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International monetary reform – some systemic issues

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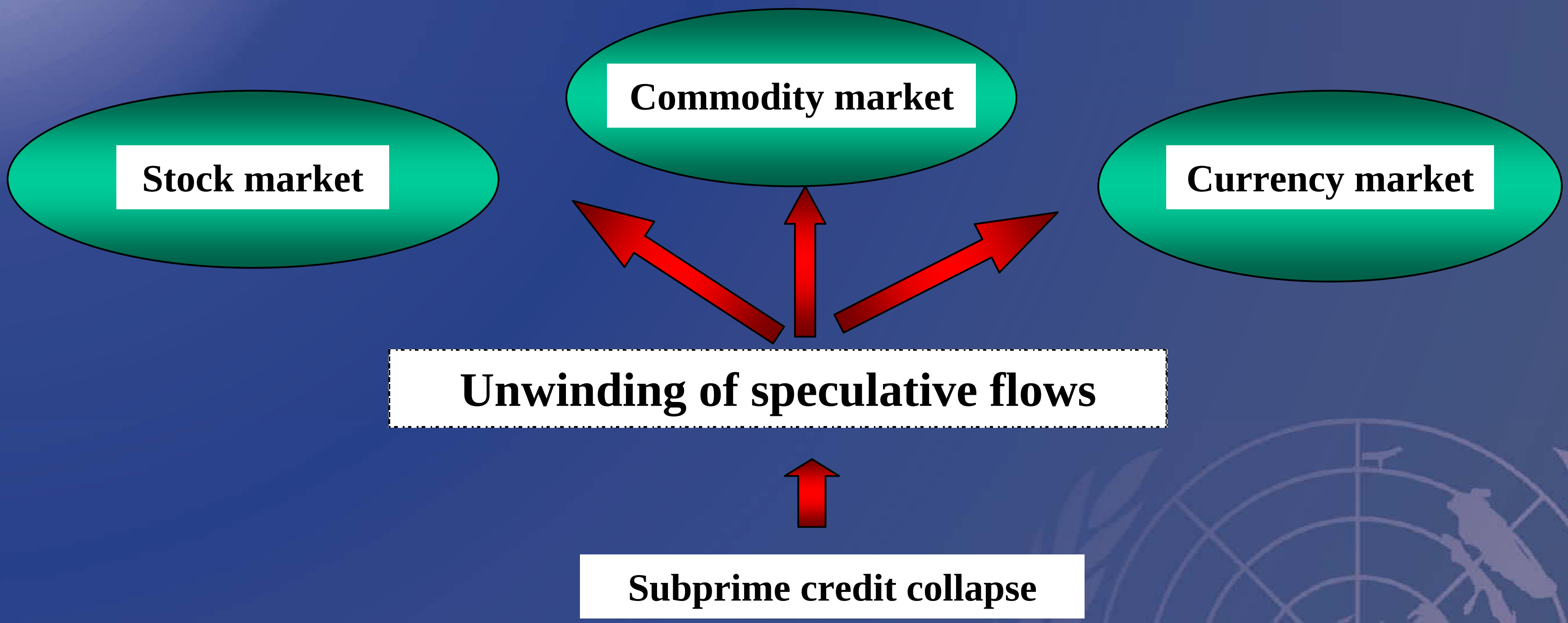
Overview

- UNCTAD’s take on the crisis
- Reducing speculative international capital flows
- Reducing the incentive for speculative international capital flows
  - Creating a multilateral exchange-rate mechanism
  - Enhancing macroeconomic policy coordination and symmetric adjustment mechanisms
  - Creating a reserve system based on the SDR
- Redefining the role of the IMF
- Conclusions

1. UNCTAD's take on the crisis

- Faith in efficiency of deregulated financial markets created illusion of risk-free profits through speculative finance in many areas;
- Financial deregulation enhances the pro-cyclicality of **financial markets** (caused by pro-cyclical risk assessments by lenders and investors);
- The absence of an international monetary system facilitates speculation on **currency markets**;
- The financialization of commodity futures trading has reinforced the proneness of **commodity markets** to overshooting.

The global financial crisis



The subprime credit collapse <u>highlighted the exposure to risk</u> in many areas and triggered the <u>unwinding of speculative positions</u> in different markets

Implications for reform debate

- No longer belief that unfettered financial liberalization and deliberate non-intervention of governments will maximize welfare;
- Most of the current debate (e.g. G-20) emphasizes the need for enlarging scope of – national and internationally coordinated – financial regulation;
- Too little attention is paid to systemic issues associated with speculative international capital flows, their management and regulation.

2. Reducing speculative international capital flows

- Reconsider the role and scope of counter-cyclical capital account management at the national level:
  - Allows countries to unilaterally improve their prospects for economic stability and development by containing the built-up of financial fragility;
  - Complements improved global macroeconomic policy coordination and multilateral surveillance by smoothing out boom-and-bust cycles in international capital flows;
- Taxing international financial transactions.

3. Reducing the incentives for speculative international capital flows

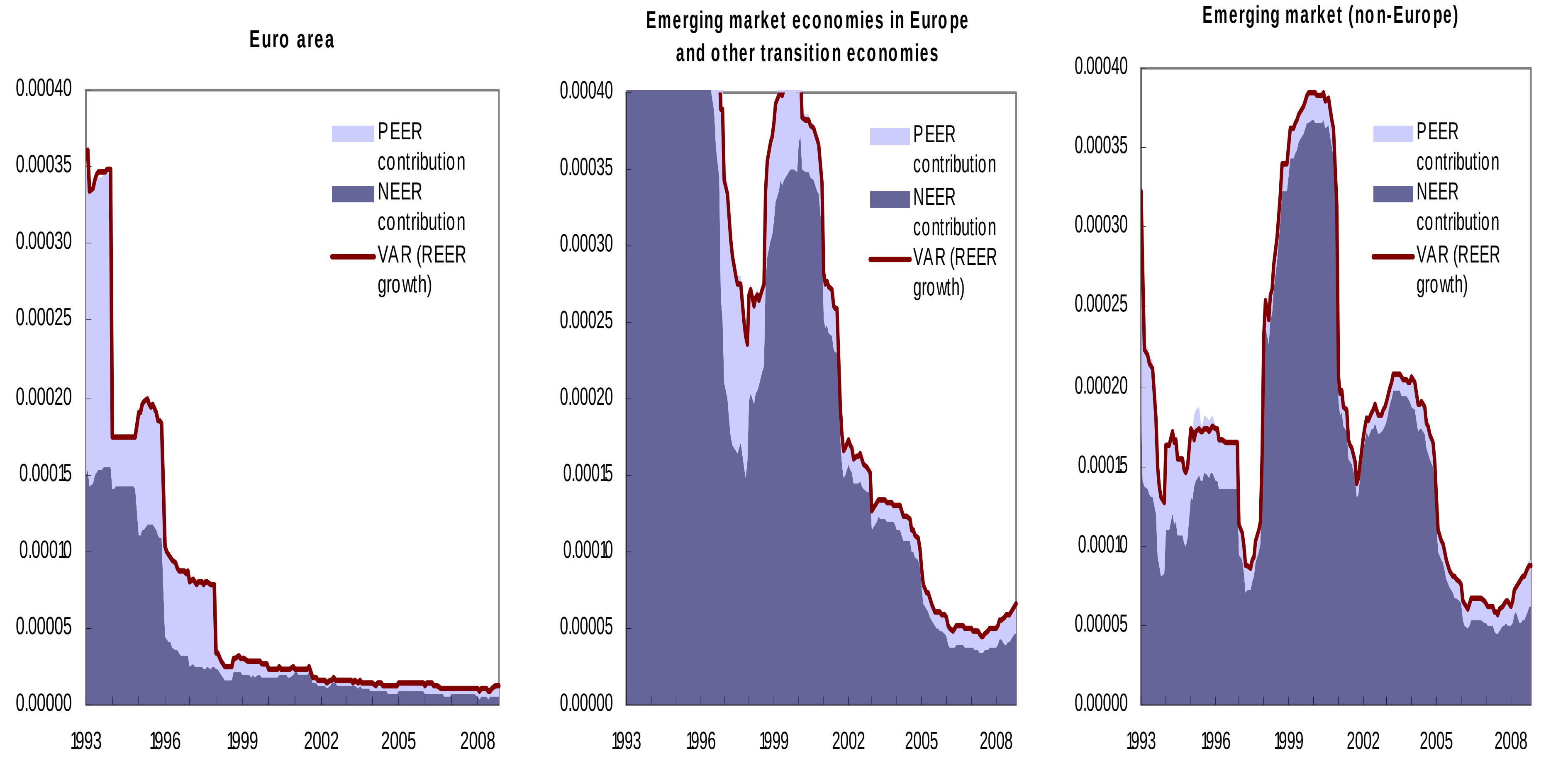
- Objective: reduce incentives for speculative capital flows and thereby scope for exchange-rate volatility and misalignment;
  - ‘Market-driven’ opportunities for arbitrage profits – carry trade caused by diverging monetary policy stances;
  - Deliberate policies of intervening in currency markets:
    - to accumulate foreign-exchange reserves as self-insurance against sudden stops and reversals of capital inflows;
    - to maintain a competitive exchange rate;
    - closely related to global imbalances and associated risk of sharp exchange-rate adjustments;
  - Problems inherent to an international reserve system based on a national currency – Triffin dilemma:
    - liquidity problem (liquidity provision relies on US current account deficit);
    - confidence problem (value of reserves)
    - these problems combined cause cycle of expansion and contraction in US external deficit, strong cyclical swings in real dollar exchange rate.

3a) A multilateral exchange-rate mechanism

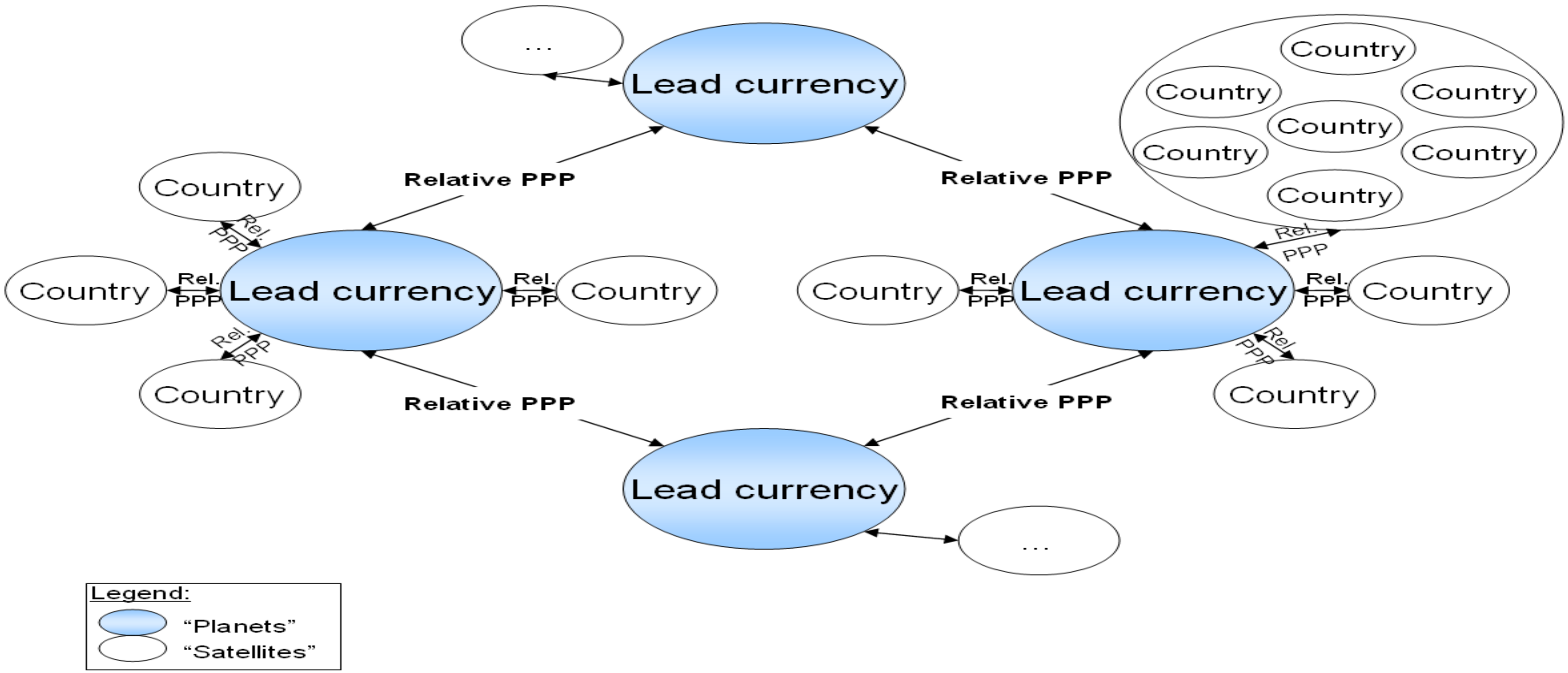
- An appreciation in the nominal exchange rate caused by "autonomous" capital flows (i.e. unrelated to the financing of real investment or international trade) can:
  - offset competitive advantages that firms achieved through innovation and productivity growth;
  - help non-competitive producers in other countries to remain in the market;
  - in this respect, nominal exchange rate appreciation has the same effects as tariff barriers;
- To maintain a level playing field in international trade, nominal exchange rates changes should reflect only the differences in national inflation rates;
- Principles for a multilateral exchange-rate mechanism:
  - Ensure a level playing field through stable real exchange rates;
  - Avoid currency speculation by adjusting nominal exchange rates in concordance with changes in nominal interest rates – maintaining uncovered interest rate parity;
  - Symmetric exchange-rate interventions.

Nominal exchange rate changes explain most of the real exchange rate changes and, thus, distort international trade

The contribution of NEER and PEER to REER volatility, 3-year overlapping monthly variance



Example of currency system with "planets" and "satellites"



- The lead currencies will be linked with each other through symmetric managed floating systems (adjustment by relative PPP)
- Regional blocks can be formed ("satellites") to be linked to one of the "planets" or a group of them
- Entry and exit include provisions on domestic monetary and fiscal policy

3b) Effective and symmetric multilateral discipline in macroeconomic and exchange-rate policies

- IMF members have same *de jure* obligations to maintain orderly exchange rates and BoP-positions. But Fund is unable to exert disciplines over its non-borrowing members. How to remove this asymmetry and make surveillance effective, even-handed and independent of IMF lending?
- Increase scope of rules on exchange-rate policies;
- Increase scope of macroeconomic policy coordination and effective surveillance;
  - Between deficit and surplus countries;
  - Engage US-responsibility.

3c) A reserve system based on the SDR

- Would a multi-reserve-currency system be more stable than the current system?
  - Would diversification generate additional volatility of the real exchange rates of major international currencies?
  - Would it resolve the Triffin-dilemma?
- Potential advantage of SDR-based system:
  - SDRs issued during periods of financial stress would be destroyed once financial conditions normalize:
    - Introduces counter-cyclical element in world liquidity management
    - Resolves problems of supplying adequate finance for extraordinary demand for official liquidity during crises;
  - Reserve diversification would not risk causing sharp exchange-rate changes.

4. The role of the IMF

- Who wants to reform the IMF with what objective in mind?
- Modalities of IMF interventions is key issue to be addressed:
  - strengthening the surveillance of major economies – emphasis on symmetric adjustment and role as honest broker in policy coordination among major economies;
  - combination of sustainability of macroeconomic policies with the counter-cyclical dimensions of macroeconomic and financial policies;
  - recognize that instability in asset markets, rather than in product and labour markets, has become major source of instability of macroeconomic aggregates and key relative prices;
  - does IMF have sufficient credibility or should a United Nations Economic Security Council play these roles?
- Immediate response to crisis: establish highly concessional global countercyclical facility (like to the two oil facilities in the 1970s), funded by a reversible allocation of SDRs.

5. Conclusions

- Greater financial regulation is necessary but insufficient;
- Reducing the incentives for speculative international capital flows is of key importance. To do this, we need:
  - A multilateral exchange rate mechanism
  - Macroeconomic policy coordination and symmetric adjustment mechanisms
  - A reserve system based on the SDR
- This would also help preventing the competition of nations and increase the consistency among international trading, financial and monetary regimes;
- Reform of IMF should have these objectives in mind, rather than simply emphasize voice and representation.

Thank you !

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