

Lorenzo Bini Smaghi: The reform of the international monetary system

Speech by Mr Lorenzo Bini Smaghi, Member of the Executive Board of the European Central Bank, at the Conference in memory of Tommaso Padoa-Schioppa, Rome, 16 December 2011.

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1. Introduction

It is a great pleasure to attend this conference today in honour and memory of Tommaso Padoa-Schioppa and to be a member of the panel discussing the reform of the international monetary system. That was a field Tommaso bore responsibility for at the ECB and which I inherited from him.

I would like to focus my remarks on his main critique – which he shared with Robert Triffin – that the international monetary system remains incapable of imposing an acceptable macroeconomic discipline on the world economy. I also wish to examine the reservations he expressed about international policy cooperation being enough to ensure stability.

I would like to organise my remarks as follows. First, I would like to explore the theoretical underpinnings of international policy collaboration, and explain why in practice it seems to fall short of what is needed in today's global world and why countries remain trapped in short-term policy-making. I will then review some proposals made by Tommaso to correct today's international monetary system, including the provision of an anchor and an exchange rate mechanism, and consider the consequences of maintaining the status quo. In conclusion, I will argue that it is better to prevent volatility than to cure it. The deployment of ever larger official resources to cope with potential crises cannot be the solution – neither conceptually nor practically.

The policy implications are that there are three key areas where preventive action could and should be taken, and which require structural change by major economies: first, financial developments in emerging market economies (EMEs); second, further financial and economic integration in Europe; and third, reforms to ensure that financial markets serve the real economy and support stability.

2. Analysis

Let me start with the global financial crisis. There is a broad consensus on some of the main factors underlying the global financial crisis – such as the growing and persistent current account imbalances, inadequacies in financial regulation and supervision, the systemic risk caused by excessive leverage combined with risky financial products, and so on. As Tommaso argued, there is also some lack of recognition of the fundamental flaws in the present monetary arrangements, or rather non-arrangements. Being a policy-maker, he not only identified the flaws, but proposed the essence of a solution to the problem. Greater cooperation between economies was a critical element in a reformed international monetary system.

Let me elaborate on this point. Why would international policy coordination be beneficial in the first place? After all, every country strives to meet its own growth and stability objectives in order to produce a strong and stable economy. Isn't that enough? The message from the crisis, loud and clear, was "no". The problem is that economic policy actions, particularly those of larger countries, create quantitatively significant spillovers, or "externalities", for other countries. Hence, achieving a global optimum means having to take such externalities into account in the decision-making process. Therefore, coordination can be regarded as a mechanism to encourage countries to include the potential spillover effects in their policy

considerations, in other words, to “internalise these externalities”. Only then is it possible to achieve a Pareto optimal outcome¹.

In practice, even though international coordination is vital to optimise global welfare, it is notoriously difficult to attain the necessary level of sensitivity and commitment from policy-makers. Economic theory provides us with a conceptual framework that helps explain why this is the case. Countries that impose negative externalities on others create a deviation from the global Pareto optimal outcome. But since such countries lack sufficient incentives to pursue the global optimum, the international community faces a prisoner’s dilemma in which systemically relevant countries pursue policies that produce mutually reinforcing negative spillovers. This dilemma however becomes smaller if the participants interact with each other continually. To put it into our context, if countries repeatedly interact with each other, cooperation becomes more beneficial than pursuing self-interest alone, particularly in complex situations when those involved have numerous options for responding to the strategic actions of others²

Countries do in fact interact with each other repeatedly, but achieving effective international cooperation and internalising externalities still appears to be largely elusive. As Tommaso said, “the self-sufficiency of national monetary sovereignty”³ is a “false idol”; countries tend to pursue policies which generate unsustainable growth *cum* imbalances in the short run, thereby neglecting global spillovers and negative feedback loops that undermine domestic long-run performance and stability. I would even go a step further. I would suggest that economic growth which relies on an unsustainable policy framework might even turn out *ex post* to be an “accounting illusion”.

So why is there such short-termism in policy-making that results in unsustainable domestic policy frameworks and global economic and financial instability? Let me offer four thoughts:

First, there is the primacy of the electoral cycle. Policy-makers tend to maximise utility functions, which incorporate only national objectives over a limited time horizon. In such a context, it is difficult to enforce policies resulting from international commitments that may, over the short term and particularly in the run-up to an election, be seen to contradict national objectives.

Second, policy-makers face asymmetric opposition to change. Interest groups that profit from the current system are usually far more organised and vocal in opposing change than the silent majority, both nationally but also internationally, which could potentially benefit from economic reforms.

Third, and moving away from political economy considerations, it is very difficult to assess equilibrium values for certain key variables. Therefore, fundamentals are often over- or underestimated depending on the country and the point in time. Imbalances are, thus, financed for too long and at too favourable prices, so any eventual corrections turn out to be very sudden and sharp.

Fourth, there is habit persistence and sluggishness in the adjustment process, as large international players are sometimes trapped in a given policy framework. For example, despite the financial crisis, policy incentives arising from the US’s exorbitant privilege remain unchanged in the presence of sizeable and liquid US financial markets and the strong international role of the dollar as a reserve currency. At the same time, in the case of China, the current growth model still delivers acceptable results – even if it is at the expense of

¹ Amartya K. Sen: *Collective Choice and Social Welfare*. Holden-Day et al., San Francisco, 1970.

² Mailath, G. & Samuelson, L. (2006). *Repeated Games and Reputations: Long-Run Relationships*. New York: Oxford University Press.

³ Padoa-Schioppa, Tommaso (2010): “*The Ghost of Bancor: the Economic Crisis and Global Monetary Disorder*” 25 February 2010, page 4.

some segments of society and, as such, represents an implicit tax on them. Given that the accumulation of major imbalances in China persists and does not disrupt other aspects of the economy – thanks to financial repression and a closed capital account – the current growth model is perceived as being sustainable. The same could probably be said of other major economies, like the US.

Sooner or later, however, the unsustainability of domestic policies can be expected to materialise in a crisis. This is particularly the case if, as we witnessed prior to 2008, rising imbalances go unchecked because of weaknesses in market discipline and, all the while, negative externalities persist without redress owing to the absence of a collective or higher authority to rein in what Tommaso referred to as “robust political and economic interests”. Crises impose potentially severe domestic economic and financial disruptions on an economy and, at best, lead to a more sustainable model of growth, albeit at a very high price. At worst, they condemn a country to protracted low growth. In both cases, global economic performance and stability are undermined to a greater or lesser degree.

3. Responses

How should these weaknesses be corrected? Is the answer to be found indeed in international policy cooperation?

I tend to share Tommaso’s view that soft international cooperation alone, though necessary, would not be sufficient. In his words, “coordination fails precisely when it is most needed, i.e. when policy preferences are most divergent”. My experience confirms that even in the wake of the global financial crisis – which brought home global interdependencies and the porosity of national boundaries for national policies – international cooperation continues to be based on the premise that the pursuit of national interests is the best approximation of the Pareto superior result. It is the philosophy underlying the G20 Mutual Assessment Process, which seeks to achieve strong, sustainable and balanced growth.

Another weakness of the current international monetary system is that in its centre of gravity – the United States – economic and monetary policy are shaped to suit domestic interests. The current system mimics therefore, as I said earlier, a generalised version of the Triffin dilemma. Tommaso recognised it as such and identified some of the elements of a solution.

First, he argued for some sort of “common exchange rate mechanism” which would ensure that every country agrees to shoulder its responsibility for the appropriate valuation of their currency *and* that exchange rates are determined by the interaction between the market and economic policy. He anticipated that this would be well supported by floating regimes for large currencies, while smaller countries may thrive with an intermediate regime consistent with the geographic pattern of their economic and financial linkages, possibly a managed peg to the regionally dominant currency. He observed, for example, the very strong regional interdependencies in East Asia and the momentum these create for a regional monetary arrangement comparable to those which Europe sought after the Bretton Woods system came to an end.

The distinctions between large and small economies, and floating and managed currencies, are particularly revealing at the present time, when we are seeing a large anomaly. We are currently facing an unprecedented situation in which a once-small economy that pegged its currency to that of a large economy has since grown to become the world’s second-largest national economy. The result is a giant economy running a fledgling currency internationally, outsourcing its monetary policy and its international requirements for money (as a medium of exchange, unit of account and store of value) to the globally dominant currency. This has been a major source of imbalances in recent years. The way in which it has been addressed has been unsatisfactory and the effects on the prospects for the global economy are likely to become graver over time.

The major economies, while recognising the domestic impact of the policies of others, have yet to appropriately factor mutual interdependence into their utility functions and policy deliberations. In Europe, we had the luxury of reflecting on European interdependencies in decades of calmer conditions when making successive attempts to produce a stable European monetary order, leading up to European monetary union. And still, we did not learn the lessons well enough and are now having to do so the hard way. There is no alternative but for a stricter supranational disciplinary element in Europe and, by corollary, at global level. As Tommaso said, it is nonsensical for countries to believe that they can reap the benefits of economic and financial integration without their policies acknowledging the two-way street.

The second issue is the need for an anchor to ensure the stability of a reformed international monetary system. More specifically, the interplay of demand for, and supply of, the reserve currency should be limited to what supports global stability. Just as Triffin saw an unresolvable tension for global stability arising from the subordination of the management of reserve-issuing currencies to domestic policy interests, Tommaso considered that this tension was keeping the disorder alive. In his view, what was needed was a quantum of supranationality that would hold sway over the global monetary policy stance. And here, he thought more could be made of a supranational currency, the Special Drawing Right (SDR). Tommaso recognised the hurdles to the SDR assuming its heralded role as the key reserve asset, in particular, the need for a critical mass of SDRs in both public and private sector circulation.

Although the SDR may have the potential to *reduce* the Triffin dilemma, it cannot *remove* it. As a basket of currencies, it would not reflect the domestic policy interests of the dominant economy, but rather the “average” for the economies of all the currencies in the basket. And in this respect, it would only improve on global stability to the extent that the “average” policy stance was better than the dominant policy. However, a mere average of policies driven by national objectives is no guarantee for the public good of a stable monetary anchor on a global scale. This would require a policy framework anchoring the global standard to an objective of global stability.

An alternative view is that of a multi-polar currency system. The emergence of such a system would accompany the global rebalancing of economic power that is taking place. It would be a market-driven process rather than requiring an international agreement, framework or mechanism. And to be most conducive to global stability, the shift to a multi-currency system should ideally occur gradually.

Like the SDR, it offers a welcome alternative to the reliance on one dominant national currency for stability, and should have the effect of eroding the exorbitant privilege of the US dollar and increasing the policy discipline on all major, internationally-used currencies. But also like the SDR, stability under a multi-currency system would still ultimately rely on nationally-oriented policies, though in the case of the multi-currency system, market participants would choose directly the sets of national policies they prefer. Would this reduce volatility, or would it be even greater, as players switch among currencies, particularly in the transition phase as the currency composition of reserves is re-weighted?

Of course, a shift to a multi-currency system requires that the privilege of incumbency of the US dollar be removed, that the sovereign debt weaknesses in the euro area be resolved, and that the renminbi develop its full international potential.

Now the suggested reforms pose many new questions. Let me focus on two in particular.

First, what political and institutional conditions are necessary to form the basis of greater supranationality? We have travelled along this path in Europe and made some progress, assisted by the principle of subsidiarity. Federations may find themselves with a conceptual headstart, but also highly open, integrated economies have an innate appreciation of the benefits of cooperation. All the same, implementing a shift of authority from the sovereign to super-sovereign level requires finding a way to overcome the perceived democratic deficit. In

this respect, Tommaso believed in the cathartic effects of crises – that they exposed flaws in a system and pointed the way forward. The global financial crisis has resulted in the G20 Mutual Assessment Process. Does it go far enough? Might it become a necessary stepping stone to an improved framework for global stability?

This prompts my second question: what kind of world are we heading for in the absence of a mechanism or anchor for global stability? The focus is likely to continue to be on measures to deal with volatility, such as increasing reserve buffers, restricting capital flows and heavily managing currency values. All of these come at a cost:

- excessive reserves, especially for EMEs, represent a tax on domestic consumption and, if widespread across countries, would produce a systematic excess of planned savings over planned investment, leading to a deflationary bias;
- capital controls are an understandable, if unfortunate, response to exceptional surges in inflows and outflows, but they produce externalities of their own, including increasing inflow or outflow pressures on other countries; and
- devaluing currencies can trigger beggar-thy-neighbour retaliatory measures that push the global economy into a downward spiral.

Now the failure to properly address these issues in the past has led to the current scramble for financial resources to shore up systemic stability. And the amount of reassurance demanded by markets increasingly exceeds the official resources available by an ever higher margin. National foreign exchange reserves stand again at an all-time high; regional financing arrangements – especially in Europe and Asia – are better endowed and more sophisticated than ever before; and the IMF had its resources trebled in 2009, and will soon reflect yet again upon the adequacy of its resources.

It is clear from this that prevention is always better than cure. Therefore, we must find better ways to reduce financial market volatility. Policy measures to address the problem need to be tailor-made.

In emerging markets, where financial sectors are underdeveloped, policy measures need to foster financial development. Domestic savings could then be more easily channelled into domestic investment, promoting domestic income growth and consumption, and rebalancing economic growth away from exports and reducing the incentive to maintain a low currency value. It would also lower the need for reserves and official outflows to advanced countries, and the excessive demand for US dollar-denominated financial assets.

In Europe, especially the euro area, we need deeper financial and economic integration to reduce the uncertainties and inefficiencies in the current institutional framework, so that the region becomes a core area of stability.

Financial markets need reform so that their structure, conduct and performance supports stability. This calls for acute risk awareness, responsible risk analysis and appropriate risk pricing. It requires that participants are able to, and do, bear the consequences of their decisions without jeopardising system stability. And achieving these things necessitates an interplay between markets and regulators in such a way that balances dynamism with stability.

Efforts are under way in all these areas, and yet there remains much work to be done. We cannot afford to wait for the cathartic effects of the (next) crisis to improve the functioning of the international financial system.