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## Emerging Economies and the Reform of the Global Monetary System

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# EMERGING ECONOMIES AND THE REFORM OF THE GLOBAL MONETARY SYSTEM

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## I. The major issues

The recent global financial crisis placed the issue of global macroeconomic and financial stability at the center of the world agenda. The first of these objectives may be understood as guaranteeing an adequate supply of liquidity at the international level and the coherence of the domestically-determined macroeconomic policies (regional in the case of the Eurozone monetary policy), particular those of major countries. The second may be understood as a coherent set of rules that helps prevent as well as better manage financial crises when do occur.

The need to strengthen financial regulation and supervision has been a clear priority in recent years. Under the coordination of the Financial Stability Board (FSB), re-regulation of finance has been going on in the industrial world, though plagued with delays in implementation, insufficient coordination and political economy pressures to weaken the reform efforts. The emerging economies had undergone similar processes after their own financial crises, which was no doubt one of the reasons why they were able to avoid domestic financial meltdowns during the recent global crisis, with the exception of some emerging economies of Central and Eastern Europe that had not been involved in past efforts to strengthen regulation.

Two remarkable absences from this agenda have been the links between regulation of domestic finance and regulation of cross-border capital flows, and the lack of initiatives to introduce a formal international debt workout mechanism. The first of these issues has been dealt with, nonetheless, in the framework of the IMF (see below). The second was the subject of attention after the 1994 Mexican and, particularly, the sequence of emerging country crises that started in East Asia in 1997. The most important initiative was the 2001-02 IMF proposals to create a Sovereign Debt Restructuring Mechanism. Although it failed, one important outcome of

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the discussion at the time was the rapid spread of collective action clauses in debt contracts. This issue has been broadly ignored during the recent crisis, despite the restructuring of the Greek debt, but there was agreement to include collective action clauses in all Eurozone debt issues starting in 2013.

The global architecture for *macroeconomic* stability, the center of attention of this paper, has not received a similar attention. Such architecture includes the global reserve system (the definition of what currencies play the role of international currencies, and the way international liquidity is provided), and the management of the macroeconomic linkages among different economies, each of which pursues its own macroeconomic policy. The latter may be understood as involving at least three separate issues: the consistency in the way different national authorities (regional in the case of the monetary policy in the Eurozone) run their macroeconomic policies, the exchange rate system and rules on cross-border capital flows.

There were significant concerns with rising global imbalances prior to the crisis and escalating U.S. net liabilities with the rest of the world. Although some saw in these trends important implications for global financial stability, few saw a significant problem in the global monetary system as such;[1] some even saw it turning into a stable "Second Bretton Woods" (Dooley *et al.*, 2003). Rising global imbalances led to the IMF initiative to launch a multilateral consultation on this issue in 2006, which did not render any significant results.

In turn, some voices were heard in the early phase of the crisis to reform the global monetary system, the most prominent being those of the Chinese central bank governor (Zhou, 2009) and 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 Joseph E. Stiglitz (United Nations, 2009) –referred to below as the Stiglitz Commission. These initiatives have not been followed up. So, the most significant trends since the crisis have been the largest issue of Special Drawing Rights (SDRs) in history, which took place in 2009, the Mutual Assessment Process (MAP) launched by the G-20 and the aforementioned debates on capital account

[1] My contributions and those of my colleagues at the United Nations were some of the few that tied these problems with the instability and inequities of the global reserve system. See, in particular, Ocampo *et al.* (2007, ch.IV), which was based on a 2005 UN report. Another important exception was Stiglitz (2006, ch. 9).

management that took place in the IMF Board in 2011 and 2012, leading to adoption of an "institutional view" by the IMF Board in November 2012

Broadly speaking, it can be argued that the global monetary system that emerged in Bretton Woods had five distinctive features: (i) a global reserve system based on a dual gold-dollar standard (gold exchange standard); (ii) a system of fixed exchange rates, but adjustable under "fundamental disequilibrium"; (iii) convertibility for current account transactions, but the possibility of managing capital flows to insulate economies from speculative capital flows; (iv) official balance of payments support, financed by quotas, complemented later by "arrangements to borrow", but limited in size, as they were initially supposed to finance only current account deficits; and (v) monitoring of member countries' policies through Article IV consultations, which were nonetheless weak vis-à-vis major countries –and thus lacked "evenhandedness", to use IMF terminology—and effectively no macroeconomic policy coordination or even consultation.

In turn, after the unilateral decision by the U.S. to abandon the first of these rules in 1971 and the failure of the effort to create a new system in the Committee of Twenty negotiations that took place in 1972-74 (Williamson, 1977), it evolved into the current international monetary "*non*-system". Its major attributes of which can be said out to be: (i) a global reserve system essentially based on an inconvertible (fiduciary) dollar –which will be called here a "fiduciary dollar standard"— but open in principle to other (and thus competitive) reserve currencies, and with sporadic issues of a global reserve currency, the SDRs, which had been created in 1969; (ii) freedom for each country to choose the exchange rate regime they prefer, as long as they avoid "manipulating" their exchange rates, a term that has never had a clear definition, thus making this the clearest case of a non-system; (iii) a significant degree of capital account liberalization, though maintaining the capacity of each country to regulate capital flows, after a failed attempt to introduce capital account convertibility into the IMF Articles of Agreement in 1997; (iv) step-by-step increase in the size of official balance of payments support, capturing the rising demands created associated with capital account crises, and accompanied by increasing conditionality in 1980s and 1990s, which moderated in the 2000s; and (v) ineffective macroeconomic surveillance, as in the past, and limited policy coordination which essentially takes place outside the IMF (in the G-7 and now in the G-20).

From the point of view of emerging economies, this new system continued to marginalize them from sharing in reserve creation, except through the minority participation in the issuance of SDRs and the possibility that the Chinese Renminbi will become gradually one of the global reserve currencies. Rather, as we will see below, they are disproportionally forced to accumulate foreign exchange reserves as "self-insurance", which imply a transfer of resources to reserve-issuing countries. They were also marginalized them from macroeconomic policy cooperation, until the creation of the G-20 at the leaders' level in 2008. Although all countries kept the prerogative of regulating capital flows, many emerging economies liberalized their capital accounts. In this context, the lack of a stable international monetary and financial system meant that they became subject to strong risks associated with the deepening of financial globalization without adequate safety nets in the form of adequate emergency IMF financing.

This paper reviews the elements of this global monetary "non-system" and its effects on emerging economies. The next section looks at the major problems of the global reserve system. This is followed in section III by an analysis of global imbalances and the interlinked issues of macroeconomic policy cooperation, the exchange rate system and capital account regulations. Section IV takes a look at governance of the system. Section V briefly draws some conclusions about the global monetary system that best meets the needs of emerging and developing countries.

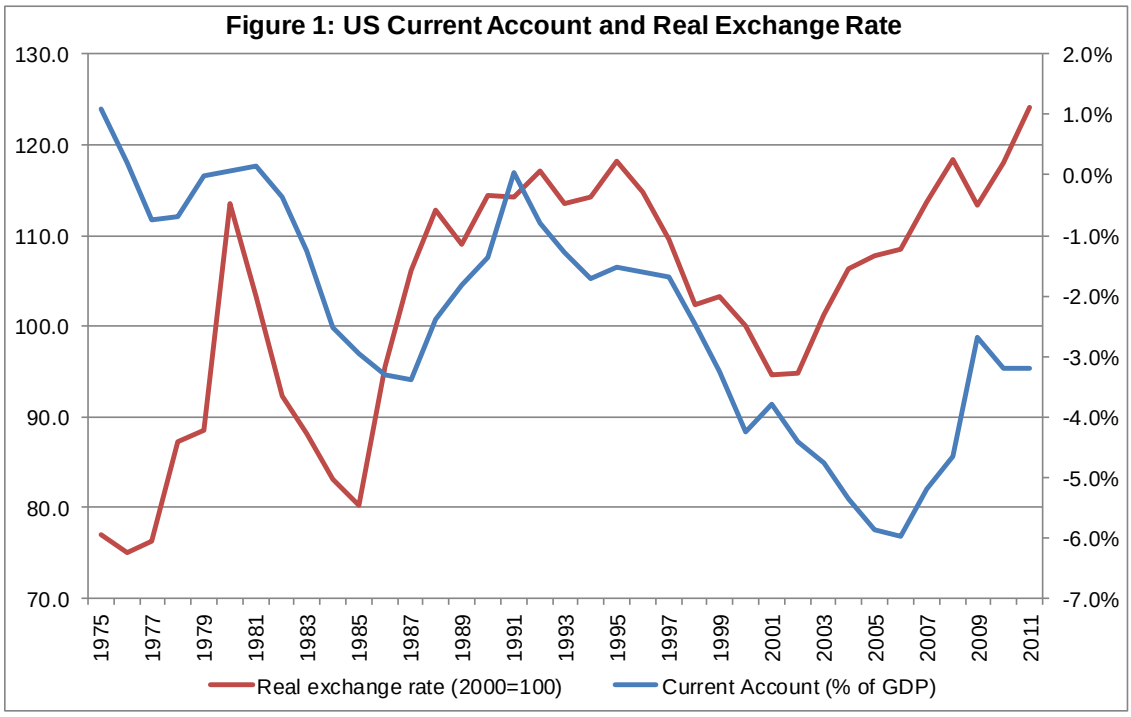
## II. The global reserve system

### *1. The flaws of the system*

The basic deficiencies of the current global reserve system are associated with three problems that were identified in a sequential way in the policy debate.[2] The first was emphasized by Keynes (1942-43) during the discussions that eventually led to the creation of the Bretton Woods institutions. The central issue, in his view, is that the system generates a *recessionary bias*[3] due to the asymmetric burdens of adjustment to payments imbalances that deficit and surplus countries face: whereas the former must adjust, particularly when financing dries out

[2] A fuller discussion of these issues can be found in two previous papers of the author (Ocampo, 2010 and 2011).
[3] I prefer this term to "deflationary", that is generally used in debates on this issue, as this pressure is more likely to be reflected today in economic activity than in price deflation.

during crises, surplus countries do not face a similar burden. As Keynes emphasized, this problem is a characteristic of all global monetary systems that we have known through history. He therefore proposed one that would correct such asymmetry, an International Clearing Union, which was not accepted in the negotiations that followed. Its best manifestation during the recent crisis has been the asymmetric adjustment in the Eurozone: whereas Greece, Ireland, Portugal and Spain have reduced their current account deficits by 6-8 percentage points of GDP between 2008 and 2012, Germany's surplus has fallen by only one percentage point, Netherlands' surplus has actually increased and France's moderate deficit has remained essentially unchanged.[4]




Source: IMF, *International Financial Statistics* . The real exchange rate is depicted here to show an increase when there is a real depreciation (the opposite convention to that used by the IMF).

The second problem is associated with the use of a *national* currency as the major *global* currency. It was formulated it in the 1960s by Triffin (1961 and 1968) and it is thus widely known as the *Triffin dilemma*. The essential problem is that the provision of international liquidity requires that the country supplying the reserve currency should run balance of payments deficits, a fact that may eventually erode the confidence in that currency. While the major risk at the time was the threat that U.S. gold reserves would tend to be depleted, the problem is

[4] Estimated with data from IMF (2012b).

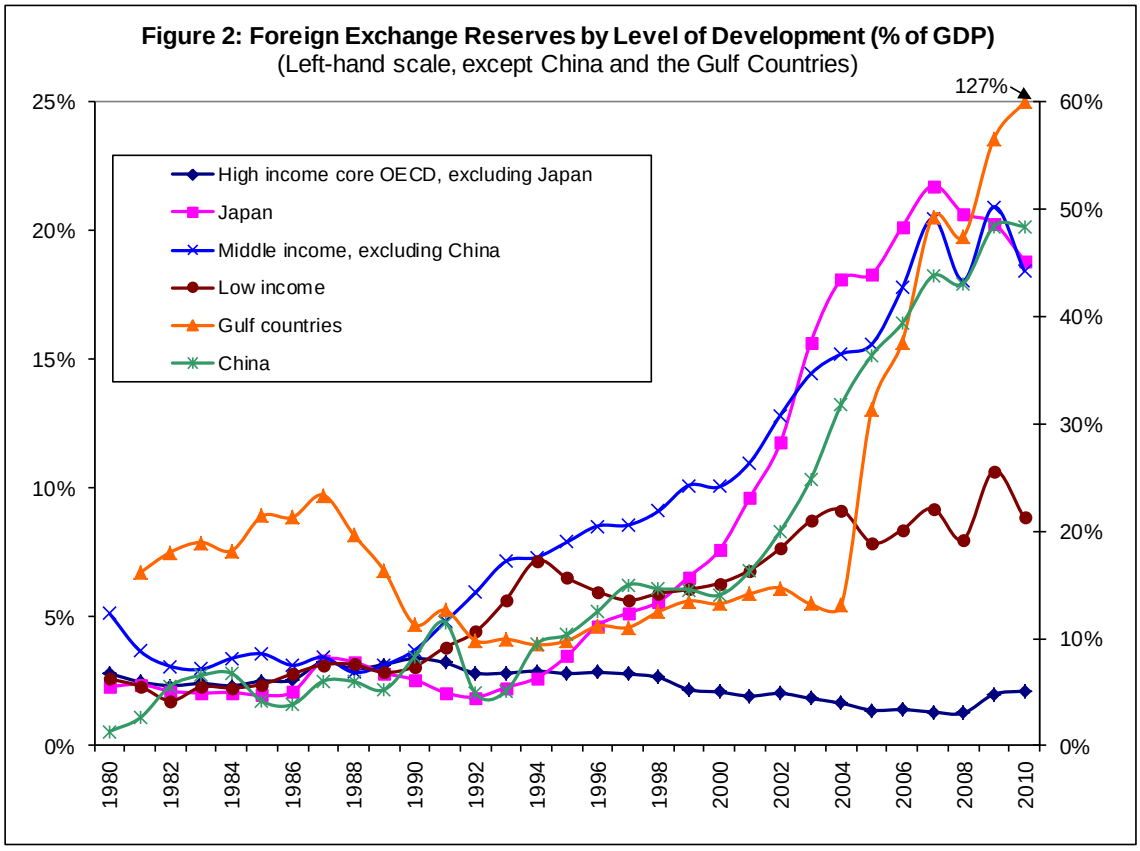
significantly different today. As Figure 1 shows, its particular manifestations is the alternation of periods in which the U.S. runs increasing current account deficits with others in which such deficits tend to be corrected. This is accompanied by a significant cycles in the real exchange rate of the U.S. dollar, which implies that the currency at the center of the system has a very unstable value. It has also been accompanied by a long-term tendency of the U.S. to run current account deficits, which was absent during the original Bretton Woods arrangement, and which has been reflected in a rising net external liabilities of the U.S since the mid-1980s.

The first flaw of the system and the instabilities generated by the second have severely affected emerging economies in the past. The first implies that large current account deficits and exchange rate appreciation during capital account booms are sources of severe risks, as they are strong predictors of vulnerability to the succeeding crisis –a prediction that was confirmed, once again, during the recent global financial crisis, particularly for several countries in the European periphery. The basic problem in this regard is associated with the financing of these deficits in the face of the segmentation of the global financial market between risky and non-risky borrowers, in which the latter are subject to greater volatility in risk spreads, availability and maturity of financing (see Section III.D below).

The attempt by emerging and developing countries to mitigate these risks has given rise the third flaw of the system: its *inequity bias*. Indeed, in the face of strong boom-bust cycles of global finance, emerging and developing countries reacted by building up a large amount of foreign exchange reserves to "self-insure" themselves against crises and increase the policy space to undertake counter-cyclical macroeconomic policies. Such policies involve accumulating reserves to absorb part of what countries consider "excess" capital inflows, and to manage an eventual "sudden stop" in external financing. A similar policy leads countries facing terms of trade booms to absorb part of the windfall gains through the accumulation of foreign exchange reserves and fiscal resources in sovereign wealth funds. Since foreign exchange reserves are invested in safe industrial countries assets, and particularly U.S. government securities, reserve accumulation by these countries is nothing else than lending to reserve issuing countries –and, particularly, the U.S.— at low interest rates. This is what generates the inequity of the system,

The magnitude of the problem is clearly reflected in Figure 2. Whereas all countries held reserves equivalent to about 2-3% of GDP up to the 1980s, emerging and developing countries started to accumulate large amounts of reserves in the aftermath of crises, and particularly of the emerging economies' crisis that started in East Asia in 1997. By 2007, middle income countries, excluding China, and low income countries had accumulated reserves equivalent to over 20 and 9% of GDP respectively, whereas high-income countries tended to reduce their reserve levels, if we exclude Japan. Reserves have remained very high since 2007 and increased in particular years (2009). The accumulation of reserves by China and the Gulf countries went further than the average trend for emerging and developing countries, reflecting additional phenomena: the undervaluation of the renminbi and strong cyclical swings in oil prices, respectively. We would return to this issue in the next section in relation to the analysis of global imbalances.

**Figure 2: Foreign Exchange Reserves by Level of Development (% of GDP)**
(Left-hand scale, except China and the Gulf Countries)




Source: Total reserves minus gold series, World Bank, World Development Indicators, based on information from the IMF

Massive self-insurance through foreign reserve accumulation has helped mitigate the vulnerability of emerging and developing countries to crises. The development of domestic bond markets after the Asian financial crisis has also contributed to reducing these vulnerabilities, by

making governments less dependent on external financing. Both led to the reduced perception of risk, reflected in the low spreads between 2004 and 2007, the reduced vulnerability to the global financial crisis, and the return of ample financing at low costs to emerging economies since mid-2009. Although this may be understood as a reflection of reduced financial market segmentation, the fact that its counterpart is massive self-insurance indicates that market segmentation is still a feature of the global economy, but one that can be mitigated by prudential policies.

In any case, given the dominance of the U.S. and other developed countries in global finance, historical evidence seems to indicate that the strength of the policies adopted by advanced economies to stabilize financial markets is critical for the length of the downward phase of the capital account cycle. So, the massive interventions after the collapse of Lehman brothers were critical for the return to more normal financial conditions in the developing world in a relatively short time period (about a year). The same is true of massive support to Mexico after its December 1994 crisis (a few months). In contrast, weak and delayed action after the August 1982 Mexican moratoria and the first stages of the East Asian crisis in the second semester of 1997 led to protracted crises in emerging markets (eight and six years, respectively).

It is important to add that, although self-insurance has a strong rationale for individual countries, and indeed helped many emerging and developing countries withstand the recent global financial turmoil, it is the source of a major "fallacy of composition": if its counterpart is current account surpluses, particularly in major emerging economies, they contribute to the generation of global imbalances. This is one way to understand the "savings glut" that, according to the Chairman of the U.S. Federal Reserve, Ben Bernanke (2005) characterized the global economy during the boom years. So, this inequity contributes to the potential instability of the system. However, as the United Nations (2006, ch. I) pointed out, a more important problem at the time was the "investment anemia" –i.e., the fact that global investment rates had experienced a downward trend since the 1970s and continued to be very low by historical standards, including in countries running current account surpluses, with the major exception of China.

*2. Reforming the system*

There are potentially many ways to reform the system. The most ambitious would be go to back to Keynes' International Clearing Union or to create a Global Reserve Bank,[5] but negotiating the creation of a new global institution would be a very difficult task. So, there are essentially two possible reform paths. The first and, in a sense, inertial solution would be to let the system evolve into what it potentially is: a multicurrency arrangement. The second would be to fulfill the aspiration set in the IMF Articles of Agreement in 1969 of "making the special drawing right the principle reserve asset in the international monetary system" (Article VIII, Section 7 and Article XXII), as well as the instrument for funding IMF emergency financing during crisis. This second path is probably the best long-run arrangement. In practice, however, these two alternatives can be combined and such combination may be politically more acceptable for the current issuers of reserve currencies, particularly for the U.S.

As already indicated, under the current system other currencies can compete with the dollar as international means of payments and reserve assets. However, this competition has been weak relatively weak. According to the IMF data on the composition of allocated foreign exchange reserves, in mid-2012, 61.9% were held in U.S. dollars, 25.1% in euros, 3.8% in both British pounds and Yen, and 5.4% in other currencies. The major historical change has been the relative reduction in the share of U.S. dollars and the rise of that of the euro in the 2000s. Since the outbreak of the global financial crisis, there has been the rise of the share of other currencies, but it has been quite limited (3 percentage points between mid-2008 and mid-2012). On top of that, over 80% of foreign exchange transactions are managed in U.S. dollars. The recent crisis has thus clearly shown that the "network externalities" in the use of money continue to favor the U.S. dollar, and that there is no alternative in today's world to the market for U.S. Treasury securities in terms of liquidity and depth.

This is consistent with several recent evaluations of the role of alternative currencies. The euro has continued to be the secondary global reserve currency, showing resilience in this regard despite the deepening of the Eurozone crisis in 2011-12. On the other hand, China has adopted for several years a policy of internationalization of the renminbi, which includes the creation of

[5] This is what Stiglitz (2006, ch. 9) proposed.

several swap arrangements, and allowing some payments of Chinese exports and some deposits in Hong Kong to be made in that currency. However, the possibility of a larger role for the renminbi depends on several conditions that can only materialize in the long-term: deep and liquid domestic financial markets, a flexible exchange rate and, more generally, a liberalization of financial and foreign exchange markets that Chinese authorities are not willing to adopt and which may, in fact, be counterproductive for the Asian giant at the present stage (Yu, 2012). A variable mix of such problems also affects other emerging economies, which can be expected to have only a marginal role in the international monetary system. The best bet would be to design arrangements to use national currencies in intraregional trade (as Argentina and Brazil have done in recent years) and swap arrangements among major emerging economies (e.g., the initiative in this regard by the BRICS).

The basic advantage of a multicurrency arrangement is that it allows reserve holders – notably, as we have seen, emerging economies— to diversify the composition of their foreign exchange reserve assets, and thus to counteract the instability that characterizes all individual currencies under the current system. In this regard, however, exchange rate flexibility among alternative reserve currencies would be an advantage but also a potential cost. The first feature would make the system more resilient than the fixed gold-dollar parity that led to the collapse of the original Bretton Woods arrangement. However, if central banks around the world actively substitute among currencies to enjoy the benefits of diversification, this could increase exchange rate volatility among major reserve currencies, and would thus require creating a "substitution account" to facilitate the exchange for SDRs of reserves in the currencies they central banks do not want to hold. This alternative has been suggested to manage the instability of the U.S. dollar since the 1970s, but has not been adopted due to the complexities involved in determining who would bear the potential costs of such mechanism (see below).

However, aside from diversification to manage the instability of the U.S. dollar exchange rate, this reform would not address any of the other deficiencies of the current system. The benefits from the reserve currency status would still be captured by industrial countries and eventually by China, so the system would continue to be inequitable. It would not solve the recessionary bias of the current system either, nor would it reduce emerging and developing countries' demand for self-insurance. Finally, in the light of the growing demand for reserves,

the dominance of the U.S. dollar could worsen the net external liability position of the U.S. and associated problems highlighted by the Triffin dilemma.

The alternative, which may also be seen as a complementary reform route, would be to place at the center of the system the only truly global reserve asset that the world has created: the SDRs. That system should fulfill the criteria set by the Chinese central bank governor: "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" (Zhou, 2009).

Under current rules, IMF makes allocations of SDRs on the basis of a long-term need a global character, and with the purpose of supplementing existing reserve assets. So far there have been four general SDR allocations: the original one, in 1970-72, for SDR 9.3 billion; a second in 1979-81 for SDR 12.1 billion; a third proposed in 1997, partly to allocate SDRs to members that had joined after 1981, was not effective until the Fourth Amendment of the IMF Articles of Agreement (of which it was part) was approved by the U.S. Congress in 2009; and a fourth, and largest in history, for US$250 billion (SDR 161.2 billion) agreed by the G-20 in 2009 as one of the measures to boost international liquidity during the global financial crisis. Allocations are made according to IMF quotas, and therefore are much larger for high-income countries. Table 1 indicates that the share of high-income countries has gradually declined through time, but was still close to 70% in 2009, with the falling share of OECD countries partly compensated by the rise of high-income non-OECD (mainly Gulf) countries. Middle-income countries have increased their share in allocations by six percentage points since the early 1970s, with China taking more than half of that. In contrast, low-income countries have seen their share reduced from in any case marginal levels.

| Table 1: SDR ALLOCATIONS BY LEVEL OF DEVELOPMENT (in millions of SDRs) | | | | | | |
|---|---|---|---|---|---|---|
| | Allocations (in mil.SDRs) | | | Allocation to each group by percent of total allocations | | |
| | 1970-72 | 1979-81 | 2009 | 1970-72 | 1979-81 | 2009 |
| High income: OECD | 6,818 | 7,956 | 114,905 | 73.8% | 66.2% | 62.9% |
| Japan | 377 | 514 | 11,393 | 4.1% | 4.3% | 6.2% |
| Excluding Japan | 6,441 | 7,442 | 103,512 | 69.8% | 61.9% | 56.7% |
| United States | 2,294 | 2,606 | 30,416 | 24.8% | 21.7% | 16.7% |
| High income: nonOECD | 41 | 363 | 10,797 | 0.4% | 3.0% | 5.9% |
| Gulf countries | 1 | 286 | 8,835 | 0.0% | 2.4% | 4.8% |
| Excluding Gulf countries | 40 | 77 | 1,962 | 0.4% | 0.6% | 1.1% |
| Middle income | 2,144 | 3,359 | 53,347 | 23.2% | 28.0% | 29.2% |
| China | 0 | 237 | 6,753 | 0.0% | 2.0% | 3.7% |
| Excluding China | 2,144 | 3,122 | 46,594 | 23.2% | 26.0% | 25.5% |
| Low income | 230 | 338 | 3,604 | 2.5% | 2.8% | 2.0% |
| Total allocations | 9,234 | 12,016 | 182,653 | 100.0% | 100.0% | 100.0% |

Source: IMF, *International Financial Statistics* .

SDRs are defined by the IMF as an "international reserve asset".[6] However, under the current rules, countries have to pay interest on allocations of SDRs, but receive interest on holdings. In this sense, SDRs are peculiarly both an asset and a liability. Moreover, since countries that use them make net interest payments to the Fund, they should perhaps be considered really as a credit line which can be used unconditionally by the holder –i.e., an unconditional overdraft facility. Use of SDR allocations is quite active and works rather smoothly, with developing countries making a frequent use of them but also industrial countries at different critical conjunctures (Erten and Ocampo, 2012).

Proposals for more active SDR allocations follow either of the two different approaches: issuing them in a counter-cyclical way (United Nations, 1999; Camdessus, 2000; Ocampo, 2002) and making regular allocations, reflecting the additional global demand for reserves (United Nations, 2009, ch. 5). The two approaches can be complementary, as regular allocations could be withheld during booms until the world economy goes into a downturn, following preset criteria. Most estimates indicate that allocations for the equivalent of US$200-300 billion a year would be reasonable,[7] but even such allocations would only increase the share of SDRs in non-gold reserves to somewhat above 10% in the 2020s, indicating that they would still largely complement other reserve assets.

[6] See, for example, http://www.imf.org/external/np/exr/facts/sdr.htm
[7] See a survey of different estimates in Erten and Ocampo (2012).

Even if the world moves moderately in this direction, a more active use of SDRs would go a long way to reduce the three major problems of the current system. First, it would partially free the international monetary system from the vagrancies of having to depend on the monetary policy of the leading country, and the associated seignorage would accrue to all IMF members. Second, by issuing SDRs in a counter-cyclical way, new SDR allocations during crises would have the potential of reducing the recessionary bias associated with the asymmetric adjustments of surplus vs. deficit countries. Third, SDR allocations could reduce the need for precautionary reserve accumulation by developing countries, and would represent a lower cost of building self-protection than accumulating international reserves through borrowing or building up current account surpluses.

Perhaps the most important and simplest reform would be to finance *all* IMF lending and in fact to make all IMF operations with SDRs, thus making global monetary creation similar to how central banks creates domestic money. This idea goes was suggested by the IMF economist Jacques Polak (1979) three decades ago. According to his proposal, IMF lending during crises would create new SDRs, but such SDRs would be automatically destroyed once such loans are paid for. The alternative I have suggested would be to treat the 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 (Ocampo, 2010). Either of these proposals would involve eliminating the division between what are called the General Resources and the SDR accounts that is an inheritance of the debates of the 1960s and make SDRs a relatively limited instrument of global monetary cooperation (Polak, 2005, part II).

The use of SDRs to finance IMF programs would help consolidate the reforms of the credit lines that have been introduced during the recent financial crisis, particularly the creation of contingency credit lines (notably the Flexible Credit Line but also the use for contingency purpose of the other facilities, particularly the stand-by), the much larger levels of financing relative to quotas, and the reforms of facilities for low-income countries. It would eliminate the need for the IMF to get financing from its members in the form of the "arrangements to borrow" or the bilateral credit lines that have been actively used in recent years. It would also eliminate, in fact, the need to adopt quota increases, and would eliminate the need of the IMF to manage multiple currencies, most of which are useless for its main operations. Quotas would still have to

be agreed to determine the size of access to Fund facilities as well as voting rights. In any case, for this reform to reduce the demand for "self-insurance", it is essential that the size of IMF credit lines, their conditionality and the stigma associated with borrowing from this institution be overcome.

Following the discussions of the 1960s and early 1970s, there are also ways of including a "development link" in SDR allocations and in the way they are used by the international community. One mechanism would be to include a criterion of demand for reserves in SDR allocation. A simple solution, suggested by Williamson (2010), would be to allocate a certain proportion to emerging and developing countries (say around 80%), and then assigning the shares of the allocation to individual countries within each category (emerging and developing and industrial countries, respectively) according to IMF quotas. Another would be to design mechanisms by which unutilized SDRs are used to provide or, as we would prefer, *leverage* financing for development, for example by allowing unused SDRs to be used to buy bonds from the multilateral development banks or institutions that provide global public goods (such as climate mitigation and adaptation) (United Nations, 2009).

Allocation rules could also be made to help correct the asymmetry between surplus and deficit countries. For example, countries with large surpluses and/or excessive reserves could be penalized by suspending their right to receive SDR allocations.[8] Of course, the definition of "excessive reserves" would have to take into account the exceptional demand for reserves by developing countries.

Some analysts have suggested that a reform along these lines would require an increasing demand for SDRs, which can only come from its transformation into an asset held by the private sector (Kenen, 1983; Eichengreen, 2007; Padoa-Schioppa, 2011). However, such private use of SDRs could generate problems of its own, particularly speculative changes in the demand for this global reserve asset. It would also face strong opposition to the reform of the system by the U.S. For these reasons, it may be better to think of a mixed system in which national or regional

[8] 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.

currencies continue to play the major role in private transactions, and the SDR performs the functions of reserve asset and medium of exchange in transactions among central banks.

As already pointed, under a mixed system that mixes SDRs with a multicurrency arrangement, a "substitution account" should be created, allowing central banks to exchange for SDRs the holdings of specific reserve assets. This account could also be seen as a transition mechanism of an ambitious reform effort (Kenen, 2010b). 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 Kenen (2010a) based on historical data for 1995-2008 indicate that those costs would have been small during that period.

The most desirable and viable reform involves, therefore, moving to a fully SDR-based IMF with a clear counter-cyclical focus. This would include counter-cyclical *allocations* of SDRs and counter-cyclical IMF *financing*, made entirely in SDRs. It would also involve designing criteria for SDR allocations that take into account the very different demand for reserves by industrial vs. emerging and developing countries. The introduction of a substitution account would in fact make the SDR complementary to a multicurrency system, a fact that would make the reforms more attractive for the U.S. This mix is probably the best practical option for moving forward.

## III. Macroeconomic cooperation

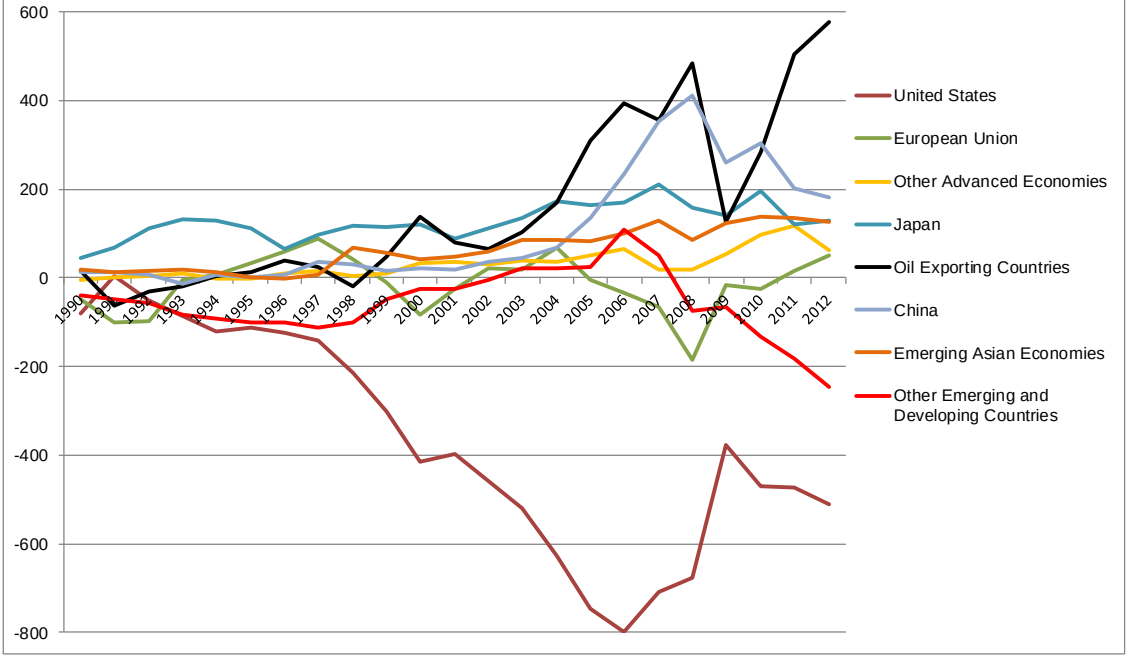
### *1. Global imbalances*

Macroeconomic policy is perhaps the best example of the tension between the strength of globalization and the persistence of policies that continue to be mainly national (regional in the case of the monetary policy in the Eurozone). The net result is that the world lacks a mechanism that guarantees the consistency of the macroeconomic policies adopted by the major economies, including that which issues the major reserve asset.

The main challenges of macroeconomic policy coordination are managing global imbalances. The world economic system generated massive current account imbalances since 1997 the Asian crisis and, particularly, during the 2003-07 boom (Figure 3). The main manifestations were the U.S. deficit, which experienced a massive increase since the Asian

crisis, though also a moderate correction at the end of the boom, thanks to the depreciation of the dollar (see Figure 1 again). In turn, the European Union went from running a current account surplus in 2002-04 to a deficit at the end of the boom. However, this was a reflection of sharply diverging trends: a massive increase in the German surplus, but also that of a few other economies (Sweden, Netherlands and Austria), together with rising deficits in the "peripheries" – both the Western (notably Spain, Greece, Portugal and Ireland, in that order) and the Central and Eastern ones (Poland, Bulgaria, Hungary and the Baltic countries)—and in France, Italy and the United Kingdom.

**Figure 3: Current Account Balances (Billion dollars)**




Source: IMF, *International Financial Statistics* .
Oil exporting countries: Angola, Bahrein, Iran, Iraq, Joran, Kwait, Lybia, Omar, Qatar, Russia, Saudi Arabia, United Arab Emirates and Venezuela
Emerging Asian Economies: Hong Kong, Republic of Korea, Singapore, and Taiwan POC

The counterpart to these deficits were massive and rising surpluses in China, the oil exporting countries and, to a lesser extent, Japan and the other East Asian emerging economies. Other emerging economies also went from a deficit at the time of the Asian crisis to a surplus at the end of the boom. But broadly speaking, the dominant characteristic of global imbalances in the run up to the global financial crisis were the massive U.S. deficits to absorb the surpluses of most emerging economies, particularly of East Asia and the oil exporting countries.

The crisis led to major changes in these trends. Particularly, the U.S. deficit fell significantly and the European Union went from a deficit to a surplus position. The latter reflected, in turn, a sharp recessionary adjustment of deficits in its peripheries (with only Poland experiencing an expansionary adjustment) while maintaining the large German and Dutch surpluses (those of Austria and Sweden moderated significantly). The oil exporting countries experienced first a short-term reduction of its surplus but then became in 2011-12 the major global source of payments surpluses. The result is that the pressure to adjust in the opposite direction fell on emerging economies. The Chinese surplus was cut by half and the non-East Asian emerging economies went from running a surplus to a significant deficit in 2012. One of the major mechanisms the latter faced was the strong pressure to appreciate their currencies to absorb large capital inflows; we will return to this issue below. Japan also experienced a small correction of its surplus.

As these trends indicate, there is no single cause of global imbalances. Furthermore, they reflect both structural as well as short-term phenomena. The strong pressure for the U.S. to run persistent deficits is, of course, the main structural factor, and it is related to the Triffin dilemma. The surplus of oil exporting countries is another structural feature, though it has, at least in part, a cyclical dimension. Other structural phenomena are the surpluses of East Asia, including Japan. As it is well known, these surpluses can be interpreted alternatively as the result of high levels of industrial competitiveness or of high savings rates. However, one of its major sources, the undervaluation of the Chinese renminbi, had a policy origin but has experienced a significant correction.[9]

The asymmetric adjustments that characterize the global monetary system are clearly at work and represent the most important short-term phenomenon after the outbreak of the crisis. The correction of the deficits in the different European peripheries is the most noticeable feature. On the other hand, non-oil emerging economies outside East Asia are now under pressure to run deficits. These deficits may have become a structural feature of the world economy but one that, as past history indicates, generate significant risks for these economies.

[9] Part is due to nominal appreciation but even more to relative wage movements, which are not generally captured in traditional estimations of real exchange rates.

I should add to these problems the global deficiency in aggregate demand that has characterized the global economy during the recent crisis. In terms of the previous discussion, the "savings glut" but particularly the "investment anemia" have become stronger as the result of the crisis. As we will see, the G-20 initially responded to this aggregate demand deficiency with relatively coordinated expansionary macroeconomic policies, but this was very soon replaced by policy divergence, with several countries moving in the direction of austerity.

Overall, therefore, we see at work, through the evolution of global imbalances since the Asian crisis, the three different deficiencies of the international monetary system: the asymmetric pressures on deficit vs. surplus countries to adjust, the Triffin dilemma, and the demand for "self-insurance" by emerging economies. Two additional phenomena have also played an important role: the deficiencies in global aggregate demand, which have become particularly severe since the outbreak of the global crisis, and the complexity of the recycling of surpluses of oil-producing nations in the new era of high oil prices that has been almost a decade long.

*2. Macroeconomic policy cooperation*

To manage these complex issues, the world counts with insufficiently developed mechanisms of macroeconomic policy dialogue and cooperation. The IMF is the major instrument of cooperation of a multilateral character. Article I.i of the Articles of Agreement defines as its first purpose: "To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems". In practice, however, most mechanisms of macroeconomic cooperation have operated outside the IMF and have not been particularly effective. The included the *ad-hoc* agreements of the 1980s among the leading industrial economies, in particular the Plaza and Louvre accords of 1985 and 1987, the major focus of which was to facilitate an orderly depreciation of the U.S. dollar and an appreciation of the Japanese Yen. The dialogue then shifted to the G-7. This is tradition that was kept until the recent crisis, when the G-20 decided in Pittsburgh in September 2009 meeting to self-designate itself as "the premier forum for our international economic co-operation". It is complemented by the informal coordination among leading central banks, which has been critical since the outbreak of the subprime crisis in the U.S. in mid-2007. Macroeconomic cooperation has thus taken place predominantly through these

mechanisms of "elite multilateralism" rather than through the formal multilateral organization that the world has created for that purpose.

G-20 cooperation was very successful in the initial phase of the crisis, when it assumed the form of a "Keynesian consensus", which led to fairly coordinated expansionary monetary and, to a lesser extent, expansionary fiscal policies. Its major success was averting a new Great Depression. However, in relation to fiscal policies, the consensus broke down in the June 2010 G-20 Toronto meeting, when it became clear that there was a deep division between countries that continued to defend expansionary policies to face the weakness of aggregate demand at the global level, and particularly in the developed world, and those countries that came to place the priority on fiscal austerity to guarantee public sector debt sustainability. The consensus on monetary policy has been more persistent, except for the temporary lapse of the European Central Bank, which partly reversed its monetary stimulus in 2011 before shifting again to a clear expansionary policy at the end of that year. The need for continued monetary stimulus in the advanced economies has generated, of course, a major contrast with the situation of emerging economies that continue to be relatively strong and therefore need less accommodative monetary policy. This has generated a strong and persistent incentive to shift capital toward the emerging world, generating strong monetary and exchange pressures. The underlying problem came to be known as the "currency wars", the term coined by Brazilian Finance Minister Guido Mantega.

The Mutual Assessment Process (MAP) launched in 2009 in Pittsburgh to implement the "Framework for Strong, Sustainable, and Balance Growth" is the major instrument of macroeconomic policy cooperation. In a two-step process that took place in Paris and Washington in February and April, 2011, the G-20 Finance Ministers and Central Bank Governors agreed what are "the persistently large imbalances that require policy action": "(i) public debt and fiscal deficits; and private savings and private debt (ii) and the external imbalances composed of the trade balance and net investment income flows and transfers, taking due consideration of exchange rate, fiscal, monetary, and other policies" (G-20, 2011a). This was followed by the determination of the indicative guidelines against which each of the indicators would be assessed, which are explicitly "not targets" but "reference values" that determine which countries would be subject to an in-depth review. For this purpose, the Ministers and Governors determined that a complementary use would be made of economic models with statistical

analysis based on each country's historical trends, a comparison with other countries at similar level of development, and all G-20 members (G-20, 2001b). It was agreed that economies that show large imbalances in at least two the exercises and represent more than 5% of G-20's GDP at either market of PPP prices should be subject to particular scrutiny in the associated imbalances.

In practice, the main technical support is provided by the IMF. In particular, the Fund was asked "to assess the coherence, consistency, and mutual compatibility of G-20 members' policy frameworks" and involves three different activities: assessing the individual countries' submissions, aggregating them to assess their mutual consistency and making policy recommendations (IMF, 2011c). This is reflected in regular analyses by the Fund that are presented simultaneously to the G-20 and the IMF Board. This activity, which is defined as technical assistance to G-20 members, generates an obvious tension between the truly multilateral character of the Fund and the specific ownership of the MAP by the G-20. In principle, a better institutional model was the consultation on multilateral imbalances that were launched in 2006 in the framework of the IMF, with participation of a subset of key countries but responsible to the whole membership. However, it led to no significant results, because it lacked ownership by the leading countries.

The G-20 activities have been combined with a proper IMF activity, which has been the strengthening of surveillance, both multilateral and bilateral. Indeed, it can be said that this, together with the significant modernization of credit lines, have been the two major innovations in the Fund work since the outbreak of the crisis, with that of surveillance having perhaps the most important global implications. Multilateral surveillance includes the use of the major IMF publications: the *World Economic Outlook* (and associated regional outlooks), the *Global Financial Stability Report*, the new *Fiscal Monitor*, launched in 2009, and the *Consolidated Multilateral Surveillance Report*. They also include reports that link bilateral and multilateral surveillance, particularly the "spillover reports" for the "systemic 5" (U.S., U.K., Eurozone, Japan and China) and the pilot "External Sector Reports" assessing global imbalances, which was created as a result of the 2011 triennial surveillance review, the first of which was issued in July 2012. This report aims at analyzing beyond exchange rates to consider a detailed examination of current accounts, reserves, capital flows and external balance sheets. We can add

to this list of the links between bilateral and multilateral the reports to the G-20. In turn, the major instrument of bilateral surveillance continues to be the Article IV Consultations. Its major changes are the more in-depth consideration of financial issues, and theoretically more "candid" assessments, particularly for major economies. As part of the modernization of Fund surveillance, in 2010 it was also decided that 25 jurisdictions with systemically important financial sectors must be subject to Financial Sector Assessments Programs (FSAP).

It is quite clear that the world had never developed an elaborate system of surveillance and macroeconomic policy dialogue such as the one that has been put in place since the global financial crisis. It is also true that there has been an improvement in "evenhandedness" of different IMF members, and in fact the more systemic economies are now a subject of particular attention. However, the system that has been put in place continues to rely essentially on a mix of surveillance and peer pressure, both of which have a weak capacity to induce change, as reflected in the limited effect that IMF criticism has had on individual countries' (or regions') policies: the limited practical attention to the spillovers generated by expansionary monetary policies in the developed countries on emerging markets and associated "currency wars", as well as the incapacity to moderate fiscal austerity in the Eurozone or to force China to appreciate its exchange rate at a faster rate. So, at a future stage, it may be essential to move to more specific targets for specific macroeconomic indicators. This is what I suggest below in relation to the exchange rate.

*3. The exchange-rate "non-system"*

Exchange rate stability was an essential element of the Bretton Woods arrangement. This objective was thus explicitly incorporated into the IMF's Articles of Agreement, but was also seen as an crucial to guarantee another purpose, "to facilitate the expansion and balanced growth of international trade". The arrangement opted, therefore, for a system of fixed but adjustable pegs, which worked well for more than a quarter century, with some flexibilities (e.g., Canada usually managing a flexible exchange rate and several Latin American countries moved into crawling pegs in the second half of the 1960s). The system initially included the principle that modifications of the exchange rate parities would have to be subject to consultation, but this never worked in practice. Given the centrality of exchange rate policies in the history of the IMF,

this is perhaps the area in which the international community should look for better forms of macroeconomic cooperation.

The major problem after the breakdown of the original arrangement in the early 1970s is, however, that it was followed by a *non*-system, as all countries are essentially free to choose any exchange rate regime they prefer. The only constraint, according to Article IV of the IMF Agreement is that countries should "avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members". This is also the center of the June 2007 decision on bilateral surveillance, which replaced the 1977 decision on surveillance of exchange rate policies that had been adopted after the collapse of the Bretton Woods arrangement. The essential problem is, of course, that the IMF has failed to determine what "manipulation" means.

The centrality of exchange rates is derived for their effects on international trade, but also their central role in correcting payments imbalances; we can add that exchange rate movements may also reflect divergence in other macroeconomic policies. In relation to the first issue, a major concern is that there is no mechanism linking world trade and exchange rate rules. This is paradoxical, given the fact that exchange rate movements can generate stronger effects on trade than the painstaking negotiations on trade rules. For this reason, some have suggested that exchange rate issues should be brought into WTO dispute settlement (Matoo and Subramanian, 2008), but this may end up weakening one of the few successful mechanisms of the sort at the international level. This decision would also leave aside the fact that exchange rates have many other macroeconomic dimensions, which is essentially why they should be under the IMF jurisdiction.

In relation to other objectives, the exchange rate non-system has also failed to meet two additional purposes set in the IMF Article of Agreement: to "lessen the degree of disequilibrium in the international balance of payments", and "to promote exchange stability". One basic reason for that is that exchange rate movements are essentially determined in the contemporary world by financial flows, which may follow boom-bust patterns and lead to high levels of volatility that have in both cases little relation with "macroeconomic fundamentals". This indictment is

extensive to exchange rates among major currencies, all of which have experienced a significant level of "excess volatility" since the global financial crisis.

The system could therefore be improved by introducing elements that enhance the capacity of exchange rate to contribute to correcting global imbalances and to provide a reasonable level of stability. Returning to fixed exchange rates among major currencies is, of course, impossible, given the magnitude of capital flows, but also inconvenient, given that exchange rates must serve also to adjust different priorities of macroeconomic policies among major countries. The best is probably a system of reference rates among major currencies, which has been suggested by Williamson (2007), among others. This implies that major countries would follow some form of managed floating around multilaterally agreed parities or bands. One of the advantages of such a system is that it would also give some guidance to markets, which may help avoid extended periods of deviation from equilibrium. Interventions in foreign exchange markets but also other macroeconomic policies would support the movement of exchange rates towards the agreed parities or bands (i.e., reinforce depreciation if the currency is perceived to be overvalued and appreciation if it is undervalued). Intervention rules would provide an implicit definition of what "manipulating" the exchange rate means.

In this framework, the process leading to the determination of exchange rate parities would have to take into account all macroeconomic determinants of the exchange rate, and would thus summarize a significant amount of information. A simpler approach would be to look directly at payments imbalances, and particularly at *current* account disequilibria which, as we know, is equivalent to looking at saving-investment imbalances.

Even better would be to look at payments imbalances among countries together with global macroeconomic imbalances –i.e., measures of the global output (employment) gaps and inflationary or deflationary pressures. Furthermore, they could include the broader set of indicators chosen by the by the G-20 for its Mutual Assessment Process. In any case, complexity may not be a good starting point for an incipient process. For that reason, a simple set of indicators may be better. This is why the reference exchange rate proposal is a good idea, complemented with information on current account deficits and global output gaps.

*4. Capital account and prudential regulations*

The central role that capital flows play in determining exchange rates and exchange rate volatility brings into attention an additional leg of international monetary reform: the management of the capital account. This issue links with the broader concerns with financial stability, which the recent crisis placed under the responsibility of the Financial Stability Board (FSB). Paradoxically, however, *cross-border* finance was left entirely out of the FSB agenda. It was, nonetheless, taken up by the IMF.

The essential problem is that capital flows, like finance in general, are highly volatile and pro-cyclical. According to IMF (2011b, ch. 4), capital account volatility has increased over the past three decades and tends to be higher in emerging market economies than in advanced economies. Bank and other capital flows are more volatile, followed by portfolio debt flows, but the volatility of foreign direct investment has increased and is now similar than that for portfolio debt flows –perhaps reflecting the fact that financial FDI (borrowing by subsidiaries from a parent banks or firms) has tended to increase. In turn, some of the major determinants of net flows to emerging economies are monetary conditions and risk perception in the advanced economies, generating significant net flows when interest rates are low and there is low risk aversion in those economies. On top of that, portfolio decisions in industrial countries may be entirely delinked from demand for capital by emerging and developing countries and can have severe effects given the relative sizes of capital markets. So, a small change in portfolio allocation in the former can have major repercussion on the latter.

This recent analysis by the IMF comes, of course, on top of massive evidence that financial markets are pro-cyclical and are highly segmented by risk categories. At the international level, this generally implies that emerging economies and developing countries are classified as riskier borrowers, and are subject to strong cyclical swings in net flows, risk spreads and availability of long-term financing. These cyclical swings are, in turn, one of the major determinants (and perhaps *the* major determinant) of business cycles in emerging economies. These countries face the further problems that their domestic financial markets are significantly more "incomplete" and are plagued by variable mixes of currency and maturity mismatches in

portfolios, and that their capital markets are shallower and, as indicated, small relative to the magnitude of the speculative pressures they face.

Under the leadership of the FSB, but also of national and regional (European) initiatives, there has been a significant move to re-regulate finance in recent years. This includes the new regulatory standards for banks known as Basel III, which increase the capital and, particularly, the core capital requirements, and added a counter-cyclical capital cushion, a maximum leverage and strong liquidity requirements. This has been complemented by stronger regulations for the most systemically important institutions ("too big to fail"), stricter rules on links between banks and capital markets and on derivative operations, and rules on the so-called "shadow banking system". This has been complemented by putting in place stronger supervision, including a common supervisory system in the European Union, as well as global standards on insurance and capital markets. There have been, however, some delays in adopting the new regulatory frameworks and some political economy pressures that already led to the softening of the more restrictive norms (those on banks' liquidity requirements).

Strengthened financial regulation will tend to reduce risk taking, particularly by banks, displace cross-country flows toward capital markets (as past Basel regulations did) and may leave loopholes in regulation that facilitate the active market participation of agents that behave in a more speculative manner. The net effect is unclear and hinges on the balance between the two forces that have been at work in recent years: the balkanization of finance that was unleashed by the recent global financial crisis (which can also be understood as increased "home bias" and perhaps an emerging financial protectionism) vs. the correction of the financial excesses that characterized the pre-crisis financial world. The result so far has been a significant reduction of cross-border flows, but this has been dominated by intra-European flows, leading to a re-segmentation of the European financial markets. In contrast, capital flows to emerging markets have experienced a strong recovery and for some regions and countries now surpass pre-crisis levels (Lund *et al.*, 2013). Rather than insufficient finance, the problem for emerging markets may be rather the pressure that large capital flows exert to increase current account deficits, as reflected in the previous analysis of global imbalances. This implies that emerging markets have become the new ground for risk taking and underscores the central role of the debate on capital account regulations.

This debate has taken place largely in the IMF, though also in part in the G-20 in late 2011. The earlier official IMF documents (IMF, 2011a and 2012a) presented a positive view of regulation of inflows by recipient countries ("capital flow management measures", CFMs, in its terminology), but had a critical view of regulations on outflows. In the first case, they recognized that regulations improve the liability structure of countries, by reducing the share of more volatile flows, and increase the policy space for restrictive monetary policies, though they may be ineffective in reducing the total size of inflows and to modify the exchange rate. These documents took into account a large-scale research effort undertaken by the Fund in recent years to evaluate the effectiveness of capital account regulations (see, in particular, Ostry *et al.*, 2010 and 2011 and Habermeier *et al.*, 2011).

On the basis of these analyses, the Fund proposed in 2011 some guidelines on the use of regulation on capital inflow (see IMF, 2011a, Box 1). These guidelines correctly pointed out that capital account regulations should be recognized as part of the "macro-prudential" family of regulations and should be seen as a complement and not a substitute for an appropriate macroeconomic policy. However, they tended to see regulations as a sort of "intervention of last resort", once other macroeconomic options had been exhausted: allowing the exchange rate to appreciate, accumulating foreign exchange reserves, adopting restrictive fiscal policies and lowering the domestic interest rate (a paradoxical recommendation, given that the objective is to reduce the aggregate demand effects of capital inflows). The guidelines also indicated that preference should be given to regulations that do not discriminate according to the residence of the agents involved.

These guidelines were considered to be excessively restrictive by many analysts, who rather conceived of capital account regulation as part of the normal toolkit of macroeconomic interventions that should be used simultaneously with other macroeconomic policies to both limit excessive capital inflows and avoid domestic overheating and exchange rate overvaluation.[10] These views see capital account regulations as a continuum of macro-prudential regulations that include strictly domestic regulations (those that affect domestic assets and liabilities in the domestic currency), those that relate to the use of assets and liabilities denominated in foreign currencies in the domestic financial system, and those that regulate cross-border capital flows as

[10] See, for example, the contributions to Gallagher *et al.* (2012).

such. The particular mix between these three forms of macro-prudential regulations depends on the authorities' policy objectives and the characteristics of the domestic financial system of the countries involved (Ocampo, 2011; Ostry *et al.*, 2011). These alternative views recognized that capital account regulations are a complement to macroeconomic policy but that there should be as part of the normal toolkit rather than as interventions of last resort. This more pragmatic view is also implicit in the only framework on this issue adopted by the G-20 (2011c).

These debates served in late 2012 as the basis for the discussion and approval (with some dissents, particularly that of Brazil), of the IMF's "institutional view" on liberalization and management of capital flows (IMF, 2012c).[11] This view recognizes that "There is no presumption that full liberalization of capital flows in an appropriate goal for all countries at all times", and that liberalization "needs to be planned, timed and sequenced". It also indicated that capital account regulations on inflows can be a useful in managing the risks associated with large inflows, with language now less inclined to posing them merely as interventions of last resort. However, it also underscored that they should be "targeted, transparent, and generally temporary". It also now agreed that regulations on outflows can be useful in crisis conditions, but again should be temporary. Finally, in both cases, regulations should avoid discrimination based on residence, a condition that may be impossible to fulfill, as agents demands assets and liabilities in different currencies based on residence. And, finally, although it recognized that push factors are important, and that the source countries should "better internalize the spillovers from their monetary and prudential policies", it gave no guidelines as to actions that they should undertake to avoid inducing large capital outflows toward emerging economies.

This "institutional view" is certainly a more nuanced than the previous IMF positions on the subject, and although it is has been taken as a "U-turn" it is rather a "half step" in the direction of re-regulating cross-border capital flows. From the IMF perspective, this "institutional view" would be used for policy advice, but it is not expected to be used in Article IV Consultations and does not eliminate the capacity that countries have to regulate capital flows according to the IMF Articles of Agreement. It is also expected to "foster a more consistent approach to the design of policy space for CFMs under bilateral and regional agreements", including OECD rules and free trade agreements.

[11] See a critical analysis in Gallagher and Ocampo (2013).

## IV. Governance of the system

Substantive reforms along the lines analyzed in previous sections must be matched by the design of appropriate governance structures. There are, in this regard, four interrelated issues. The first one is the design of the apex organization. The second is the reform of "voice and participation" of developing countries in the Bretton Woods Institutions, and now in the Financial Stability Board (FSB). The third is the design of a multi-layered architecture, with active participation of regional and sub-regional institutions. The fourth is the clear definition of the objectives of global cooperation in this field.

In the first area, the major step, as already pointed out, has been the decision of the G-20 to self-designated itself as "the premier forum for our international economic co-operation". The creation of this G-20 at a leaders' level was, of course, a step forward compared to the G-7, in terms of representation of developing countries. But this "elite multilateralism" also created problems, as *ad-hoc* self-appointed bodies cannot replace representative institutions in a well-structured international institutional architecture.

This preference for "Gs" over representative international institutions has deep historical roots, as it reflects the revealed preference of major industrial countries for institutional mechanisms over which they can exercise direct influence. It is possible that this may have also become the view of the emerging economies that are members of the G-20. The basic issue is, of course, the tension between representativeness and the legitimacy associated with it, on the one hand, and power structures, on the other.

In a recent analysis, Ocampo and Stiglitz (2011) evaluated the G-20 as a mechanism of global economic governance on the basis of five criteria. On one count, leadership, it has shown a positive record, notably in term of steering change in financial regulation and in putting in place a new mechanism of macroeconomic cooperation, the Mutual Assessment Process. On a second, effectiveness, the record is more mixed. It was quite good in the early phases of the crisis but has since then weakened considerably. According to three other criteria, performance is rather poor, given the suboptimal character of *ad-hoc* representation, the limited contribution to the coherence of the global system of governance, and the lack of an effective secretariat that can support continuity.

For all these reasons, the G-20 would be a better option if it were a transition to a more representative, and thereby legitimate, mechanism of international economic co-operation. In this regard, the best recent proposal has been that to create a Global Economic Co-ordination Council made by the Stiglitz Commission of Experts (United Nations 2009, ch. 4). It is, in turn part, of a long history of proposals to create a UN "Economic Security Council". According to this proposal, the Co-ordination Council would be set in the framework of the UN *system*, to which the BWIs belong, and formed on the basis of constituencies elected through weighted votes. So, although designed in the framework of the UN system, its voting structure would be made along the lines of the BWIs, correcting of course for the problems of representation that these organizations face today.

The reforms of "voice and representation" of developing countries in the Bretton Woods Institutions (BWIs) predate the creation of the G-20 at the leaders' level, and have continued to take place partly on a parallel track. In 2006 and 2008 modest agreements were adopted on reforming quotas and votes in the IMF Board, which entailed a redistribution of the quotas and a tripling of the basic votes. A more ambitious reform was adopted by the G-20 in October 2010, just before the Seoul Summit, which was then approved by the IMF Board in November 2010. This had been preceded by a somewhat less ambitious reform of World Bank voting power in the spring 2010 meetings of the BWIs, based on an *ad-hoc* capital increase. Both efforts are considered to be part of an ongoing process that will continue in the next few years, as they only go in a limited way in the direction of re-balancing the representation of emerging and developing countries in these institutions.[12]

There are, of course, many other issues of governance that have on the table, including those proposed by the 2009 Commission for IMF Governance Reform headed by Trevor Manuel (IMF, 2009) and, in relation to the World Bank, by the 2009 Commission headed by Ernesto Zedillo (World Bank, 2009). The pending issues include the selection of the heads of these organizations on the basis of transparent and open processes. Although these principles were formally endorsed by the G-20, the election of the IMF Managing Director in 2011 and the

[12] In the case of the IMF, the increase in quotas and voting power of emerging and developing countries relative to the pre-Singapore 2006 annual meeting was 3.9 and 5.3 percentage points, respectively, It was also largely concentrated in a few emerging economies (China, Republic of Korea, Brazil, India, Mexico, and Turkey, in that order), which added up 7.3 and 6.7 percentage points in terms of quota and voting power, respectively. So, part of their gain came at the expense of other emerging and developing countries.

World Bank President in 2012 represented only a marginal change and ended up with the traditional allocation of the first to a Western European and the second to a U.S. citizen.

New issues are now the result of the responsibilities assigned to the FSB to coordinate global regulation. This was a step forward in relation to the past, as emerging economies that are part of the G-20 were included in the FSB as well as the Basel Committee on Banking Supervision. Again, however, an *ad-hoc* body is not a good substitute for a treaty-based organization. This is particularly critical in this regard, as non-G-20 countries will continue to be pressured to adopt regulatory principles and norms in the design of which they have no voice. One alternative could be to expand the responsibilities of the Bank of International Settlements to include global financial regulation, making it at the same time a universal organization.

A multi-layered architecture that relies more broadly on regional institutions offers interesting opportunities. Indeed, in a heterogeneous international community, the creation of *networks* of global, regional and national institutions can provide a better system of governance than arrangements based on single global organizations. This is based on old federalist principles: regional and sub-regional institutions give stronger voice and a sense of ownership to smaller countries. These institutions are, therefore, more likely to respond to their demands.

What this means is that the the IMF of the future should be conceived as the apex of a *network* of regional reserve funds (Ocampo, 2002 and 2006). A system such as this would be closer in design to that of the multilateral development banks (MDBs), where the World Bank coexists with several regional development banks and, in some parts of the world, with several sub-regional institutions, and even an inter-regional bank (the Islamic Development Bank). As Figure 4 makes clear, this dense network of institutions provides quite a useful supply of services to several parts of the world (including Western Europe, through the European Investment Bank), mixing in variable ways its different layers. Interestingly, the structure of a network is also closer in design to the European Central Bank and the Federal Reserve System than to the current IMF.

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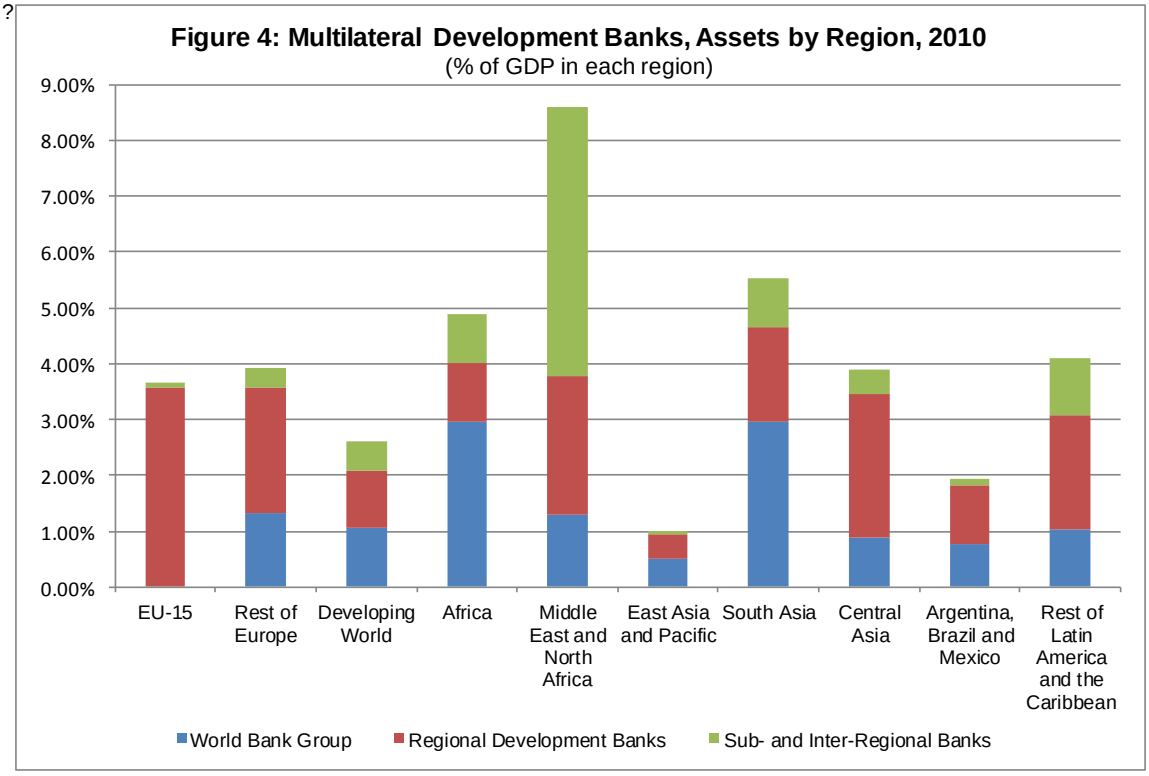


Source: Author estimates based on information from each bank and GDP according to IMF.

In the monetary area, regional arrangements can 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 made a significant step towards full multilateralization in December 2009. The creation of a European Financial Stability Facility and the future European Stability Mechanism are also major steps in that direction, which would complement the role of the European Central Bank.

However, careful consideration should be given to the links between global and regional arrangements. In this regard, during the recent crisis, Europeans chose rescue packages that mixed resources from the IMF and the European Financial Facility. In contrast, as access to Chiang Mai swap lines beyond a certain limit (20% of the agreed swap lines, now 30%) requires an IMF programme, countries that may have used the initiative during the crisis (Indonesia and the Republic of Korea) did not do so as they were unwilling to agree on any such programme. In turn, the use of the Latin American Reserve Fund has traditionally been delinked from any

programme with the global institution. The links between the IMF and regional arrangements must be subject, therefore, to flexible designs –a "variable geometry" to use a term that has become common in relation to the design of the world trading system.

Finally, it is essential that this system of governance should include the two objectives highlighted at the beginning of this paper: macroeconomic and financial stability. In relation to emerging and developing countries, the latter should include encouraging more stable flows and, in the negative sense, mitigating and possibly reversing the pro-cyclicality of flows toward these economies. This is an essential task of prudential and capital-account regulations, which should thus focus not only on mitigating the volatility of cross-border capital flows, but also encouraging longer-term flows. It is also an essential function of MDBs, which must provide stable long-term as well as counter-cyclical financing. And it is a function of macroeconomic policy cooperation, which must avoid the accumulation of global imbalances and, in the particular case of emerging and developing countries, the accumulation of current account imbalances and debt levels and profiles that will at the end prove unsustainable and lead to costly crises.

## V. Conclusions

This paper highlights several elements of an emerging and developing countries-friendly agenda for international monetary reform. In terms of the global reserve system, the most desirable reform involves moving to a fully SDR-based IMF with a clear counter-cyclical focus. This would include counter-cyclical allocations of SDRs and counter-cyclical IMF financing, made entirely in SDRs. In the first case, it could include criteria for SDR allocations that take into account the very different demand for reserves by industrial vs. emerging and developing countries. In turn, the use of SDRs to finance IMF programs would help consolidate the reforms of the credit lines that have been introduced during the recent global financial crisis, particularly the creation of contingency credit lines and the much larger levels of financing relative to quotas. The introduction of a substitution account by which central banks can exchange for SDRs the reserves in currencies they do not want to hold would make the latter a complement to the multicurrency reserve system that may be emerging.

From the point of view of macroeconomic policy cooperation, the major issues are counteracting the deficiencies in global aggregate demand and avoiding building up large global imbalances. The latter require, in turn, the need to move to a system of reference exchange rates among major currencies. In terms of global imbalances, the most troublesome trend since the global financial crisis has been the pressure being faced by non-oil emerging economies outside East Asia to run deficits, with large capital inflows being the most important transmission mechanism. Past history indicates that current account deficits generate risks for these economies. Managing these pressures requires, therefore, recognizing the role that capital account regulations play as a complement to counter-cyclical macroeconomic policy and prudential regulations, and thus as part of a normal policy tool rather than as interventions of last resort.

Governance reforms should take into account four issues. The first one is the design of a more representative apex organization than the G-20. The second is the reform of "voice and participation" of developing countries in the Bretton Woods Institutions and the Financial Stability Board. The third is the design of a multi-layered architecture, with active participation of regional and sub-regional institutions. The fourth is clearly defining the objectives of global cooperation in this field, which should include at one of central purposes encouraging more stable flows toward emerging and developing countries.

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