THE INSTABILITY AND INEQUITIES OF THE GLOBAL RESERVE SYSTEM

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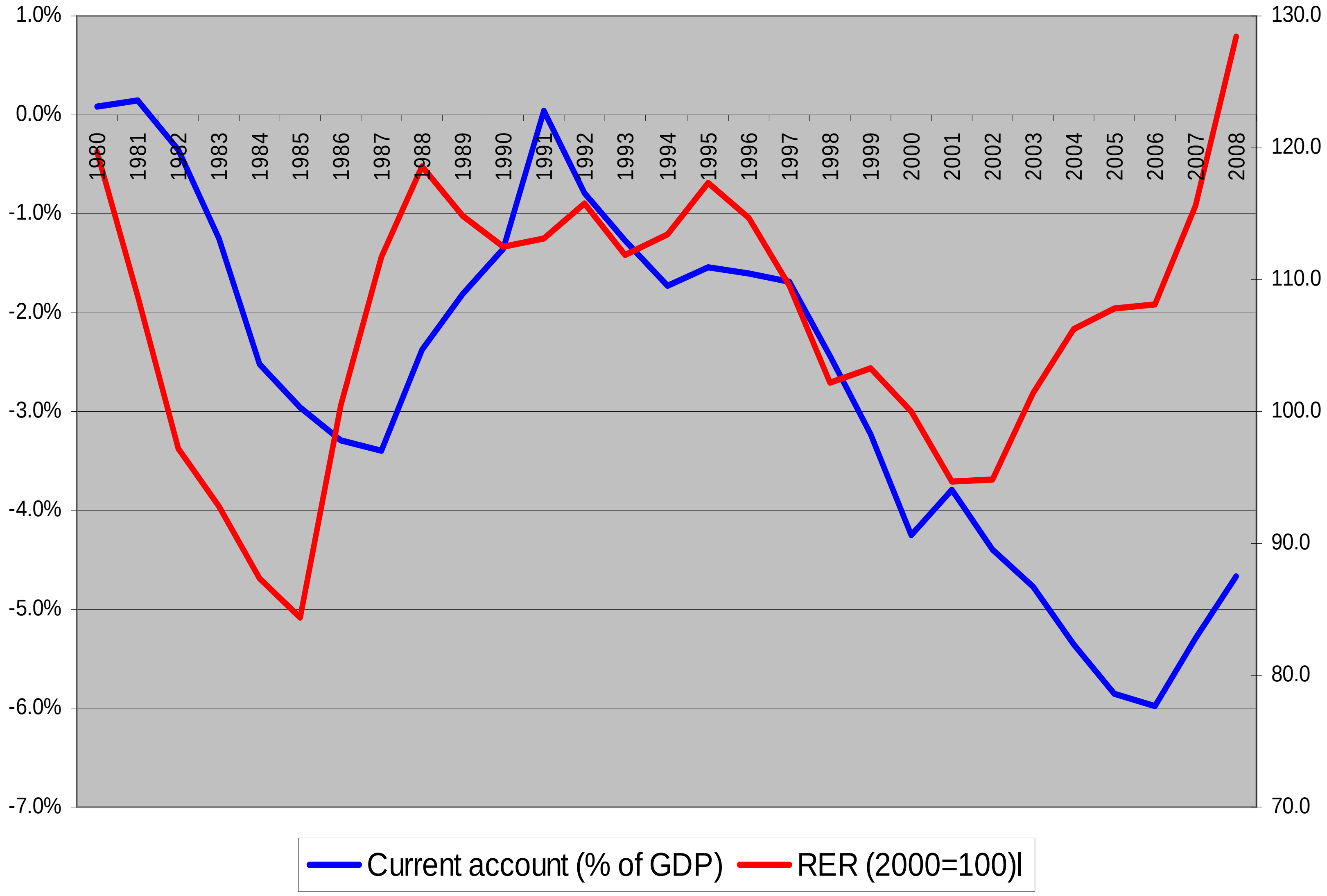
CRITICAL ISSUES

- An international reserve system based on a national currency is inherently unstable (Triffin dilemma)
- Pro-cyclicality of finance, particularly for agents perceived to be risky
- On both counts, developing countries face major asymmetries
- The inequities of the system feed into its instability

THE INSTABILITY OF THE GLOBAL RESERVE SYSTEM

- Triffin: Cycles of confidence in the US dollar.
- The breakdown of the original BW system may have worsened this dilemma.
- Persistent US current account deficits since the 1980s.
- Worsened by large divergence in growth rates in late 1990s/early 2000s –the US as the “consumer of last resort”.
- Corrections of US current account deficits have been accompanied by major disturbances in world financial markets and growth deceleration

US CURRENT ACCOUNT vs. RER



THE ASYMMETRIES OF THE SYSTEM (1)

- Reserve currency country has greater autonomy to run an independent monetary policy –indeed, imposing it on the rest of the world.
- The role of US Treasury bonds as the most liquid and "safest" asset reduce the links between US interest and exchange rates.
- The reserve currency role is closely linked to the role of the US as a world financial center.
- The US must run a current account deficit for the ROW to accumulate net dollar assets, or finance the accumulation of gross dollar assets

THE ASYMMETRIES OF THE SYSTEM (2)

- Capital gains for the US during periods of depreciation. Losses for the rest of the world.
- This reduces the contractionary effects of US depreciation…
- … but limits its contribution to the correction of global imbalances.

THE ASYMMETRIES OF THE SYSTEM (3)

- A system based on competing reserve currencies would not solve the problem
- Seignorage powers will still be concentrated in a few countries…
- … and the system may be even more unstable
  - Alternative monetary strategies (US Fed vs. ECB, in particular)…
  - … resulting in large exchange rate fluctuations
  - Lack of any mechanism for international policy coordination

FINANCIAL INSTABILITY

- Instability is an inherent feature of finance (cycles of “appetite for risk” followed by “flight to quality”)
- Liberalization has increased financial linkages, increasing the likelihood of contagion and reducing the room for diversification.
- Regulatory deficit and, particularly, lack of a macroprudential focus, have had a similar effect.

THE ASSOCIATED ASYMMETRIES (1)

- Instability treats "risky" agents particularly harsh, in terms of availability and/or cost of financing (spreads).
- Major issues for developing countries:
  - Small size relative to speculative pressures
  - Due to limited financial development, inevitable mix of maturity and currency mismatches.
  - This has not been solved by the development of local bond markets
- Integration into world financial markets is always segmented integration.

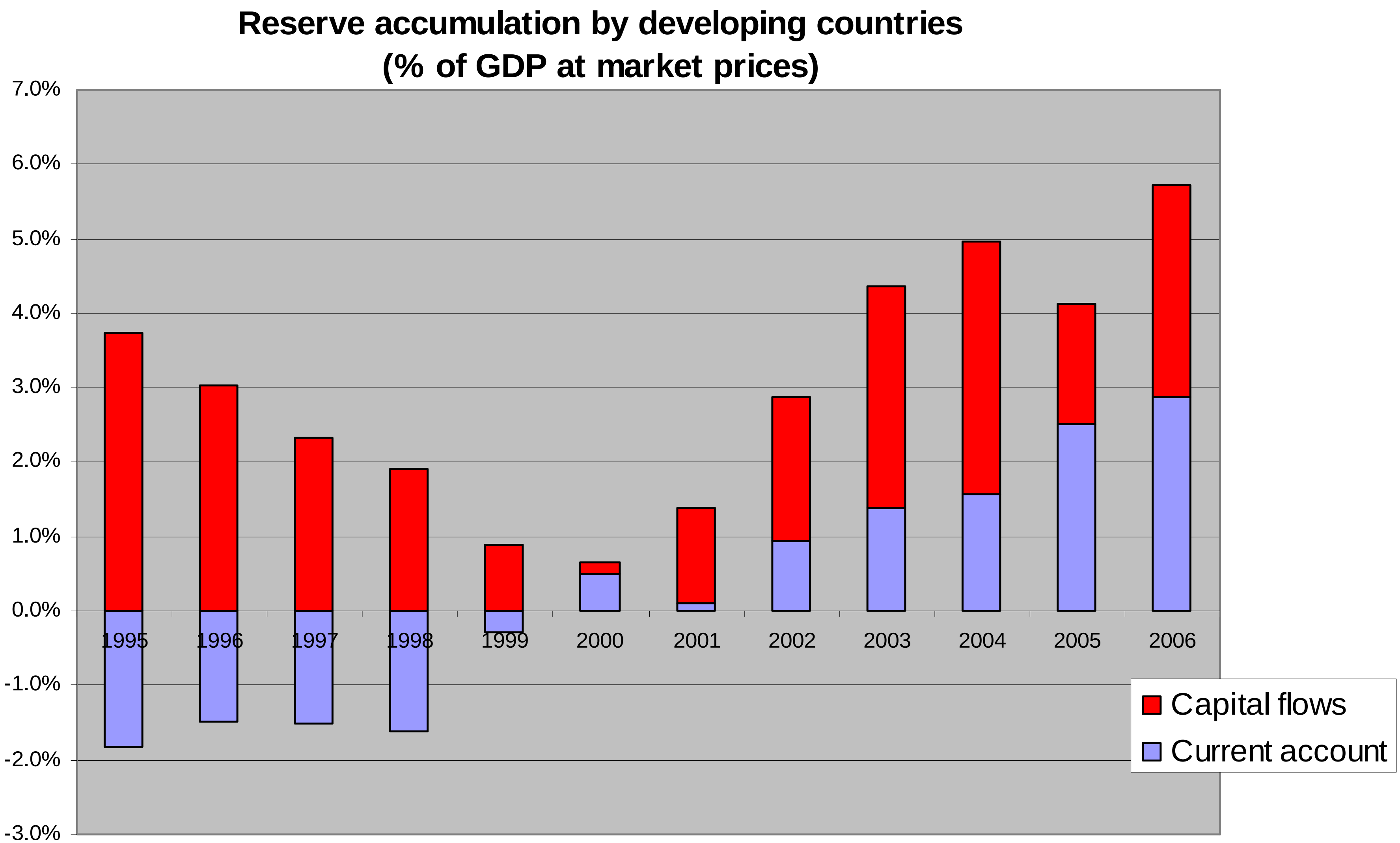
THE ASSOCIATED ASYMMETRIES (2)

- In liberalized financial environments, there is a reduced room (“policy space”) for counter-cyclical macroeconomic policies…
- … and, in the absence of good “collective” insurance, an increased demand for “self-insurance”
- Self-insurance implies that the demand for foreign exchange reserves depends on total external liabilities (or on broad money).
- This is more important than the “mercantilist” motives emphasized by the “Second Bretton Woods” literature

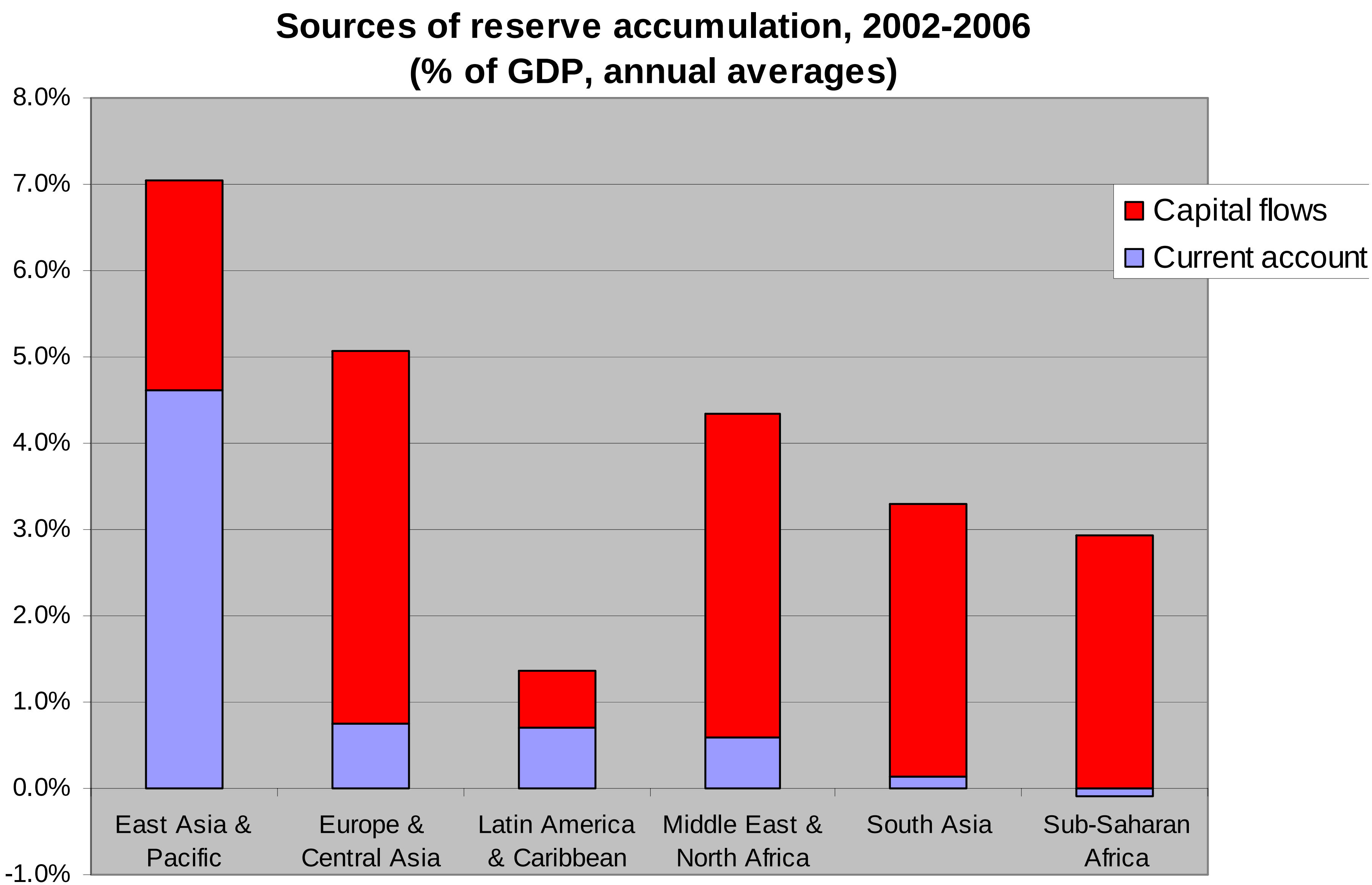
THE LINKS BETWEEN ASYMMETRIES AND INSTABILITY

- Counter-cyclical macroeconomic policy in the developing world requires improved current accounts during upswings (a counterpart of booming commodity and, more generally, export revenues).
- Self-insurance requires additional reserves as capital flows in.
- Both have “fallacy of composition” effects, which contribute to global imbalances.
- Asking developing countries to appreciate begs the basic questions, which relate to the functioning of the global system

PROCYCLICAL CAPITAL FLOWS HAVE BEEN AT THE CENTER OF RESERVE TRENDS IN DEVELOPING COUNTRIES…



… PARTICULARLY OUTSIDE EAST ASIA



POLICY IMPLICATIONS: IMPROVING THE GLOBAL FINANCIAL ARCHITECTURE (1)

- Create a truly global reserve currency to overcome the Triffin dilemma.
- Multilateral macroeconomic policy coordination. IMF “multilateral surveillance” as a first step (frustrating so far).
- Mainstream “macroprudential” regulatory frameworks.
- Counter-cyclical framework for macroeconomic surveillance and support to developing countries.

POLICY IMPLICATIONS: IMPROVING THE GLOBAL FINANCIAL ARCHITECTURE (2)

- Improved collective insurance against crises (closer to lending of last resort). CCL or proposed "reserve augmentation line" as steps forward.
- Active use of SDRs is one way to solve some of these problems:
  - Permanent issues, which can be linked to aid
  - Counter-cyclical issues, which can be linked to financing of "collective insurance"

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