Fabrizio Saccomanni: How to deal with a global Triffin dilemma

Keynote address by Mr Fabrizio Saccomanni, Director General of the Bank of Italy, at the Conference on the International Monetary System: sustainability and reform proposals, marking the 100th anniversary of Robert Triffin (1911–1993), at the Triffin International Foundation, Brussels, 4 October 2011.

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1. Introductory remarks

I am very happy and honoured to have been invited to speak at this conference celebrating Robert Triffin's 100th birthday and I am glad that the Bank of Italy has been able to support this initiative of the Triffin Foundation.

I had a first opportunity to learn Triffin's provocative and prescient ideas about the working of the world's monetary system as a student of international economics at Princeton in 1969–70. Shortly after that, I was privileged to witness the fulfilling in August 1971 of Triffin's prophecy about the downfall of the Bretton Woods system from the vantage point of the IMF where I served as an economist. In subsequent years, I was fortunate to meet Prof. Triffin in person on several occasions, as he was a frequent visitor to Italy to attend conferences and seminars on international monetary reform, a topic which has been given traditionally a high priority in the research agenda of the Bank of Italy.

Triffin published many of his seminal contributions to international monetary theory in the Banca Nazionale del Lavoro Quarterly Review, a prestigious Italian scientific journal. In recognition of his close relationship with the Italian academic and financial community, Triffin was awarded, in 1987, the San Paolo Prize for Economics by a jury presided by Prof Paolo Baffi, a former Governor of the Bank of Italy.

In his presentation of the award, Baffi praised Triffin as a "cosmopolitan scientist" who had devoted his life to the pursuit of international monetary order in Academia, in Central Banks and in international organisations, in a splendid career that had seen moments of great satisfaction as well as of deep bitterness. But, Baffi noted "I do not believe that any intellectual gratification that he may have derived from the infallible accuracy of his forecast can alleviate his dismay of cosmopolitan scientist in the face of the utter mismanagement that currently afflicts the international monetary system".

Indeed I can vividly remember that Triffin in his late years was not only disappointed by the failure of the reform of the international monetary system, but was really angry and indignant at what he regarded as an irrational and incompatible behaviour of the countries bearing the main responsibility for the management of the world economy. It was, in his own words, an international monetary scandal and he was infuriated by it.

I have no doubt that Robert Triffin would be equally infuriated, if not more, by the current state of the international monetary and financial system, still beset by the global crisis set in motion by the seizure of the US subprime mortgage market in August 2007. The fact that the crisis has now moved to Europe and is destabilising the eurozone would certainly be a cause of deep regret for Triffin, who firmly believed that regional monetary integration in Europe could contribute to fostering stability in the world's monetary system. In the age of financial globalisation, unfortunately, this assumption no longer holds true.

In my remarks today I will briefly review what is wrong with the present international monetary system and will try to argue that there is an urgent need to give new impetus to the reform agenda originally agreed within the G20, if we want to deal with the "global Triffin dilemma" that is currently threatening the stability of the world economy.

2. What is wrong with the present international monetary system?

- The past twenty years have been characterised by significant exchange rate misalignments, large and persistent external imbalances and the accumulation of huge stocks of official reserves. I believe that these phenomena are symptoms of an inefficiency of the present international monetary system.
- Since the move to floating in 1973, ***flexible exchange rates*** have not behaved according to textbook predictions:
  - Their volatility has exceeded what could be justified by shocks to fundamentals.
  - Persistent misalignments have emerged among the major currencies.
  - Partly as a result, many countries have been reluctant in practice to allow full exchange rate flexibility ("fear of floating"), resorting to various forms and degrees of exchange rate management.
- Both policy failures and market failures have been responsible for this:
  - Misguided and unsustainable policies have frequently been a source of macroeconomic uncertainty and structural distortions. Exchange rate policies and capital controls have often been used to prevent the correction of misalignments.
  - At the same time, market exchange rates are not guided by fundamentals in a reliable way, partly because market participants (as also economists) do not seem to share a common view of what those fundamentals are.
- All this can be summarised by saying that flexible exchange rates have proved not to be an effective and reliable mechanism for enforcing policy discipline. Markets sometimes fail, even for long periods of time, to focus on fundamentals, only to suddenly "wake up" and enforce a correction that, being too late, is often inefficient, costly and traumatic. As we know from recent experience, this pattern applies to credit risk premia as well as to exchange rates. Market-based discipline alone is not enough.
- The emergence of ***large and persistent external imbalances*** over the past twenty years is closely connected to the lack of an effective policy discipline.
  - Some of the countries with the largest surpluses and deficits have been under no effective pressure from the markets to correct the imbalances. China and oil exporting countries seemed to be able and willing to continue to accumulate reserves almost indefinitely. As a result, the United States, issuer of the principal reserve currency, faced a highly elastic demand for its dollar liabilities and therefore did not need to incur either currency risk or a rising cost in financing its deficit.
  - However, exchange rate manipulation was just an element in a broader constellation of structural factors and policy settings, in both surplus and deficit economies, that allowed the imbalances to persist. Neither multilateral surveillance nor peer pressure had sufficient "teeth" to induce a correction of those policies before the crisis.
- Although the imbalances declined during the recent recession, this was largely due to cyclical factors, and they are now starting to widen again. They remain a potential source of strain for the global economy and financial systems.
- ***The accumulation of large stocks of official reserves*** has reflected in part a widespread desire to accumulate precautionary buffers in the face of increasingly large and potentially volatile capital flows; in part an effort by a number of countries

to maintain undervalued exchange rates to support export-led growth. Both drivers, in different ways, point to weaknesses and inefficiencies of the present international monetary system:

- The accumulation of precautionary reserves is costly, as the return on reserve assets is typically lower than the country's borrowing costs. Moreover, even countries holding large a buffer may face constraints in actually using it, if a falling reserve stock is perceived by the market as a negative signal.
- Moreover, if a country accumulates reserves to forestall an overdue exchange rate appreciation it may eventually face substantial capital losses.

• In addition to being inefficient for the reserve holders, the accumulation of large official reserves has undesirable spillover effects on the international monetary system:
  - Since reserves are held predominantly in US Treasuries, strong official demand tends to compress yields, causing financial market distortions. For example, in the years leading up to the crisis it contributed to trigger a global "search for yield".
  - In addition the seemingly insatiable global demand for dollar reserves allows the United States to enjoy the "exorbitant privilege" of financing external deficits in its own currency at a low cost, thus blunting the incentive to adjust.

3. Towards a multi-polar system?

• The central role of the US dollar is connected to several features of the functioning of the present system that I have just outlined. How can that role be expected to evolve? Will the system remain essentially dollar-centered or become more multi-polar?

• I believe that over the next few decades we will probably see an evolution toward multi-polarity, although the shift is likely to be gradual. Some trends are relatively easy to identify, others less:
  - The ***US dollar*** is likely to remain the main international currency in the near term. The shares of other currencies may grow over time, but inertia due to the dollar's incumbent advantages will tend to slow the process. Specific events could trigger an acceleration, but this is hard to predict.
  - The future role of the ***euro*** will largely depend on how we come out of the present crisis. I think we now stand at a crossroads: either the euro area institutions are strengthened and this allows the single currency to regain its attractiveness and to develop into a true global currency; or, if the crisis is allowed to fester, even the euro's role as a regional currency will be in doubt.
  - Given China's growing importance in global trade and its links to a fast-developing East Asia, it appears almost inevitable that over the next 10–20 years the ***RMB*** will become an international currency alongside with the yen, at first regionally, later perhaps on a broader scale. However, it may take some time for the process to take off, as some essential pre-requisites (such as full convertibility) are still lacking.
  - Regional cooperation arrangements, such as those that exist in the European Union and the Chiang Mai initiative in Asia, could become part of this multilateral system.

- ***How would a multi-polar system work?*** In principle, being more "balanced", it may even alleviate some distortions of the present system. In particular:
  - The demand for US dollar reserves should in principle become less elastic, thus diminishing the United States' "exorbitant privilege" and allowing market discipline to work more symmetrically.
  - If a number of Asian countries were to peg their exchange rates to the RMB (or to manage their exchange rate policy with reference to it), it may be easier for China's authorities to accept greater exchange rate flexibility vis-à-vis other currency areas.
- But could the coexistence and competition between two or more reserve currencies be a source of instability? My own view is that, although not necessarily unstable, a multi-polar system probably ***requires a high degree of international cooperation***.
  - At present, both the high degree of financial integration among economies and the awareness of their interdependence have made the costs of isolationist or non-cooperative behaviour more evident than in earlier periods of systemic transition such as in the interwar years.
  - However, having stronger incentives to cooperate is not enough. We also need a greater capacity to do it, which means having an effective political leadership and the right institutions. We know from experience that the ability and willingness of national policy-makers to act cooperatively, even in the face of a clear and present danger, cannot be taken for granted.
- ***Does the SDR have a role to play in the future evolution of the IMS***, either as a complement to the existing reserve instruments or, in a longer-term perspective, as a forerunner of a true global currency on which the IMS could be centered?
  - At present, ***the role of the SDR is very limited***. Allocated SDRs cannot be used directly to conduct interventions. More than a true reserve asset, they are a tool for redistributing reserves, for countries that cannot borrow them on the market. ***There is strong resistance to expanding the SDR's role*** on the part of several IMF member countries. The SDR is seen as an unconditional form of credit, giving rise to moral hazard. And central banks see the risk of politically-driven SDR allocations stoking global inflation.
  - It has been suggested that ***developing "private SDR markets"*** (in analogy with the experience of the private ECU in the 1980s and 1990s) could be a way of making SDRs more attractive as reserve assets and expanding the SDR's role as a unit of account in trade and finance. The ultimate goal would be to create the conditions for an expanded role of the SDR in the international monetary system. To jump-start this process, public authorities could undertake coordinated actions such as issuing SDR-denominated debt, helping create market infrastructures and providing legal certainty.
  - I believe that in order to have a chance to work in practice, such actions ***would need to be part of a long-term strategy supported by a strong political commitment***. My understanding of the experience of the private ECU is that a key factor of its success was the link to the long-term process of European monetary integration, which provided not only a legal, economic and institutional frame of reference but also a strong political constituency. By analogy, making the SDR a credible reserve asset and unit of account for both official and private agents would probably require a commitment to eventually transform it into something more than a basket, i.e. a currency in its own right. As we know, we are still very far from having a broad consensus on such a prospect.

4. The reform of the international monetary system: the role of the G20 and of the IMF

- To summarize, we have an international monetary system that lacks an effective mechanism for ensuring the mutual consistency of national policies. The costs of this in terms of distortions and instability are already evident, and will probably be further exacerbated as the world becomes more integrated economically and financially. On top of this, as we move toward a multipolar system we will need even greater cooperation to manage this process and contain the risk of instability.
- Indeed, the need to review the functioning of the international monetary system was put on the G20 agenda early on after the crisis. Following some bold G20 statements, there was even hope that a "new Bretton Woods" system could be shaped under the aegis of the G20.
- In this spirit, a group of former senior policy-makers assembled by Michel Camdessus, Alexandre Lamfalussy and Tommaso Padoa-Schioppa (the ***Palais-Royal Initiative***) chose to emphasize in their report ***the great urgency*** of tackling the reform of the international monetary system, and proposed a number of significant and far-reaching changes in the current arrangements.
- But despite the best efforts of the French Presidency, the G20 work agenda has been fragmented into a variety of "silos", which are meant to distil specific "deliverables" for the Leaders at their next meeting in November. Thus, the global vision has been lost. In addition, progress on specific fronts has been rather modest so far, reflecting countries' conflicting views on many such aspects
  - The most promising workstream is the ***Mutual Assessment Process*** (MAP). Quite frankly, I do not see other substantial IMS-related deliverables for the Cannes Summit. On issues such as global liquidity, capital flows, reserves, and the SDR, countries' views are too divergent to imagine real progress.
  - ***So far, the record of the MAP has been mixed.*** The MAP is a peer review process "owned" by the G20 (the IMF only provides technical support). It is aimed at defining (and then monitoring the implementation of) a set of mutually consistent policies to achieve a rebalancing of global demand and restore conditions for growth. But economic imbalances are still wide and worrisome.
- The G20 has failed to deliver reassuring massages to markets. Why? I see two main reasons. First, the whole process is bound to remain rather cumbersome reflecting the need to maintain G20 "ownership" – i.e., to reflect the inherent diversity of its members and the rule of consensus used in its deliberations. More importantly, the MAP has been conceived as an exercise with a medium to long term orientation, not as a platform for discussing national policy changes dictated by the evolution of G20 economies in the short term. Explicit discussion of exchange rates has been taboo, which is a serious limit. And reconciling short-term objectives (supporting growth) with medium-term goals (rebalancing) is a challenge, particularly at the present juncture as the global recovery seems at risk.
- Hopefully this is all part of a necessary learning process. It is neither policy coordination nor true multilateral surveillance yet, but it is a step in the right direction. While it is still too soon to say whether the G20 can become an effective vehicle for steering the governance of the IMS, real progress will depend on whether ***the IMF is allowed to play a central role in the governance of the IMS***.
  - One area where important improvements could be achieved is ***IMF surveillance***. The systemic importance of financial sector issues and the existence of cross-border policy spillovers have highlighted the need to

ensure: (a) greater interaction between bilateral and multilateral surveillance, and (b) greater focus on the financial sector. Some progress has already been made on these fronts, but there are limits to what can be realistically achieved on the basis of the existing legal foundations of Fund surveillance.

– One option would be a modification of the IMF Articles of Agreement – envisaging stronger obligations on countries' domestic policies. A less ambitious option would be a new Board Decision on "Multilateral Surveillance".

5. Concluding remarks

The world economy is still in the midst of the most severe financial crisis of the last 80 years but the reform process of the international monetary and financial system is stalling. In Washington at the IMF meetings two weeks ago, it was clearly visible that dealing with the worsening outlook of economic activity in the major industrial countries would take precedence over the reform agenda of the G20.

This is a serious mistake if one considers the origin of the crisis. Since the beginning of the third millennium there has been a constant erosion of the creditworthiness of issuers of supposedly "safe" assets, be they the shares of dotcom companies in Wall Street, the subprime mortgages marketed with the unforgivable AAA blessing of rating agencies or the bonds issued by major financial institutions like Lehman Brothers. This erosion of trust is now creeping into the supposedly risk-free world of sovereign debt.

The history of the international monetary system can be interpreted as the endless search for safe assets, safe from the erosion of value and the debasement of the currency that can derive from the misguided actions of monarchs, elected governments, parliaments and central banks.

Gold was initially considered the safest asset as it was nobody's liability, but then the relative shortage of gold led to the creation of the gold-dollar standard, where the safety of dollar-denominated assets was indirectly guaranteed by the link of the dollar to gold. When that link was severed, the world *de facto* delegated to financial markets the task of determining which assets are to be considered safe and which not.

The problem with this arrangement is that markets are fickle and they can oscillate between one extreme, where all assets are safe, even junk bonds, Greek bonds, or Depfa bonds, and the opposite extreme, where there are virtually no safe assets, except a happy few, where every investor would like to place his or her money, irrespective of the yield.

The age of financial globalisation has brought us to the verge of this second extreme. The extraordinary growth of financial activity has far outstripped the growth of real economies, leading to the accumulation of financial assets that are largely the liabilities – i.e. the debts – of countries, banks, corporations. The markets are telling us now that this process has gone too far and that a "deleveraging" – i.e. a reduction of the indebtedness – is now required by all debtors, public and private.

The world economy is, in other words, confronted with a "global Triffin dilemma" in which the excessive indebtedness of the issuers of financial assets is now affecting the value of the assets themselves; of all assets, not just of reserve currencies, as in the early Triffin dilemma.

But, how is it possible to carry out this huge process of deleveraging in an orderly manner and without further destabilising the world economy?

The obvious answer is that it may take time and in any case a longer period of time than financial markets, suddenly become aware of the unsustainability of the situation, seem willing to concede. At the same time, financial market participants should be aware of the simple fact if they want to cash in all their financial assets, at once, this will result in the immediate bankruptcy of all debtors, be they private or public.

I do believe that both creditors and debtors have a strong interest in the preservation of an open financial system, well regulated but free from protectionist restrictions. Thus, it should be possible to agree on some sort of a "truce", whereby market participants grant the time required for an orderly deleveraging, in return for a credible commitment by national governments to pursue stability-oriented macroeconomic policies at home and to carry out a sensible reform of the current international monetary system.

Such truce can only be enforced in the G20, which its leaders have elected to be the "premier forum for international economic cooperation". A credible reform agenda should include:

- a strong multilateral surveillance procedure managed by the IMF and designed to adjust global payments imbalances and to contain the impact of the cross-border policy spillovers on the financial system;
- the implementation of the financial regulation reform elaborated by the Financial Stability Board to strengthen the resilience of banks and financial intermediaries and to discourage excessive risk taking;
- the implementation of the WTO's Doha Development Agenda to preserve an open, multilateral and rule-based trading system;
- the commitment to establish a new multilateral reserve asset – hopefully with a more appealing name than the SDR – to become the "safe asset" that financial markets demand and that could be the anchor and the standard of a more stable international monetary system.

Is this agenda "politically acceptable" to the G20 leaders? Probably not, but it may become soon the only available alternative to the present slow-moving, incremental approach to reform, if they want to prevent more serious troubles for the world monetary and financial system and for the world economy.