Reforming the International Monetary and Financial System

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Problems with Global Financial Architecture

- High level of volatility
- With developing countries bearing burden of risk
- Rapid spread of crisis from the U.S. to the rest of the world
- Not the way efficient markets are supposed to work
  - Supposed to be stable, self-correcting
  - Rich countries, better able to bear risk, should bear the brunt

Interplay of Causes

- Deregulation, capital and financial market liberalization allowed banks/financial sector to engage in excessive risk taking (and in many cases predatory lending)
  - Facilitated rapid spread of crisis around the world
  - Only period without financial crisis was four decades after Great Depression when there was strong regulation
    - Not only was there greater stability, but also faster growth
    - Instability is bad for growth—raises risk premium

- Misalignment of incentives (private rewards differ from social returns) contributed not only to excessive risk taking and short sighted behavior, but also to distorted innovation
  - Didn’t innovate in ways which enhanced ability to manage risk
  - Aimed at regulatory, accounting, and tax arbitrage
  - Volcker: hard to find evidence of positive effect of most of innovations on growth

- High volatility induced large increases in reserves
  - Especially after IMF/Treasury mismanagement of ’97 East Asia crisis
  - Large reserves weaken global aggregate demand
  - Problem not savings glut, but investment dearth
    - Financial and economic system failed to recycle savings to meet global needs—addressing poverty, retrofitting world to address problems of global warming
    - Instead, money went into housing bubble in U.S.

Global Imbalances

- Part of world producing much more than it is consuming, part consuming much more than it is producing
  - Problem is opposite of direction that one would have expected
    - US should be saving for retirement of baby boomers
  - Surplus countries contribute to weak global aggregate demand
    - Key problem facing world today
- Disorderly unwinding of global imbalances did not cause this crisis
  - But could cause next
    - Crisis not caused by savings glut
    - Low cost money could have been used as basis of global boom *if financial sector had allocated it well*
  - Pressures to redress

Sources of Global Imbalances

- Need to be viewed as part of global general equilibrium
- Excess spending in U.S.—facilitated by its role as reserve currency
- Excess savings in rest of world
  - Savings for reserves—to protect against global volatility
    - Class of 1997: learned what happened if reserves were inadequate
    - Class of 2008: learned benefits of reserves
    - Could lead to problem being exacerbated
  - Export-led growth model
  - High volatility of natural resource (oil) prices

Prospects and Consequences

- U.S. will increase its savings, at least temporarily
  - Risk is that it will happen faster than the surplus countries increase their consumption/investment
  - Leading to further weaknesses in global aggregate demand
- Crisis has increased demand for “precautionary reserves”
  - Those countries with large reserves fared better
  - IMF proposals to take on greater role in “insurance” not likely to work
    - Lack of confidence that money will be there when they need it
  - Demand by natural resource countries for buffer against volatility likely to remain strong
    - Volatility remains high

An Alternative Model to Export-led Growth?

- High unemployment in Europe and America will put significant pressure on China and others running large surpluses
  - These countries are contributing to weak global aggregate demand
  - Exerting a negative externality on others
- Can have export-led growth without large surpluses
- But WTO removed some key instruments other than the exchange rate
- TRIPS has made it more imperative for countries to develop their own technological capacities
- China has resources and capabilities for an alternative model based on innovation
  - But many other countries don't

Resolution of Global Imbalances

- G-20 proposal
  - U.S. save more
    - Already happening
  - China consume more
- Problems
  - In absence of coordination—risk of global slowdown
  - Planet cannot survive if everyone consumes in America’s profligate style

Alternative Resolution

- Deeper reforms
- Based on recommendations of UN Commission
- Global Regulatory System
- Reform of Global Reserve System
- Improvements in risk mitigation
  - Including new mechanisms for restructuring sovereign debt
- Recycling savings to meet global needs

A New Global Financial Regulatory System

- Obvious that the current international institutions did not prevent crisis
  - Promoted policies that led to crisis and its rapid spread around the world
- Change in name from Financial Stability Forum to Financial Stability Board not likely to be sufficient
- Has to be predicated on a changed understanding of the role of regulation
- Global coordination required to avoid regulatory arbitrage
- But will be difficult to achieve
- Alternative strategy: regulate first, harmonize later
  - Each country has obligation to its citizens to protect its economy

New Global Reserve System

- Weaknesses of current system long recognized
  - Contributes to instability
    - Especially as the dollar becomes a poor store of value
  - Contributes to weaknesses in global aggregate demand
    - As countries have hundreds of billions of dollars in “precautionary savings”
  - Inequitable
    - Poor countries lend reserve countries trillions of dollars at low interest rates
    - Value of “foreign aid” to rich greater than that they receive
- Dollar reserve system already fraying
- Makes little sense in 21st century multilateral world for so much of the world’s global financial system to depend on the currency of one country

Instability

- Basic trade identity:

  sum of surpluses = sum of deficits

  – If some countries insist on having a surplus, some others must have deficit

  – Hot potato of deficits: as one country eliminates its deficit, it appears somewhere else in the system

  – U.S. has become deficit of last resort

    - Apparent in statistics
    - But is this sustainable?

- Surplus countries are as much a part of systemic problem as deficit countries
  - Keynes emphasized negative effect on global aggregate demand
  - Keynes argued that one should “tax” surplus countries to provide appropriate incentive

Proposed Global Reserve System

- Issued in amount commensurate with reserve accumulation
  - Offsetting negative effect on aggregate demand
  - Would thus not be inflationary and would avoid deflationary bias of current system
- Would enhance global stability
  - Inherent instability in any single country providing reserve currency
  - But provide an additional degree of flexibility
    - Countries could run a small trade deficit without having a problem
    - Net reserves would still be increasing

- Could provide incentives *not* to have surplus by reducing surplus country’s allocations of global reserve currency
- New allocations could be used to finance global public goods and development
- Would not be inflationary as long as annual issuances were less than or equal to increases in reserves

- There are two precursors—IMF’s SDRs and Chiang Mai Initiative
  - SDR issuances are episodic, and U.S. has vetoed last expansion
  - Proposal can be thought of as globalization and refinement of Chiang Mai initiative
- Since UN Commission Report, idea has had considerable support from around the world

- U.S. will resist, since it thinks it gains from low interest loans
  - But it loses from high instability
  - And amounts of loans will in any case be decreasing
  - And trade deficit—flip side of reserve accumulations—contributes to weak aggregate demand

Risk mitigation

- More extensive lending in borrowing country currencies
  - Already happening
  - IFIs could promote
- Sovereign debt restructuring
  - Reducing costs of restructuring
  - Giving a fresh start
  - If history is guide, likely to be many problems in years to come

Recycling Savings to Meet Global Needs

- Global problem: a world with excess capacity and a world with huge unmet needs
  - Global warming
  - Global poverty
- Solution: More investment
- Challenge: Recycling savings to more productive use
  - Global financial markets before the crisis failed
  - Money “recycled” to what in the end proved a highly unproductive use

Prospects

- Prospects of a globally coordinated resolution under the G-20 framework not good
- Alternative frameworks may have better prospects
  - Especially working towards creation of new global reserve system
    - Can be used to help address issues of global warming and global poverty and help stabilize global economy
    - An old idea (Keynes), but perhaps an idea whose time has come