Vítor Constâncio: The future of the international monetary system

Speech by Mr Vítor Constâncio, Vice-President of the European Central Bank, for the Golden Series lecture at the Official Monetary and Financial Institutions Forum (OMFIF), London, 23 November 2011.

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Ladies and Gentlemen,

It is with pleasure that I have accepted the invitation from the OMFIF Golden Series on World Money to talk about the future of the international monetary system. This subject has become very topical this year, not least in view of the discussions and progress achieved at the very recent Cannes Summit.

I will start by briefly recalling the key features of a good international monetary system and on this basis, I will try to define what are, in my view, the main weaknesses of the present system (or "non-system" as many describe it). This will allow me to dwell upon the possible evolution over the medium run of some of the main components of the international monetary system. When concluding, I will assess whether such an evolution may prove to be an adequate response to the challenges we are confronted with.

What can we expect from a good-quality international monetary system?

The ultimate goal of the international monetary system (hereafter: IMS) is to maintain an orderly system of payments among nations. To this aim, the IMS has to provide the services of an international currency, ensure adequate creation of global liquidity, define an exchange rate regime among national currencies and include an adjustment mechanism to avoid excessive external real and financial imbalances across nations.

Both global liquidity and the adjustment mechanism can be interpreted as global public goods (see e.g. Eichengreen 1987, Camdessus 1999, Dorrucci and McKay 2011). It is indeed only through access to ***global liquidity*** that it becomes possible to participate in, and finance, the global economy by using one or more reserve currencies as a means of payment, a unit of account or a store of value.

And it is only through an efficient and effective ***adjustment mechanism*** that it becomes possible to benefit from "external stability", namely a global sustainable constellation of cross-country economic linkages (e.g. via current accounts and asset/liability positions). Once external stability is achieved, cross-country linkages do not give rise to disruptive developments, such as disorderly exchange rate and asset price swings or contractions in real output and employment. External stability crucially depends on the policy behaviour of those issuers and holders of international currencies that are systemically relevant.

The ***exchange rate and capital flow regimes*** are probably the core elements of the adjustment mechanism, since they define the degree of flexibility of each IMS, i.e. its adaptability to changing economic circumstances. In contrast to the Bretton Woods system with fixed exchanges rates, semi-closed capital accounts and a strict adjustment mechanism, an IMS such as the present one enjoys a much higher degree of adaptability. Each country is free to choose its exchange rate and capital account regime, and the reserve-issuing countries face no IMS-embedded limits to the creation of global liquidity. This is a fundamental strength of today's system, but it may also become – as we will see – a major weakness to the extent that it creates scope for unsustainable domestic growth models and the ensuing accumulation of real and financial imbalances.

What are the shortcomings of the present "non-system"

Besides the persistent external imbalances, there are many other shortcomings being mentioned about the present "non-system". I can mention a few of them: abrupt reversal of capital flows; systematic inflows going from emerging to developed countries; inefficient accumulation of reserves by emerging countries; excessive exchange rate volatility ineffective to ensure external balance; asymmetry of adjustment pressure between deficit and surplus countries; absence of mechanisms to ensure the sufficient and timely supply of global liquidity in times of financial crises.

This list means that, potentially, all the features of an IMS can be at stake in the present discussion, contrary to what happened in the late nineties when the discussion revolved around the functioning of the financial sector and the crisis prevention and resolution in emerging economies. The debate then was not about the reform of the IMS but rather about a new Global Financial Architecture, meaning the international framework for safeguarding and ensuring the efficient functioning of the global financial system.

Today, after the start of the crisis in 2007, the issues under discussion are at the core of what constitutes an International Monetary System: 1) Are new international currencies necessary and/or unavoidable in the present circumstances? 2) Should changes be introduced in the foreign exchange regime? 3) Does the system need new and stronger instruments of liquidity provision, especially in times of financial crises? 4) What changes should be introduced in the adjustment mechanism? 5) Which reforms are needed in the about international regulation of the financial sector?

I will not address this last point. Regarding the second issue on the exchange rate regime, I will only mention that I see no justification to change the floating regime among the major currencies or to modify the recommendation that big emerging economies should also adopt much more flexible rate regimes. This means that in the conflict characterised by MacKinnon (1994) between the *international adjustment* view of exchange rates and the *monetary standard* view, I take the side of the former. Also, the present situation of financial globalisation confirms the early "bipolar view" of Alexander Swoboda that with high capital mobility the only stable exchange rate regimes are floating rates or hard pegs, of which monetary unions are an extreme example (see Eichengreen, 2010).

Towards an unavoidable, but desirable, multi-polar IMS?

There are many predictions about the gradual addition of other currencies to the dollar as truly international currencies. What seems to make this unavoidable it is not only the emergence of the euro, the increasing strength of China or the growing vulnerabilities of the US. The growth in importance of emerging countries, that have seen their share in the world GDP augmented by 15 percentage points in the last 20 years, creates a structural increase for the demand of reserves that the developed countries, including the USA, will not be in a position to supply.

This question is linked with the problem of the provision of official international liquidity. As Maurice Obstfeld (2011) has recently recalled, there is a fiscal dimension to the supply of official reserves. No single country in the world could indefinitely offer its currency as the reserve asset that could satisfy all the needs of a growing rest of the world. In the present circumstances where deficit and debt ratios need to be decreased, the US could not offer its bonds and T-bills as the almost exclusive reserve asset of the world. In this context, Euro assets are necessary. Even if they are clearly seen as an unrealistic prospect, Eurobonds, from the pure perspective of the International Monetary System, would be useful as a reserve asset for the world economy. In the future, the system will also need assets in the Chinese currency, when China will have a convertible currency, a flexible exchange rate and a developed bond market.

All this implies that one possible scenario is the evolution towards a ***truly multi-polar IMS***, which, as many have recently observed, would produce credible alternatives to dollar-denominated investments, thereby enhancing policy discipline in the core reserve issuer. Also, a multi-currency world would imply greater monetary policy autonomy in emerging economies such as China, which would thus be in a better position to tackle its own imbalances (see e.g. Bini Smaghi 2011).

- There are five key conditions for a currency to become a major international currency. The first one is having a *very large economy*, which engenders network externalities and lowers transaction costs. The second is given by deep, efficient and open *financial markets*. Third, good *political and macroeconomic governance* is of course of the essence to preserve the external value of a currency. Fourth, full *enforcement of the rule of law* is equally crucial as it ensures the protection of investors' property rights. Fifth, one should not overlook the importance of *geopolitical influence and political stability*.
- It is therefore not easy for a currency to fill all the conditions necessary for it to have an international role. Consequently, I do not think that we will see a major change in the role of the *US dollar* over the next 10–15 years – though the conclusion may well be different over a longer horizon. The appearance of the euro as a new globally important currency has not produced a shift to a genuine duopoly in the supply of international currencies, and had little impact on the dollar's centrality in the IMS. We are likely to see the shares of other currencies growing over time, but it is unlikely that there will be just one currency replacing the US dollar's hegemony.

The ***euro*** has established itself as the second most important international currency after the US dollar. At the same time, this role is predominantly regional in nature, since the euro is mainly used by economic agents resident in euro area neighbouring countries with special political and economic ties to the European Union and the euro area. More recently, it is known that Asian investors and foreign central banks accounted for a sizable share of the demand for bonds issued by the European Financial Stability Facility (EFSF).

Looking ahead, the share of the euro in international markets has the potential to rise further once financial stability and market integration is restored in the euro area. The ongoing efforts to improve the governance of the euro area and provide it with a credible crisis resolution mechanism will also indirectly affect the international use of the euro, even if the ECB and the Eurosystem do not take any initiatives to directly promote its use (Angeloni, Sapir 2011). This neutral stance – neither foster nor hinder – is based on our conviction that the international use of currencies should be a by-product of autonomous market decisions driven by the aforementioned five determinants.

Turning to the *Chinese* ***renminbi***, one can observe that the use of the renminbi as an international currency has remained limited although China is now the third largest economy (after the United States and the euro area) and second largest exporter (after the euro area) of the world.

The Chinese authorities have launched several initiatives since March 2009 to promote a wider international use of the renminbi, e.g. in trade invoicing, in deepening the role of the offshore centre played by Hong Kong S.A.R., or in agreeing local currency swap agreements with several central banks.

Nevertheless, the full potential of the renminbi can ultimately only be achieved with the liberalisation of the capital account, accompanied by the reform of domestic financial markets. Once these will be in place, a major internationalisation of the renminbi will happen as a by-product. For the time being, Chinese authorities seem to be trying to prudently promote financial liberalization via experimenting with market-driven renminbi securities in Hong Kong S.A.R.. But this comes at the expense of increasing exposure to capital flows which poses challenges for the macro-prudential set-up, especially given the current

undervaluation of the renminbi. Hence, Chinese authorities may also slow down the use of the renminbi abroad should tensions for domestic policy makers mount. All in all, the potential for the renminbi to upgrade as an international currency is clearly huge, but the timing is difficult to predict.

The necessary reform of the adjustment mechanism

I share Kregel's (2010) view that "the basic problem [with the current IMS] is not the particular national liability that serves as the international currency, but the failure of an efficient adjustment mechanism for global imbalances".

Indeed, one needs only to look at the problem of global payment imbalances to find weaknesses of the current IMS, or rather "non-system". The build up of increasingly large current account surpluses in some export-oriented economies, which rely on a growth-model based on over-savings, was, in conjunction with accumulating deficits in a number of consumption-driven economies, a major source of concern in the years which preceded the global financial crisis. Such imbalances were coupled with "twin gluts" in global liquidity and planned savings which led to historically low risk premia – the main symptom that systemic risk was escalating in the presence of easy finance accommodating complacent borrowers.

Even the global financial crisis and the policy responses have reduced the imbalances only partly and temporarily over the most recent years. The fact that these imbalances have persisted for so long exposes a key weakness of the system, namely the ***inadequacy of the adjustment mechanisms***. Let me explain this in more detail by looking at the various stakeholders:

National authorities in deficit and surplus countries had little incentives to depart from their growth model and policy course. Indeed, prior to the crisis the economies with the largest external imbalances were often outperforming their peers in terms of GDP growth: the larger the imbalance, the higher was the growth rate *over the short run*. Moreover, the deficit and surplus countries, rather than exerting policy discipline on each other, in fact accommodated the other in the pursuit of their respective growth models (see Dooley et al. 2003).

Market discipline also proved partly unreliable for a number of reasons.

Firstly, markets frequently do not function in line with fundamentals as expected, leading to mispricing and undue volatility in, for example, exchange rates and credit risk premia. This may be explained in part by factors such as herding behaviour, but also the lack of a shared view on the relevant fundamentals.

Secondly, market behaviour has also been constrained by structural factors and policy regimes. *On the deficit side*, the fact that the United States provides the deepest and most liquid financial market – and issues the dominant reserve currency – provides it with an unparalleled platform to offer "safe" debt instruments. The insatiable demand for such debt instruments puts strong pressure on the US financial system and its incentives (Caballero 2009). At the same time, the US derives its "exorbitant privilege" from this situation. The demand for US assets constrains the growth in credit and exchange rate risk premia charged by markets on rising US debt. This effectively limits the increase in external borrowing costs, thus removing an incentive to curb borrowing. *On the surplus side*, the semi-fixed exchange rate regimes and the semi-closed capital account of some major surplus countries prevent markets from exerting excessive pressure on capital flows or the exchange rate of such countries.

Thirdly, accommodated by a trend towards self-regulation, financial markets encouraged rather than tamed excessive borrowing. Income constraints on debt accumulation were circumvented through innovative debt instruments, which were insufficiently checked by quality credit analysis and internal controls. Moreover, in the search for yield and diversification, capital flows to emerging markets and "carry trade economies" have surged,

prompting, in certain cases, the imposition of capital controls to limit the potentially disruptive influences of both excess inflows and their reversals.

The ***international community*** has a role to play in exerting pressure on countries to adjust, primarily the International Monetary Fund (IMF) and the G20. Although helpful policy recommendations have been put forward at the global level, the traction gained by the international community has often not been as strong as it needed to be. The IMF, to some extent, has been hampered in its efforts to ensure the stability of the IMS. The existing rules were designed for the pre-globalisation era and the enforcement mechanisms are not sufficiently effective.

Regarding the *rules*, these were agreed in an era of fixed exchange rates, closed capital accounts and highly regulated financial markets when the financial sector was the handmaiden of the real economy. This was well before the widespread liberalisation of trade, financial markets and capital accounts that defines globalisation. For example, under the IMF Articles of Agreement, members are free to pursue capital account regimes and exchange rate regimes of their choice, with only limited constraints.

The outcome is a global constellation of exchange rate regimes that does not ensure sustained economic, financial and monetary stability. The peg of currencies of a number of emerging economies to the US dollar creates a symbiosis that fosters ever larger imbalances and hence risks of disorderly adjustment. Particularly when one of the emerging economies is very large, the pegging of its currency to another risks limiting the flexibility of adjustment in both, which in turn threatens to distort the exchange rate of other major currency pairs, with implications for global economic performance.

Turning to the *enforcement mechanisms*, surveillance and peer policy review have an essential role to play in identifying risks and encouraging remedial policy action. But international pressure – including via the IMF and the G20 – still suffers from lack of grip. Even when risks are correctly identified and policy recommendations are appropriate, as it happened during IMF's multilateral consultations in 2006–07, there is no guarantee of necessary policy adjustments being made. This remains the weakest aspect of the surveillance process.

The crisis has led to increased efforts to improve surveillance, e.g. with the transformation of the Financial Stability Forum into the Financial Stability Board (FSB) with an enlarged membership and broadened mandate, changes inside the IMF, and the launching of the G20 Framework for Strong, Sustainable, and Balanced Growth and its Mutual Assessment Process. There is a general recognition of the need to strengthen the multilateral angle of surveillance, to better encompass interlinkages and spillover effects, and to better integrate macroeconomic and financial sector.

More work needs to be done, however, to further strengthen the effectiveness of surveillance. There is no widespread consensus yet on how a country's policies impact on other countries and – more importantly – no willingness of countries to submit themselves to closer scrutiny. By contrast, we can observe a lot of mutual finger-pointing, mainly between advanced and emerging economies, but to some extent also within the two groups. It follows that EMEs push for an inclusion of global liquidity and its drivers into multilateral surveillance, whereas advanced countries see a need for more scrutiny of reserve accumulation practices, exchange rate policies and capital controls. Against this background, it is also obvious that a lot of countries do not have any appetite to change the IMF's Articles of Agreement to ratify a broadening and strengthening of surveillance.

What can be done in such circumstances? I think that first of all we need to work even harder to achieve a better understanding of interlinkages and spillover effects. This implies the need for more and better analysis. The new pilot spillover reports that the IMF started this year with a handful of systemically important countries are one welcome step in that direction. Further research on the impact of policies in systemically important economies on global liquidity conditions and on capital flows will also help framing the discussions.

Going forward, better awareness, a certain spirit of multilateralism and, last but not least, improved mechanisms to foster traction of policy advice will be crucial elements to strengthen the effectiveness of surveillance in contributing to global stability.

Evolution of global official liquidity

Another area in which views are very much divided is the debate about the enhancement of official liquidity provision. One idea is to strength the so-called ***global financial safety net (GFSN)***. It would be used in those exceptional situations when countries with sound fundamentals suffer from financial market disruptions – such as foreign currency liquidity shortages or sudden stops in capital inflows – caused by contagion from major (e.g. Lehman-type) external shocks .

Also here significant progress has been achieved over the last years: IMF resources have been tripled compared to 2008, access rights to IMF financing increased, and new facilities were created. But some believe that this is not enough, and argue with pertinent arguments, that further enhancing the global financial safety net would provide incentives for countries to decrease their reserve holdings (see Fahri, Gourinchas and Rey, 2011). However, as I mentioned earlier, the accumulation of large stocks of reserves is not only based on precautionary motives. Even the most customer-friendly IMF facilities might not lead countries to lower their reserves since they offer a higher level of comfort and convenience than IMF facilities. At the same time, countries might face problems in actually using their reserves in times of crisis, given that markets might not focus on the absolute level, but rather on the relative changes.

Further reforms of the Fund's toolkit need to be based on a thorough assessment of the experience with the existing tools and the resource implications further insurance-type facilities would have. The call for increased Fund resources, which is recently being voiced again, has also to be assessed carefully in light of existing and potential demand for Fund support. Concerning another SDR allocation, one should consider that during the recent crisis only a very small amount of SDRs allocated in 2009 has actually been converted into usable currencies.

What would seem to be justified is to foresee established mechanisms to provide liquidity in times of financial crises when private liquidity suddenly disappears. In this context there have been also calls on central banks to establish a permanent scheme of swap lines to help countries in times of systemic stress. However, while central banks will certainly continue to assume their responsibilities in times of distress, they cannot commit ex-ante to any significant provision of liquidity as this could interfere with their mandate and create moral hazard.

Concluding remarks: is this enough?

Will the changes in the IMS which, based on current information, we are likely to witness over the next ten-fifteen years be sufficient to make it resilient and sustainable? I am certainly not among those who consider that this is the case. But then, what further changes are indispensable? The answer to this question depends upon the longer-term vision. If we are really heading towards a multi-polar system, this may well set stronger incentives for policy discipline, since the exorbitant privilege will be more widely shared.

But will the road towards the new multi-polar system be smooth or very bumpy? Well, a lot will depend on the path of further financial market development, capital account liberalisation and exchange rate flexibility in EMEs, since this will progressively reduce the demand for safe debt instruments issued by advanced economies. It will also allow a better channelling of domestic credit to investment and consumption, which in turn will help to promote growth driven by domestic demand. And a lot will obviously also depend on the ability of advanced

economies, starting with the euro area, to learn the appropriate lessons from the current sovereign debt and banking crisis. The speed and scope of this process will depend on decisions of policy makers and market participants in the various parts of this world. If this whole process will be resolute and gradual at the same time, it should allow for an orderly transition towards a multi-polar IMS.

Another question is whether the new IMS would be steady in nature or whether a new hegemon would emerge possibly to accomplish the "hegemonic stability theory" promoted by Kindleberger (Kindleberger, 1970). The answer will, again, depend predominantly on policy-makers. It remains to be seen whether the currency competitors of such a multi-polar world will be of relatively close weight, both in economic and financial terms, but also with respect to the political and governance factors discussed before when considering the preconditions for a currency to become a major international currency.

As regards the necessary changes to international cooperation, we will need to see a greater awareness among global partners about their interlinkages and the ensuing responsibilities to ensure the stability of the whole system. I am convinced that, without a minimum spirit of multilateralism and a minimum degree of cooperation, no future IMS will remain stable for long. It is to be hoped that countries, especially those with systemic relevance, understand that it is in their best self-interest to consider externalities and cooperate. But such "enlightenment" alone will not be sufficient to ensure stability. If the IMS as such does not deliver the right incentives, the international community will have to eventually agree on enhanced adjustment mechanisms, e.g. in order to foster the traction of policy recommendations. It is to be hoped that we do not need another global crisis to instil the necessary incentives.

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