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Reforming financial regulation and the International Monetary System

I will structure my talk around three themes:

1. What have been, historically, the conditions for a proper functioning of a true International Monetary System (IMS)?
2. Is it possible, in the world of today, to recreate such conditions?
3. Absent a positive answer to this question, what can be done?

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1. <u>What have been the key elements of the functioning of the gold standard and, later, of the dollar exchange standard under Bretton Woods?</u>

   The gold standard that stabilised the exchange rates in the second half of the XIXe century and until the first world war and played an important role in fostering economic growth, was built on three pillars:

   a) the adoption by States of the gold standard was voluntary. But the large countries -which were, at the time, relatively balanced in terms of geopolitical power - chose to make their currencies convertible. That was a key element for their trade and financial influence world wide;

   b) the system was self-disciplinary: protracted balance of payments deficits were sanctioned by gold losses and had to be corrected by adequate policy adjustments;

   c) the system could not be negotiated or tinkered with. It was a binary one: either the currency was convertible into gold or it was not. In the latter case, it could not become a reserve currency, nor an instrument for international payments.

This system was far from being perfect. It relied on the production of gold for providing liquidity to the world (but the pace of gold extraction could not be an adequate determinant of sustainable growth). And it was asymetric (the counties in surplus could accumulate gold without facing sanctions, while the deficit countries were the only ones who had to adjust).

The gold standard, that was an essential element of the “first globalisation”, broke down with the 1914 war. Efforts to rebuild it were made in the 20’s and 30’s, but to no avail: nationalism, beggar thy neighbour policies, capital controls and competitive devaluations prevailed with all the dramatic consequences that we know too well.

With Bretton Woods, an indirect form of the gold standard was established after the war. The dollar was the centre of the system: all par values were determined by a fixed - but adjustable - link to the dollar. The quid proquo was that the dollar was convertible into gold (at a fixed price).

This system survived as long as the United States followed a stable and non-inflationary economic and monetary policy. But in the 60’s, the Vietnam war and the financing of the welfare state created large deficits and, in turn, a loss of confidence in the dollar.

The pressure on the US gold reserves eventually led the Administration in August 1971 to break the link between the dollar and gold.

A world of floating currencies - some being more or less pegged to the dollar - prevailed since then.

After a decade of high volatility and inflation in the 70’s, the period of the “great moderation” began in the 80’s with Paul Volcker’s crush on inflation, productivity gains stemming from technological changes, and Central Banks independence. But, in the 90’s, the “great moderation” became to some extent an illusion. Much of the reduction in inflation was the consequence of low wages contained in emerging countries exports. In fact, monetary policy of the advanced countries was too loose with real interest rates hovering around zero. The explosion of credit and of leverage - favoured by those low interest rates, deregulation and external imbalances - led to a strong expansion of the money supply in the run up to the 2007-2008 crisis. All this did not amount to a “system”. Indeed:

- no common discipline was applied to reduce external imbalances;
- each country was free to float or to peg its currency to another one;
- the dollar, as the primary international currency, gave the Federal Reserve System a predominant influence on world monetary conditions.

The results of such a “non-system” are: volatility, disorderly capital movements, currency misalignments, “currency wars”, and eventually capital controls…

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2. Does the present world offer the conditions for a proper functioning of the SMI?

By “present world”, I mean:

- no envisageable return to a form of gold standard;
- freedom of capital movements, and the importance of liquidity in financial markets (essentially in the US) as a key determinant for the success of international currencies;
- a world composed of States determined to preserve their own interests (or what they believe are their interests) without having to accept external constraints.

If we want to imagine a true SMI, at least the latter factor has to change.

The word “system” implies indeed the acceptance of an element of “externally agreed consistency”. The juxtaposition of national positions cannot, by definition, amount to a “system”.

Nations should therefore accept to truly coordinate their economic and financial policies in order to achieve a sustainable global macro-economic balance, under the surveillance of an international institution disposing of adequate powers and sanctions. If the IMF were to be chosen to fulfil such a role, it would have to better reflect the real world and in particular the growing importance of emerging countries.

This, in theory, should not be an unattainable objective, if States were ready to convince themselves that the common discipline which they would have to abide by, is not only desirable internationally, but also in their own interest. Indeed, in a financial globalized world, exchange rate volatility, currency misalignments and structural deficits are in the interest of no one.

But, in the present circumstances, the probability of a common macroeconomic governance with some form of constraints on member countries policies seems to be very remote.

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3. Absent such an agreement, what can be imagined?

a) Several adjustments can be made to the present “non-system”. Some proposals concern an increase in financing facilities provided by the IMF. The G20 has already considerably reinforced the Fund’s resources and made their use more flexible. But some argue that this is not enough and that the IMF should be allowed to provide last resort funding to countries affected by a liquidity crisis (not by solvency problems that are usually linked to inadequate economic policies). To that effect, they propose that the Fund should be allowed to borrow on the markets and to substitute or complement the Central Banks swap lines that are often uncertain and therefore not adequate to prevent looming crises.

Other ideas touch on the extension of the role of the SDR (introducing the RMB, allowing the IMF to borrow in SDRs…). But it is highly improbable that the SDR could become a substitute to the dollar. Besides, it should not be used as a form of mulilateral guarantee for countries having accumulated excess reserves. At any rate, in relation to the size of financial markets, the potential offered by the SDR seems weak.

b) More important than he proposals mentioned above, is the enforcement of a true international system of macroeconomic oversight.

Given the low probability of a "grand" reform of the IMS, I believe the world will evolve slowly over the years towards a more multipolar system. The emergence of countries like China, India, Brazil… is a powerful factor of change. Monetary power will eventually match economic influence. We are already seeing the harbingers of such a transition: domestic currencies of emerging markets are getting more and more used in local and regional transactions, non-residents are beginning to have access to emerging currency pools, emerging financial markets are gradually expanding, issues of bonds denominated in emerging currencies are developing on international markets... These changes will take time before they translate into universal convertibility. But the direction is clear: more currencies will count and participate in international finance.

But such a transition will not solve all problems. As I mentioned above, it is the excess of credit expansion that fueled the financial crisis. Too much bank leverage contributed to the explosion of money supply. And monetary policy limited to inflation targeting (but not concerned by bubbles and asset prices) was powerless.

In order to avoid the repetition of such crises in a world where currencies will continue to be free to misalign, another approach seems essential: macro economic oversight. Central Banks and regulators together should be watching, early on, signs of nascent systemic risks and acting to prevent disruptions. If, for example, real estate borrowing becomes excessive in a country, regulators should react for instance by setting limits on borrowers (loan to value ratios…), or if credit bubbles threaten, monetary policy should respond by increasing interest rates or by other measures (like raising reserve requirements or introducing countercyclical provisioning)… If the present network of mushrooming systemic boards could work together to foster this "fine tuning" of monetary and regulatory measures - to be applied not uniformly across the board but according to the problems of each country - then we would live in a more stable environment. The absence of an IMS would, to a certain extent, be mitigated by a serious macroeconomic oversight system.

One could object that Governments might not be willing to apply such anticyclical policies (often unpopular). But I believe that Central Banks and regulators have more leeway and

independence to act in such a diversified manner than Governments to abide by multilateral surveillance.

Capital requirements are not the only way of increasing the resilience of the system. Actually, increasing the global “headline” ratios can be very costly in terms of reducing normal credit availability. Sectoral and cyclical regulatory modulations and capital requirements would be much more effective and less expensive than the race to “one size fits all” higher and higher capital ratios.