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SOME SIMPLE OBSERVATIONS ON THE REFORM OF THE INTERNATIONAL MONETARY SYSTEM

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A New International Reserve Currency?

The rapid spread and global dimensions of the current financial crisis have drawn attention to the need for reform of the international financial system forged in 1944 at Bretton Woods. Both the G-20 and the United Nations have made formal proposals in this regard. In recent discussions, most of the attention has been focused on the role of the U.S. dollar in the international system, and the need to find a substitute that would better preserve the purchasing power of foreign currency reserves; in particular, those held by developing countries.

These discussions seem to ignore two basic criticisms, made by John Maynard Keynes and Robert Triffin, of the functioning of the existing monetary system. These criticisms suggest that the basic problem with the system is not the particular asset that serves as the international currency but rather the operation of the adjustment mechanism for dealing with global imbalances. They also suggest that the recommendations contained in the Report of the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System need to be interpreted as an integrated whole.[1]

In the Beginning: The Gold Exchange Standard

The 20th-century gold exchange standard was based on an international system of free exchange—of goods, services, and capital. In such conditions, it was presumed that competition among countries would support the law of one price for all goods traded in global markets. When this was not the

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case, international arbitrage would take place. If the gold price of goods were below that prevailing in other countries, there would be an incentive to exchange gold for goods and to export those goods to foreign markets where the gold price was higher. Private individuals seeking to maximize profits would engage in international exchange that would result in an equivalent gold price for similar goods in all countries. A corollary of this system of arbitrage was the elimination of trade imbalances, as surplus countries would be accumulating gold. This was presumed to bring about a rise in the gold price of domestic goods, reducing their competitiveness in the global marketplace. Gold exports would replace goods exports, and the surplus would be reduced until gold prices were brought back to international levels and the external accounts returned to balance. Another corollary was that the purchasing power of private savings would be stable on average over time, whether invested in domestic or in foreign currency. The stability of the purchasing power of savings was a result of the operation of the international adjustment mechanism rather than some quality or value inherent in gold itself.

Keynes and the Barbarous Relic

Keynes criticized the international gold-standard system because the mechanism for addressing imbalances was normally not through arbitrage to eliminate price differentials but rather through adjustments in the level of activity—particularly in the level of employment. Further, he noted that this quantity adjustment process tended to be asymmetric. Since deficit countries that experienced a gold outflow could run out of gold before the price arbitrage process was operative, they would have to take measures to stem the outflow of gold, usually through an increase in interest rates, a cutback in domestic financing for investment, and a reduction of incomes that would lead to a fall in the demand for imports. This would improve the external balance, but at the cost of a lower level of output and employment. Surplus countries, on the other hand, could simply let their surpluses accumulate without allowing the expansion in the gold supply to induce changes in their domestic policies. If the only adjustment in the international system were a reduction in activity, this would lead to a tendency for global demand to be consistently below that necessary to allow full employment. This would constrain the ability of countries that chose to implement full employment policies, if other countries elected not to adopt such policies as well.

Keynes was especially concerned that the active policies he had proposed to support the level of employment in response to the Great Depression would be stymied by the actions of countries that believed the appropriate response to financial crisis was to increase saving by cutting government expenditures. There was a second asymmetry involved, since the costs of quantity adjustment were borne by labor (i.e., the loss of employment reduced wage incomes), while the purchasing power of private savings was preserved—or, in the case of a reduction in activity leading to deflation, augmented. There was also an asymmetric relationship between debtors and creditors (in favor of the latter) that made recovery more difficult.

To resolve the problem of asymmetric adjustment, Keynes recommended the creation of an International Clearing Union, with temporary payment imbalances settled by means of a notional unit of account that could not be traded in private markets. However, it was not the proposal to replace gold with a notional unit of account that was critical. It was that member governments would agree to implement coordinated symmetric adjustment policies, either by rule or by mutual consultation, with policy actions taken by both deficit and surplus countries—the reduced activity in the former to be balanced by the expansion of activity in the latter in order to keep global demand unchanged. The costs of adjustment would then be borne equally by all countries and by capital and labor, and would allow countries to pursue national policies of full employment if they chose.

Keynes's proposed system did not envisage private currency trading or the presence of large international capital flows, intermediated by private financial institutions, to finance external imbalances. The simple reason was that, not only could such flows be destabilizing (as had been the case in the interwar period), but they could also allow imbalances to increase without limit as long as countries could borrow in private markets. This would put the size of imbalances and their adjustment in the hands of private bankers rather than in the hands of government policymakers.

Under Keynes's proposal for reform of the gold-exchange standard, the maintenance of purchasing power depended on an adjustment mechanism that constrained the size of imbalances and thus preserved the exchange rates between national currencies and the notional unit of account. But there is no automatic mechanism that ensures this result, nor any mechanism that ensures full employment. It is the result of coordinated policy action taken mutually by members of the clearing union.

The Triffin Dilemma

In any event, Keynes's proposal was not adopted. Instead, the dollar was inserted into the system in place of gold by pegging the dollar price of gold and the parity of all other currencies to the dollar. This dollar-exchange standard, adopted at Bretton Woods, possessed an additional difficulty identified by Triffin. He observed that, irrespective of whether the dollar (or any national currency) playing the role of international reserve currency were fixed in terms of gold, global confidence in its value would eventually erode. This was because the asymmetric adjustment that Keynes had noted with respect to the gold standard would still exist for all countries—except for the country whose national currency served as the international means of payment and store of value. Thus, surplus countries, without the necessity of introducing adjustment policy, would increase their holdings of the national currency (the dollar), and all countries seeking increased international liquidity would do so as well. This would lead to ever-increasing deficits for the country issuing the reserve currency—in the Bretton Woods system, the United States. If the currency were linked to gold, its outstanding international currency issue would soon exceed the gold supply on which it was based, leading to an inability to meet the commitment to fix the exchange value of the currency in gold. This is the dilemma in the dollar exchange system that was noted by Triffin in the 1950s and which occurred in the 1960s.

In this system, there may be a tendency to support global aggregate demand if the country issuing the reserve currency is willing to accept the increasing current account deficits required to satisfy the growing demand for global liquidity. But the Triffin dilemma will always be present, and at some stage there will be a crisis caused by a collapse in international confidence in the currency's value and calls for a substitute currency.

The opposite would be the case if the country were to pursue a policy of external balance, or of building external savings or following a strategy of export-led growth. This was more or less the case of the United States in the period of dollar shortages after the war, and of Germany in the European Monetary System before the creation of the euro. In these cases, the problem was the lack of global liquidity caused by excess savings held by the country issuing the reserve currency—the problem that special drawing rights, or SDRs, were originally meant to resolve. However, by the time they were created, the problem was an excess of dollar liquidity, a problem that SDRs were unable to solve.

A version of the Triffin dilemma is also present in a system in which the national currency serving as the international means of payment is not fixed in terms of gold or any other physical asset. In this case, its value in terms of other currencies is dependent on the willingness of surplus countries to hold the currency. In simple terms, once the link to gold is broken, the system becomes a Ponzi scheme in which the external value of the international currency is determined by the demand for reserves and liquidity by other countries. Thus, the ultimate value of the international currency lies in its purchasing power over the goods and services of the issuing country. If foreign holders are not willing to purchase the country's exports, then the value of the currency will decline until the price of its exports becomes sufficiently attractive. In contrast to the gold standard, the price adjustment mechanism here functions through changes in the international value of the currency—the effect of the exchange rate adjustment on the relative prices of goods and on the capital value of international reserve holdings. The latter represents the loss in purchasing power that has become the center of attention in recent discussions about reforming the international financial system.

Finally, in all of these different forms of the international financial system, the stability of the purchasing power of the reserve currency is inherently linked to the operation of an adjustment mechanism that eliminates international imbalances, either automatically or through a coordinated policy mechanism. The question of stable purchasing power would thus appear to have little to do with what asset actually serves as the international reserve currency.

A New International Reserve Currency?

The demand for reform of the financial system has not focused on the current system's inability to support global full employment. Rather, it concerns the dollar's loss of international purchasing power and its substitution by an international reserve currency that is not a national currency. Some have suggested the use of the SDR as a substitute for the dollar. However, as long as the SDR remains a basket of national currencies, of fixed or flexible proportions, it cannot resolve the problem—although it may, through diversification, reduce the volatility of the international reserve currency's purchasing power. It should be noted that this diversification could always be achieved without the use of SDRs, through a policy of international reserve diversification. This problem might be avoided through a fiat issue of SDRs or creation of a truly supranational currency. But, aside from political and other difficulties, this would also require international coordination on the means and control of its supply, as well as a mechanism to coordinate and manage the adjustment of imbalances.

Changing the international currency does not provide a solution to the problem of the declining value of accumulated surpluses in the form of reserves, which is caused by the absence of an automatic adjustment mechanism that is compatible with the full utilization of global resources. One attempt to resolve this problem was the proposal of a commodity reserve currency, which was widely discussed in the postwar period; though it had the support of economists as diverse as Keynes and Friedrich Hayek, the United Nations, and legendary hedge fund manager Benjamin Graham, it was never tested. The basic idea was that an increase in the demand for the international commodity currency would precipitate an increase in the demand for commodities produced by developing countries, so that symmetry would be automatic.

From this point of view, the question of preserving the value of accumulated reserves from external surpluses should rather be seen as the overvaluation of those surpluses or the inappropriate distribution of that value between the support of employment and the defense of capital values, or between creditors and debtors. For example, in the case of China, the feared decline in the value of its reserves through depreciation of the dollar would already have been eliminated as a possibility if an automatic adjustment process had been in effect, achieved through a reduction in domestic income and employment or an adjustment in the exchange rate. The introduction of the SDR or other alternative currency will not protect the value of dollar reserve holdings accumulated when the dollar is overvalued relative to what is required for external equilibrium.

How Do the U.N. Commission Recommendations Deal with the Problem?

It is in this framework that the U.N. Commission recommendations are to be interpreted. The basic point of the analysis in the Commission's report is that the international system suffers from an inherent tendency toward deficient aggregate demand. This is a reflection of the asymmetry in the international adjustment mechanism mentioned above. This tendency has only been checked in recent times by anomalous developments in the U.S. financial system that allowed household balance sheets to offset an increasingly inequitable domestic distribution of income and deficient demand in the world's other industrialized economies. This has been exacerbated by the lack of official international liquidity, as the International Monetary Fund (IMF) has imposed quantity adjustments on many developing countries to safeguard fiscal surpluses. Many of these countries have responded by undertaking policies to create external surpluses and rising international reserves, thus ensuring that they will not need external liquidity.

Thus, the first steps in the reform process must be (1) to offset the balance sheet losses caused by the collapse of asset values and (2) to provide an alternative source of demand to replace the U.S. consumer and an alternative source of finance to counterbalance the deleveraging of financial institutions. This can be done through traditional, countercyclical deficit expenditure policies. To maximize their impact, these policies must be implemented on a global scale; that is, both developed and developing countries must introduce them. If developing countries follow IMF advice and seek to shore up their finances by running surpluses, this would simply reduce the impact of the developed countries' stimulus policies. But stimulus policies are difficult for most developing countries, because additional liquidity is required in order to finance their deficit expenditures.

This leads to the necessity of an alternative financial facility in addition to those available from existing international financial institutions, since the IMF discourages countries with weak fiscal or external positions from participating in such policies. One method of financing such a facility would be through an additional SDR allocation. At the same time, countries with sufficient external reserves that adopted policies to strengthen their external positions found that they attracted additional external capital flows, which rapidly reversed as private international financial institutions delevered, creating liquidity shortages. Thus, the recommendation of the introduction of SDRs is to provide liquidity for developing countries, in a way similar to the "link" proposal introduced in discussions at the United Nations Conference on Trade and Development in 1964, and to emerging market countries that may be adversely affected by the rapid contraction in international flows. This recommendation is very much in line with the original objective of SDRs as providing additional liquidity in the absence of dollar liquidity and liquidity provided by the IMF.

It is also clear in the U.N. Commission's report that the introduction of SDRs or another global currency cannot resolve the problem of the adjustment mechanism's operation. Even the simple creation of a notional currency to be used in a clearing union cannot do this without some commitment to coordinated symmetric adjustment by both surplus and deficit countries. This is a function that was to have been undertaken by the IMF, under its Article IV surveillance mandate, but which has been just as asymmetric as the Bretton Woods system; it is only effective where the IMF has the sanction of a lending program—that is, in deficit countries. The Commission recommended that this role be taken on by a proposed Global Economic Coordination Council, to be formed at a political level that would guarantee commitments to coordinated solutions. This council is an integral part of the Commission's reform proposals for the international financial system, as it is the seat of the political commitment to symmetric adjustment of international imbalances and thus the locus of the stability of the international reserve currency's purchasing power.

Two Additional Problems

This leaves two related problems. The first is that some developing countries may choose to adopt a development policy based on net exports, which would be in direct contradiction to the operation of an automatic or coordinated adjustment policy to eliminate imbalances. Countries that choose this national development strategy (as have many successful countries, such as Japan, the newly industrialized countries, and others) can be viewed either as lending resources to the rest of the world or as borrowing effective demand from the rest of the world. The successful pursuit of these policies will thus require a distortion of prices, of exchange rates, or of the global distribution of demand. The resulting surpluses and deficits will also have values that are distorted and therefore cannot be guaranteed. They require not only a coordinated policy to distribute surpluses and deficits but also an appropriate allocation of the costs of this distribution, as well as the required liquidity provision to finance them. The SDR may play a crucial role here as well, but as a provider of liquidity rather than a guarantee of a stable store of international value. Again, there is no automatic market mechanism to bring this about.

The second problem concerns international capital flows. As already mentioned, the original Bretton Woods proposal did not envisage that such flows would play a substantial role either in meeting payment imbalances or in the allocation of international capital. The system has turned out to be rather different, and private flows have been shown to be capable of creating substantial distortions to the international adjustment mechanism, abolishing limits to the size of imbalances and granting to international investors the control of the adjustment mechanism—which usually had operated through financial crisis rather than smooth adjustment.

If international adjustment is to be coordinated, either to ensure the elimination of imbalances or to permit imbalances in order to further the purposes of the national development strategies of particular countries, management of capital flows will have to be part of the coordination process. Thus, the Commission also recommends that capital inflows be managed or controlled. This management would in addition have a major impact on the stability of the purchasing power of whatever is used as the international currency.

Thus, to sum up, the problem of the instability of the international reserve currency's purchasing power is less a question of the asset that serves as that currency and more a question of the operation of the international adjustment mechanism, and of whether that mechanism is automatic or coordinated, and also sufficiently compatible with global aggregate demand to provide full employment and support the national development strategies of developing countries.

Note

1. The preliminary version of the U.N. Commission's report, issued in May 2009, is available at www.un.org/ga/president/63/interactive/financialcrisis/PreliminaryReport210509.pdf.