Welcome Remarks

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With the global economy entering the 5th year since the start of the financial and economic crisis, policy makers, market participants and academics are shifting their focus from fire fighting to the reform of the financial system. At the centre of this debate lies the international monetary and currency system set up in 1944 at Bretton Woods, which set the ground for formation of the current multinational financial organisations and international monetary and currency coordination led by the United States. The conference at Bretton Woods set the scene for the US dollar to become the major international reserve currency as the Sterling's decline in significance.

The Bretton Woods system resulted in the creation of the World Bank and the IMF, which were tasked with post war reconstruction and orderly maintenance of the international financial architecture. Currencies were fixed but later freely convertible for trade related transactions. Governments were allowed to adjust their currencies to address balance of payment difficulties. They were allowed to maintain capital controls which were deemed harmful and volatile though overall, the system was designed and coordinated so that each member while adjusting for short term financing deficits were not allowed to undermine and harm other members' policies through exchange rate practices. Overall the system was designed to provide stability to the international payments and financial system, fostering stability and promoting long term trade, employment and growth.

Debate on the Bretton Woods System

The recent financial and credit crises has thrown the spotlight on the functioning and deficiencies of international financial system in a more critical manner than at any other time since Bretton Woods was established. Going into the Lehman credit crises with the international financial system experiencing considerable imbalances, questions are now being posed about the stability of the current system given the reliance of the global payments and financial system on a singular reserve currency, whose policies post 2008 have been criticized by some as being serving at the expense of its main trading partners and the long run stability of the system itself.

However, the debate on reform of the global financial system has so far been limited to fire fighting policies in response to the wave of credit and financial crises witnessed in the US and Europe. *Very little attention and debate has been devoted to the reform of the international monetary system and policy coordination.* There seems to be no policy design for the 21st century!

More importantly, little debate and policy coordination has been paid on how to

- accommodate a country which will be larger than the USA by 2020 in economic terms
- reform the international monetary system to accommodate for this change in a coordinated manner
- define the role of the multilateral institutions in the new economic order, including the role of the IMF
- treat capital flows in a world of two dominant serve currencies.

Indeed, the issue of global adjustment has not been resolved in such a context. While individual country and region specific reforms have been initiated to stabilise debt markets and introduce banking and financial sector reforms, issues such as the problems and fiscal vulnerabilities of the euro area have not been resolved. Some innovation seems to be happening on a bilateral basis, such as the opening of SWAP arrangements between China and various countries as a prelude to the internationalisation of the renminbi yuan. Multilateral cooperation seems to be absent with perhaps political impediment to debate making fragmentation dominate cooperation.

Despite the considerable evolution of global banking regulations, with improved capital and liquidity requirements and the growing maturity of macro- and micro-prudential policies and frameworks, much remains to be done to ensure future economic and financial stability. The interconnected, dynamic nature of the modern global economy means spillovers are inevitable, highlighting the urgent need for increased awareness, communication, cooperation, and collaboration between global policymakers.

The continued dominance of the US dollar as both a reserve and trading currency, not least in the current fiscal context in advanced economies, potentially poses a significant risk to global financial and economic stabilities going forward, particularly but not exclusively in the event of a significant re-pricing of US sovereign credit risk.

The current state and effectiveness of the global financial infrastructure must be re-assessed, and the rapidly increasing importance of emerging and developing markets must be recognized through greater participation in global decision-making, particularly within multilateral institutions.

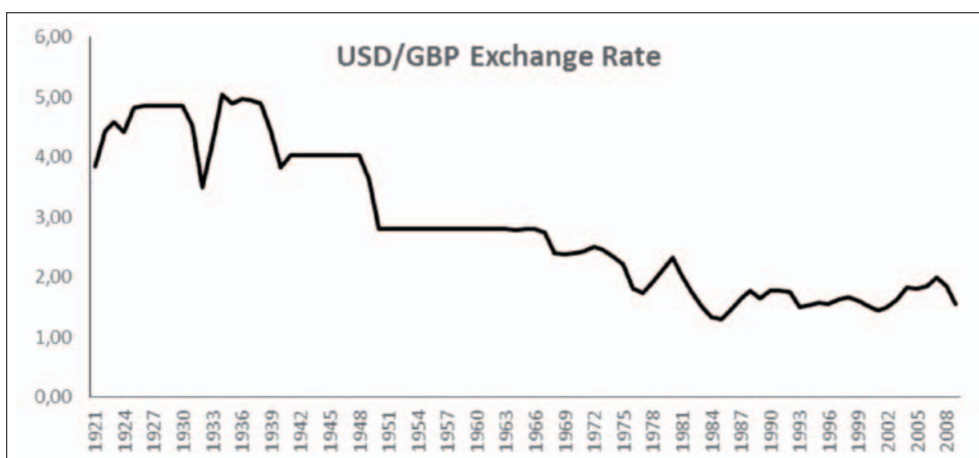
The institution of a global currency or another credible alternative to the de facto US dollar standard has become more visible in policy reform forums. On international governance, the adequacy of current multilateral institutions and the

extent of recent and ongoing reforms must be evaluated and re-assessed. Where governance gaps remain, effective measures must be speedily taken to adequately address perceived weaknesses. The need for new multilateral institutions must be identified and addressed where required, representing the interests of emerging and developing countries.

Parallels between 1944 and 2014

The decline of the British Empire coincided with formation of the Bretton Woods system and emergence of the US dollar as the main reserve currency after the war. By 1945, the US has emerged as the largest and most powerful economy. Although initially isolationist and reluctant to take the lead in the global economy, the Second World War spurred the US to take its responsibility in economic and political spheres. Meanwhile, the British Empire was in decline, bankrupted by the War, and with diminished reserves, the UK had to concede its leadership of the financial system as its economic influence declined and Empire diminished.

Chart 1: US Dollar/GBP Exchange Rate



Source: Bank of England.

Indeed, the status quo in 2014 has parallels to the pre-war situation: a new emerging economic power, reluctant to exercise its rising affluence to lead global currency coordination, and a declining power, becoming more and more indebted, and resorting to abusing its status as the issuer of the reserve currency in order to maintain its influence and affluence. These policies have obviously led to considerable system wide spillovers an unsustainable asset bubbles.

What Should the New System Look Like

In order to answer this question, however, one must first consider more fully what "Bretton Woods" and the IMF, the institution established to oversee the new monetary order, were intended to achieve. "Bretton Woods" has become almost synonymous with the fixed exchange rate system that prevailed from the time of the IMF's establishment until the abandonment of fixed rates in 1973. However, the visionaries at the Bretton Woods conference had broader objectives in mind. As stated in the IMF's Articles of Agreement, they were striving toward a system that would "promote international monetary cooperation", "facilitate the expansion and balanced growth of international trade," and "contribute thereby to the promotion and maintenance of high levels of employment and real income...." They also aimed to "promote exchange stability...maintain orderly exchange arrangements among members and... avoid competitive exchange depreciation." At the same time, they wanted to "assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade." As these goals suggest, the purpose of "Bretton Woods" was above all to establish a more stable and prosperous world economy, and the role of the IMF *would* be to help promote the preconditions for this.

The feasibility of multilateral policy coordination today appears remote. The collapse of the fixed exchange rate system backed up by gold in 1973 led to the current system of a de-facto single reserve currency. Up to the time of the Nixon price shock, the former system worked well, reasonably but could not prevent the build-up of significant imbalances that eventually led to its collapse.

With the abandonment of the Gold standard, the United States had no incentive to limit the issuance of debt and the discipline of an exogenous monetary anchor disappeared. This new Bretton Woods system thus created a perverse incentive for the issuer of the de facto reserve currency to change its monetary base in order make external and internal adjustments while creating considerable spillovers to its main trading partners. In the early 1980s, as the second oil shocks took hold, leading to higher US fiscal deficits and inflation, capital still flew into the US due to the higher interest rate differentials with Europe and Japan. The main trading partners of the USA hence had to contend with the spillovers of higher rates as well as weaker growth.

1994, the 50th Anniversary of the Bretton Woods Conference, provided the opportunity for a thorough review of the functioning of the international monetary system. This took place in an atmosphere of satisfaction and complacency with the general operation of the system. Long gone were the complaints which characterised the 1970s about the monetary anarchy created by the collapse of the par-value regime for exchange rates and the calls for the IMF to regulate world liquidity through its multilateral new currency the SDR. Indeed, following the wave

of deregulation and liberalisation, the concept of an international monetary system seemed increasingly inappropriate or even obsolete: if every country kept its house in order, floating exchange rates and free capital movement would cushion national economies while facilitating adjustment of international payment imbalances. Hence there would be no need for institutions to manage "systemic" issues. Very few voices were to be heard complaining about the current non-system and calling for a new Bretton Woods conference to reinvent the monetary system for the new millennium.

By 2004, the 60th anniversary of the institutions, however, the landscape had changed dramatically. The wave of financial crises in emerging markets in the previous decade Mexico in 1994/95, East Asia in 1997, Russia, Brazil 1998, Argentina 2001 – had generated growing discontent with the system. This debate, which took place under the label of reform of the *international financial architecture,* passed through various phases. Initial radical thoughts for setting up a global central bank or a world financial authority, were rejected as impractical. Subsequent thinking coalesced around more pragmatic measures designed to help prevent financial crises and to manage those that occurred better. An important part of the reform was the establishment of comprehensive standards, representing best global practices toward which all countries participating in the global system would strive. At that time, some observers argued that we had re-entered "the old paradigm ". Professor Michael Dooley and his colleagues argued that the previous system was never actually destroyed, just put into hibernation. Just as Europe and Japan benefited from fixed exchange rates in the 1950s and 1960s, the reasoning went, so Asia was now profiting from the same. The success of China and India in exporting goods and services respectively was certainly built in part on undervalued currencies. Some Asian currencies kept fixed rates, some had a managed float, but all of them continued to intervene in exchange markets to maintain relatively stable exchange rates. The insight of Dooley's team was that this was a contract, like Bretton Woods, not the operation of a free market. China had the potential to be a source of strength as well as vulnerability in reinforcing the precarious stability that had returned to the international financial system, and in underpinning the recently interrupted move toward a genuinely global system of open finance.

Emergence of the Euro as a Reserve Currency

The European Monetary System and the euro were conceived as pillars of the European Union, fostering greater trade, growth and income convergence through a common monetary policy. While the creators of the euro were correct to foresee its rise as also a reserve currency, they did not anticipate the problems of internal adjustment and political integration currently plaguing the common currency. Indeed, precedence seems to have been given to "convergence" over "confidence,

adjustment and liquidity”. Policy makers have thus been focused forced to reverse engineer some of these deficiencies following the euro crisis, unforeseen at the time of conception.

Regardless of these recent adjustments, the euro area will be only become a true monetary and currency area once political and fiscal integration becomes complete. While flexibility of product and labour markets lie at the heart of a successful currency union, they alone are not sufficient to guarantee its long term viability.

It was Robert Mundell who advocated the creation of true currency areas as opposed to pseudo currency areas[1]. In a true currency area, such as a metals or gold standard, there is an automatic commitment to stability and adjustment during peace time. In other systems, such as Bretton Woods and EMU system, countries may not automatically adjust and parities could be changed with ministerial decisions. In a true currency area, interest rates converge and stabilization occurs through changes in forward exchange rates. According to Barry Eichengreen[2], the euro lacks both an internal adjustment process to correct for imbalances and the automatic provision of liquidity required of a reserve asset. In other words, there is a shortage of “safe assets” in the EMU armoury.

Both the euro and the US dollar are now being questioned over their roles as reserve currencies. While the euro faces existentialist doubts given the gravity of the challenges faced at such an early stage in its life, the US dollar meanwhile seems to be facing a structural decline, in line with the rise of Asia in trade and commerce and lack of global adjustment.

In 2014, as we approach the 70th anniversary of the Bretton Woods conference, pessimism has returned. The global financial system continues to stumble from crisis to crisis. From the great recession of 2009, to the longest financial crisis in history, to the travails of the euro area, there is no end in sight. There is a growing feeling that the major challenge for the new generation of policy makers will be to regain control of the international monetary system. Today the philosophy of the global financial system seems to rely on each country managing its own economy in what it perceives to be its own best interest without giving much attention to global consistency. This is the age of fragmentation and divergence. Supporters of “muddling through” hope that this will lead to a satisfactory outcome for the world, just as, given certain conditions, the actions of individuals who follow their own self-interest leads to a socially efficient outcome. And so far the world has indeed muddled through in this way, without a disaster comparable to the global depression

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[1] *Robert Mundell,* Currency Areas, Common Currencies and EMU, American Economic Review, Volume 87, Issue 2, Papers and Proceedings of the One Hundred and Fourth Meeting of the American Economic Association, (May 1997), p. 214–216.

[2] *Barry Eichengreen,* Implications of the Euro’s Crisis for International Monetary Reform, Berkeley, January 2012.

of the 1930s. Yet many observers feel that it would be wrong to accept this for two reasons: first, the output losses from the great financial crisis have been appallingly high; secondly, there is no guarantee that the next crisis may not be even more severe.

Regaining Control

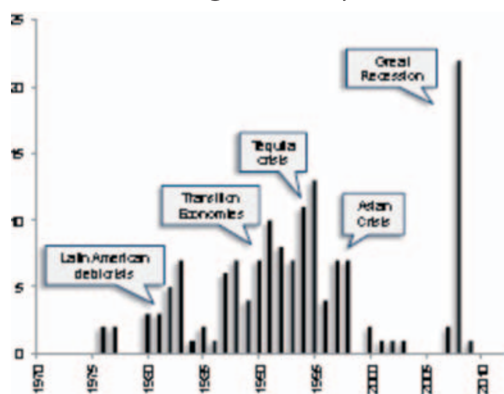
The features of the international monetary system today reveals high exchange rate volatility, persistent large external imbalances, competitive devaluations, significant international reserve accumulation, fragmentation of financial markets, financial repression and growing difficulties in maintaining a satisfactory international level of cooperation.

Moreover, there is a need to identify global trends, taking into account the rise of new creditor nations. Any likelihood of regaining control of the financial system will depend on having the correct tools and system in place to correctly measure and influence trends on financial markets. For example, questions which arise include whether such the size of the global financial system should also fall in order to regain control combined with enhanced policy tools? What should the role of the IMF be in such a system? Failure to correctly frame these issues will only result in more costly crises in the future. It is perhaps important to tale not of past crises in order to put in perspective what is at stake.

Costs of Crises

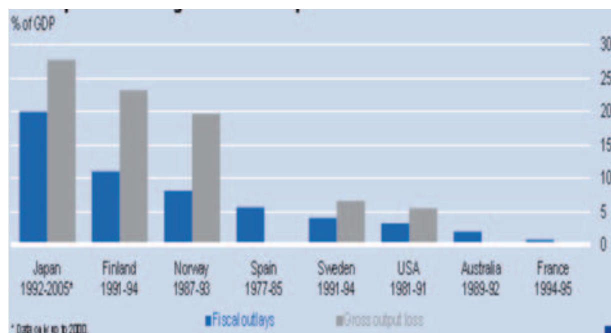
Since the advent of the de facto US dollar standard, both the frequency and severity of systemic banking crises have increased markedly, as attested by Laeven and Valencia (2012) and World Bank data.

Chart 2: Banking Crises Cycles



Source: Author's calculations.

Chart 3: Cost of Previous Banking Crises in Developed Countries



Source: World Bank.

According to a recent paper by the Dallas Fed, the total cost of the recent crisis to the US economy is estimated at 40% to 90% of GDP (Atkinson, Luttrell, and Rosenblum (2013)). Each successively stronger "Minsky moment" has subsequently drawn progressively lower interest rates, with increasingly accommodative monetary policy culminating in today's zero lower bound environment.

Policy Coordination

What is different now from the 1980s concerns the coordination of policy. While the Plaza accord in the mid-1980s was an example of a compromise to adjust currencies without a big adjustment in US consumption, it appears unlikely today that the main power blocks may reach any such agreement. China has taken Japan's place in terms of the main "culprit" of the US high current account deficit. China has however asserted that the fixed exchange rate level of the renminbi yuan is not to blame for this, but instead is a result of excessive, leverage-driven consumption in the USA. China has also pointed out that while it indeed has a current account surplus with the USA, it has a deficit with other countries as it needs to import raw materials and intermediate goods.

In this light, multilateral initiatives such as the BRICS' announcement of a new development bank and more recently, a joint currency reserve pool to protect against "unintended negative spillovers", may be seen as pragmatic steps towards providing alternative, multilateral solutions. The continued dominance of the US dollar as both a reserve and trading currency, not least in the current fiscal context in AME, potentially poses a significant risk to global financial and economic stability going forward, particularly but not exclusively in the event of a significant re-pricing of US sovereign credit risk. The development and growth of local currency bond markets in EMEs, along with increasing liquidity and currency convertibility

provide a growing new source of diversification of reserves for central banks and sovereign wealth funds.

The medium-term challenges facing the US economy has raised a number of concerns globally, exposing the vulnerability of the current de facto US dollar standard and the over-reliance in a single country's currency and policies. In the absence of a de jure global currency, an international system based on a basket of both AME and liquid EME currencies would potentially provide lower volatility going forward, while providing a more accurate reflection of the modern global economy and current trade flows. The IMF may consider adapting and developing its Special Drawing Rights towards this end, potentially establishing it as a Global Currency Unit benchmark, akin to the World Currency Unit proposed by Lok Sang Ho. The significant developments in local currency bond markets in many emerging economies, as outlined in our last background paper, have potentially crucially increased the viability of such a project. At the margin, the mere diversification away from any single country's policies would likely result in a less volatile currency, with potential for truly multilateral, complementary and synergistic coordination of domestic policies and greater global stability going forward.

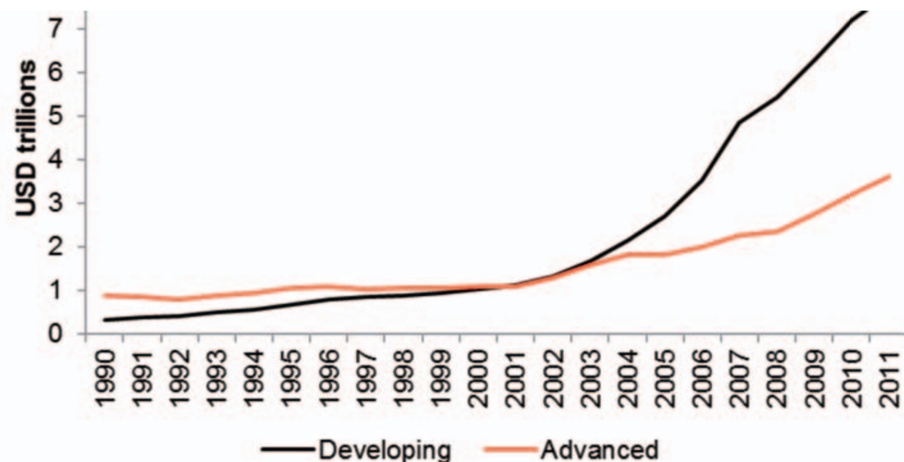
Today, policymakers globally face a new set of challenges in determining domestic policy, balancing national and international interests at an unprecedented pace. They are accountable to and have a duty and responsibility towards their own populace, but also have the obligation to consider the global consequences of their own actions, as well as those of others. Cooperation, coordination and collaboration entail clear communication and common objectives, with synergies among the potential rewards. Countries undergoing necessary structural reforms with clearly defined, sustainable policies should be actively encouraged to do so by its partners, which may contemplate and coordinate potentially supportive and mutually-beneficial measures. Correcting global current account imbalances requires internal as well as external adjustments; higher-surplus countries are expected to do their part in decreasing domestic savings and increasing domestic demand, while their higher-deficit counterparts are expected to curb heated domestic consumption in favor of higher domestic savings and investments to increase real potential output.

The stability provided by the positive spillover effects of unconventional MP thus far must not instill complacency in policymakers, and greater progress must be made towards designing, implementing, managing, and coordinating cogent macro- and microprudential policies both in AME and EME. For open-capital-account EME in particular, care must be taken to avoid the development of localized bubbles during unconventional MP, and clear and robust legal and institutional frameworks are required to minimize potential negative spillover effects in the eventual normalization of monetary policy.

Creditor Nations Matter

Ultimately, it will be the creditor nations which will drive this new currency and policy coordination. China is also the largest net external creditor nation while the USA and Europe have become more indebted. As seen by the charts below, emerging nations, led by China are now net creditors, especially vis-à-vis the current reserve currency issuer.

Chart 4: Foreign Exchange Reserves (including Gold)

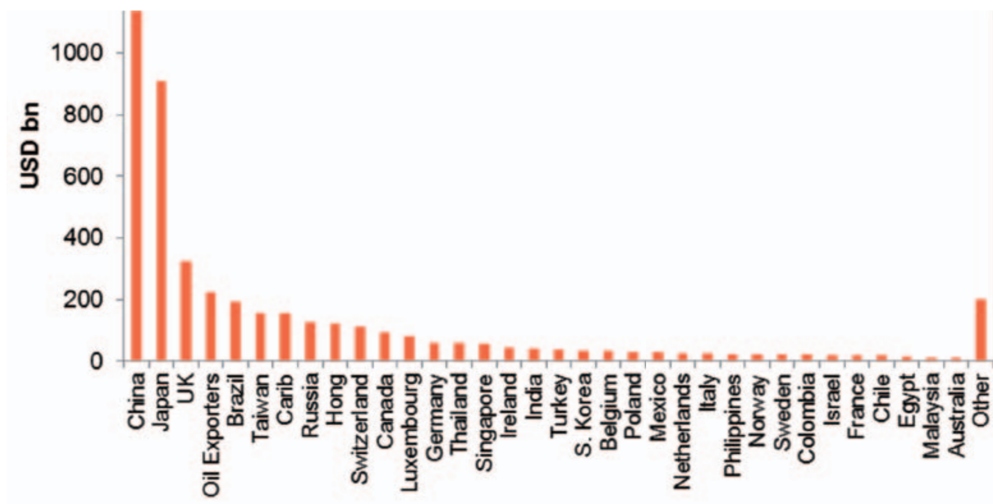


Source: World Bank.

We expect emerging nations, which are less indebted to take this lead in defining a new system of reserve coordination as the current system has become too asymmetric.

Against this background, the project's concept can be simply summarized. Looking ahead to the 70th anniversary, public officials, private sector practitioners, and academics from around the world will convene in a number of meetings to develop a new normative and practical agenda. During the course of the year, a series of discussions, supported by commissioned research, will aim to improve the clarity of thinking and broaden the area of common ground on steps needed to adapt the international financial architecture to current challenges. The process – in effect, a rolling public-private international workshop – will culminate in a final report prepared by the Secretariat of RBWC summarizing the proceedings and providing an analysis with recommendations, including suggestions aimed at reviving global cooperation in an age of market fragmentation and policy divergence. The final report will be supplemented by publication of the commissioned working papers.

Chart 5: Foreign Holdings of US Sovereign Debt



Source: World Bank.

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