Jürgen Stark: The future of the international monetary system – Lessons from 1971 for Europe and the world in light of past and present experience

Speech by Mr Jürgen Stark, Member of the Executive Board of the European Central Bank, for the Golden Series on World Money, organised by the Official Monetary and Financial Institutions Forum, London, 11 May 2011.

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Ladies and Gentlemen,

It is a pleasure to talk in front of this distinguished audience about the future of the international monetary system and I would like to thank OMFIF for inviting me to its Golden Series on World Money.

As you know, this lecture series takes place against the background of the fortieth anniversary of the closing of the gold window, also dubbed the “Nixon shock”, which marked the end of the Bretton Woods system. Let me however also recall another anniversary which is less well known. It was today, on the 11th of May, of 1998 that the first euro coins were minted. This, in some way, marked the beginning of the euro as “real” money that would circulate among by now 330 million European citizens. And no doubt, the single currency is and will in the future remain a guarantee of stability and prosperity in Europe.

But before I turn to the future of the international monetary system, let me look back in history and briefly sketch the evolution – and trace out some constant elements – of the international monetary system since the gold standard.

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Let me anticipate my conclusions already now: The history of the international monetary system is marked by repeated – and often failed – attempts to establish fixed exchange rate regimes, in one way or another. The reason is that the underlying belief that freely floating exchange rates are unambiguously an obstacle to international trade and domestic macroeconomic stability is based on a fundamental confusion.

It is true that, in Europe, we are witnessing that economies at a similar stage of development, with a high degree of real and financial integration and largely synchronised business cycles greatly benefit from a common currency under a common monetary policy and in a common market. At the global level, however, where the degree of convergence, integration and synchronisation is far less pronounced, countries at very different stages of development and with very different growth models stand to benefit instead from the corrective mechanism that fluctuating exchange rates constitute. Fixing exchange rates at the global level, to the contrary, has rarely benefited the global economy.

In fact, domestic policy objectives have too often proved to be incompatible with fixed exchange rate regimes. At the same time, domestic macro policies have too often conflicted with the objective of external stability. The result has been the periodic emergence of domestic and external imbalances, which not infrequently unwound in a disruptive manner. Let me give you just a few examples.

A first period that characterises the evolution of the international monetary system is that of the classical gold standard from the second half of the 19th century to the outbreak of World War I. At first sight, this appears to have been a period of considerable stability and prosperity. Countries enjoyed low average long-term inflation and steady growth of economic activity. Exchange rates were fixed via parities to gold and the money supply was thus tied to gold reserves. Therefore, any balance of payments disequilibria would trigger changes in monetary conditions and thus external balance was easily restored through the adjustment of prices and production. The drawback of this mechanism, however, was that it induced significant volatility within the domestic economy, as prices and production fluctuated considerably in the shorter term. Thus the gold standard, while delivering external and internal balance over the long run, came with substantial welfare costs in the short run.

In order to accommodate adverse shocks, some countries in exceptional periods temporarily abandoned the gold standard but subsequently resumed convertibility. This was also the case during World War I. The attempt, however, to return to a gold standard after the war ultimately failed. States had allowed for massive inflation given the need to finance the war, but then reintroduced gold parities partly at pre-war rates. This led to substantial misalignment of exchange rates. In addition, the process of democratisation made it increasingly difficult for the authorities to subordinate domestic policies to the stability of the exchange rate. Thus, the interwar gold bullion standard suffered from a structural lack of credibility and trust in the sustainability of the fixed exchange rate regimes that were in place. Eventually, the international monetary system collapsed, triggering competitive devaluations, barriers to international trade and capital controls in the midst of the Great Depression.

The Bretton Woods agreement that framed the international monetary order after World War II was influenced by these failures and therefore included some corrective elements: Exchange rates could be adjusted where needed and capital controls would limit speculative flows. At the same time, the International Monetary Fund (IMF) was established in order to finance exceptional balance of payments needs. Nevertheless, it was a system of fixed exchange rates, with the dollar as the vehicle currency, which in turn was convertible into gold at a fixed rate. Thus, the Bretton Woods system, too, was a gold standard and ultimately suffered from the same weaknesses: domestic policy objectives were incompatible with the objective of fixed exchange rates.

After a considerable period of prosperity that came with the economic rebuilding after World War II – which was beyond question bolstered by the Bretton Woods system itself – expansionary economic policies in the core of the system led to inflationary pressures and rising doubts about the dollar's convertibility. It was only by moving to flexible exchange rates that some countries were able to avoid the "Great Inflation" that shook the United States and that was exported to numerous other countries which pegged to the dollar.

The monetary order after Bretton Woods was however not a system of fully flexible exchange rates either. Within Western Europe, a system of soft pegs was introduced that marked a first step in a long process of convergence which led to the creation of European Monetary Union. Many emerging economies, instead, continued to peg their exchange rates to the dollar. For some countries, these pegs over time led to substantially overvalued exchange rates and massive indebtedness, often culminating in devastating currency crises, such as the Mexican "tequila crisis" or the Asian crisis of 1997.

Ironically, it was the susceptibility to currency crises that encouraged many emerging economies to continue pegging their currencies to the dollar, though this time at undervalued exchange rates. The emerging system of what some observers conceptualized as "Bretton Woods II" was again misperceived as a period of unambiguous stability and prosperity. The world economy grew by on average almost five percent a year. This was accompanied by an unprecedented wave of financial globalisation. In the five years up to 2007, prior to the eruption of the first financial market turbulences, global foreign assets and liabilities grew more than half to over 340 percent of world GDP, and gross financial flows grew even threefold. To put this into perspective, global trade flows over that period increased at a much slower pace, from around 25 percent of world GDP in 2002 to roughly 30 percent of world GDP in 2007.

The micro and macro factors behind this recent wave of financial globalisation are by now well known. At the micro level, asymmetries in financial development facilitated the emergence of large uni-directional financial flows from emerging economies to the core of the global financial system. At the macro level, large domestic imbalances were externalised to the global economy. Emerging surplus economies relied on an excessively export-led growth model. This necessitated artificially undervalued exchange rates which were pegged to the dollar by means of massive accumulation of reserves. On the flip side, deficit countries relied on large capital inflows to finance excess domestic consumption and provide the overleveraged financial system with liquidity. Thus, imbalanced domestic growth in both deficit and surplus countries and distorted global trade and financial flows were symbiotically linked through fixed exchange rates, which constituted a major vulnerability of the system: the absence of a corrective mechanism that would prevent the collapse we ultimately witnessed.

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Let me stress right away that we are far from being safe of a repetition of the past unless we take our lessons seriously.

It is true that during the crisis the "ingredients" of the recent wave of financial globalisation that I described before seemed to disappear. Home bias increased sharply as risk aversion rose and global markets experienced an extraordinary retrenchment of capital flows. At the same time, global trade collapsed, oil prices fell sharply, and some emerging economies encountered substantial pressure on foreign reserves.

However, this unwinding was largely cyclical and the structural forces at the micro and macro level are still in place. The resumption in global growth and trade, rebounding oil prices, the recovery of global equity markets and the impact of fiscal stimulus are increasingly being felt. At the same time, the sustainable rebalancing of demand and supply remains a key and unresolved issue in major advanced and emerging economies. This is all the more the case as some surplus economies continue to accumulate large excess reserves while maintaining fixed exchange rate regimes which – as I have argued – were at the core of many crises in the past, including the most recent one.

Projections by the IMF actually show that we are currently already past the low point of external imbalances, both in terms of the US current account deficit and the surpluses of major emerging economies. Foreign exchange reserves of emerging economies are currently already above their peak levels prior to mid-September 2008 when the turmoil erupted into a full-blown crisis. According to the IMF, around half of all emerging economies hold reserves above any measures of optimality which could be defined as self-insurance against possible shocks. This creates an immense economic cost not only for the global but also for domestic economies.

At the global level, the accumulation of sizeable stocks of foreign exchange reserves results in a gigantic misallocation of capital flows by the public sectors of reserve accumulators, with capital flowing "uphill" to advanced economies instead of "downhill" to emerging economies as economic theory would predict. The cost of the resulting distortions of exchange rate configurations, global liquidity conditions and asset prices but also international trade is difficult to quantify but in all likelihood sizeable.

At the domestic level, the cost of reserve accumulation is unlikely to be less significant. Simple back-of-the-envelope calculations would narrowly focus on the sterilization cost of central bank intervention in foreign exchange markets. In the case of China, for instance, this cost is usually put at around 1 percent of annual GDP. Much more importantly, however, the primacy of exchange rate policy hinders the effective use of monetary policy in response to macroeconomic shocks and is therefore a source of significant volatility in the economy. Speculative capital inflows need to be absorbed and thus reinforce the need for reserve accumulation. This, in turn, further restricts the room for manoeuvre, for instance in response to the import of inflationary pressures and the build-up of asset price bubbles. As a consequence, national wealth is increasingly badly diversified and returns to foreign exchange reserves and income on foreign assets become less and less attractive. At the same time, domestic financial markets are penalised, as the concomitant restrictions imposed by the central bank hinder financial development and lead to financial repression. This has adverse implications for the distribution of income and the development of the non-tradable sectors with negative consequences for employment and consumption growth.

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But what is then the cure to the disease of excessive reserve accumulation? The debate in this respect is currently very much embedded in the more general discussion on how to improve the resilience of the international monetary system. In essence, this discussion focuses on greater multilateral cooperation, including a further strengthening of the role of the IMF. This implies reinforcing the Fund's lending role, also through enhanced collaboration with regional pools, in order to reduce the need for precautionary reserve accumulation, examining and monitoring capital flows and global liquidity conditions, as well as considering a more prominent role for Special Drawing Rights (SDRs).

While I will not elaborate on each of these initiatives in all detail, I would like to argue that in pursuing our goals we have to make sure that we do not indiscriminately buy insurance against future crises. We also have to carefully consider the cost of insurance. In particular, we have to weigh this cost against that of making an effort to invest in pre-empting the failure of the system in the very first place.

The SDR, for instance, is not a cure-all for the international monetary system. The crux of the system is not the international use of national currencies, but the myopic use of domestic policies for achieving short-term gain at the cost of long-run pain. Assigning a more prominent role to the SDR by increasing allocations would hence by no means prevent the build-up of excessive reserves in countries which accumulate them for reasons beyond precautionary motives.

It is not clear either to what extent enhanced access to IMF lending reduces the incentives for the accumulation of large excess reserves. In fact, the IMF has already modified its lending toolkit and multiplied its resources. A Flexible Credit Line was introduced, as well as a Precautionary Credit Line for countries which do not meet the high qualification requirements for the former. In the absence of a counterfactual it is impossible to give a reliable estimate of the impact of these measures on global reserve accumulation. Looking at the data, however, I dare speculate that if anything the impact has been very limited.

And also where the insurance motive of reserve accumulation prevails, it is not clear that enhanced access to IMF lending and regional pools, SDR allocations, or other forms of global liquidity provision could reduce the stigma attached to such external financing and thus avoid the further build-up of precautionary reserves.

The cost of these insurance policies, on the other hand, can be substantial. Large-scale "issuance" of SDRs could interfere with the implementation of monetary policy. Together with badly designed multilateral coordination on global liquidity conditions these could undermine central banks´ authority as the ultimate provider of liquidity and thus dangerously impinge on central bank independence across the globe.

At the same time, any schemes of cross-border liquidity provision at the global or regional level need to involve central banks, because only these can provide the needed amounts of liquidity. But central banks cannot commit to providing funds indiscriminately without setting incentives for moral hazard. Resorting to the IMF and regional pools does not solve this problem, and the parallelism of global and regional pools further increases the complexity of the issue.

Initiatives to improve the global financial safety net should therefore concentrate on helping countries with sound fundamentals that are hit by financial market disruptions from exogenous shocks. Home-made crises resulting from domestic imbalances should be tackled differently and always involving strong conditionality.

The guiding principle should therefore be to limit incentives for moral hazard. At the same time, it must be clear that only sustainable domestic policies can guarantee stability on the external side. Hence, as reserve accumulation beyond insurance cannot be compensated for by creating more insurance devices, the key to limiting the accumulation to what makes economic sense lies in removing the distortions in the domestic economy that cause excess accumulation.

While the ultimate aim is of course achieving greater flexibility of the exchange rate, an abrupt move to fully floating exchange rates would be disruptive as it would most likely trigger large speculative inflows with the risk of over-borrowing, asset price bubbles, and an overheating of the economy.

The key is that the exchange rate reform and capital account liberalisation have to be accompanied by domestic reforms that aim at improving and ensuring the proper functioning of domestic financial markets, reducing the excessive reliance on external demand, and strengthening domestic demand. Hence, any exchange rate reform needs to be carefully phased in. First countries should develop and liberalise the domestic financial system, while at the same time strengthening its prudential framework. In a second step, the currency needs to be made convertible. Finally, the current and financial accounts need to be gradually opened and the exchange rate needs to be gradually made flexible. A new, credible, equilibrium level of the exchange rate would emerge and would discourage speculative capital inflows. Even if foreign exchange markets were liberalised, capital controls could for some time prevent an abrupt adjustment of the exchange rate and discourage inflows of hot money. Thus, the cure to the disease of excessive reserve accumulation lies in reforming the domestic financial system and allowing for a strengthening of domestic demand.

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One of the most significant innovations in the international monetary system, in this respect, has been the G20 Framework for Strong, Sustainable and Balanced Growth, launched at the Pittsburgh Summit in September 2009. Its aim is precisely to ensure the mutual compatibility of domestic policies and to monitor the progress of needed domestic structural reforms. G20 members review each others' policy actions and frameworks in order to grasp the combined effect of policies on the global economy. The G20 then explores the scope for improving the global outcome by defining the necessary policy measures to make adjustments where possible.

In order to monitor the progress made with regards to external balance G20 Ministers and Governors had already in February in Paris agreed on a set of indicators that aim to identify G20 members with persistently large imbalances within the context of the Mutual Assessment Process of the G20 Framework. These indicators include: public and private savings and debt, as well as the external balance composed of the trade balance, the income balance and the balance on current transfers. In April, Finance Ministers and Governors in Washington agreed on quantitative guidelines against which these indicators would be assessed so as to identify members with large and persistent imbalances that would be analysed in a second step in-depth assessment.

The process is still insufficiently advanced to judge its contribution to more effective surveillance. In my view, for the process to be successful certain conditions will have to be met:

First, only a limited number of economies should move into the second step in-depth assessment. This would ensure that resources are efficiently allocated and efforts are concentrated on the most relevant and pressing cases.

Second, exchange rate factors and in particular the issue of the exchange rate regime will be critical in the second step in-depth assessment. This, naturally, would also include an assessment of reserve accumulation. Only if the root causes behind excessive external imbalances are frankly and openly identified and discussed, it will be possible to remove the underlying distortions in the domestic economy.

Finally, cyclical factors should be given due consideration in the assessment process to ensure that the imbalances identified are those that can be expected to either persist or re-emerge in the coming years if current policy frameworks are not adjusted accordingly.

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Let me in concluding reiterate that in the absence of determined action imbalances are almost certain to persist. These, as I have just argued, are the outcome of currently still not sufficiently sustainably framed policies. This, in turn, reflects a lack of progress at the domestic level, rather than a failure of the system itself.

As I have said, the international monetary system after Bretton Woods was characterised by flexible exchange rates between the most important currency blocs. The system only moved into disequilibrium as a result of the growing economic weight of emerging economies that have kept their exchange rates at artificially low levels via massive accumulation of reserves. At the same time, expansionary economic policies in some advanced economies, on account of the massive capital inflows from emerging economies, were the flip-side to the build-up of imbalances.

The window of opportunity to change the relevant policy frameworks is closing quickly as global growth is resuming and the cyclical determinants that led to the temporary unwinding of imbalances disappear. In addition, with the two-speed recovery and different cyclical positions, political interests have started to diverge again between the major currency blocs. The corrective mechanism hence needs to be restored. Greater flexibility in the exchange rates of major emerging economies is in this respect a fundamental precondition for a stable international monetary system. At the same time, macroeconomic policies should avoid the externalisation of domestic imbalances to the global economy. Hence, the restoration of a stable international monetary system based on flexible exchange rates requires a fundamental change in economic mind-set across the global economy, rather sooner than later.

Let me thus close citing from the foreword of John Maynard Keynes' Tract on Monetary Reform which represents a fervent argument for targeting domestic stability even at the cost of fluctuating exchange rates: "Nowhere do conservative notions consider themselves more in place than in currency; yet nowhere is the need of innovation more urgent." Against these lines, written in 1923, my remarks today may not have been overly innovative, but I would say innovative enough for an alleged conservative. On that note, I sincerely thank you for your attention!