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Research Report

Aspects of the International Monetary System: International Reserves and International Exchange Rate Regimes

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Staff Memo

Aspects of the international monetary system: International reserves and international exchange rate regimes

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Ingimundur Fridriksson:

Aspects of the International Monetary System: International Reserves and International Exchange Rate Regimes¹

The global economy has in recent years been characterized among other things by large imbalances between countries and regions, capital flow volatility, and large reserve accumulation by several countries, in some cases well beyond any reasonable measure of reserve adequacy. The global imbalances were most clearly reflected in large current account deficits in the US and large current account surpluses in many emerging market economies in Asia and elsewhere. The surpluses were in at least some cases the result of aggressive export oriented policies and limited exchange rate flexibility. Persistent large imbalances are themselves a potential source of disruptive developments, and the policies of the largest reserve accumulators are likely to have played a role in creating the conditions that brought about the global financial crisis. The report of a high level EU group of experts concluded among other things that “credit expansion in the US was financed by massive capital inflows from the major emerging countries with external surpluses, notably China. By pegging their currencies to the dollar, China and other economies such as Saudi Arabia in practice imported loose US monetary policy, thus allowing global imbalances to build up. Current account surpluses in these countries were recycled into US government securities and other lower-risk assets, depressing their yields and encouraging other investors to search for higher yields from more risky assets. In this environment of plentiful liquidity and low returns, investors actively sought higher yields and went searching for opportunities. Risk became mis-priced.”²

Reserve developments

Global reserves have risen significantly over time, both in absolute and relative terms, and very rapidly in recent years. The abolishment of fixed exchange rate parities in the early 1970s did not lead to reduced demand for reserves, as might have been expected. The gradual liberalization of capital movements was accompanied by increased volatility in markets, prompting countries to increase their reserves beyond what otherwise might have been deemed sufficient. The feared shortage of reserves or limits on reserve creation which surfaced in the 1950s and 1960s did not materialize as governments became increasingly able to tap international markets for loans to supplement their reserves. These fears had resulted in the agreement to create a new reserve currency, SDRs (Special Drawing Rights), to be issued and allocated by the IMF.

The globalization and rapid growth of international financial transactions have indeed increased the demand for international reserves, and in recent years there has been an

¹ Senior Adviser in the International Department in the Monetary Policy Wing of the Central Bank of Norway. The note was written in late 2009. Its purpose is to briefly review international reserve developments and prospects and related aspects. These are among issues which are likely to figure prominently in international discussions in the period ahead. The note builds on a range of publications by institutions, like the IMF, and on the writings of authoritative academics. The list of references includes only sources which are directly quoted.

² Report of the high-level group on financial supervision in the EU, chaired by Jacques de Larosière, Brussels, February 25, 2009, p. 7.

exceptionally rapid build-up of reserves in some countries, mainly fuelled by the global current account imbalances, persistent and large US current account deficits and large surpluses in various other countries, notably in Asia. Following the Asian crisis of the late 1990s, many countries embarked upon a policy of reserve accumulation in order to insure themselves against external shocks. In the period from the late 1990s, global reserves have risen from about 2 trillion US dollars to over 8 trillion. The increase is mainly concentrated in Asian and some other emerging market economies. In the period from 2003 to 2008, the share of emerging and developing countries' reserves in global reserves rose from 42% to 63% while the share of advanced countries fell correspondingly from 58% to 37%.

Considering the increase in reserve holdings by some countries, Stanley Fischer pointed out in 1999 after the eruption of the Asian crisis that "the first line of defense in dealing with capital flow reversals, aside from macroeconomic policy and exchange rate responses, is to use the foreign exchange reserves. There has been surprisingly little emphasis in discussions of the present crisis on the fact that the countries with very large reserves have done better in dealing with the crisis than those with small reserves. But that is a fact, and it is very likely that countries seeking to draw the lessons of the present crisis will decide they should hold much larger reserves than before. This is already happening in the case of Korea -- and it will not be the only country to move in that direction."³

Reserve holdings are highly concentrated. The top five countries account for more than 50% of global reserve holdings. Important portfolio decisions of one central bank could therefore have a large impact in financial markets. In the years 2006 to 2008, China held on average over 23% of global reserves with the second largest reserves being held by Japan, less than 14% of the total.⁴ In the latter half of 2009, China held \$2.1 trillion worth of foreign reserves, equivalent to 49 percent of its 2008 GDP and over two years worth of imports.

The role of the US dollar as the main reserve currency in the global financial system has broadly remained intact. For decades it has roughly maintained its relative position with a share of close to two thirds of the total. Changes over the past decade or over the period since the 1970s are relatively insignificant. It may nevertheless be noted that the share of the euro has risen since its establishment in 1999 but has yet to reach the share earlier commanded together by the previous European currencies, primarily the Deutschmark. In early 2009, the US dollar accounted for 64% of global reserves, the euro for 26%, the Pound sterling for 4% and other currencies for less. After the historically large allocations which were agreed and ratified in 2009, the share of the SDR in global reserves is still below 4%.

Global economic prospects and implications for reserve developments

After subsiding during the financial crisis, the global imbalances are projected to intensify anew. At unchanged policies, many countries will continue to run large current account surpluses and reserve accumulation is set to continue in many high reserve countries.

In its October 2009 World Economic Outlook, the IMF stated that the process of rebalancing global demand would be drawn out and that a rebalancing must involve a broad range of

³ Stanley Fischer: *On the Need for an International Lender of Last Resort*; Paper prepared for delivery at a joint luncheon of the American Economic Association and the American Finance Association in New York, January 3, 1999.

⁴ Isabelle Mateos y Lago, Rupa Duttagupta and Rishi Goyal: *The Debate on the International Monetary System*; IMF Staff Position Note, SPN/09/26, November 11, 2009, p. 9.

emerging economies if solid global growth is to be sustained over the medium term. It would also require major changes in consumption patterns, supported by an economic environment that fosters lower precautionary saving and higher investment, including in emerging economies that have traditionally exported large amounts of capital. This was a long-term policy challenge that involved complex issues related to lowering corporate saving, expanding and improving financial intermediation, eliminating distortions that foster production of tradable goods, and strengthening social safety nets. Rapid progress could not be expected in the near term. The projections painted a sobering picture of the path for demand-side rebalancing. Little current account adjustment was forecast by the IMF for the emerging economies of Asia, notably China, over the medium term.⁵

These prospects have *inter alia* prompted concerns about reserve creation in the period ahead and the dominant role of the US dollar as a reserve currency, and thrown the spotlight at the potential for other reserve currencies, including “synthetic” ones.

The G20 responded with determination to the global crisis, and in September 2009 it embarked upon an unprecedented coordination of economic policies with the adoption of the Framework for Strong, Sustainable and Balanced Growth. The timetable subsequently agreed by the G20 for its work in 2010 is a tight one and poses significant challenges both for the policy formulation of individual countries and for the group as a whole in ensuring the internal consistency of their policies for the achievement of the goals of their Framework. The IMF was assigned a vital role in assessing the policies of the G20 countries and their consistency with the objectives of the Framework.

The prospects of continued and even intensified global imbalances and reserve hoarding by several already large reserve holders carry with them the potential for disruptive developments in the years ahead. It is thus crucial for the global economy that the G20 Framework is successful in effectively tackling the causes of the global imbalances and restoring a stable and sound global economy and financial system. The transparency and candidness of the IMF’s analysis will be very important in the process.

In a speech in November 2009, the Managing Director of the IMF said that “for the world to succeed in its rebalancing efforts, exchange rates must be allowed to reflect medium-run fundamentals. Based on our analysis, many Asian currencies are still undervalued related to those of their major trading partners, while the euro is somewhat overvalued on this basis. So long as this remains the case, the price signals sent about the returns from tradable goods compared to those from nontradable goods will continue to be skewed—thus delaying the rebalancing across countries, and more specifically the necessary recalibration of Asia’s growth model. In my view, the region should not resist a gradual appreciation of its exchange rates, which I consider an important prerequisite for long-term rebalancing.”⁶

Reserve currencies

As mentioned, the currency composition of global reserves did not materially change in recent decades. The US dollar has broadly held its share in the period of very rapid growth of reserves. This is to an important degree explained by the US current account deficit, but also

⁵ IMF: *World Economic Outlook*, October 2009, pp 33-34.

⁶ Dominique Strauss-Kahn: *A Leadership Role for Asia in Reshaping the Post-Crisis Global Economy*, Annual Lecture at the Monetary Authority of Singapore, November 13, 2009.

by the superiority of US capital markets over other reserve currency markets in terms of size, depth, liquidity, and maturity composition of outstanding issues.

A 2006 BIS Working Paper argued that the emergence of a reserve currency is influenced by at least four factors: First, a country's share in world output and trade, second, macroeconomic stability, third, financial market development, and, fourth, network externalities, i.e. a currency's status depends on others' use of it as a reserve currency. An important feature of the main determinants of a currency's international status is that they tend to change slowly, inducing inertia. The authors found that empirical studies on the evolution of the currency composition of official reserves across countries and its determinants confirmed the importance of the four factors cited above.⁷

Concerns about the creation of reserves have *inter alia* been voiced by China, the largest reserve holder, and the issue was also discussed thoroughly in a recent UN expert report.⁸ This is at least partly motivated by the potential risk to systemic stability should the US dollar suddenly lose its historic status as a reserve currency. Concerns have surfaced that the credibility of US markets may have been impaired by the financial crisis. Nevertheless, the view prevails that changes in the composition of international reserves are likely to come slowly. Central banks will want to hold a diversified portfolio of reserves while taking into account such factors as the availability of high quality assets, liquidity and the size of the market, network effects, trade patterns, and the currency denomination of trade.

The alternative to continued reserve accumulation, in several cases from levels far beyond any reasonable measure of adequacy, is economic policies aimed at significantly reduced global imbalances and a potentially large IMF, able to provide financing on a large scale when needed. Irrespective of whether policies are agreed that reduce the demand for reserves, the creation of reserves will be discussed in the period ahead as large reserve holders have become concerned about the predominant role of the US dollar as a reserve currency and the supply of reserve currencies in general. Given the continued superior characteristics of the US dollar as a reserve currency, and because changes in global reserve composition will only come about slowly, the US dollar is likely to continue to have a commanding share for many years to come. That does not mean that other currencies may not make some headway, particularly the euro in the short to medium term, and potentially the yuan in the (very) long term, depending on economic policy developments in China. Yet another potential candidate is SDRs through a global agreement and commitment to give it a greater role.

SDRs were allocated to IMF members in the years 1970 to 1972, a total of 9.3 billion SDRs. The initial round of allocations was equivalent to about 17% of global reserves (excluding gold) in 1970. SDRs were again allocated in the years 1979 to 1981, a total of 12.1 billion SDRs, bringing total allocations to 21.4 billion SDRs. After that there were no allocations for 28 years. The membership of the IMF expanded significantly, and because it was felt to be unfair that the new members had not received SDRs like the previous members, a special ad hoc allocation of 21.5 billion SDRs was agreed in 1997 to only those disadvantaged countries. However, that increase was not ratified by a sufficient majority of IMF members until 2009.

At their summit in London in early 2009, the leaders of the G20 countries agreed to support a large general allocation, in the amount of over 160 million SDRs, as a part of a wider package

⁷ Gabriele Galati and Philip Wooldridge: *The euro as a reserve currency: a challenge to the pre-eminence of the US dollar?*; BIS Working Papers No. 218, October 2006, pp. 2-3.

⁸ Report of the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary System (chaired by Joseph E. Stiglitz), United Nations, September 21, 2009.

aimed at tackling the crisis in global financial markets and the global economy. It was thus a crisis driven decision. The 2009 allocations brought the total allocated amount to 204.1 million SDRs. Until then, SDRs represented only a minimal portion of world reserves. The 2009 allocations reflect recognition and a significant enhancement of the reserve currency status of SDRs, even though their relative share in global reserves remains low at under 4%.

However, the 2009 allocation does not necessarily reflect support by the G20 collectively for a larger future role for SDRs, let alone the objective set out in the Articles of Agreement of the IMF that SDRs become a principal reserve asset, as referred to below.

The UN Expert Commission concluded in its September 2009 report that it “should be emphasized that a system based on multiple, competing reserve currencies would not resolve the difficulties associated with the current system, since it would not solve the problems associated with national currencies—and, particularly, currencies from major industrial countries—being used as reserve assets. [...] The basic advantage of a multi-polar reserve world is, of course, that it provides room for diversification. However, it would come at the cost of adding an additional element of instability: the exchange rate volatility among currencies used as reserve assets.”⁹

Alternative reserve currency creation

The IMF Articles of Agreement include *inter alia* the following: “Each member undertakes to collaborate with the Fund and with other members in order to ensure that the policies of the member with respect to reserve assets shall be consistent with the objectives of promoting better international surveillance of international liquidity and making the special drawing right the principal reserve asset in the international monetary system.”¹⁰ Thus, the intentions of the IMF membership were clear: SDRs were to become the principal reserve asset.

The Governor of the People’s Bank of China raised concerns in early 2009 about international reserve currencies: “Theoretically, an international reserve currency should first be anchored to a stable benchmark and issued according to a clear set of rules, therefore to ensure orderly supply; second, its supply should be flexible enough to allow timely adjustment according to the changing demand; third, such adjustments should be disconnected from economic conditions and sovereign interests of any single country. The acceptance of credit-based national currencies as major international reserve currencies, as is the case in the current system, is a rare special case in history. The crisis again calls for creative reform of the existing international monetary system towards an international reserve currency with a stable value, rule-based issuance and manageable supply, so as to achieve the objective of safeguarding global economic and financial stability.”¹¹

He went on to say that the frequency and increasing intensity of financial crises following the collapse of the Bretton Woods system argued that the costs of such a system to the world may have exceeded its benefits. He thus suggested that a desirable goal of reforming the international monetary system was to create an international reserve currency that is disconnected from individual nations and is able to remain stable in the long run, thus removing the inherent deficiencies caused by using credit based national currencies. A super-

⁹ Report of the Commission of Experts of the President of the United Nations General Assembly, op.cit. p. 114.

¹⁰ IMF Articles of Agreement, Article VIII, Section 7, <http://www.imf.org/external/pubs/ft/aa/aa08.htm>.

¹¹ Zhou Xiaochuan: *Reform of the international monetary system*; March 23, 2009 (<http://www.pbc.gov.cn/english/detail.asp?col=6500&ID=178>).

sovereign reserve currency would not only eliminate the inherent risks of credit-based sovereign currency, but also make it possible to manage global liquidity. A super-sovereign reserve currency managed by a global institution could be used to both create and control global liquidity. And when a country's currency is no longer used as the yardstick for global trade and as the benchmark for other currencies, the exchange rate policy of the country would be far more effective in adjusting economic imbalances. This would significantly reduce the risks of a future crisis and enhance crisis management capability. He then suggested that special consideration should be given to enhancing the role of SDRs. They had the features and potential to act as a super-sovereign reserve currency.

Similar concerns and ideas were addressed in the UN Expert Commission Report already cited. "The increases in the U.S. national debt and the size of the balance sheet of the U.S. Federal Reserve have led to concerns in those countries holding large dollar reserves about the stability of the dollar as a store of value. In addition, the low (near zero) return on dollar holdings means that they are receiving virtually no return in exchange for the foreign exchange rate risk which they bear. However, any attempt to reduce dollar holdings will produce the Triffin dilemma noted above, provoking the collapse in the value of their dollar holdings that they fear. These are among the reasons to adopt a truly global reserve currency. Such a global reserve system can also reduce global risks, since confidence in and stability of the reserve currency would not depend on the vagaries of the economy and politics of a single country. The current crisis provides, in turn, an ideal opportunity to overcome the political resistance to a new global monetary system. It has brought home problems posed by global imbalances, international instability, and the current insufficiency of global aggregate demand. A global reserve system is a critical step in addressing these problems and in ensuring that, as the global economy recovers, it moves onto a path of strong growth without setting the stage for another crisis in the future. It is also a propitious moment because the United States may find its reserve currency status increasingly costly and untenable. The dollar can be a reserve currency only if others are willing to hold it as such, and as the return falls and the risk increases, greater reservations about the dollar as a reserve currency are being expressed. The dollar reserve system is likely to fray, if it is not already doing so. Moreover, the U.S. has embarked on a response to the crisis that will involve large domestic imbalances and also potentially large external imbalances, with unpredictable implications for the international reserve system. Thus, both the United States and foreign exchange reserve holding countries may actually find it acceptable to introduce a new system. The former would be able to take policy decisions with less concern about their global impact; the latter would be less concerned about the impact of U.S. policies on their reserve holdings. {...} In setting up such a system, a number of details need to be worked out, including who would issue the reserve currency, in what amounts, to whom, and under what conditions. The issues are largely separable. Responsibility for managing the global reserve system could be given to the IMF, which currently issues the only global currency, Special Drawing Rights (SDRs), on which the system could be built. But it could also be given to a new institution, such as a "Global Reserve Bank." If we turn to existing institutions, this could be contingent on needed reforms of these institutions. "¹²

Richard Cooper addressed the potential role of SDRs in a 2009 paper. Like some other observers, he was skeptical about the SDRs' potential; "...the US dollar is likely to remain the dominant international currency for many years, certainly the next decade and probably longer. [...] A deliberate international decision to create an alternative global currency could

¹² UN Expert Commission Report; op. cit., p. 115.

displace the dollar, but that task would confront formidable practical difficulties. The prospective gains from such a creation would have to be sufficiently great to make governments willing to overcome the practical difficulties and to adopt the complementary policies (mainly concerning exchange rates) that would be necessary to give a new international currency a compelling advantage over present arrangements.”¹³ He also states: “If the SDR were to become a truly international currency, it would have to be made accessible to private parties, or else the modus operandi of international financial relations would have to be radically revised. This applies to holdings of and payments in SDRs. Nothing prevents transactors in many countries today from using the SDR as a unit of account in their transactions with foreigners. The SDR is priced daily, indeed hourly, in terms of other currencies, so there is no ambiguity about its value at any moment. That it is not used widely suggests either that inertia in human behavior is very high, however irrational that may be, or that transactors see no compelling reason to shift to SDRs from dollars or whatever currency they may be using. A third practical issue is what would become of all the US dollars held in both private and official balances if the SDR (or some other synthetic unit) replaced the US dollar? One approach would be to leave them and substitute SDRs through incremental growth, such that the US dollar (and other national currencies now held abroad) would gradually recede in relative importance, without any formal displacement. Given the amount of foreign balances held today (over \$5 trillion in official reserves alone), it would take a very long time for the SDR to become the predominant reserve asset through such an approach—and perhaps it would never predominate in private balances, unless the process were forced in some way.”¹⁴

The UN Commission of Experts took a more aggressive view on the SDRs’ future. In their call for a global reserve currency, they claimed that it would reduce global risks since confidence in and stability of the reserve currency would not depend on the vagaries of the economy and politics of a single country. A global reserve system would be a critical step in addressing the problems posed by global imbalances, international instability and the current insufficiency of global aggregate demand. For this purpose the Commission proposed the establishment of a new global reserve system, the responsibility for which could be given to the IMF or a new institution, further elaborated in the report. It also suggested that one way of establishing a new global reserve system would be to broaden the existing SDR arrangements, making their issuance automatic and regular. Doing so could be viewed simply as completing the process begun in the 1960s, when SDRs were created. The simplest version would be an annual issuance equivalent to the estimated additional demand for foreign exchange reserves due to the growth of the world economy. They could be issued in a counter-cyclical fashion, thereby concentrating issuances during crisis periods. One advantage of using SDRs in such a counter-cyclical fashion would be that it would provide a mechanism for the IMF to play a more active role during crises.¹⁵

In a September 2009 paper, John Williamson saw potential benefits in a larger role of SDRs: “The world may be destined to see a multiple reserve currency system in the coming years, irrespective of whether or not the role of the SDR is expanded. The euro is now sufficiently widely accepted and held that an effort to avoid reserve-currency status by the European Central Bank (ECB) seems unlikely to be attempted and, if attempted, to succeed. However, a

¹³ Richard Cooper, *The Future of the Dollar*; Peterson Institute for International Economics, Policy Brief, September 2009, p. 6.

¹⁴ Richard Cooper, *op.cit.*, pp. 3-4.

¹⁵ UN Expert Commission Report; *op.cit.*, p. 117.

larger SDR role in such a system might help to stabilize it...¹⁶ He concluded that SDRs were created to be central bank money and that they were well designed for that role. Large regular allocations of SDRs would be a mechanism to reduce the inconsistency of payments objectives, one that involves a far fairer distribution of seigniorage than otherwise seems conceivable. The interests of major reserve currency countries, like the United States and potentially China, could be disputed, but they too might benefit from an enhanced role of SDRs.

In an article in early October 2009, Williamson went further in saying that that “the world would be a better place if a substantial portion of the demand for holding additional international liquidity were to be met by creation of more SDRs instead of exclusively by expanding reserve currency holdings, as in the recent past. [...] It is quite difficult to think of other reforms that promise equally profound benefits to the world and that demand so little in the way of change. SDR allocation involves merely making use of what already exists, not making big and difficult reforms.”¹⁷

C. Fred Bergsten argued in 2009 for the evolution of a multi-currency system in which other monies increasingly share the international position of the US dollar in private markets, the euro being an obvious candidate. He also supported further allocations of SDRs which would enable countries to build up their reserves without having to run large trade and current account surpluses. “A more balanced composition of global reserve assets is quite feasible and very much in the interests of both the United States and the rest of the world.”¹⁸

In the discussion of a potential future role for SDRs, the attention has again been drawn to the idea of a substitution account, initially suggested in the 1970s.¹⁹ It involves the IMF setting up a facility which would allow central banks to swap US dollar assets for SDRs. It could potentially alleviate concerns of a disorderly diversification out of dollars by the largest reserve holders.

In a 2002 paper, Clark and Polak presented their view of a future role for SDRs. At that time, global reserves were still significantly below present levels and the magnitude of their subsequent growth was not foreseen. Nevertheless, they concluded that there was likely to be growing demand to hold larger stocks of reserves on the part of most countries. They asked whether some of this growth should be met by “modest” allocations of SDRs and their answer was in the affirmative. Similar arguments were made by Michael Mussa in 1996.²⁰ Clark and Polak suggested that there were efficiency gains for the world economy if SDR allocations substituted, at least in part, for reserves that otherwise would be acquired by running a current account surplus or by borrowing on the world capital markets. A number of considerations suggested that the provision of reserves in the form of SDRs would in fact reduce credit risk.

¹⁶ John Williamson: *Why SDRs Could Rival the Dollar*; Peterson Institute for International Economics, Policy Brief, September 2009, p. 4.

¹⁷ John Williamson: *The Case for Regular SDR Issues: Fixing Inconsistency in Balance-of-Payments Targets*; Op-ed in VoxEU.org, October 2, 2009.

¹⁸ C. Fred Bergsten: *The Dollar and Deficits: How Washington Can Prevent the Next Crisis*; Foreign Affairs, Volume 88, No. 6, November/December 2009.

¹⁹ See for example Isabelle Mateos y Lago et. al., op.cit., p. 19; and Mark Carney: *The Evolution of the International Monetary System*, Remarks at the Foreign Policy Association in New York City, November 19, 2009.

²⁰ Michael Mussa: *Is There a Case for Allocation Under the Present Articles?* In Michael Mussa, James M. Boughton and Peter Isard: *The Future of the SDR in Light of Changes in the International Financial System*, IMF, Washington, 1996.

Allocations of SDRs would make more external resources available to a country, enabling it to weather potential balance of payments crises without undue reliance on import compression or the imposition of trade or other restrictions. Reserves supplied by allocations of SDRs would tend to reduce systemic risk because they are a permanent addition to the world's stock of reserves.

Exchange rate systems

In an Occasional Paper published in 2010, staff of the IMF identified three related potential sources of instability. “First, the recent crisis could heighten EMEs’ incentives to self-insure via reserves accumulation. This could create pressures for competitive depreciations, exacerbate global imbalances, and—if accumulated against persistent U.S. deficits—ultimately undermine confidence in the reserve currency status of the dollar. Greater access to Fund resources, including precautionary instruments, or to a synthetic reserve asset (such as the Special Drawing Right) could help prevent this outcome. Second, because external imbalances are more persistent under less flexible exchange rate regimes, greater exchange rate flexibility in key surplus countries, together with the full range of supporting policies envisaged in the IMF-sponsored Multilateral Consultation for other countries, would tend to reduce systemic risks. Finally, continued U.S. deficits over the long term could eventually undermine confidence in the dollar’s reserve currency status. Although a sudden and destabilizing stock adjustment in reserves composition seems unlikely, appropriate exit policies from the crisis that credibly narrow future deficits would provide additional confidence in the dollar’s reserve currency status.”²¹ Non-systemically important countries could choose an exchange rate regime that was best suited to their particular economic challenges. Systemically important countries should factor in the potential for their choice of policy to moderate or exacerbate destabilizing global imbalances.

The paper found that pegged exchange rate regimes provided a useful nominal anchor for both developing and emerging market countries, delivering lower inflation compared to other regimes without compromising growth performance. By combining the benefits of still relatively low exchange rate volatility with a competitive level of the real exchange rate, intermediate exchange rate regimes were associated with the fastest output growth, particularly in EMEs. Floating exchange rate regimes were, however, found to be associated with lower susceptibility to financial crisis and faster and smoother external adjustment than pegged or intermediate regimes. And, the paper concluded, as referred to above, that “a country should choose the regime best suited to address its particular economic challenges, factoring into its decision in systemic cases the implications of that choice for overall systemic stability”.²²

There is concern that some countries will emerge from the current crisis determined to build up even larger reserves for self-insurance purposes against a future crisis. In the view of the IMF staff, this might be avoided by providing alternatives to reserve hoarding, such as a larger IMF and greater access to its resources, and/or by further allocations of SDRs, i.e. by the creation of reserves that do not require corresponding balance of payments surpluses or deficits. The IMF staff also finds that imbalances (especially surpluses) tend to be more

²¹ Atish R. Ghosh, Jonathan D. Ostry, and Charalambos Tsangarides: *Exchange Rate Regimes and the Stability of the International Monetary System*; IMF Occasional Paper no. 270, 2010, p. 1

²² Atish R. Ghosh et. al., op.cit., p. 3

persistent under less flexible exchange rate regimes coupled with the finding that the low inflation benefits of pegs are lost when there are large current account surpluses suggests that greater exchange rate flexibility in key surplus countries would tend to reduce systemic risk. Greater exchange rate flexibility in key surplus countries could thus reduce systemic risks associated with the global imbalances while supporting sound economic performance at the national level.

Last but not least, the IMF staff points to the potential risk that long term US deficits could undermine confidence in the US dollar as a reserve currency with potential disruptions for the global system.

In the IMF classification of exchange arrangements, China is said to have a crawling peg, India, Indonesia, Malaysia, Russia and Thailand to have managed floats, and Argentina, Saudi Arabia, Oman, Qatar and the United Arab Emirates to have US dollar pegs, to take but a few examples. The remaining BRIC, Brazil, has an inflation targeting framework and thus a floating exchange rate.²³ China's exchange rate remained virtually unchanged against the US dollar in 2009. In its 2009 Economic Review of China, the OECD said: "Allowing greater exchange rate flexibility and putting more weight on an inflation objective as the nominal anchor – while keeping a vigilant eye on asset prices – would offer the central bank more scope to tailor monetary policy to domestic macroeconomic conditions and reduce the costs and risks of sterilizing foreign reserve inflows. Besides, real exchange rate appreciation is to be expected over the medium run in an economy that is catching up rapidly."²⁴

Summary and prospects

The rapid widening of global imbalances in recent years, the build-up of reserves in many Asian countries and the prospect of intensified imbalances following some narrowing during the financial crisis have provoked discussions of how the demand for reserves can be satisfied, about the role of reserve currencies and whether a new reserve currency can be created, and last but not least about the urgency of reducing the imbalances and stemming the accumulation of reserves in high reserve countries, far beyond any reasonable measure of adequacy. Partly, the roots of the global imbalances lie in the rigidity of exchange rate policies of many Asian countries and the reluctance of some of them to increase flexibility. Partly at least, the large reserve accumulation by some countries is motivated by their intent to insure themselves as much as possible against a crisis.

General IMF recommendations on exchange rate regimes are that each country should choose the one best suited to its particular economic challenges. However, systemically important countries would also have to consider the global implications of their policies and specifically their contribution to reduced global imbalances. Under current conditions, the IMF argues that greater exchange rate flexibility in key surplus countries could reduce systemic risks associated with the global imbalances while supporting sound economic performance at the national level.

The G20 adoption in Pittsburgh of the *Framework for Strong, Sustainable and Balanced Growth* was an important milestone. Under it, the member countries commit themselves to develop "a process whereby we set our objectives, put forward policies to achieve these objectives, and together assess our progress. We will ask the IMF to help us with its analysis

²³ IMF: *Annual Report on Exchange Arrangements and Exchange Restrictions* 2008, pp. xiv-xv.

²⁴ OECD: *2009 Economic Review – China*; October 27, 2009, p. 9.

of how our respective national or regional policy frameworks fit together”.²⁵ Among the key objectives is to “...promote more balanced current accounts...”. The IMF is assigned the role of assisting “our Finance Ministers and Central Bank Governors in this process of mutual assessment by developing a forward looking analysis of whether policies pursued by individual G20 countries are collectively consistent with more sustainable and balanced trajectories for the global economy...” At their meeting in early November 2009, G20 Finance Ministers and Central Bank Governors agreed on a Mutual Assessment Process (MAP) and a timetable for the work under the Framework in 2010.

The objectives of the G20 are noble and ambitious. However, it is well known that there is considerable reluctance on the part of some of the countries to consider certain important issues. Additionally, if history is any guide, one should not be overoptimistic about the potential success of the G20 process. The challenge of subjecting national policies to the discipline of peer review and of the continuous consistency assessment and advice of the IMF will be great. In a 2006 speech, Lawrence H. Summers stated, in commenting on the need for a global strategy, that he was not falsely optimistic about the ability of any international forum to influence US fiscal policy. Nonetheless, he believed that much more frequent and intense discussions on a multilateral basis than had taken place would raise the prospects for a successful adjustment process and reduce the risks of either a hard landing or of dangerous unilateralist responses to current account imbalances. Scepticism about the success of international coordination of policies can also be detected in public statements by senior European officials.²⁶ In October 2009, Obstfeld and Rogoff pointed out that an aspect of the international monetary system that is ripe for improvement is the surveillance of and coordinated response to large imbalances. The September 2009 G20 Pittsburgh statement on the surveillance of external imbalances was therefore a useful step in drawing attention to the dangers they create and to their underlying origin in national policy choices. “In the interest of global stability, the policy choices of sovereign nations, including their exchange rate arrangements, must be viewed as legitimate subjects for international discussion and negotiation.”²⁷

In the absence of effective corrective policies, the global imbalances are set to intensify anew following a temporary shrinkage which, in addition to being detrimental to the restoration and maintenance of global financial and economic stability, would be likely to bring with it further reserve accumulation and associated strains in foreign exchange markets and possibly in the national capital markets of the main reserve currencies. Although history does not provide great comfort, it is possible that the lessons of the crisis and appreciation of the various factors underlying it will provide the discipline and international statesmanship needed to adopt coordinated policies aimed at effectively reducing the global imbalances. Current prospects might sufficiently frighten policy makers in the most critical countries, and peer reviews and pressures ought to bring about better global balance.

The currency composition of global reserves did not materially change in recent decades. The US dollar has more or less held its share in the period of very rapid growth of reserves. This is

²⁵ The G20 Leaders’ Statement at the Pittsburgh Summit September 24-25, 2009.

²⁶ See for example Ignazio Visco: *Challenges to international cooperation in the wake of the global crisis*; Speech at the Italian Chamber of Commerce and Industry for the UK, London, October 16, 2009; and Axel A. Weber: *The global economic crisis and the challenges it poses*; Introductory remarks at the Israeli Presidential Conference, Jerusalem, October 22, 2009.

²⁷ Maurice Obstfeld and Kenneth Rogoff: *Global Imbalances and the Financial Crisis: Products of Common Causes*, Paper prepared for the Federal Reserve Bank of San Francisco Asia Economic Policy Conference October 18-20, 2009, p. 36.

to an important degree explained by the superiority of US capital markets over other reserve currency markets in terms of size, depth, liquidity, and maturity composition of outstanding issues. Given these facts, and because changes in global reserve composition will only come about slowly, the US dollar is likely to continue to have a commanding role as a reserve currency for many years to come. That does not mean that other currencies may not make some headway, particularly the euro in the short to medium term, and potentially the yuan in the (very) long term, but much has to change in China before that happens. The dark horse is potentially SDRs through a global agreement and global commitment to give them a greater role. The political process is likely to be slow. It appears to be much simpler to take ad hoc decisions on allocations, like the one in April 2010, under the intense pressures of the global crisis than to agree on a more substantive future role for SDRs with at least an element of automaticity in allocations. Nevertheless, there is pressure from some quarters to move in that direction, i.e. to further develop a significant reserve currency role for a synthetic currency where SDRs would be an obvious choice, if only because they already exist along with the associated institutional infrastructure. The UN Expert Commission report cited earlier argued strongly for such a solution as did the Governor of the Peoples' Bank of China, the holder of the world's largest reserves. However, the objective of the Articles of Agreement of the IMF to make "the special drawing right the principal reserve asset in the international monetary system" is unlikely to be attained in the foreseeable future.

A potential alternative to the large reserve build-up in many Asian countries is a large, strong and influential International Monetary Fund. As earlier mentioned, one of the factors motivating several of the Asian countries' policies of building up large reserves may have been self-insurance against external shocks, i.e. to reduce to the extent possible the likelihood having to go the IMF for support in the event of crisis. To get past that problem, it is not only necessary for the IMF to command large financial resources but also to be seen as being legitimate by the membership, particularly by those who feel that their increased relative economic weight has not been duly recognized in the governance structures of the IMF. For that reason, it is important to conclude the process of governance reform within the timeframe that has been broadly agreed for it and on the basis of sound and transparent principles commensurate with the mandate of the IMF.

At the same time, it is important that the countries whose share in the world economy has grown rapidly and to a significant level not only claim and gain increased voice and representation, but that they also shoulder the responsibility of conducting sound economic policies not only for themselves but for the good of the global economy. "With the world economy still in a precarious state, beggar-thy-neighbor policies by major players can't be tolerated. Something must be done about the Chinese currency."²⁸

It is important that future policies and arrangements are based on sound reserve accumulation premises, better balanced economic policies of major countries, a better balanced world economy and a legitimate institutional order. Much depends on the performance of individual countries where each will have to mind its own store. But much hinges also on the declared policy collaboration intentions of the G20 and on the role and effectiveness of the IMF. The process and timetable for 2010 adopted by the G20 finances ministers and central bank governors at their meeting in Scotland in early November 2009 subjected the G20 countries to historically tight discipline in the coordination of economic policies end in ensuring the compatibility of economic and financial policies with shared goals.

²⁸ Paul Krugman: *The Chinese Disconnect*, Column in the New York Times, October 23, 2009.

The UN Expert Commission Report includes the following: “Any future governance format must ensure inclusiveness and adequate representation of developing countries, including least-developed countries (LDCs), promote complementarity and coherence, and establish links between existing and new forums. Thus, although informal groups such as the G-7 and G-20 can play a useful role, they should not be allowed to undermine the functioning of formal institutional arrangements and the discharge of their respective mandates. This inclusive response will require the participation and the involvement of the entire international community. Apart from the G-7, G-8, or G-20, it must encompass representatives of the entire G-192.”²⁹

In a 1992 book, Paul Volker and Toyoo Gyohten described from their own experiences the differing success of various attempts at international economic policy cooperation, primarily on the 1970s and 1980s. In Paul Volker’s words: “Coordination becomes much more complicated when it moves into broad questions of trying to manage different economies at different rates of growth, or of influencing tax policy or energy policy. To a politician, that all implies some loss of sovereignty. Academics dance around that philosophically in emphasizing quite correctly that participation in an open world economy necessarily implies a loss of autonomy, and that external influences on policy are bound to become larger as the volume of international trade and investment increases. Nonetheless, to those politically responsible for decision making in the real world, the idea of coordination invades very sensitive political territory.”³⁰

In his speech in Oslo in October 2009, the Managing Director of the IMF stated that the fear which engulfed the world in late 2008 had turned to hope. “This was no mere accident. It was not just good luck. It came from the bold decisions taken by policymakers the world over, and—just as importantly—from an unprecedented degree of economic policy cooperation. In the face of crisis, countries came together to face common challenges with common solutions, focusing on the global common good. We saw this in fiscal policy, in monetary policy, and in financial sector policy. This collaboration encompassed more countries than ever before in history—showing us that in our modern globalized world, responsibility for the economic policy agenda can no longer rest with a small club of countries. This crisis heralded the ascent of the G-20—a group that includes the dynamic emerging economies—as the leading vehicle of multilateral cooperation. The challenge is to sustain this spirit of cooperation as we venture into the post-crisis world. In an atmosphere of great fear and uncertainty, cooperation was not so hard to achieve. But with optimism on the rise, and recovery on the horizon, countries may be tempted to go their own way, and to abandon the cooperative approach that served them so well during the crisis. I am happy to note that early signs are positive. Meeting a short while back in Pittsburgh, G-20 leaders stressed that the global collective interest must always infuse national policy decisions. Multilateralism, I hope, is here to stay.”³¹

Thus, the Managing Director is hopeful that multilateralism will prevail. It is tempting indeed to share his hope. Judging from past experience, however, there is reason for modest optimism that economic policy cooperation within the G20 will be successful in effectively reducing global imbalances and stemming or even reversing reserve accumulation where reserves have expanded beyond any reasonable measure of adequacy. Nevertheless, the

²⁹ UN Expert Commission Report; op. cit., p. 90.

³⁰ Paul Volker and Toyoo Gyohten: *Changing Fortunes*; Times Books, New York 1992; p. 145.

³¹ Dominique Strauss-Kahn: *Economic Stability, Economic Cooperation, and Peace – the Role of the IMF*; Speech in Oslo, October 23, 2009.

possibility of disorderly adjustment and developments cannot be excluded. Perhaps the best hope is that the alternative to cooperation will be frightening enough to force countries to work together to restore and maintain a balanced and sound global economic and financial system. The principle that keeping one's own house in order will "do the job" may not work because of different perceptions of what that order entails.

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