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PALAIS-ROYAL INITIATIVE*

REFORM OF THE INTERNATIONAL MONETARY SYSTEM: A COOPERATIVE APPROACH FOR THE TWENTY FIRST CENTURY

* A group convened by **Michel Camdessus**, **Alexandre Lamfalussy** and **Tommaso Padoa-Schioppa**, and also comprising **Sergey Aleksashenko, Hamad Al Sayari, Jack T. Boorman, Andrew Crockett, Guillermo de la Dehesa, Arminio Fraga, Toyoo Gyohten, Xiaolian Hu, André Icard, Horst Koehler, Guillermo Ortiz, Maria Ramos, Y.Venugopal Reddy, Edwin M. Truman**, and **Paul A. Volcker**

« I would suggest that all those eager
to envisage the post-crisis era in constructive terms
need to promote the reconstruction
of a fully fledged international monetary order.»

TOMMASO PADOA-SCHIOPPA (†),
"*The Ghost of Bancor:*
the Economic Crisis and Global Economic Disorder"
25 February, 2010

Tommaso Padoa-Schioppa, who was one of the conveners of the Palais-Royal Initiative, passed away on December 18, 2010, a few days after the penultimate meeting of the Group.
With him, the world has lost an outstanding architect and advocate of the global common good.

PREFACE

The global crisis, which swept through almost all the economically well-developed nations and curtailed world growth in the first decade of the new century, is being contained. However, the cost has been enormous in human and financial terms: unacceptably high unemployment, shattered financial institutions and markets, and budget deficits that threaten to become unmanageable.

The purpose of this report is not to judge all the factors contributing to the crisis: the relative importance of misguided economic policies, structural weaknesses in financial institutions, failures in regulation and supervision, and weaknesses in international monetary arrangements. While we agree that, in spite of recent progress, there remains much to be done in the financial sector, the focus of this report is on international monetary reform. We share a conviction that too little attention has been paid to the importance of the International Monetary System (IMS). The G20 Leaders on the occasion of their Toronto meeting, agreed on the common goal "to build a more stable and resilient international monetary system". Indeed, the risks inherent in the current system (or "non-system" as many describe it) are too large to ignore. Those risks include retreating into a fragmented economic system vulnerable to protectionist pressure, and resorting to mutually inconsistent national or regional policies. In sum, the progress toward open, competitive markets on a global scale that has brought so many gains to so much of the world population, is at risk.

As former Ministers, Central Bank Governors and officials in national or international institutions[1], we are all too familiar with the weaknesses and inadequacies of the existing system. This note outlines our diagnosis and some avenues of reform toward a more cooperative governance of the global monetary system that can produce the discipline and stability needed to underpin sustainable growth and employment creation.

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I. THE NEED FOR REFORM

1. **The global crisis.** The crisis that engulfed the global economy in 2008 caught most experts and policy makers by surprise, bringing to light a number of hitherto unnoticed vulnerabilities. While these were chiefly found in the financial sectors of major advanced countries, troubles there quickly spread to the entire international monetary and financial system, in the form of a sudden stop or reversal of capital flows and in liquidity shortages, as investors scrambled to reduce risk exposures and deleveraged. The crisis made even more obvious how tightly the economies and financial markets of the world are tied together, with a shock in one major country rapidly propagating to the entire system.

2. **The response.** The crisis response highlighted the benefit of policy coordination as global fiscal and monetary stimulus, and the injection of massive amounts of liquidity averted an even more dramatic worldwide collapse in economic activity. These developments also resulted in some narrowing of global imbalances. In the *financial* sphere, a series of reforms have been adopted and are now in the process of being implemented, and others are under consideration. These developments justify a measure of optimism.

3. **Persistent dangers**. However, significant vulnerabilities remain in the financial sector, related inter alia to the role of the shadow banking system. In addition, the long-standing structural weaknesses of our international monetary arrangements have yet to be addressed. These weaknesses put in doubt the ability of the International Monetary System to durably fulfill its fundamental purpose, namely "… to provide a framework that facilitates the exchange of goods, services, and capital among countries, and that sustains sound economic growth (Article IV of the International Monetary Fund). These weaknesses include the following:

➢ ***Ineffective global adjustment process***

- The system lacks effective discipline and countries can accumulate large current account imbalances for extended periods without facing effective pressures for adjustment.
- The peer review over the policies of member countries to be exercised by the IMF (“surveillance”) has often been ineffective in bringing about policy adjustment on the part of countries with internal and external imbalances, especially when they have no need to borrow from the Fund, reflecting, among other issues, the lack of teeth of IMF procedures.
- This situation is fraught with three major risks: (i) the resurgence of prolonged and ultimately unsustainable current account imbalances, susceptible to unwinding in a very disorderly way, (ii) global inflationary pressure if too many countries run excessively expansionary fiscal and monetary policies or, conversely, (iii) undue restraint on the global economy if too many countries try simultaneously to run current account surpluses.

➢ ***Financial excesses and destabilizing capital flows***

- In the run up to the crisis, an unsustainable global expansion was facilitated by rapid growth in global credit. Exceptionally low interest rates (accompanied by massive official reserve accumulation over the same period) triggered an intense search for yield. Combined with

inadequate supervision over the financial system, including a blossoming shadow banking system, unrealistically compressed risk spreads and asset bubbles developed. These mounting vulnerabilities went unchecked in part because there are no commonly agreed definitions and measures of global liquidity.

- Large swings in capital flows as have occurred recently, in part as a symptom of an expansion of unchecked global liquidity, can overwhelm countries' ability to preserve macroeconomic and financial stability.
- The capacity of individual countries or international institutions to cope with a future systemic liquidity crisis is not assured. In dealing with sudden shifts in international liquidity, unlike at the national level, globally there is no lender of last resort. In the recent crisis, effective cooperative measures were taken at the peak of the crisis. These included swaps and liquidity lines extended by a number of central banks to counterparts, including in some emerging markets; tripling of the IMF's resources and revamping its lending facilities to allow for large scale precautionary and liquidity support; and a $250 billion SDR allocation. But these measures were ad hoc.

➢ ***Excessive exchange rate fluctuations and deviations from fundamentals***

- Since the advent of generalized floating in 1973, exchange rates among the major currencies in the system have fluctuated widely, reflecting strong and capricious speculative forces often disconnected from fundamentals. Exchange rates have failed to move consistently in a direction promoting the adjustment of imbalances. Such deviations from fundamentals can be the result of either inadequate fiscal, monetary and exchange rate policies or market behavior. This has posed particular problems for small open economies. Large, lasting swings in currency values can cause serious distortions in the system and in the allocation of resources.

➢ ***Excessive expansion of international reserves***

Neither the supply of nor the demand for reserves are subject to collective decision-making. Several consequences of this can be identified:

- A number of emerging market countries and, to a lesser extent, advanced economies have accumulated an unprecedented volume of international reserves, either as a goal in itself (e.g. as a cushion against future uncertainties) or as a result of other policies domestic or external (e.g. to limit exchange rate appreciation). The resulting large and persistent net export of capital from emerging markets to advanced economies appears contrary to longer term priorities for economic development.
- Easy availability of financing has contributed to financial imbalances by postponing needed adjustment, including domestic policies such as fiscal imbalances.
- Reserve balances have remained concentrated in a small number of currencies, predominantly the US dollar. Some diversification of reserves is taking place, but the question is being raised of the need for a multilateral way of facilitating such diversification to avoid the risk that expectations of moves by official reserve holders may trigger destabilizing shifts in private portfolios. It is important that such issue be properly dealt with.

4. Lack of effective global governance. There is no unified global governance structure to help ensure that major economic and financial policy decisions made nationally, including exchange rate policies, are mutually consistent and contribute to global stability. In a world so deeply inter-connected, economic outcomes in each country depend significantly on developments and policy decisions made in others. In such a world, there is a strong case for rules and processes to be developed to help ensure that major economic and financial policy decisions made nationally are mutually consistent and contribute to global stability. The IMF was intended to provide this structure, but has been insufficiently effective, for three reasons:

- For too long, it was presumed by many that if each country kept its own house in order, and did not manipulate its exchange rate, that would be enough to guarantee global stability. This view has proven too optimistic with respect to the self-equilibrating function of markets and economies.
- There is no shared analytic framework for assessing the spillover effects of policies in large countries on other economies and the system at large.
- The IMF, as the central institution of the system, has suffered from a "legitimacy deficit", reflecting both the underrepresentation of some emerging market and developing countries, and the failure of the Fund's peer review process to have much influence over the policies of its largest members.

The failure to adjust its governance structure in a timely manner has hindered the Fund's ability to act as the intended institutional "machinery" to promote international monetary cooperation (Article I). The emergence of the G20 as the de facto primary forum for economic and financial cooperation contributed to fill that void. Notwithstanding the success of the G20 in reacting to the onset of the recent crisis, its effectiveness and legitimacy could be improved if somehow it could speak for all countries in the global economy.

5. Urgency. Most of the problems described above are not new, but the consequences of not addressing them are increasing and inhibiting the realization of the full benefits of globalization. As long as problems in the international monetary system are not addressed, an increasingly integrated world economy becomes more and more vulnerable. A muddling through approach therefore is an increasingly inadequate response. Any meaningful comprehensive reform will require taking near-term steps within a longer-term vision.

The remainder of this report outlines avenues for reform that could meet these aims. At the request of the chairman of the G20, a follow-up report in coming weeks will provide more specific suggestions on these issues.

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II. AVENUES FOR REFORM

6. **The key long-standing issues** that governments have to resolve seem to be the following:

i. The absence of effective discipline towards global adjustment in the system;
ii. The volatility of exchange rates and their behavior that often appears to be inconsistent with orderly adjustment and allocative efficiency;
iii. The difficulties in managing global liquidity to avoid both droughts and floods;
iv. The questions surrounding the role of the SDR;
v. The governance issues tied up in the decision-making and operations of the system.

In what follows, we sketch some of the issues that we believe need to be addressed as elements of a comprehensive reform of the International Monetary System.

1. ECONOMIC AND FINANCIAL POLICIES

7. **Policy spillovers.** Countries' policies, both domestic and external, interact and affect regional and global stability in ways that go beyond each country's domestic policies and stability. The experience of the past decades has shown that problems emerging in national economies have often not been addressed in a timely manner, reflecting both differences in analytic understanding and the inability of IMF surveillance over its members' economic and financial policies to yield needed policy adjustments. Even when policies are appropriate for a country's own stability, they may have adverse spillovers on others.

8. **Stronger surveillance**. Strengthened surveillance over its members is therefore required. It should address fiscal, monetary and financial policies of national governments, with particular attention to exchange rate and global liquidity developments, as elaborated below. Stronger surveillance necessitates review of the governance of key international institutions and their relations with all countries. It should contain, in particular, the following key elements: (a) stronger multilateral obligations, backed by clear, objective norms or quantitative benchmarks on economic and financial policies and performance to function as alarm signals with appropriate thresholds, (b) assessment procedures that permit judgment about the causes and implications of any deviation from those policy norms, and (c) consequences, including the possibility of both incentives and sanctions. While all countries should have the same obligations and assessment procedures, particular attention should be directed to countries whose policies have a larger potential impact on the stability of the International Monetary System.

2. EXCHANGE RATES

9. **Importance**. Exchange rate regimes are at the heart of any international monetary system. An essential objective of a well functioning International Monetary System should be delivering exchange rates that are reasonably stable and in line with fundamentals. In this regard, tensions are all too obvious in the current environment. Exchange rates are driven by a

combination of present and anticipated policies, and by market forces. Thus, instability may arise from several sources: inconsistent or unsustainable policies (or policy mixes) that can give rise to large and persistent exchange rate misalignments, false perceptions by market agents regarding long-term fundamentals or future policies, and more purely speculative activities.

10. Policies and benchmarks. For the system to operate effectively, countries need to conduct their economic and financial policies with an eye to fostering exchange rates broadly in line with fundamentals and with global balance. Under the Articles of Agreement, members of the IMF already have the right to choose their own exchange rate arrangements, and a stated obligation to avoid manipulating their exchange rate or the International Monetary System in order to secure an unfair competitive advantage. The IMF is expected to exercise "firm surveillance" over all members' exchange rate policies. Forceful pronouncements from the IMF on this front have been rare, however, and generally with insufficient or no effect on the policies of the largest members. There is, then, a need to make countries' obligations on exchange rate policies more specific, including possibly through the use of benchmarks based on macroeconomic fundamentals to identify instability and misalignment. Such benchmarks could also inform strengthened efforts to mitigate market-driven deviations from fundamentals. In particular, major countries have a special responsibility to mitigate the large and persistent swings of their currencies and their negative impacts on the rest of the world. Further consideration of the best ways of achieving this in a new international context is necessary.

3. GLOBAL LIQUIDITY

11. A critical concept. Global liquidity conditions are influenced by the monetary policy stances in major financial centers, exchange rate arrangements, and the innovative and risk-taking behavior of the financial system. Conditions that are either too loose or too tight can have undesirable consequences. Liquidity has many dimensions and can change quickly as, to some degree, perceptions are a state of mind dominated by confidence or fear . The search for the appropriate approach to the management of liquidity conducive to balanced monetary and financial conditions at the global level is thus particularly challenging.

12. Monitoring and surveillance. A shared approach to the understanding and measurement of global liquidity is needed, as is better surveillance of developments that can dramatically change liquidity conditions when there is a significant change in market confidence (as reflected, for example, in risk spreads). This approach will require reinforced cooperation among the central banks and authorities in charge of macro-prudential policies of the largest economies and financial centers, with a view to ensuring global liquidity conditions consistent with sustained systemic stability.

13. Dealing with capital flows. One potential consequence of excessive global liquidity is large and volatile capital flows, which can pose acute challenges to macroeconomic and financial stability. Thus, further consideration should be given to measures, such as capital controls and broader macro-prudential measures that might effectively allow countries to protect their economies from their negative effects. Such interventions should be limited and a key challenge in this regard is to ensure that the measures do not create distortions more harmful in the longer run than the inflows themselves, and do not affect other countries negatively (e.g., by deflecting capital flows to them). The development of internationally agreed guidelines in this area,

covering both issues of disruptive inflows and outflows would be useful. It should be clear that using capital controls to maintain an either overvalued or undervalued exchange rate is not compatible with a well-functioning International Monetary System.

14. Liquidity provision in crisis times. In light of the experience of the recent crisis, further steps should be taken to make the IMF more akin to a global lender of last resort ready to act in a reliable, rules-based fashion, and with appropriate protections to limit moral hazard. This would provide the membership with a stronger financial safety net at a lower cost for the countries and for the system itself than through reserve accumulation.

4. THE ROLE OF THE SDR

15. The International Monetary System will continue to evolve, in part reflecting continued shifts in the relative weights of different economies in the world. There is a question of whether non-national currency instruments may have a role to play in addressing some of the new needs that arise in a multi-polar world, e.g. demand for a complementary reserve asset or for an international numeraire not directly affected by the domestic policies of one economy. The SDR – a basket made up currently of four freely usable currencies issued by economies accounting for large share of world trade – was first created in 1969 to ensure an adequate long-term creation of primary reserve assets in the context of the Bretton-Woods system. Its use was considerably reduced after the system of fixed exchange rates and the peg of the U.S. dollar to gold was dismantled. It has nevertheless demonstrated its usefulness during the recent crisis with an exceptional allocation. It might be useful to re-explore its potential role (e.g. as a reserve asset or as a unit of account, etc.) in serving the public common good of monetary and financial stability in the new context of today's globalized and increasingly multi-polar world. Furthermore, the issue of its potential role in a long term perspective should remain under consideration, not only to stay in compliance with the undertaking of the Articles of Agreement[1], but also in view of the role it could play in addressing potential demands that may arise.

5. GOVERNANCE

16. Issues. Three essential issues have surfaced over recent years in the governance of the International Monetary System, hindering its proper functioning:

- The need for a decision-making structure combining legitimacy and effectiveness by giving a formal framework to the relationship between the pertinent group of Heads of State or Government, their deputies, and the key International Financial Institutions;
- The tendency for peer review process to operate as peer protection, suggesting the need for a mechanism to break the de facto "pact of non-aggression" among countries that leaves the global interest without an effective advocate;

[1] Art. VIII, Section 7: *"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"*.

- The legitimacy deficit of the IMF, partly addressed by the Seoul G20 meeting of November 2010.

17. An integrated architecture. A better functioning system could be achieved by the adoption of a system of governance based on a three level integrated architecture, comprised of:

- The Heads of Government or State, meeting sparingly (e.g., once a year) except in times of crisis;
- The Finance Ministers and Central Bank Governors, taking strategic decisions related to the functioning of the International Monetary System in the framework of a "Council" as envisaged in the Fund's Articles of Agreement, and,
- Executive Directors overseeing the work of the IMF, and its managing director.

All three levels would have a constituency-based organization similar to that which generally has served well the IMF and World Bank.

18. Global interest perspective. In order to give a stronger voice to the global interest, a Global Advisory Committee (GAC) made up of eminent independent personalities appointed following a transparent procedure could be useful to provide independent and public advice to the key organs of the IMF in the fields of surveillance and the management of international liquidity and reserves, whether at its own initiative or at their request.

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CONCLUDING REMARKS

The crisis heralded, indeed accelerated, a transition to a new world where emerging market economies together play a large role on a par with advanced ones in driving global growth; a world that will be fundamentally multi-polar, and in which global monetary problems must be dealt with cooperatively. The reformed International Monetary System we aspire to is one that preserves the gains of the past sixty-five years, without succumbing to its own instability. It is a system that maintains freedom of trade and current payments and that allows sharing more widely the benefits of financial globalization, appropriately regulated. It is a system where all countries recognize their stake in global stability and accept that near-term national objectives may, if needed, be constrained by the global interest. International cooperation is, in the long run, a necessary ingredient in the search for national prosperity. This should lead every country to look with a renewed sense of responsibility and discipline to the system as a whole. The G20 is in a powerful position to promote the global common good, and to make it prevail, at times against limited, parochial interpretations of national interests. The opportunity for the emergence of a fully fledged international monetary order is here at stake.

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