INSTABILITY AND REFORM OF THE INTERNATIONAL RESERVES SYSTEM

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ISSUES

- The Triffin problem of inherent instability of a reserve system based on a national currency is aggravated by:
  - **Absence of multilateral discipline over US policies**
  - **Procyclical finance and absence of collective insurance**
  - **Greater capital account openness in DCs.**
- Examine:

1. **The link between current crisis and global imbalances**
2. **Capital account and exchange rate polices and reserves in EMs.**
3. **Reform of the global reserve system– a new role for SDR**

1. CRISIS AND IMBALANCES
US Asset Bubbles and Deficits

- Swing in CA between early 1990s and 2007 is fully accounted by increased propensity to consume:
  - **Household savings fell from 7.7% of income to zero**
  - **CA almost balanced during 1990-91, now deficit, 6% of GDP**
  - **CA moved into deficits as budget moved to surplus in 1990s**
- Impact of capital gains during the dot-com bubble and easy access to credits on consumption.
- Property bubble, easy money, equity withdrawals and consumer profligacy in the 2000s.

With a little help from friends

- Readiness of EMs to provide external financing to US by translating their CA surpluses into dollar reserves facilitated US property bubble through their impact on credit market conditions and LT rates.

- Importance of exchange rate pegs and reserve policies of China and FEs which together account for entire CA surplus and 75% of reserves accumulated by DCs after 2002.

- Impact on LT interest rates in US:
  - **90% of China's and 65% of FEs' holdings of US debt are LT**
  - **Yield curve became flatter as monetary policy tightened– margin with 10-year TB falling from 104 bp in 2003 to 5 bp in 2006.**

Under-consumption in China

- Disparity between I and C growth; reflecting imbalance between profits and wages; implying dependence on foreign markets for realization of profits and savings (rather than transferring a pre-existing savings surplus to the US, as commonly portrayed).
- 2002-07: Consumption growth 8%; investment 15%; exports 25%.
- C/Y=39%, less than I/Y (=45%); and almost half of the US rate.
- C/Y mirrors W/Y. Despite impressive growth wages lag behind productivity, resulting in falling W/Y.
- Also high savings from wages due to inadequate public provision of health, education, housing. Attracted by stock market bubble.

2. RESERVES IN EMs

- Reserve needs expected to lessen with development of and access to international capital markets and greater exchange rate flexibility

- Result is opposite due to forex debt and procyclical finance

- Reserve accumulation as self-insurance
  - **Against capital account instability (Greenspan-Guidotti-IMF)**
  - **Against commodity instability (Prebisch)**

- Sources of reserve accumulation
  - **Earned *vs* borrowed reserves**
  - **Earned reserves: export expansion *vs* import compression**

Recent experience and diversity among DCs

– **80% of reserves of DCs added after 2002: 2/3 earned, 1/3 borrowed**
– **FEs: Reserves fully earned; net capital outflow; rapid growth**
– **China: Twin BOP surplus; reserves largely earned, partly borrowed; aggressive export push and very rapid growth**
– **Outside FEs and China reserves are mainly borrowed**
– **India: Reserves entirely borrowed; CA deficit; very rapid growth.**
– **Brazil: Twin surplus; reserves largely borrowed, partly earned; sluggish growth; growth now accelerating, CA moving to deficit.**
– **CEE : Reserves small and entirely borrowed; large CA deficits; currency appreciations; relatively rapid growth.**

Rationale for Borrowed Reserves

- Sounds sensible: prevents appreciations and CA deficits and provides insurance against sudden stops and reversals.
- But implies that you borrow money without using it for imports and investment, but only to pay back creditors at times of exit.
- It is expensive: $100 billion for DCs and $50 billion for Asia.
- Intervention also cause problems for macroeconomic management
- Better to restrict inflows, but DCs do not do that, even in Asia. Response is to liberalize resident outflows.

Investing Reserves Through SWFs

- Fiscal surpluses (Singapore)/oil revenues (Gulf FEs)

- Privately earned reserves (China):
  - **Domestic use is like debt-financed spending and should be decided on its own merit.**
  - **Options abroad: equity investment in ICs or EMs. Seeking control over natural resources (minerals/oil).**
  - **Perhaps better to expand domestic consumption, adjust currency and reduce CA surplus.**

- Borrowed reserves (India, Taiwan, partly China):
  - **Not sensible; maturity mismatch of forex assets and liabilities.**
  - **Temptation to liberalize private resident outflows;**
  - **Better not to borrow – control inflows unless some benefits can be shown.**

Regulation of SWFs

- MAI: Few years ago ICs were seeking in WTO absolute freedom for FDI by their TNCs and strict obligations for DC governments. Now they are arguing for code of conduct for SWFs, but not for TNCs.

- 1961 OECD Code of Liberalization of Capital Movements and 1976 OECD Declaration on International Investment and Multinational Enterprises leave considerable discretion to IC governments under national security safeguards.

- There should not be a cross bargain with the regulation of hedge funds. Any multilateral agreement on SWFs should be part and parcel of a broader code of conduct for TNCs.

3. MULTILATERAL ARRANGEMENTS

Two Key Issues

1. Reduce the need for self insurance and reserves:
   - **Greater stability of capital flows through**
     - **Effective surveillance over policies in major countries (IMF)**
     - **Global financial regulation (WFO)**
   - **International lender of last resort (ILOLR) (IMF)**
2. Design a reserves system that does not rely on national currencies and entail international resources transfers

Reducing Reserve Needs

- **IMF surveillance over macroeconomic and exchange rate policies**
  - **Absence of meaningful multilateral obligations (Triffin)**
  - **Governance-related impediments**
- **Global Financial Regulation (WFO):**
  - **Sovereignty-related problems (supervision)**
  - **Governance-related problems (WTO example);**
  - **One-size-fit-all regulations no good for DCs, and S&DT does not work.**
- **ILOLR:**
  - **Practical problems; resources; difficulties in prequalification. CCL/RAL**
  - **Moral hazard problems; burden on debtors.**

Capital Account Regimes in DCs

- **Has IMF learned on capital account issues in EMs? What is the new paradigm, position and policy advice?**

- **Control over inflows: Help, encourage, request control over certain types of inflows in bilateral consultations.**

- **Control over outflows: Multilaterally sanctioned temporary standstills and exchange restrictions– mechanisms to ensure that private investors and lenders bear full consequences of risks they have taken.**

An SDRs-Based Reserve System?

- Holding SDRs entails no cost; cost incurred only when used. Proposals for regular allocation to all members or only to poor members.

- Going further and funding IMF by SDRs, not by quotas, GAB or NAB. IMF could distribute SDRs to itself at regular intervals, linked to growth in world income or trade; guaranteed by its shareholders (like WB).

- Allow banks to hold SDRs. Make it possible to use SDRs for currency interventions.

- Greater automaticity in access: widen reserve tranche on the basis of need (not subscriptions); should be designed for countercyclical CA financing.

- Any additional access to IMF during a capital account crisis should be conditional on bailing-in private investors and lenders through application of mandatory standstills and rollovers.