Reform of the International Monetary System and the IMF

Kick-Off seminar of the Jean Monnet Network, Annual Triffin Lecture

comments on Marco Buti's presentation

Stephany Griffith-Jones
IRELAC
sgj2108@columbia.edu

A. Europe

1.European growth

Growth in the European Union, and specifically in the Eurozone was very anemic and disappointing, after the 2007/9 crisis and till 2015. In fact, growth in EU was much slower than in the United States. This was accompanied by very high levels of unemployment, especially in countries like Greece and Spain. Fortunately, since 2016 all EU economies have been growing and are projected to grow in the next two years.

Indeed, in the last two and a half years, the Eurozone grew 5.1%, which was faster than the United States, that grew 4.6%.

2.Widening divergences

There have been widening divergences in economic growth and employment levels between the more successful and the weaker European economies. Unemployment rates, especially of the young, have been extremely high in the countries that suffered crises, whereas countries like Germany have very low levels of unemployment.

These problematic aspects had implied loss of faith in the future in the European Union.

Slow growth in the EU has had a depressive effect on world trade and on the growth of the rest of the world, including the emerging and developing economies.

3.Current account surplus large

The Eurozone as a whole has a large current account surplus, which reached more than 0.5% of world GDP in 2016, according to data from the International Monetary Fund. Most of this current account surplus is in Germany, where it represented almost 0.4% of world GDP. In absolute values, German current account surplus is the largest in the world, reaching 8.6% of German GDP in 2016;however, Dutch current account surplus, at 10.0 % is even higher as proportion of GDP.

As Keynes pointed out so clearly in the mid 1940s, during the run up to the negotiations at Bretton Woods, and as was then followed up by Robert Triffin during the next decades, management of current account imbalances is key at the global level to maintain growth.

In the current system, deficit countries are forced to adjust, due for example to a sudden stop of private capital inflows, (or even worse, due to a reversal of such flows and/or capital flight by its citizens), or by a sharp increase in the cost of external finance. The only source of funding then, are official flows, accompanied by strong conditionality, requiring strict austerity. Then, the burden of adjustment falls only or mainly on the deficit countries, if no offsetting expansionary policies are adopted in creditor countries. This means the policy thrust in the whole EU region is recessionary as a whole.

Adjustment in surplus countries is therefore also needed; this can be implemented via higher wage growth, and some expansion of fiscal policy, via higher public investment. This will be good for growth and improved income distribution in those countries, and will have positive spillovers for neighboring countries, including deficit ones. It will also be good for growth in the Eurozone as a whole, and in the world economy.

By adjusting, surplus current account surplus countries would turn the negative externalities they are currently generating, which impose costs on deficit countries, into positive externalities.

B. International financial and monetary reform

1 Financial regulation

In the crucial area of financial regulation, much progress has been achieved, nationally, at EU level and internationally. However, a key question is whether enough progress been achieved, to prevent another major financial crisis?

Additional concerns are delays and watering down in implementation, due in great part to political economy pressures from the financial industry. Finally, last but not least is the threat in the US of a reversal of financial regulation.

In this difficult context, the European Union has a particularly major and key role to play.

An important limitation of current financial regulation is that domestic financial regulation and its reform does not include regulation of capital flows, which should be integrated into the broader discussion. In this area, it is encouraging that the International Monetary Fund has changed its views on regulating capital flows quite remarkably, change which is very positive.

After the very costly financial crisis in the US, and especially the Eurozone, a daring and apparently radical but relevant question seems to be if full freedom of capital flows in developed economies is optimum for them. If not, should macro-prudential regulation on capital flows be part of the regulatory toolbox, also in developed economies?

2.Current global reserve system

The current global multi-currency system has three major problems.

The first problem is that it makes it more likely that there is asymmetric adjustment between deficit and surplus countries. As discussed, this implies a global recessionary bias. This can be called the Keynes problem.

The second problem is the Triffin dilemma. As based mainly on the US$, the current international monetary arrangements require the United States to have a current account deficit, so that enough international liquidity is provided. This may erode confidence in the US $ and/or may lead to financial crises. Indeed capital flows to the US, which helped fund the US current account deficit, helped fuel the US sub-prime crisis, which was transformed into the global financial crisis.

More broadly, the current system implies that world economy, and its financial stability, is too reliant on US monetary policy. As Jose Antonio Ocampo clearly puts it, the world needs (using the terminology of the 1960s) a less 'erratic' and 'capricious' system for providing global reserves, and particularly one that is not hostage to the macroeconomic policies and the potential effects of the deterioration in the net investment position of the United States.

The third problem is the inequity bias. The current international monetary system requires emerging economies to self-insure, both due to fluctuating terms of trade and, especially due to volatile capital flows. The most frequent way of self-insurance used by those countries is through large foreign exchange reserves, which gives these countries policy-space.

A problem for those countries is that this is costly, as they borrow at fairly high interest rates, and tend to invest their reserves in US and other developed economies, especially government bonds, which have a very low yield.

A solution, long proposed in the Keynes and Triffin tradition, is to increase the role of the Special Drawing Rights, or SDRs. A more specific proposal is to increase the role of SDRs especially to fund IMF operations, in a counter-cyclical way, whilst simultaneously guaranteeing that the supply of SDRs reflects the additional global demand for foreign exchange reserves. Most estimates indicate that average allocations for the equivalent of US$200–300 billion a year would be reasonable, but even this allocation would only increase the share of SDRs in non-gold reserves to just over one-tenth in the 2020s, indicating that SDRs would largely complement other reserve assets.

As Ocampo and others have pointed out, even a moderate move in this direction would go a long way to reduce the three major problems of the current system. First, the associated "seignorage" would accrue to all IMF members. Second, by issuing SDRs in a counter-cyclical way, it can contribute to reducing the recessionary bias associated with the asymmetric adjustment problem. Third, SDR allocations could reduce the need for precautionary reserve accumulation by developing countries, and would represent a lower cost of building self-protection than accumulating international reserves through borrowing or building up current account surpluses.

The most important reform, in any case, would be to finance *all* IMF lending with SDRs, thus making global monetary creation similar to how central banks create domestic money. This would build on the proposals made by the late IMF economist Jacques Polak almost four decades ago. According to his proposal, IMF lending during crises would create new SDRs, but such SDRs would be automatically destroyed once such loans are paid for. The alternative Ocampo suggested is to treat the SDRs not used by countries as deposits in (or lending to) the IMF that could then be used by the institution to lend to countries in need.