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Reforming the International Monetary System: Comments on Jane D'Arista and John Williamson

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In this volume, authors make proposals as to how the international monetary system should be reformed, and what role they see for the IMF in addressing global imbalances in the future. As Mark Allen has already provided comments on Ariel Buira's and Martín Abeles' proposals in his contribution to this volume, I will limit my comments to the proposals put forward by Jane D'Arista and John Williamson.

Jane D'Arista calls for a "true international standard" in the international financial system, pointing out that the current system is not desirable as it is causing capital to flow from poor to rich countries. The source of this problem, she claims, is the US dollar being *the* global currency, as such a system requires emerging economies to hold the dollar and, consequently, finance the US external debt. She proposes new "closed-end funds for emerging market investment," by creating a new institutional framework under the Bretton-Woods umbrella. Such funds would "redirect external savings back into the economies of the countries that own them," to finance their own development strategies that "increase demand and income more equitably," and "reduce dependence on exports for growth."

John Williamson claims that such a system has "zero chance of adoption," because countries would have to give up too much of their national sovereignty. At the same time, he stresses that the current global exchange rate arrangement is unfit to solve the global imbalances problem. He proposes a "more balanced international financial system,"

based on "increasing the effectiveness of the IMF while respecting the bases of national sovereignty," which specifically implies a combination of exchange rate flexibility and inflation targeting, instead of pegging to the dollar. To achieve this, he claims that the IMF's surveillance of its systemically important members should be based on regular calculation of a set of mutually consistent reference exchange rates believed to be compatible with a generally acceptable set of current account balances.

Let me discuss Jane D'Arista's paper first. I welcome her candid proposal to restructure the current international monetary system. However, her proposal is not a new one – a similar proposal for a global currency was made by Keynes at the Bretton Woods conference in 1944, and then followed by similar proposals afterwards. None of them has ever materialised, mainly because the major economies – most notably the US – opposed. This is related to my first comment on her paper – I do not think that her proposal is feasible, as there will be too many political obstacles to be overcome. The reality is that the effectiveness of any international economic institution depends on the participation of major economies, and there is no law-enforcement mechanism in the international community to force any country into participation. The international monetary system needs to be consistent with the main players' economic and political incentives and, unfortunately, I do not think the proposed system fits the bill.

Second, regarding her point that the dollar's dominance as a vehicle currency is *the* main source of global imbalance, I see why it can be *a* source (as it allows the US to run sizeable deficits), but I do not think it is the main source. Many developing countries, as well as some developed ones (such as Korea and Japan), are intervening in foreign exchange markets not (just) because the dollar is the world's vehicle currency, but also because they want to maintain their international price competitiveness by keeping their currency from appreciating. In addition to this, some countries turn to the dollar-peg for a credible nominal anchor – the motivation for so-called "dollarisation" proposed in many Latin American countries is to get inflation-fighting credentials for their monetary policy (Frankel, 1999). My point is that dollar dominance is a reflection of the US economy's large size, credible US monetary policy, and the dollar's high liquidity rather than a reflection of an unfair international monetary system.

Third, D'Arista's claim that capital is unfairly flowing from "poor" economies to "rich" nations is not really correct, for two reasons. First, many developing countries are running current account *deficits* – for

example, sub-Saharan Africa and Central & Eastern Europe are running current account deficits of 1.2 percent and 4.2 percent of GDP, respectively (in 2005), whereas many Asian countries are running substantial surpluses as we all know. The reason why some emerging economies save abroad is largely due to their limited domestic absorption. To put it another way, different degrees of financial market development can be a source of global imbalances (Mendoza *et al.*, 2006). That said, financial development in emerging economies is in rapid progress. If this process continues, the absorption problem should eventually subside. Second, there is no evidence that surplus economies lack sufficient investment to achieve their economic growth. As of 2005, investment as percentage of GDP is around 34 percent in developing Asia, 22 percent for the Middle-East, 19.7 percent for sub-Saharan Africa, and 21 percent for advanced economies. This tells us that investment in developing Asia (in general) is by no means *insufficient*, although it is probably partly *inefficient*. In addition, recent IMF research (Prasad *et al.*, 2006) shows that capital outflow from non-industrial economies does not dampen economic growth in these countries by depriving them of financing for investment.

Let me now turn to John Williamson's paper. I agree with his point that although the dollar is likely to continue to dominate as an international currency for the foreseeable future, the current global exchange rate arrangement cannot really address global imbalances. The current system, under which surplus economies try to stabilise their exchange rate vis-à-vis the dollar, could indeed create serious problems to the euro area as it is difficult to see how the dollar would depreciate without causing a substantial effective appreciation of the euro.

I have two points that I would like to raise. First, Williamson's proposal of setting a "reference exchange rate" would not only require frequent policy negotiations among the major countries including China, it will also be very difficult to reach an agreement on the level of this reference exchange rate, let alone doing so regularly. Moreover, I doubt that the IMF or any other international institution has the ability to facilitate the regular negotiation process. A more realistic approach is one where the exchange rates between the key currencies – the dollar, the yuan, the yen, and the euro – would be, by and large, freely floating. Policy interventions should be an exception rather than the rule (Joshi, 2006). International dialogue should include those economies which are important for the international monetary system – China first and foremost.

Second, even though I am in favour of better policy coordination among the major economies, we should not overestimate the effectiveness of international policy coordination or underestimate what domestic policy can do to address the global imbalances problem. For example, there are various *domestic* distortions – such as a lack of proper insurance and pension systems in China, and public dissaving in the US – that can and should be addressed by domestic monetary and fiscal policies (Blanchard, 2006).

References

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