Toward a World Reserve System

Co-sponsored by: Friedrich Ebert Stiftung and the Initiative for Policy Dialogue, with support from the Ford Foundation

November 6th, 2009, Columbia University, New York City.

Opening Remarks

Joseph Stiglitz (Chair):

Many of you have been at this debate for a long time. (Is there anyone here from who was actually at the original Bretton Woods meeting?) Keynes thought the global reserve system reform was key to growth and stability, and the meeting at Bretton Woods was that key moment of reform. The US vetoed that, and we have all been suffering since. The current crisis has put this issue back on the agenda. The UN Commission [Commission of Experts of the President of the UN General Assembly on Reforms of the International Monetary and Financial System], on which Jose Antonio Ocampo and I were on, noted that at the most reforming the global reserve system is a medium-term reform, (although we wanted it to be a short-term reform). Bruce Greenwald thinks reform going to happen in 2013, after the global economy has been in recession for five years. This provided a little impetus for China to start talking about it; the largest holder of reserves has some say even if the US doesn't want to say anything about it. But not just China: at Davos, Putin raised concerns. Talk of reform has now reached a very political level, and it is something that is going to be on the political agenda, but it could take many different forms.

We thought it would be great to get people who together who have been involved in this debate for some time. There are many forms the system might take, many arguments and constituencies, and different risks. That's the agenda, where we ought to be going and how we get there.

Session 1

Chrystia Freeland:

Congratulations on holding a meeting on this subject. It was a bit arcane, but the global reserve system has really started to hit the front pages. One measure of this is a recent Julian Robertson interview. He mentioned one thing about the dollar, proudly, one of his "tiger cubs" is the world preeminent expert on gold. Who is he? I couldn't tell you...I have so many emails about who this is. Even outside the ivory tower, this issue is coming to the top of people's minds. I can't imagine a better way to start than with Barry Eichengreen.

Barry Eichengreen:

We have to look at the lessons of history. I'm going to throw something into the works right at the start of the day. The demand of a unit has always flowed from that use in private transactions. There have been many attempts to try and elevate something that is not in private use to reserve status, bancor etc.. This is not just a matter of political will.

SDRs can be used only with the IMF, not for forex market intervention with market participants. For central banks and governments to see reserves as proper insurance, anticipating actually having to use them, this limited liquidity is critical, rendering them unattractive. Making them more attractive entails making them more liquid, ie private market development. This means building a broad and liquid market in which governments, financial and non-financial companies can issue SDR bonds, banks take SDR deposits and make SDR loans, and so on. Pension funds, the main demander for term assets, need to be attracted to SDR assets despite having liabilities denominated in one currency. An entire restructuring of the forex markets would be involved.

It's all possible, but it's not easy. It's worth recalling that there was a modest attempt to commercialize SDRs and it was very hard: Citi tried to get deposits in SDRs in the 1980s, not known if permission given. It's possible but it is a task for decades rather than years. The crisis itself is a reminder that building markets in new novel assets is not something that can be successfully completed overnight.

Moreover, for the SDR to be meaningful, the IMF would have to be authorized to be issue SDRs in a crisis much like the Fed. At the moment, thanks to some concerns of France in the 1960s, 80 percent of the IMF's membership would have to agree for this to happen. This is not a formula for speed; the Fed's emergency decisions are fast. The IMF would have to become more like a true independent central bank. I'm for this, but China, Russia, and Brazil, are they aware that this is the logical implication of their proposals?

To end on the possible, the future will see diverse resources of international reserves. That's what the future will look like a little after 2013. Three economies of roughly equal size will be traded. No one will be able to reduce investment as global demand for reserves would have grown. Global imbalances from demand for reserves were large but share of US in global system was small, so US came to account or 75 percent of global current deficits. With the US, EU, and China all dealing in reserves in years from now, those imbalances will be less. Given the existence of alternatives, excessive deficits will be disciplined.

This is the direction we are heading. The EU's proportion of reserves is rising. The Chinese have also launched a campaign to make the yuan an intentional currency: they have started some currency swaps and issued RMB-denominated debt in Hong Kong. But only when their issuers posses deep and liquid financial markets will the yuan be able to act as a global reserve currency. The US Treasury market the most liquidity market in the world, by far and away. Others might succeed, but the time frame is measured in decades not years. The EU's problem is that there are heterogeneous sovereigns. German debt is held to maturity by German pension funds while Italian debt, though widely traded, is not attractive as a safe asset. Would EU-area bonds be an option? That would be enough to catapult the EU into leading status, but that's not going to happen unless the EU turns into an actual federation of states.

As for the RMB, full capital account convertibility is a necessary requirement for reserve status. This is necessary but not sufficient for market liquidity. 2020 is the target for Shanghai to become a financial center. This means that capital controls would be gone by 2020, by implication. At that point, the process of building true markets will begin. At that point, it will be a multiple currency system.

That situation will then resemble the pre-1913 system, and that will be a good thing with greater discipline and fewer less imbalances. But we will not enter that world tomorrow.

Peter Kenen:

I'm not in a mood to propose grandiose solutions. My concern is: What is the possible role for the SDR as a store of value, not as a reserve currency in the full sense that Barry was mentioning. In the late 1970s, a substitution account within the IMF was mooted whereby nations would deposit US dollars and receive SDR claims. The plan failed for two reasons: US dollar strength meant SDR weakness, and a refusal by the US to take sole responsibility for SDR value.

As a consultant for Treasury at the time, I did simulations on how the substitution account would function. That was 1999, and the question has laid dormant for three decades. In 2009, the Chinese central bank had about USD 2 trillion in reserves. Naturally, it can't get out of dollars without depreciating the dollar. The creation of substitution account could get China out without dollar depreciation. This produced a new set of simulations.

[runs through simulation]

US support would be required, and the US would incur a liability to maintain the dollar value. The total cost to the US does not include the interest earned on dollar treasuries. Interest costs defined narrowly as dollar cost with compound interest on any cost-sharing borne by the US. The simulation showed that even for non-trivial shocks, say when SDRs rise and USD interest rates fall and thus the USD falls, the cost borne by the US is not large. Though unlikely, this is important to show that even the worst case scenario is not going to be that bad. As the account gets up and running, the limits of US liabilities should be clear. Eventually it will stand on its own.

One important thing to note is the role of the US Congress as an obstacle to reform. US participation in the IMF is not governed by treaty, which means that two-thirds of the Senate and agreement by both houses would be required. This is difficult unless the White House provides a good and convincing rationale for any proposal.

Absent a global market in which SDRs can be traded for national currencies, the IMF cannot perform main functions of intervention. But the SDRs from a substitution account could be transferred to another IMF member. The store of value function is central here, not the medium of exchange function. Under such a regime, IMF members would have to agree to currency deals off market rather than preventing other currency to float. This would bring the SDR close to being a supranational currency without a substantial vesting of power in the IMF. Members would have to vest the power to issue SDRs as collectively sought to grow reserves.

Many Asian countries, including China, have more than enough reserves to cover an emergency duration of imports. We must therefore assume that some of them will want to exit, and take Governor Zhou at face value, while weighing the potential costs and benefits.

Jose Antonio Ocampo:

My presentation will complement the previous two by outlining the role of developing nations in the system. I will first provide a typology of problems of the system and then outline the historical content as the problems came in historical order.

First, there is a deflationary bias to the system as the burden of adjustment falls on deficit nations. This can also be thought of as an anti-Keynesian bias. From the Triffin Dilemma, namely having a national currency serve as the international currency, we know that an inflationary bias possible as well. Nations lose control over their current account deficits. The resulting dynamic instability of the system was Triffin's main point. This was the 1960s debate.

Developing nations demand for reserves reflects their need to manage the instability of capital flows that they face. This can therefore be seen as "self-insurance." This is the only way they can respond to the current system. Yet there is a fallacy of composition with this insurance: if all developing nations insure themselves at the same time, there is a destabilizing systemic effect. We can call this the instability-inequity link,which leads again to a deflationary bias.

The rise in the US current account deficit and instability of US dollar have been worse in the post-Bretton Woods period. Capital account volatility in the developing world has resulted. In response, the share of reserves in developing GDP has taken off. This is a broad-based problem: even while China is the champion, most developing nations have done the same thing. There is no such effect for industrial nations.

Developing nations have learned that if they let their exchange-rates rise in the face of capital flows, current account deficits rise and this becomes a certain route to crisis. So they don't do that any more. The system has to solve this problem, which means that developing nations have to use controls and collectively we have to design system better, one or both. We also have a choice between a multicurrency standard and an SDR-based system. The first is more natural while the second more evolutionary.

A multicurrency system has some beneficial properties. With no fixed exchange-rates, it would not have the problems of bimetallism or gold/dollar while the system would benefit from diversification. Yet there would be new instabilities with exchange rates becoming more unstable. We would still have the present system's inequities as developing nations would still still be forced to accumulate reserves.

An SDR system would have two main properties, by contrast. First, there would be a countercyclical provision of SDRs matching the long-term demand for reserves. (This was something that a 1990 UN report suggested.) This might of course result in an inflationary bias during booms. Secondly, we could tie IMF lending during crisis to SDRs. If the IMF moved into SDRs entirely, we could have two alternatives. First, all lending could be made in SDRs, whereby lending would create SDRs and loan repayment would eliminate SDRs. Alternatively, unused SDRs could be considered as deposits that be lent at the IMF.

A key question is how to solve the inequality-instability link. Here we have three alternatives:

1. Asymmetric Issuance of SDRs. Since the demand for reserves is more from developing nations, they would be the main receipts. This would be de-linked from quotas.

2. Development-link SDR Allocations. This proposal would be similar to that made by a 1960s UNCTAD panel. One mechanism for this is to allow the IMF to use excess SDRs to buy development bonds not from governments but from development banks.

3. Regional Reserves Funds. This could be achieved by making contributions to these reserve funds equivalent to SDRs for IMF allocations.

Two additional features would be necessary. First, greater multilateral surveillance for macro policy. And second, a reduction in demand for reserves. The latter would entail more unconditional lending by IMF, having it function as lender of last resort, or allowing the broader use of capital account regulation.

John Williamson:

The use of the SDRs is the natural solution to the present problems. Werner's topic first: whence the need of world issue right now? The US is unwilling or unable to finance its current account deficit. Summers said the US is unwilling to be the consumer of last resort. What is the alternative? Others will be unwilling to finance the deficit. Either way, the US current account deficit will get smaller. Then Greenwald will be right that recession's end will see the solution.

While there is a shortage of aggregate demand from the crisis, there is no structural shortage of demand in the system. Nor is there a deflationary bias in this system but an inflationary bias instead. But there is still a danger of the shortage of demand. We need greater deficits by other nations and less reserve accumulation.

SDRs already exist, that's an advantage. No lengthy negotiation really needed. The SDR250 billion done by G20 was pretty rapid by international standards. Joe's solutions will come only after a long period in the interim. The logic behind those proposals is impeccable, but not practical. It does have the advantage of universal participation and it does not rely on regional arraignments.

As far as objections go, SDRs can't be used to intervene in the market as there are no transactions in SDRs. But most will be held for precaution, proponents will assert. Sure, but for precaution to work there has to be the ultimate feeling of use, and in fact there is a mechanism for this.

SDRs come from the IMF, and that's a problem for Joe. Traditional high conditionality is good for those who got themselves into their currency crises; there is no way out of this medicine. However, in Asian crisis, it was purely a crisis created in Wall Street, nothing to do with fundamentals. Indonesia was not the best, but was fine. The IMF has a big blot on its record. Flexible credit lines are really important, to be welcomed. We need to discriminate between nations. Yes, that's right, and there will be a line and tough decisions, but that is unavoidable. We can't get over this by adopting solutions for externally-made crises for self-made ones.

On seigniorage, who is going to benefit by SDR creation? The benefits would go to advanced nations as they have the highest quotas, way in excess of demand for reserves. Neutrality means getting what nations demand. But we have to align incentives as if they get what they ask for, you ask for the moon. A compromise would be allocation on the basis of realized demand. Within that, you allocate by means of quotas. Any other allocation would take years to negotiate.

Even an unreformed SDR system dominates the present system. Demand is so far out-sizing the supply at roughly 200 billion USD per year. Countercyclical issuance of SDRs, along the lines of the Polak proposal, is also a good idea.

Eric Helleiner (Discussant):

Over all, we have heard no new arguments for SDRs since the 1960s and 1970s, but there have been some new twists. What is new now? The politics. There are three kinds of arguments that we have heard, which I will outline below. We should note that interest in SDRs is episodic. But this time is different, and a longer-term interest will be sustained.

The first argument we have heard is one of demand for reserves. This is the Triffin argument. If demand continues to grow, SDRs will continue to be talked about. Demand for self-insurance is up, especially after the crisis. The alternative, IMF reform, is a multilateral process that is a long way off. Historically, demand for reserves grows in periods of instability, but this time it is also politically driven in a different way from the 1960s.

A second argument is reserve switching, outlined by Peter Kenen. This argument is also episodic, as it was in the 1978-80 period. The aim of course is diversification in a way that doesn't provoke a dollar crisis. In that last period, the dollar rose, so the argument went out of the window as the question of how to finance the facility bit hard. Both these reasons are not present at the moment. Concerns about the decline of dollar are persistent, and there is no possibility of another Volcker-type interest rate hike. We also have the Euro. In addition, we lack the glue of military alliances. Agreement over financing is more promising now than in the past. Who are the actors? Dollar holders. The US itself has interest from overhang, compounded by the sense that it doesn't have the allies. But the EU is a new third-party. Fred Bergsten has raised the point that we should think not just about cost-sharing arguments but broader IMF reform. The US should agree to more quotas, China to more monetary commitments, and the EU to vote consolidation.

The third argument is equity. There is deep frustration at the US's "exorbitant privilege." Using the reserve system for development purposes goes back to Keynes. Is this demand also episodic? I think this is likely to endure more than in the past. The major reserve nations are those who are suffering from the present system. This is different than the last time, when reform was a plea from non-core nations.

We ought to see arguments for new system in historical perspective. Economic arguments are not new, but the political conditions are in fact new. This suggests that these discussions are not a one-off, so this gives us more time to think about the details.

Discussion

Joseph Stiglitz: (To Eichengreen) Whether one needs to have store of value as a medium of exchange...I don't think you do. Liquidity is a result of commitments of governments. This is a political issue. Whether the markets work is something developing nations holding SDRs will have to insure. Indeed, having the SDRs as a medium of exchange might undermine the system. It would make more transparent through market arbitrage and governments would be induced to speculate on which SDR basket to hold, and this would undermine SDRs. The fact that it hasn't worked in the past is not a deal-breaker.

What's changed? Now the discussion is over the capital rather than trade account. This is about equity. What are the rules of the game without capital account restrictions? IMF is open to capital controls, but they don't think they can work. That implies that there's a threat of a rush out of a nation by Wall St., reserves get built up which have low returns, a mismatch that is tantamount to a transfer to developed nations. This is an involuntary tax imposed by the system.

I agree with everyone that the broader framework will not happen overnight. Yet we don't have to think about this as an either/or choice. We are in a crisis and the immediate is important: regular issue of SDRs of the kind we have is critical. But we need to begin a discussion on the new formula. What compromises are we going to have? We have to undertake fundamental reforms to have equity. The time scale is a longer for that discussion.

Barry Eichengreen: Private markets are a big deal. The evidence that all monetary functions [means of exchange, store of value...] come bundled is pretty compelling. Yes, it is possible to make a less and more liquid if you have a willing counterparty. Central banks have been moving away from less liquid assets, the Reserve Bank of India notwithstanding. So SDRs will have some role, yes, but that it will displace major currencies is unlikely.

There is a claim that there is a willingness to hold SDRs as precautionary rather than for use. If that's true, then there are better ways to do it. Reduce the need to hold reserves in the first place through IMF reform and flexible credit lines.

John Williamson: Precautionary demand means that you will have to use them, but not regularly.

Joseph Stiglitz: IMF reform is the key. We talked about collective insurance at the Istanbul meeting. The IMF took the view that it could provide the insurance, others were not confident in the IMF as it didn't have the . Even with the current management, who knows what the management is doing to be in five years....formal structure required to keep the system equitable.

Bruce Greenwald: Precautionary balances that someone else owns are not precautionary.

Jose Antonio Ocampo: overdraft facilities should be unconditional to a certain point. As asset and a liability are not equivalent, that would be a liability. This has to come through the asset side.

Peter Kenen: The substitution account is not designed to rescue the US, and the US will oppose it. Not being bound by treaty, the US has to put any IMF amendment through both houses of Congress. Development assistance will make things even harder. Governor e comments will revive suspicions in Congress that if it's good for China it can't be good for the US.

A central repository for transferable assets on the IMF's books that can provide something that nations can use for intervention is a key. A store of value function not is not a medium. Rescue for US dollar is a thing of the past. But I see the substitution account as a feasible medium term to solution to install the SDR as a major reserve asset *before* we enter an era of competing currencies. It can be used as a prime vehicle for transfers among central banks. If the main thrust is development assistance, you will tie several opposition consistencies together. This might be parochially US point but it's key. We can get to the SDR system first before competition from other currencies which will be a far more volatile system in which the dollar might vanish.

Amer Bisat: Liquidity is hugely important. [Went through three episodes where liquidity in even highly-liquid dollar markets such as the Euro forwards market dried up during the crises. The other episode involved Fed swap lines to other central banks. "Liquidity is more than a theoretical concept."]

Jo Marie Griesgraber: The need for self-insurance comes from the IMF stigma. There is a political channel through the G20 to get IMF reform through. What would be necessary to gain trust back? The IMF was designed to be a cooperative to begin with. What is the nature of reform?

Secondly, I take exception to the "beware the Congress" line. Debates around the last package of funding for IMF indicated that it was not opposed to discuss the substance. The administration gave it to the full appropriations committee and got it through in the afternoon. Yes, there is an automatic anti-China reflex.

Takatoshi Ito: No Asian country had any currency problems during this crisis, so they feel vindicated that the self-insurance worked. They are not in a mood to accept anything else. In 1997, Indonesia started to borrow unconditionally from the IMF and then it turned out to be conditional.

So there's a deep distrust...how do you overcome this? It is a very hard sell to substitute self-insurance. China is the exception: two trillion US dollars is not meant for self-insurance. No, this level of accumulation is an unintended consequence. The motives are different for China and for others.

Aleksei Mozhin: Is there a Russia-China nexus? At another time maybe. Historical analogies are always exciting, but can globalisation continue without major systemic reform? Who is going bear the current account deficit in the new world? Iceland, UK, Romania, Latvia, all gone. Who other than US and EU, reserve-issuing entities, will run the deficit?? Asians have been successful. Russia vs Ukraine comes down to money. The appropriate historical analogy is the early 1990s in EU, when they were facing a clear choice between abandoning the EU project after twenty years of chaos in forex markets and lunging into the unthinkable. Are we at that moment? Is this the analogy?

Stephany Griffith-Jones: Peter Kenan made a nice point that the entire SDR issue should not linked to aid for political reasons. In the past they have tried to do that and it has weakened the case. Conceptually, SDRs should be liquid, aid is not. Could we make a political case for SDRs by linking it to climate change? Funding for climate change...developed nations love this and developing nations get more resources.

Session 2

Stephany Griffith-Jones, Moderator

Bruce Greenwald:

The issue is one of great urgency. This is the one thing missing from Bretton-Woods analogy. The meeting was convened in 1944 because the concern was that postwar the depression would come back. The 1930s was a different kind of business cycle. This was going to be the global part of the preventative mechanism; the institution had to be in place. Crucially, the concern was not the IMF but GATT, the trade policy that could be counter-productive. The aim was to prevent trade wars.

The first twenty years of IMF, it does nothing but keep the UK afloat. It was not as central as was thought. What might have been worried about the business cycle was fixed by World War II. The countries that differed most were the big agricultural producers: the US, Canada, Argentina, Germany and France. The 1920s saw successions of agricultural crises. Productivity was 4 percent and demand was growing at 1 percent. Agriculture was collapsing. But 35 percent of the labour-force was isolated on the farms, geographically and institutionally. No demand from industry was coming on to employ them. The 1937-38 recession in the US was the result, which was preceded by a collapse in agricultural prices.

During World War II industrial policy gets people off the farms. Argentina never recovers as it didn't do this. With savings high, demand was now there for manufacturing. The government succeeds in intervention to overcome the housing shortage.

In the 1990s, we saw the collapse of manufacturing. Productivity was 4 percent at least, whereas demand was between 2 and 5 percent. Countries are isolated, but China is committed to growth through industry. Because it has no domestic demand, it exports its way out, namely the 1930s solution. China and Japan can't be accumulating reserves because of precautionary self-insurance. In Germany, there are powerful unions and manufacturing firms, so protection takes the form of currency manipulation in China.

Two things make this worse today. First, export-led growth. Manufacturing may be in real trouble but a command economy is its own version of war. Second, energy exporters are natural sources of surpluses. Stability is predicated on a flow condition. In the shift from manufacturing to services, France has done well.

There may be a deflationary problem during this shift. In 1944-6, this was solved thanks to War. This time we might be not so lucky. I think 2013 is the US drop-dead date. The government can't stabilize demand. Unemployment is going up at 1-2 percent per year. This was the EU in the 1990s and Japan for a long time.

We now have an opportunity to add value to stabilize the international system. IMF institutions have been on balance in this crisis, but the surplus nations are driving others into the dust. We have to alter the distribution. There are economic and political balances, and all are committed to keeping their manufacturing balance. But we must manage the transition.

Joseph Stiglitz:

We have to think in terms of the objectives of a global reserve system in the context of an insufficiency of global aggregate demand. In the long run, things might be solved, but that is not the relevant time frame. Deficits are a political problem, and it is difficult to maintain stimulus politically. Reserves are a mechanism from precautionary demand: the form in which they are held has implications for risks. Export-led growth is based on competitive devaluations which has been advertised as the most efficient way to grow.

Why else would countries hold on to assets that have little return and high risk, unless their exchange-rate policy was part of their development strategy? So we have an adjustment problem. Equilibrium ought to be 20 percent higher, but this would entail a USD300 billion capital loss. Hence there is no willingness to adjust. Even if you could change the structure of the economy, there ought to be a price to pay for the mistakes of the past.

Apart from the supply side of reserves, trade deficits reduce aggregate demand domestically. So to maintain full employment, we needed loose monetary and fiscal policy. We are now hitting the limits on both of these facilities. We can no longer be the deficit of last resort.

We need new forms of finance for development and climate change. The developed nations don't want to come up with this, especially with their deficits. Emissions of new reserves could be linked to development or climate change. There are five points here regarding the structure of a new system: size, rules, allocation, institutions, and transition.

1. There is a reduction in global aggregate demand resulting from reserve accumulation. There are two kinds of accumulation: one from current account surpluses and one from borrowed reserves that are the result of currency management. Keynes focused on first not second, and the externalities resulting from it. USD200 billion is a conservative estimate for a new issuance of SDRs. We must start with SDRs being a complement to other reserves and begin with a comfortable number. Then we can begin to have a intelligent discussion.

2. The UN report [The Report of the Commission of Experts of the President of the UN General Assembly on Reforms of the International Monetary and Financial System] noted that there's

a important trade-off between simplicity and complexity viz. reform. With more objectives there is less agreement. There is also a trade-off between speed of response and long-term needs. It is difficult in a short time to change rules, so we should start simple with SDR emissions that are countercyclical and rule-based. We should relate the issuance to global unemployment and global growth. Rule-based emissions have advantages. The more rule-based the system, the more comfortable nations will be with using existing institutions. Greater discretion leads to greater anxieties.

3. On the allocation formula, emissions should be linked to effective demand, so stability and equity should be the main drivers. The compromise proposal that John Williamson proposed seems like it has nothing to do with equity. There seems to be an aversion to equity issues. We ought to have a technical formula with equity impact. We should have an allocation that would pay more attention to development and climate change.

4. On institutional arrangements, the question is how ambitious does one have to be? If we're just talking about issuance of SDRs, a rule-based IMF would be fine. SDR loans and conditionality are separate, and would involve rescue mission politics rather than annual emissions. Rules would not create a big bureaucracy.

5. On transition, regional funds will eventually link to a global system in an evolutionary way.

Liqing Zhang:

I would like to outline three questions: 1. Why reform?, 2. How are we to reform?, 3. What is China's role, especially in transition?

1. The beginning of the 1970s and collapse of Bretton Woods and rise of dollar standard saw a system with three flaws:

    (a) The issuing nation could not maintain exchange-rate stability while providing sufficient liquidity to the rest of the world.

    (b) There was a conflict in the monetary policy of issuance viz. domestic and global needs. Any mistakes could have had unexpected and negative consequences to the rest of the world. Policy coordination was a problem. No single nation could have negotiated with the US on its monetary policy. The rest of the world had to live with "it's our currency, but it's your problem." The exorbitant privilege led to easy monetary policy and current account deficit indulgence. Loose policy led to global imbalances, one of the main reasons for the Subprime Crisis.

    (c) With the dollar reserve system, resources were going from poor to rich nations. Theoretically, this need not have been the case: the US could have exported capital to the rest of the world. This did not happen thanks to financial globalisation and financial stability. Emerging markets were cautious and invested in Treasuries. As the Stiglitz Report noted, the system was both unstable and unequal.

2. On the eve of the G20 meeting, the People's Bank of China Governor called for augmenting the role of the SDR, saying that it should be the main reserve asset in the future. A super-sovereign currency can overcome the Triffin Dilemma and other related problems. On the supply side, the US has little incentive to halt a slide in the dollar. If the IMF becomes

more democratic, representative, efficient, and fair, the SDR will have a bright future. On the demand side, the SDR would only be a credit from IMF with limited liquidity. How can it be made more liquid? I agree here with Barry Eichengreen on the problems. Two things to consider would be SDR-denominated bonds by IMF and members and encouraging commercial use of SDRs.

3. China will share the seigniorage in SDRs if it becomes the principle reserve asset. But this is not the main benefit. Global financial stability would be the main thing, and this is important to China as instability hurts development. The yuan will take time to be an international currency; this is not realistic in the short to medium term. So for several decades, we will still be multicurrency system. A multicurrency system means extending RMB usage. The Triffin problems would be alleviated as it became internationalized. Work by Eichengreen has highlighted the use of RMB bilateral currency swaps with emerging markets, encouraging RMB as settlement a currency, and the extension by the Hong Kong government usage of RMB for bond issuance. We would also have to accelerate domestic financial reform. Restriction on overseas investment would have to end. There would be danger in convertibility from outflows if we liberalized too fast. The RMB should be in the SDR basket by 2011 in next round of adjustment and Asian financial integration should proceed, including the enhancement of the Chang Mai initiative. The accumulation of reserves that you see is a result of integration into globalisation. Deglobalization remains a challenge.

Deepak Nayar (Discussant):

There seems to be broad agreement, apart from some minor issues, but some questions remain. How do we get there? The logic and necessity seem almost obvious, and follows from the history. Eric and Joe are right when they say that it is the economics and politics of the conjuncture that is different. The issue is on the agenda because of the conjuncture. We must maintain the distinction between analysis, diagnosis and prescription. I agree with analysis and diagnosis, the prescription I have some issues with.

The analysis is simple: the Dollar Standard is asymmetrical. It is unstable with huge current account deficits and inequitable from transfers of wealth. And there is a nexus between inequity and instability. The diagnosis is that the logic of system that uses a national unit as global reserve is flawed. The political logic of continued dominance of US is untenable, being always prone to crisis and disequilibrium.

The prescription comes in many forms, all of which are variations on the SDR, a new global greenback, and so on. I'm not convinced. Barry Eichengreen has pointed to an inconvenient truth. For better or worse, the dollar is the only game in town: it is the unit of account, the medium of exchange (most liquidity), and store of value. This is true not just with reserve holdings but foreign-exchange markets as well. There is no alternative. There is not likely to be a massive loss of confidence as it would be self-destructive. The dollar carries with it its own insurance.

So I have six questions and one suggestion:

1. Which function as international money are the SDRs in their new incarnation meant to perform? Unit of account? Medium of exchange? Store of value? The final one, in part, is the consensus.

2. Are SDRs to be complements or substitutes? Complements, at best.

3. Is there a role for other national currencies and not the Euro alone? Yes, but there are risks. There would need to be a willingness and ability to run deficits in those countries. There is none in the EU, and China seems unlikely. For currencies to become reserves have the capital account open?
4. What is the transition path? Evolution, learning by doing? Checks and balances? "Plurilateralism" seems to be the path forward. The UN Commission called for the creation of a unit that nations will join, or regional solutions as building blocks. Grand design of the Bretton Woods variety would seem to call for an international lender of last resort. Here, the EU rather than Fed would seem to be the model.
5. What would the institutional mechanism be? There are serious concerns with the IMF because it is there, it has SDRs. We would be parading the problem as the solution. It has a democratic deficit in its history, and is quite ideological. Old habits die hard; we all have that concern in the emerging world.
6. Incremental steps or grand design?

The suggestion: Economists have a propensity for single causes and unique solutions. But there's a little bit of wisdom in everything. Many solutions are not mutually exclusive, it's a question of what is feasible. Enlarge SDR, size, rules, allocation, multiple reserve currency systems are possible as history has taught us. The situation is unstable and inequitable, so we might have to do many things at the same time to reduce the stress and allow the space for new ideas to evolve.

Discussion

Barry Eichengreen: Reserve nations do not have to run deficits: UK, US, and EU did not do so at different times. But further, can a multiple currency can be stable?

John Williamson: A multiple currency system, unless it has fixed parities, will be unstable. Central Banks try to jump on bandwagons. But central bankers are not picked for trading, they make the system more unstable.

Stephany Griffith-Jones: Do we all agree that a multiple currency system is inherently unstable?

Jose-Antonio Ocampo: Agreed, it has to be fixed rates.

Barry Eichengreen: If one eliminates one-way bets and has fully flexible exchange rates, that will be fine.

Gerald Epstein: A degree of stability is achieved in properly-regulated international system. If we don't change that, it will be unstable. The US played the role of lender of last resort this time so we dodged the bullet. Politically, we might not be able to reproduce that, as international coordination will be very hard. How can we articulate that function at the global level and in the context of regulation?

Shari Spiegel: On John Williamson's point, there is tremendous herding in financial markets, and central banks are traders as well. One currency tends to be forced to be the reserve, but this is not always the optimal one.

John Williamson: On Liqing Zhang's point regarding the RMB in the SDR basket: short-term conversion on RMB would be difficult as there would be no incentive to arbitrage. With controls, there might be such an incentive, but then it would be hard for it to be part of the SDR basket. We should also note that SDR250 billion allocation was regarded as an anti-recession measure and was not seen as a regular thing.

Peter Kenen: A multi-currency system is intrinsically unstable. Cooperation helps, but speculation has to have its stake. Cooperation cannot be guaranteed. Strong and Norman could do it, but it's not always in everyone's interest. The substitution account does not rule out a multi-currency system. It has nothing to do with currency trading. Central banks have a choice viz. cooperation, but reform of the IMF is key. If we were in a multi-currency system without a strong reserve asset, we would be in trouble. The substitution account would match the growth of reserves. There will always be a democratic deficit in the IMF. Let's get started on the first stage: pool resources. Then let the system evolve.

Benu Schneider: If we are to internationalize at the RMB, which function are we talking about? India has the seventh largest currency in the world, even with capital controls. But some functions become irrelevant. The RMB might be included in the SDR basket, but the Rupee is way ahead than the RMB on transactions.

Jane D'Arista: Proposals have short-changed the transactions functions of the reserve currencies. The reserve accumulations have never been based on transactions! How would we move back to a public system in SDRs and link it to transactions? Capital account? Liquidity? Fiat issue? Link to national economies? Not a substitution account. Much better to have swap arrangements. IMF purchasing government securities in SDRs to make it useful to national economies.

Takatoshi Ito: The Triffin Dilemma is wrong. All nations had capital accounts closed in that world. If the account had been open, you could have had a balanced account and have reserve currency in exchange for assets. There's an Asian experiment to issue Asian bonds denominated in US Dollars: an Asian bond fund.

Peter Bofinger: A multiple-currency system is not unstable. A dual system is working now. On Liqing Zhang's point, how can China complain about the US privilege and unfair flows? China could have had it differently? Why should a developing nation accumulate so much in reserve when there is so much to do domestically? On the global greenback, in an emergency, I need dollars. Who is exchanging the global greenback at short notice when I need dollars?

Bruce Greenwald: There is a reason we are here today: most of the time the systems works fine. Bretton Woods happened in 1944 because the system created the Depression. There is now a sense that the international system is responsible for the long Japanese crisis. The deflationary bias is a long-run problem.

Joseph Stiglitz: The capital account can be used as a basis for draining reserves in an open account world. Russia found this out. The trade account can adjust, but not as fast as the capital account, so the danger from trade openness is less. On the liquidity of Global Greenbacks or SDRs, it all depends on the rules of the game. The system will not work unless governments agree to do it...

Peter Bofinger: The burden of adjustment has to be US mainly as we want dollars.

Joseph Stiglitz: Yes, but if they issue more dollars, the temporary liquidity crisis might be averted but would that impose a long-term fiscal burden on the US? It would not be costless but the benefits, even for the US, are there. With the trade account open, the EU would mind but the US doesn't. The US can undo the impact of a negative aggregate demand shock by fiscal stimulus and the monetary authority has few constraints. Maastricht and orthodox central banking is a problem. The deflationary impact is stronger in EU.

Liqing Zhang: Controls can be flexible to some degree, 100 percent, 50 percent, 30 percent. Is international usage a precondition for China to make the RMB convertible? Gradually, but it's not necessary for it to be fully convertible. A more open capital account in important but not necessary. We would reduce the foreign-exchange risk at firm level if RMB is used more internationally, and reduce original sin. Chinese firms would be quite happy about that. Diversification would eliminate the Triffin Dilemma. Lending abroad can get us out of the present impasse.

Session 3

Peter Bofinger:

There are two dimensions of the international reserve situation that I would like to mention before I start my presentation. First, there is a stock issue viz. the huge dollar hang-over and the related risk of exit. But, secondly, there is also a flow issue that we were discussing this morning. Over time, supply of reserves will be commensurate to demand in the absence of inflationary problems. Our problem, then, is to decrease the stock of reserves even while increasing the flow thanks to increased demand.

It is not ideal to discuss the reserve system in isolation from the more broad topic of the exchange-rate system. This is putting the horse before the cart. The main infirmities are in the exchange-rate system. We now have an anarchic system that is totally unregulated. Exchange-rate policy in mainly unilateral; there is no multilateral or bilateral approach. On the positive side, nations can freely decide their exchange-rates. On the negative side, if nations get into trouble, there is no automatic support. Nations have to defend themselves with their own resources.

In 1973, no one regarded this as a problem: flexible rates were thought to adjust to fundamental a disequilibrium. No reserves were thought necessary as there would be no manipulation. This was the rationale of the system. There is no need to say that the reality was and is different. We have self-insurance and precautionary demand for reserves, while nations use their exchange-rates as a trade policy tool. While the insurance element leads to the voluntary accumulation of reserves, mercantilist policies lead to involuntary accumulation of reserves.

Is an SDR-based system a substitute for this configuration? SDRs cannot substitute other reserves viz. the precautionary demand as they have no liquidity. Regarding the mercantilist motive, a decline in the dollar is good as the Euro is stronger. Some increase in SDRs will be okay, but the current increment is not that much.

Can we get away from unilateralism and at least have bilateralism? The US is still behaving as the center of the Bretton-Woods System, even though Bretton Woods is gone. This has resulted is the default policy of the US under Bretton Woods, namely benign neglect. This might have been a good idea at some point, but not now. What happened in Indonesia [1998] and Argentina [2001] was very bad. The US could have stabilized them and taken responsibility.

Facing a long-term decline in manufacturing, should the US just do nothing and just adapt? We need to rethink the whole system and move to active involvement from benign neglect. If we start with mutually-agreed currency supports, including crisis supports, then perhaps a system of bilateral deals would be a transitional stage to a genuinely multilateral arrangement.

On regional arrangements, they could work in principle but there would still be a risk of speculative attacks and therefore the need for insurance. But keeping rates fixed intra-regionally would be difficult, as Europe's experience indicates. There would have to be a great deal of regional stability and fiscal discipline, as well as a critical mass of internal trade.

On the substitution account proposal, it's already in place but not called that. There is an SDR note issuance program. China has used this to a greater degree than the new sanctioning of SDRs. It is a securitized substitution account. Is this something we want? Is it incentive compatible? If China's manipulation can be dealt with in this way, then there is no sanction on it. The dollar should lose value in order for a loss on Chinese reverses to occur. This is what Keynes had in mind: nations with excessive surpluses should be punished. This would of course be problematic.

The main constraint is the stock problem. We all have to bear the cost of mercantilism. The dollar is a good peg at this point. Regional plans are a good idea but difficult to implement.

Ricardo Ffrench-Davis:

Latin American nations are doing okay: there is price stability and they have good ratings. But volatility has allocative implications. Money does not go into real investment when it is volatile; it flows to financial assets. We have econometric evidence of this. Savings leads to capital formation, but instability of flows is bad for aggregate demand.

There needs to be an improvement of domestic policies in a countercyclical direction. Compensatory finance can help here. Reserves might indeed be costly but recessions are even more costly. But there is a danger with certain kinds of countercyclical measures. If you correct for excess aggregate demand with a steep interest rate hike, there will be a positive effect on the exchange-rate and the nation will stay in a recession for a longer time. The Latin American experience indicates that this could go up to six years. Korea also has evidence of this effect.

On regional institutions, they are basically a pooling mechanism for reserves and capital. They get good grades from the ratings agencies, better than the individual developing nations. But they ought to have a countercyclical component. And they will not alter the need for IMF reform.

Alexander Dynkin:

We need to keep in mind what Churchill said about democracy when thinking of redefining the system: it is awful but all others are worse. The SDR is not for private markets, there's no liquidity. This is the key issue. There would be many players eager to sell but few to buy. Further, they did not perfectly work as an element of aid.

Exchange-rate volatility and cross-border financial flows create a lot of problems for nations, especially for Russia. The stock exchange and commodity prices see bubbles. With global uncertainty, there is a spread of possibilities as reserve assets, including the dollar and crude oil. We can measure the confidence intervals in each of these assets from options calculations [indicated on his charts].

Reserve accumulation is the result of this uncertainty interacting with insufficient domestic aggregate demand in developing nations. This is now true for Japan as well. The problem of course is that this creates two unprecedented deficits. Containing them is a political problem.

On the use of the ruble in international settlements, it is realistic, but can we use a bottom up approach? First, we removed the convertibility constraints, then there were ruble futures on the Merc where 35 percent of the transactions are non-resident, and we have embedded the currency in the Eurasian economic community. But there is a dark side to this: financial debts are still lower than in industrial nations, and 75 percent of our exports are in hydrocarbons, which are dollar-denominated. Russian oil and Gazprom ought to be pushed towards a massive introduction of ruble-denominated contracts.

After two decades of double-digit inflation in Russia, there was no strong banking system. Making the ruble a regional currency for CIS countries was intensively discussed. There was strong support from parts, but CIS nations have large deficits with Russia. So they had large credit facilities in Russia, and subsidized oil and gas as in Soviet times. The broad basis of trade might not be in place for a common currency. Thus the rationalization of world system should proceed cautiously. The Sterling zone, Franc zone, and Ruble zone are all gone, so we need to ensure conditions for gradual transitions for a new multi-zone system.

The politics of leading nations might, in the distant future, lead to a soft Maastricht agreement at the global level or even a world government that allocates international reserves, governs nuclear war heads, and makes hydrocarbon allocations. But the new requirements of the present global economy see the existing exchange-rate system as critical. Floating rates saved us in the early 1970s, but now financial bubbles are the main dangers. Floating rates create conditions for bubbles. We need cross-border coordination of financial policy and predictable exchange-rates.

Aleksei Mozhin (Discussant):

The G20 agreement to increase resources lent to the IMF was significant. The BRIC nations were able to impose this solution on the IMF, which does not happen too frequently. Although BRIC nations had less than 10 percent of the voting power, the rest wanted their financial contribution and so ceded power to them on this occasion. One reason for this rather than credit lines was domestic politics. It is easier to explain that the government is not lending to the IMF but diversifying its international reserves by investing in SDRs.

The Chinese then had it in mind that this could develop into an SDR system. But these are not tradable instruments. What is behind the statements regarding the SDR proposal? The Russian Prime Minister says he is unhappy about the system and wants a multipolar one. The Chinese central bank governor says the same. Are there geopolitical considerations in play? Yes, to some extent: they see the currency with the same geopolitical vision as the rest of international politics.

That's a shame. Behind this "noise" there is the fact that we don't like the present system. What kind of system is it when oil price goes all over the place in a couple of months? The Federal Reserve just printed money for many years and we were at the receiving end of massive inflows of speculative capital. The whole system forced us to specialize in commodity exports. Putin failed to diversify the Russian economy and indeed moved it the opposite direction. But the question is how to do that when the exchange-rate goes up by 9 percent per year in real terms?

Talking with Chinese colleagues once a week, I get the sense that exchange-rate policy in China focuses on safety and stability. ASEAN believes that Chinese policy is the pillar of stability in the region. They are very happy about it and target the RMB implicitly or explicitly.

Is global money possible? Yes. The whole history of mankind, save the last forty years, was that global money was gold. The last 40 years was an experiment. Do we need it? Ask the Europeans why they decided to sacrifice their DMs and Francs and Liras? Not because they wanted to: there was a deep emotional attraction and reluctance to surrender sovereignty. But after twenty years of chaos, the Snake, the ECU (akin to the SDR), ERM I and II, nothing worked. In the 1990s, the EU faced a choice to abandon the project or take the plunge.

When will global money take shape? Only when the US and EU want it. This may happen much sooner than we expect. The exorbitant privilege of the reserve currency country is that they need to run current account and fiscal deficits. Demand can only be met if the US is running a deficit. The Euro is limited in its reserve role as these deficits are restricted. It's a little bit of a chicken and egg situation.

Discussion

Thomas Trebat: The lessons of Latin America indicate that self-insurance is not such a bad thing, it keeps the IMF out! It does require the capital account to stay open but there is some control. Are Brazil's recent efforts a model? Or Chile's experience with controls? What might other Latin American nations do? Can there be broader BRIC solidarity?

Jane D'Arista: There will be some of these difficulties in a transitional moment. Capital flows are excessive and the carry trade is ongoing. Would a new system be in the US interest? Yes, to any rational person. The reality is that the status quo benefits the financial sector: they are in control. There are profits from the uncertainty by continuing, for those who can, the proprietary trading, carry trading that goes on. Another crisis might be an issue that will drive the US into more reasonable positions.

On the stock issue viz. reserves, what is being done with the stocks? There is no way for it to be handled well, save China, as it is spending to buy assets and commodities. Look at the Japanese experience in 2005, it was destructive. There was a build-up of reserves, commercial banks were allowed to lend in yen that lead to a carry trade. Unless the international financial system is controlled as a player, or we have another crisis, we may not be able to move to reform.

Stephany Griffith-Jones: Regulating finance and currency issues are intertwined. What is in the US interest in short-term? Peter Bofinger's use to the term "manipulation" is too strong a word...

Jose Antonio Ocampo: The exchange-rate system is indeed very important. Indirectly, we talked about it when we talked about the stability of a multicurrency system. Look at the volatility of Euro-Dollar exchange-rate. What is the value of that flexibility? Central banks only serve to increase this volatility. Self-insurance gives a nation the room to maneuver: this is a countercyclical luxury. But there is a collective problem from a fallacy of composition.

Where does mercantilism stop and insurance start? External instability is the problem, the number one macro problem for developing nations. What is the equilibrium exchange people have in mind when they speak of "manipulation"? There are cyclical swings that make it very hard to determine what fundamental value ought to be. Even in trade, with China between 2000-4, should they have appreciated their exchange-rate? Ex ante we might think that right then, but it's the wrong thing now. It's the same with oil surplus nations; how do you tell cyclical swings from structural trends? "Manipulation" implies some structural reading. On the contrary, most central banks intervening perceived the boom to be temporary!! It shows the illogic of the system but from the individual unit's perspective their actions were correct.

Joseph Stiglitz: To amplify that, in capital control nations like China, the current account numbers might be false as there's a serious evasion of controls. Over-invoicing or under-invoicing of trade disguises capital flows as trade. The stock and flow distinction is important, and there are interactions between the two: the existence of stocks impedes the adjustments of flow.

This is indeed part of a broader debate. The problems are with the global system, but we are talking about just one part. Grand design would be different, we might begin with something else. No one here is suggesting that we have a global monetary unit, and no one, save perhaps Robert Mundell, thinks that the world is an Optimal Currency Area. There is no global coordination adequate to a single currency either, so we would have instability. Insurance is therefore needed. But global systems will be needed in the long term, and the more stable the system is the less insurance will be needed. The more the IMF does a good job, the less self insurance will be required.

This will not happen overnight. The lesson that people are taking from this crisis leads to increasing reserves, which decreases global aggregate demand. There are strong interactions here: more global aggregate demand problems will lead to more bad behavior. The Fed is flooding the system with more liquidity and it's difficult to tie the hands of the Fed. We need to reduce the scope for behavior that has negative externalities.

On exchange-rates as industrial policy, I think it's clear that export-led growth is the policy. As of 1994 and the WTO, the instruments of industrial policy of the kind that East Asia used in its high growth period were diminished. Macro tools are the preferred instruments of policy, said economists, as they do not pick winners.

Finally, there are many kinds of monetary cooperation. There might not be a single global or regional currency in East Asia or Latin America. There are various forms things can take. Chang Mai, which was not discussed, was the real initiative. It only has an insurance function. They would rather pool insurance than go to the IMF or the Fed.

On what is in the US's interest, in any society there are different groups of winners and losers. There is an awareness of the two sides of this debate. The big advantage of seigniorage, of borrowing infinitely, is mirrored by a trade deficit that is bad for aggregate demand. They are aware of that. Yet there is still a conservatism: what we are talking about is a big change, even when you run on a platform of change. Greater discussion makes it more acceptable.

Daisuke Kotegawa: Today is the twelfth anniversary of the liquidation of one of the seventh largest Japanese banks. The fourth largest also had to get through some tough government intervention. There is a big difference between this Japanese bank and Lehman. We didn't wan to become the center of a world crisis in November 1997. We unwound all outstanding transactions through their headquarters, plus in London and New York, including derivatives. Without that, we would have had a world crisis.

My concern is that authorities in charge of Lehman did not approve of Lehman merger with another international bank. If that happened, tax payers of one country would have had to pay that for the failure of another nation's bank. Had they floated a rumor of the success of such a transaction, foreign transactions would have unwound and there would have been no crisis.

With the Japanese monetary locomotive post-Plaza, the yen went as we were asked to run the world economy. We were not worried. The economy was stimulated again and again, until in late 1980s we had a bubble. Japan's share in world GDP was 12-13 percent in those days, while the share of the EU and US was 35 percent. Today, the share of growth is a third from developed nations and two-thirds from others. One third of growth comes from the BRICs alone, while a full quarter from China alone, equivalent to the EU and US combined. Who should compensate for the loss of this growth impetus from the US and the EU in the future?

Jo Marie Griesgraber: We do not have the luxury to treat the reserve question separately from the regulation question. We can't talk about one without the other. Jane and Gerry are correct: we need to regulate private finance. We are saying that RMB capital controls need to be gone for the currency to play an international role. This is the wrong direction. We need more regulation of capital. Without regulations, we get the excesses that we have. Finally, when we look at climate change, what is the kind of the aggregate demand that the planet can take? We need to think of services rather than consumption.

Liqing Zhang: "Manipulation" is a misleading concept, political rather than economic. In economics, we only have intervention. Global imbalances are not in China's interest, particularly in the long-run. There is indeed too much accumulation. Even if there was support for currency appreciation, what good would it do? Look at Japan's experience. But also look at wages. The Chinese wage is only 1/35th of that in the US. Even a 100 appreciation appreciation is not going to dent this comparative advantage.

John Williamson: There's altogether too much emphasis on self-insurance. Sure, it's worthwhile but that there is a collective action problem. Look at the Russians: they have spent USD200 billion of USD600 billion of reserves. But if you have USD600 billion, they you have that much to spend. But you stopped well short. Additional reserves would not be useful, and the private market takes umbrage at any running down. Export-led growth used to be thought of as co-terminus with current account deficits as nations would import scarce capital. Now people think of it as entailing surpluses by definition.

Peter Bofinger: There is potential for manipulation when there is no rule at all, and countries will use that flaw. Instability will result. Will we really maintain a system by a market? What is the exchange-rate system of the future? The efficiency of markets has never been in question viz. foreign exchange markets. We should target exchange-rate purchasing power parity along an uncovered interest parity path. It is also better to regulate financial markets and capital accounts. The flexible system is not what was promised. Allocating SDR will not do it.

Alexander Dynkin: We mustn't make the best the enemies of the good. Financial innovations are currently ahead of the institutions. This happens, it is normal, but we have to pay attention to the leaks such as off-shore havens etc..

Aleksei Mozhin: We are already back to the pre-crisis world. The Moscow stock exchange up 100 percent since the beginning of the year. Bubbles and the carry trade are back. It's like Groundhog Day.

Joseph Stiglitz: That's a good note to end on. The kinds of reforms that we hoped would happen have not occurred and now there is a risk of more instability, a lack of aggregate demand globally, and no growth. We need more fundamental reforms, and the global reserve system is one of the components.

Many thanks to all for coming, some from afar.