



Dialogue on
Globalization

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Why Should The Global Reserve
System Be Reformed?

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1 Background

In 1971 the U.S. unilaterally abandoned the gold-dollar parity established in Bretton Woods. Since then the world has lived under a global monetary system based on an entirely fiduciary U.S. dollar—i.e., a dollar that has no backing except the trust in the government that issues it. Other currencies can compete with the dollar in terms of their potential as foreign exchange reserves, but the dollar is the dominant reserve currency—the “center” of the global reserve system. A complementary feature of the system is floating exchange rates among major currencies, with other countries free to adopt any exchange rate regime.

This system must be reformed. The central currency of the system as well as its alternatives lack what should be the essence of reserve currencies: a stable value. The system also contributes to the generation of payments imbalances, which can be reflected alternatively in inflationary or recessionary pressures on the world economy—the latter being the most likely scenario under current conditions. And it is inequitable for developing countries, which must accumulate their reserves in assets issued by the major industrial countries.

Prior to the current crisis, the most pressing concerns were the weakening of the dollar and escalating U.S. net liabilities with the rest of the world, as part of a broader problem of global payments imbalances. The financial meltdown of September 2008 led to a temporary strengthening of the dollar, indicating that in the “flight to quality” there was, after all, no acceptable alternative to U.S. Treasury bills and bonds. But dollar weakness returned in the second quarter of 2009—now mixed with fears for the stability of the world’s main currency associated with the large *fiscal* deficits that the U.S. has been running during the current crisis—and is expected to maintain for some time, which will lead to a rapid accumulation of public sector debt. It must be added that this recent weakening has happened despite the fact that U.S. current account deficits have narrowed down.

The need to change the global reserve system went from an academic to a—still incipient—global policy debate as the result of proposals made by the Chinese Central Bank Governor, Zhou Xiaochuan, just before the Summit of the Group of Twenty (G-20) in London on April 2nd 2009, reflecting the concerns of the major creditor of the U.S. government about the

security of its dollar reserves. Proposals along similar lines were simultaneously made by the Commission of Experts convened by the President of the UN General Assembly on Reform of the International Monetary and Financial System and chaired by Professor Joseph E. Stiglitz. The G-20 in turn revived the almost defunct Special Drawing Rights (SDRs) with a decision taken at the London Summit to issue the equivalent of US\$250 billion dollars in SDRs. This act was complemented by U.S. Congressional approval in June 2009 to issue the 21.4 billion SDRs (approximately U.S.\$33 billion) agreed to by the International Monetary Fund (IMF) in 1997.

2 The Flaws of the Current System

The present system may be seen as having three basic flaws. The first is the recessionary pressure associated with the fact that the burden of adjustment to payments imbalances falls on deficit nations. This feature—which the present system shares with all monetary systems that have preceded it—might as well be called the *anti-Keynesian bias*, as it was the issue particularly emphasized by Keynes during the debates that led to the creation of the Bretton Woods institutions. It is particularly noticeable during crises, when the threat of capital flight and/or the lack of adequate financing forces deficit nations to adjust, a dilemma not faced by surplus nations. Keynes’ proposal to create an International Clearing Union was meant to make the system symmetric, by forcing surplus countries to automatically finance deficit countries, but his proposal was rejected. Instead, the mechanism that was adopted was very limited—and largely conditional—financing provided by the IMF.

The second flaw is associated with the use of a *national* currency—the U.S. dollar—as the major *global* currency. It has been called the *Triffin dilemma*, in honor of the Belgian economist who formulated it in the 1960s. The source of the problem is clear: to provide adequate liquidity, the country issuing global reserve assets must run a deficit, either in the capital or the current account, with the latter becoming the dominant feature since the 1980s. But these balance of payments deficits and the growing liabilities with the rest of the world that they generate can lead to a loss of confidence in the dollar. The world thus becomes hostage to cycles of confidence in the major reserve currency, a phenomenon reflected in the large swings in real value of the U.S. dollar over the past four decades. The creation of the SDR as a new

and true global reserve asset in the 1960s was meant to design a less “erratic” or “capricious” system of providing global liquidity, to use the adjectives that were common at the time.

The third flaw is the *growing inequity bias* that characterizes the system. The fact that foreign exchange reserves are largely held in dollar assets (particularly U.S. Treasury bills) and other assets issued by industrial countries implies that developing countries’ reserve accumulation is nothing other than lending to rich countries at low interest rates.¹ This problem has been considerably worsened by the risks generated by a pro-cyclical pattern of capital flows to these countries that has characterized financial globalization in recent decades. In the absence of a global lender of last resort, the instability of capital flows and, particularly, the fear of sudden stops in external financing led to a defensive, or precautionary, demand for foreign exchange reserves by developing nations as a form of “self-insurance” or “self-protection” against financial crises. Up to the 1980s, these countries held reserves equivalent to about 3 per cent of Gross Domestic Product (GDP), a similar level to that of industrial countries. By 2007, low income and middle income countries (excluding China) held foreign exchange reserves equivalent to 20.6 per cent and 16.2 per cent of their GDP, respectively. At that point China had accumulated reserves equivalent to 46.7 per cent of its GDP.

While these reserve built-ups might be rational from the point of view of individual nations, they generate a fallacy of composition at the systemic level as, in the aggregate, this reserve build-up contributes to global imbalances. A better collective insurance in the form of ample and less conditional IMF financing could help by discouraging developing countries from holding such significant reserves. However, the limited financing available from the IMF and the excessive conditionality associated with it became part of the problem, as developing countries preferred the protective effect of self-insurance over the very imperfect collective insurance available. The systemic inequities and instabilities of the system are, therefore, deeply interconnected.

¹ The term “developing countries” is meant to include the “emerging” economies, as there are no clear-cut divisions between these two categories.

3 Reforming the System

There are essentially three alternatives to reform the current system. The first—and in a sense *inertial* solution—is to let it evolve into a multi-currency arrangement. The second is to gradually move into a system based on a truly global reserve asset. Since the SDRs have already been created, and have received increased attention by the G-20 during the current crisis, the obvious solution is to strengthen this mechanism of international cooperation. The third is to create a new institution, either Keynes’ International Clearing Union or a Global Reserve Bank that would issue a global currency (“Bancor” in Keynes’ proposal) and serve as bank of the world’s central banks. Negotiating the creation of a new global institution would be a daunting task, and for that reason I will leave this alternative out of the present discussion.

Of course, still another solution would be a return to gold—the “barbarous relic” in Keynes’ terminology. But this would be swimming against the tide of history, as the monetary history of the world since the nineteenth century has been a movement away from gold and toward placing *fiduciary* currencies at the centre of modern monetary systems. Thus, although some voices have been heard calling for the return to a form of gold standard, this would be a non-starter and will also be left out of the discussion here.

4 Moving to a Multi-Currency System

The multi-currency features are already present in the current system, but they are still secondary, as dollar assets have represented about two-thirds of global foreign exchange reserves over the current decade. This reflects the fact clearly shown during the recent crisis that there is no alternative to the market for U.S. Treasury bills in terms of liquidity and depth. In particular, the closest alternative, the euro, has been shown in the present crisis to be inferior, as there is no truly regional reserve asset denominated in euros and—more generally—because the euro is backed by a heterogeneous group of countries of unequal strength.

The basic advantage of a multi-currency arrangement is that it would provide all, but especially developing countries, the benefit of diversifying their foreign exchange reserve assets. However, none of the other deficiencies of the system would be addressed. In particular, it would continue to be inequitable, as the benefits from the reserve currency status would still be captured by industrial countries. Also, this reform

would neither eliminate the anti-Keynesian bias nor developing countries' need for self-protection.

Exchange rate flexibility among major reserve currencies is, paradoxically, both an advantage and a potential cost of such a system. The benefit is derived from the fact that the system would not be subject to fixed exchange rate parities, which doomed dual systems in the past—both bimetallism in the nineteenth century and the fixed gold-dollar parity of the original Bretton Woods arrangement. However, to the extent that central banks around the world actively substitute among currencies to enjoy the benefits of diversification, exchange rate volatility could arise among major reserve currencies. This could generate a call for fixed parities among these currencies, but reestablishing such a feature of the Bretton Woods arrangement would not only be an almost insurmountable task in the current world of large and free capital movements, it would eliminate the flexibility of the system, which is precisely one of its virtues.

What this implies is that all individual reserve currencies would lack the basic advantage that a global reserve asset should have: a stable value. Thus, although the inertia of the system may move the world in that direction, this would certainly be a sub-optimal solution.

5 An SDR-Based Global Reserve System

The alternative reform route would be to design an architecture based on a truly global reserve asset. The most viable option, as indicated, is to pursue the transition launched in the 1960s with the creation of SDRs, fulfilling the objective then included in the IMF Articles of Agreement of "making the special drawing right the principle reserve asset in the international monetary system" (Article VIII, Section 7 and Article XXII). These expectations were not fulfilled in the following decades, but were given a good start. The initial allocations made in 1970-72 were equivalent to close to 10 per cent of the world's non-gold reserves. However, with time, SDRs fell to an insignificant 0.5 per cent. Even with the two recent allocations, the stock of SDRs now represents only about 5 per cent of global non-dollar reserves, still a very modest amount.

A reformed system must meet today's somewhat different needs to those emphasized when SDRs were created. Particularly, the issue of inadequate provision of international liquidity at the center of post-

war debates is certainly not important today, except in extraordinary conjunctures. If anything, the fiduciary dollar-based system that we have has generated excessive world liquidity during certain periods, including the boom that preceded the current crisis. But the world still needs a less "erratic" system for providing global reserves, particularly one that does not depend on the idiosyncrasies of the dominant economy and its macroeconomic policies.

This is precisely what the Chinese central bank governor called for: "an international reserve currency should first be anchored to a stable benchmark and issued according to a clear set of rules, therefore to ensure orderly supply; second, its supply should be flexible enough to allow timely adjustment according to the changing demand; third, such adjustments should be disconnected from economic conditions and sovereign interests of any single country". However, on top of creating a more orderly international monetary system, unburdened by the Triffin dilemma, an SDR-based system should also at least partially correct the other flaws of current arrangements.

SDR allocations could follow two different approaches. The best would be issuing them in a countercyclical way, which would mean that they would be issued during crises rather than booms. Concentrating issuance during crises would help circumvent the deflationary pressures that the world economy faces during these periods due to demands on deficit countries to adjust. The second approach would be regular allocations of SDRs, reflecting an additional global demand for reserves. The United Nations Commission proposed allocations equivalent to US\$150 to US\$300 billion a year, which of course would be the magnitude of SDRs to be issued in the long term with a countercyclical approach. One way to match these two approaches would be to make regular allocations but to withhold them during booms until the world economy goes into a downturn, following preset criteria.

An important way to match the counter-cyclical issuance of SDRs with the objective of avoiding the strong pressure on deficit countries to adjust would be to tie them to IMF financing, thus improving "collective insurance" against crises. An example would be the way proposed by IMF economist Jacques Polak three decades ago: IMF lending during crises would create new SDRs (similar to the way lending by central banks creates domestic money, a mecha-

nism heavily used during the current crisis), but such SDRs would be automatically destroyed once such loans are paid for, thus eliminating the global monetary expansion generated during the crisis. There would, of course, be limits on the magnitude of such lending, both overall and for individual countries' borrowing. An alternative would be to combine the allocations of SDRs with the lending capacity of the Fund, by treating those 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.

Any of these solutions would also solve the recurrent problem of making more resources available to the IMF during crises to increase its lending. The traditional way of doing so, which was approved by the G-20 in April 2009, has been to expand the IMF's borrowing from member states. But this mechanism is problematic, as it is not truly multilateral and, in particular, gives excessive power to those countries providing the financing.

Any reform must also increase the size of the IMF, which has lagged significantly behind that of the world economy since the 1970s, particularly in relation to global capital flows. Quota increases would be one way of solving this problem, but it may be better to move to a fully SDR-based IMF, in which the "quotas" would be the SDR allocations. One advantage of such a system is that it would eliminate the need for the IMF to manage a multiplicity of currencies, only a small fraction of which (about 30 per cent) could be used for IMF lending. If the current quota system is followed, a more equitable arrangement would be to allow all countries to make contributions exclusively in their own currencies, thus eliminating the obligation by developing countries to make a fourth of their contribution in SDRs or hard currencies. This would make quotas equivalent to a generalized swap arrangement among central banks.

There are, of course, concerns about what the "backing" for SDRs would be under these proposals. Strictly speaking, as with national currencies, the essential issue is not backing, but the willingness of all parties to unconditionally accept fiat money when payment is received from other parties. So, what really matters is the commitment of all IMF members to accept exchanging SDRs for its national currency when asked for by another member, a commitment that—strictly speaking—was made when SDRs were created in the 1960s. But under the system outlined

above, according to which unused SDRs would be considered as deposits in the IMF that this institution could then invest, backing would be provided by lending and investments made with SDR "deposits". During booms, the normal instrument would be bonds from member countries that have a high level of liquidity and can be redeemed in convertible currencies. During crises, part of such bond holdings would be redeemed to generate funds to lend to countries facing balance of payments' crises. Both aspects would mimic the way central banks operate.

Of course, whatever system is introduced must continue solving the problem of the redistribution of IMF quotas which, despite recent improvements, do not reflect the realities of the world economy today. In a fully SDR-based IMF, "quotas" would have entirely different connotations, as they would not involve actual contribution of resources, but would still determine the shares of countries in SDR allocations, their borrowing limits and, together with basic votes, their voting power.

Under any arrangement, the demand for SDRs is a crucial issue, the crux of which is the commitment by all IMF members to receive SDRs from other central banks. Strict rules on holdings of SDRs by IMF members could also be established, possibly including the obligation of all countries (or countries that hold a certain minimum proportion of SDRs) to keep their allocations when they are not borrowing from the IMF, and to gradually reconstitute them after they pay their debts to the Fund. The alternative would be to allow the use of SDRs in private transactions, thus turning it into a true global monetary instrument. In the short-term, however, it may be useful to concentrate on reforming the global *reserve* system, rather than the broader *monetary* system. This would imply that, although the role of the dollar as a *reserve* asset would be eroded, it would still keep its role as the major international *means of payment*.

These proposals should be complemented by reforms in other areas, to help reduce both the anti-Keynesian bias as well as the asymmetries that developing countries face under the current system. A first essential ingredient is improving macroeconomic policy coordination, with the central role being institutionally handed to the IMF rather than using ad-hoc arrangements (i.e., either G-7/8 or G-20). Such coordination should make adjustment pressures on deficits vs. surplus countries more symmetric. In the case of deficit countries, one way to solve this prob-

lem would be to adopt at least one part of Keynes' original plan for a post-war arrangement: the creation of generous overdraft (drawing) facilities that can be used *unconditionally* by *all* IMF members up to a certain limit and for a pre-established time period. In the case of countries with large surpluses and/or excessive reserves, relative to the size of their economies, one way of penalizing them would be by suspending their right to receive SDR allocations.² Of course, the definition of "excessive reserves" would have to take into account the exceptional demand for reserves by developing countries.

From the point of view of developing countries, the solution adopted must reduce the special asymmetries that these countries face under the current system. This could be done through asymmetric issues of SDRs, which would take into account the demand for reserves and would thus give larger relative allocations to developing countries. The second would be to create a "development link" in SDR allocations. One possible mechanism would be allowing the IMF to buy bonds from Multilateral Development Banks (MDBs) with the SDRs not utilized by member states. These funds would then finance developing countries' demands for long-term financial resources.³ One of the basic advantages of this solution is that developing countries make a broader use of MDBs than of IMF lending.

Whatever solution is adopted would also involve reducing the conditionalities associated with IMF lending, which led to both the stigma associated with borrowing from the Fund and to the strong preference for self-protection. Positive steps in this direction were taken by the IMF in March 2009 with the creation of the Flexible Credit Line (FCL) for crisis prevention purposes, doubling other credit lines, improving the use of stand-by agreements as a preventive tool (the so called "high-access precautionary arrangements") and eliminating the ties between structural conditionalities and loan disbursements. One basic deficiency of the FCL, however, is that it unduly divi-

des developing countries into two categories, those with supposedly good policies and those with ostensibly bad policies, which is not only an unclear and in a sense arbitrary division, but also increases the risks for countries not classified in the first category.

The most desirable—and viable!—reform involves, therefore, moving to a fully SDR-based IMF with a clear countercyclical focus. This would involve countercyclical *allocations* of SDRs, which would generate "unconditional" liquidity, together with countercyclical IMF *financing*, made entirely in SDRs, that provides both unconditional (the overdraft facility) as well as "conditional" liquidity (other forms of lending) to countries facing balance of payments crises.

6 Transitional Arrangements and Complimentary Reforms

As recently pointed out by Fred Bergsten and Peter Kenen, the idea launched in the debates of the late 1970s of creating a "substitution account" in the IMF would be a useful complementary reform. This account would allow countries to transform their dollar reserves into SDR-based assets issued by the Fund. It would provide stability to the current system but could also be seen as a transition mechanism towards a true global reserve currency. The July 1st 2009 IMF decision to issue SDR-denominated notes to some emerging economies (Brazil, China and Russia) could be considered a step in that direction. An essential issue is how to distribute the potential costs of this mechanism, the problem that blocked its adoption three decades ago. However, these costs are not necessarily very high. Simulations by Peter Kenen based on historical data for 1995-2008 indicate that those costs would have been minimal during that period.

Regional monetary arrangements could also play a useful complementary role. Indeed, the IMF of the future should be conceived as the apex of a *network* of regional funds—i.e., as an institution closer in design to the European Central Bank or the Federal Reserve Bank than the unique global institution it now is. An alternative that the UN Commission has suggested is to build a new global reserve system bottom-up, through agreements among regional arrangements.

These arrangements not only provide complementary forms of collective insurance, but also fora for macroeconomic policy coordination and voice to smaller

² The discussions of the early 1970s could be illustrative in this regard. The US backed at the time a "reserve indicator" system, under which each IMF member would have been assigned a target level of reserves and forced to adjust to keep reserves around that target.

³ A third alternative would be to use the SDRs allocated to developed countries to finance additional aid for the poorest countries and the provision of global public goods. This proposal has many virtues, but poses the problem that such transfers are fiscal in character, and may thus require the approval by national parliaments on every occasion.

countries. Existing regional arrangements take different forms—payments agreements, swap lines, reserve pools, common central banks—and exhibit different degrees of multilateralization. A small but very successful institution of its kind has been the Latin American Reserve Fund (FLAR, according to its Spanish acronym), made up of the Andean countries, Costa Rica and Uruguay. The Chiang Mai Initiative is the most ambitious of all, and is committed to full multilateralization.

Regional monetary arrangements might run against the principle of diversification given the possibilities of contagion within a region. However, as the experience of FLAR indicates, despite contagion, members of a regional fund are heterogeneous and their demand for crisis liquidity does not exactly coincide in time, reflecting the fact that there is no perfect correlation of macroeconomic variables. So, these funds can have important stabilizing properties.

7 Conclusions

The current global reserve system based on a fiduciary dollar has fundamental flaws and must be reformed. Although inertia may lead into a multi-currency arrangement, I have argued that the best solution is to fulfill the promises created by the SDR when it were created, by transforming it into the major global reserve asset. Indeed, the IMF could move into a fully SDR-based institution, as some have argued it should be for decades. SDRs would be issued primarily during crises and could be used to improve the collective insurance against crises that it provides, which should include generous overdraft facilities. SDR issues could also take into account the demand for reserves, and thus concentrate on developing countries, or there can be a special “development link”, by allowing the IMF to buy bonds from the MDBs. This could be accompanied by a substitution account, which would allow IMF members to substitute foreign exchange for SDR-denominated assets issued by the Fund, and by encouraging strong regional monetary arrangements.

Although a reform along these lines is viable, several political obstacles must be overcome. The most significant concerns the fears generated in the U.S. by the eventual loss of the preeminence of the dollar. But the U.S. can also gain by avoiding possible destabilizing speculation on the dollar and by being able to run its macroeconomic policies with greater independence without the concerns associated with be-

ing at the center of the system. This shows that the current system has costs for the U.S., particularly when its domestic concerns call for expansionary policies. For the same reason, the euro area would benefit from being able to avoid such costs. In any case, the proposed reform would leave the dollar (and the euro) as the world’s major means of payment. Finally, issuances of SDRs under current conditions would be most welcome in a world with strong recessionary effects generated by the fact that no country wants to run balance of payments deficits. Thus, while the political challenges of the proposed reform are considerable, they are not insurmountable, as it contains benefits for all countries. For this reason, reform of the global reserve system should be a priority for policymakers in all countries.

8 Further Reading

Papers presented to the workshop “Toward a New World Reserve System”, organized by the Friedrich Ebert Stiftung, New York Office and Initiative for Policy Dialogue of Columbia University (with support from the Ford Foundation) are available at: <http://www0.qsb.columbia.edu/ipd/programs/it-em.cfm?prid=133&iyid=5&itid=1927&list=papers>

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