixed. Anecdotal evidence provides confirmation of the fact that “low intensity protectionism” is spreading. Over 450 protectionist measures have been introduced last year by G20 members, both industrial and emerging countries, of which one-third against China. The Doha negotiations, moreover, continue to be hampered by disagreements among industrial and emerging countries and that the practice of bilateral and regional trade agreements continues to pose a threat for the multilateral nature of the world’s trading system.

Work on reforming the financial regulatory system is well under way under the aegis of the Financial Stability Board (FSB). The main areas of this critical work include:

- strengthening the global capital framework (by building stronger buffers into the financial system, covering capital, liquidity and provisioning);
- making global liquidity more robust (by introducing new minimum liquidity standards and a structural ratio to address liquidity mismatches);
- reducing the moral hazard posed by systemically important institutions (by envisaging specific additional capital, liquidity and prudential requirements to reduce the complexity of group structures);
- strengthening accounting standards (with the objective of convergence, transparency and the mitigation of pro-cyclicalities);
- expanding oversight of the financial system (to ensure that all systemically important activity – such as that of the hedge funds and credit rating agencies – is subjected to appropriate oversight and regulation);
- strengthening the robustness of the over-the-counter (OTC) derivatives market (strengthening capital requirements and incentives, moving to central counterparties or organized exchanges);

The enormous complexity of the technical issues at stake, the strength of conflicting vested interests and the expanded number of participants in the negotiations explain why the process of financial reform is still underway more than two years after the outbreak of the crisis. Nevertheless, a high degree of consensus has been reached on the main components of the reform and it seems unlikely at this stage that the process will be stalled.

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The outline of a new international monetary system is being drafted within the G20 and in the broad fora of the academic community of the public opinion. The main pillars of a new system – a stability oriented anchor for macroeconomic policies; an open multilateral trading system; a more resilient and risk-averse regulatory regime; a reserve regime based on a multilateral asset – are in different stages of construction. The world economy shows signs of recovery but it is essential that the pace of reform is not slowed down. It is imperative to

reduce significantly the risk for the world economy of a devastating crisis such as the one we have just experienced. This requires to tackle the potential sources of instability that lie in our very imperfect international monetary arrangements.

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