

## **A New International Monetary System?**

**Presentation by Governor Luc Coene**

**The International Monetary System: sustainability and reform proposals**

**A conference to celebrate the 100<sup>th</sup> anniversary of Robert Triffin (1911-1993)**

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Dear friends,

It is a great pleasure for me to welcome you at the National Bank of Belgium on the occasion of this prestigious conference, "The International Monetary System: sustainability and reform proposals", for the 100<sup>th</sup> anniversary of Robert Triffin.

Robert Triffin is generally considered to be Belgium's greatest economist.

He is famous for arguing that the Bretton Woods system was not sustainable, the well known Triffin dilemma: the increase of foreign dollar balances to meet international liquidity needs made the system dynamically unstable. Accumulating dollar reserves was attractive only as long as there was no doubt about their convertibility into gold. But once

foreign dollar balances loomed large relative to US gold reserves, the credibility of this commitment was threatened.

In the restructuring of the international payment system. Triffin's role has been seminal and decisive, but had also its limitations. In his first and best known publications, Triffin pleads for a strengthening of the role of the Fund as lender of last resort. He bases his demonstration on the risk of a global shortage of liquidity likely to lead to world deflation. But the liberalisation of financial markets and the suspension of gold convertibility of the dollar have imposed, to the contrary an abundance of liquidity in complex and hard to define modalities. But because of Triffin's dominant role at the time in the discussion of the international payments system, the work of institutions and governments remained captive of his premises. As result the SDR can only be allocated on the basis of a demonstrated global liquidity need. The allocations have therefore to be distributed proportionally to quotas, not in function of the effective and demonstrated needs of countries. The US receives large amounts of unwanted reserves.

The reform of the international monetary system figures highly on today's international policy agenda. Persistent current account imbalances, exchange-rate misalignments, unprecedented reserve accumulation, volatile capital flows and liquidity floods and droughts, contributed to this renewed debate. Moreover, the debate was further fuelled by the financial crisis. What began as a crisis of subprime mortgages turned into the deepest global recession since World War Two. It made painfully clear how tightly the economies and financial markets of the world are tied together. The inability to grasp the strength and pervasiveness of macro-financial linkages, and their interrelationship with the international monetary system, was a major failing.

During the last decade, the world economy has changed dramatically. With the growth of China and other emerging economies, we are experiencing a transition from a uni-polar to a multi-polar system. However, this transition is taking place at significantly different speeds in different areas: the real economy, the financial markets and economic policy.

Firstly, there is a clear difference in growth between emerging markets and developed countries. This implies that emerging economies now account for half of global output, up from just over a quarter in the early 1970s. So, in terms of production, the world economy has indeed become multi-polar.

Secondly, from a financial markets perspective, the world is far from multi-polar. Indeed, the dollar remains the world's most used currency. This is the outcome of decisions by economic agents to use the dollar as a means of exchange, store of value and unit of account.

Thirdly, also from a policy perspective, the world is far from multi-polar. In particular, many countries in Asia do not follow independent monetary policies but peg their currencies to the US dollar. They follow an export-led growth strategy, preventing an appreciation of their currencies.

The central role of the dollar then not only transmits the direction of US monetary policy to a large part of the world, but also exempts the United States from external discipline. Furthered also by the globalization of finance, payments imbalances in the world economy have grown dramatically in the 21st century. They were not corrected with macroeconomic policies. On the contrary, an accommodative US monetary policy was a significant factor in the abundance of liquidity at the beginning of the century, keeping interest rates and risk premia down, and stimulating risk-taking and a massive debt build-up.

However, there was a huge gap between the type of assets which were offered by US creditors and those demanded by foreign investors. Foreign investors expected their US investments to be liquid and safe, preferably triple A. Borrowers in the US, especially households, needed long-term credit but offered only low or even substandard credit standing. To bridge this gap, a huge transformation in terms of maturity and credit risk was undertaken by the financial sector. Financial innovation created, out of long-term substandard loans, seemingly highly liquid assets of the highest credit quality. Financial innovation seriously complicated a proper assessment of the nature and size of liquidity and credit risk. The reserve currency status helped in preserving creditor confidence in US assets.

The present international monetary regime can then be characterized as a hybrid. It comprises countries with a floating exchange rate regime and countries whose currency is pegged to the US dollar. Consequently, there are significant asymmetries. The international monetary system does not provide incentives to countries in external surplus to adjust, nor does it give incentives to the United States, who issues the international reserve currency. This all raises the risk of inconsistent policy choices. Moreover, what may be convenient at the national level, can be globally suboptimal.

As the late Tommaso Padoa-Schioppa argued, in his Triffin lecture last year, Triffin's analysis transcends the Bretton Woods system and can also be applied to the current system, "What we might call Triffin's 'general dilemma' can thus be expressed as follows: the stability requirements of the system as a whole are inconsistent with the pursuit of economic and monetary policy forged solely on the basis of domestic rationales in all monetary regimes devoid of some form of supranationality".

Which policy conclusions can we draw from this analysis?

It is clearly necessary to build a more stable and resilient international monetary system. This is a multi-faceted task. A crucial condition is a stronger coordination of macroeconomic policies, applying to all countries.

The unprecedented international policy cooperation during the global financial crisis, which helped prevent a much deeper global recession, was a fine first example. However, policy cooperation is equally important today, as we have to secure the global recovery and create the conditions for strong, sustainable and balanced growth.

The emergence of the G20 as the de facto primary forum for economic and financial cooperation contributed only partially to fill the void in international policy cooperation. The G20 functions indeed on an informal basis without binding powers and it cannot speak for all countries in the global economy. Indeed, it are often the smaller countries, not represented at the G20, that are the victim of ill-suited policies in larger countries. This aspect is often overlooked in the emerging new framework of global governance. It shows the importance of restoring the IMF's role as the central institution of the international monetary system.

A significant deficit of the IMF's surveillance of the world economy in the run-up to the global crisis was that the Fund's peer review, overall, failed to have much influence over the policies of the largest member states. Strengthening IMF surveillance is therefore crucial. Stronger multilateral obligations, backed by clear objective norms or quantitative benchmarks, as also proposed by the Palais Royal Initiative, could be an important element of the new system. There should further be assessment procedures to analyse the causes and implications of deviations from those policy norms. Finally, one might ask whether an approach such as the one introduced in Europe, which also includes the

possibility of sanctions if a country persistently violates its obligations, could be considered.

Another major issue for a new international monetary system, as became abundantly clear with the financial crisis, is the need for a better measurement and surveillance of global liquidity.

As is well known in the economic literature, liquidity has always been an elusive concept. Naturally, global liquidity conditions are influenced by monetary policy in the major economies, exchange rate arrangements, and the behaviour of the financial system. However, liquidity has many dimensions and can change quickly, since it is also influenced by perceptions and states of confidence or fear, as we have seen all too often in the last few years.

In the international economy, the concept of liquidity has also evolved significantly. Traditionally, the term "international liquidity" tended to be interchangeably with "foreign exchange reserves". More recently, in the context of a more globalized economy and deeper financial markets, the concept has become more fuzzy. Indeed, gross financial flows have become much larger, currency swaps and hedges are more prevalent, and borrowing can occur either domestically or abroad. All this multiplies the potential sources of liquidity creation.

Consequently, as noted by the Palais Royal Initiative, "The search for the appropriate approach to the management of liquidity conducive to balanced monetary and financial conditions at the global level is thus particularly challenging".

International policy-makers have taken up this challenge. In the context of G20 workstreams, the central banks and the BIS are currently developing new sets of global liquidity indicators. These could serve as the basis for a better monitoring of the global liquidity situation and the associated risks for liquidity "floods and droughts". These indicators should be used in future surveillance exercises. Naturally, they will need to be reviewed on a regular basis, as financial innovation will always lead to new forms of "shadow banking".

The role of central bank reserves is to cover risks that cannot be predicted accurately. They provide insurance against uncertainty. The magnitude of such risks has increased massively because of the size of pure financial transactions compared to real transactions, the intricacy of financial markets and the overreaction of these markets to current information. The American bank crisis and the European debt crisis took the world by surprise. Their magnitude was beyond anything that could have been forecasted and beyond anything that was assumed initially. The reaction was therefore bound to be fragmentary, late and insufficient.

The entire burden of global demand stabilisation rests now primarily on the monetary authorities of Europe and the US. Their role has to be buffeted by possible recourse to a last resort source of liquidity, independent from the national budgets and from domestic monetary considerations.

It is important to provide countries with an insurance mechanism, at a lower cost for themselves and the system, rather than stimulating reserve accumulation.

When designing this additional layer of liquidity provision, it is important to make sure that institutional arrangements grant it the same independence that the central banks enjoy. When thinking about the IMF to fulfil this role one should be aware that this goes against the recent trend whereby politics is assuming a greater role at the IMF as witnessed by the growing role of the IMFC compared to the Executive Board. This is an issue that demands further reflection.

However, let me be clear, sound, stability-oriented economic policies are the first and best line of defence to preserve global stability. More effective surveillance, including financial sector surveillance is essential.

Dear friends, let me conclude. The discussions about a new grand design are certainly interesting and stimulating, but one should not forget that the process to such a new system is evolutionary, step by step. Pragmatic steps forward in the direction of the grand design are as important. In this field, central banks have an important role to play, based on their practical experience.

This was also the case in the discussions that lead to the creation of the SDR. The first specific proposal in the direction of the SDR was submitted by Cecil De Strycker, who later became governor of the National Bank of Belgium, in the framework of the Ossola

group, which was the committee on the creation of reserve instruments, a committee created in the mid sixties at the insistence of the French Minister of Finance Giscard d'Estaing. The proposal would give the IMF the power to create additional central bank reserves in the form of IMF-liabilities. It broke the deadlock between competing views advanced by the French, American and German delegation.

Much later the National Bank contributed through its Executive Director at the IMF Jacques de Groot to the discussions which Jacques Delors had launched on the substitution account and on the allocation of SDR's to the IMF.

Also this time central banks will continue to contribute actively to this debate.

Finally, the timeliness of the conference could not be better underscored than by the fact that at the end of the week a similar conference will take place among the world leaders on the same subject. I wish you every success tomorrow.