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POLICY DEPARTMENT
ECONOMIC AND SCIENTIFIC POLICY **A**

Financial, Economic and Social Crisis

NEW GLOBAL MONETARY SYSTEM

Compilation of Briefing Papers

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DIRECTORATE GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICIES

SPECIAL COMMITTEE ON THE FINANCIAL, ECONOMIC AND SOCIAL CRISIS

NEW GLOBAL MONETARY SYSTEM

COMPILATION OF BRIEFING PAPERS

Abstract

This compilation of briefing papers was written by two members of the expert panel to the Special Committee on the Financial, Economic and Social Crisis. Its aim is to support the committee discussions on key questions arising from the crisis and thus feed into the preparations of the final report.

The briefing papers take a look on the previous experiences of world monetary systems such as Bretton Woods and the current exchange rate misalignment as well as taking into account the influence of modern trading platforms. This also implies a consideration of the role of the Euro at world stage. Both authors argue for improvements of the current systems but remain sceptical towards building up a new global monetary system.

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THE CASE FOR A NEW GLOBAL MONETARY SYSTEM

BRIEFING

by Sony Kapoor, Managing Director Re-Define

Abstract

The discussion on reform of the global monetary system is a central theme of the French G-20. A renewed growth of global imbalances, an increasing volatility of exchange rates, a proliferation of unilateral measures by countries to manage capital flows and exchange rates – part of the so called "currency wars", and the continuing inefficient accumulation of foreign exchange reserves by many countries has set the context for this discussion. This policy brief pins down the main elements of what a monetary system is, gives a brief history of what systems the world has seen in the recent past and then highlights the main problems faced by the current system.

Next we look at the various options for reform that are being considered for each of the main aspects of the monetary system namely 1) the anchor currency 2) the exchange rate system 3) the institutional structure and 4) the rules of the game. We conclude that any radical shift in the current regime does not seem to be politically feasible and that the case for the EU pushing for the Euro to become an anchor currency has not been made. There are a number of elements such as a more prominent role for Special Drawing Rights, an improvement of the IMF and an agreement on principles for capital account and exchange rate management that are clearly both feasible and desirable.

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1. INTRODUCTION

What exactly constitutes the Global Monetary System is somewhat hard to pin point but it broadly refers to the rules and institutions for cross-border payments. It is the international equivalent of domestic monetary systems that normally include

1) currency;
2) rules for transactions between cash and other forms of monetary holding
3) a central bank and payment system;
4) a lender of last resort function performed by central banks; and a
5) store of value function taken on by assets and accounts denominated in the national currency.

The global monetary system thus includes

1) exchange rate arrangements;
2) cross-border flows through current and capital accounts;
3) the IMF that was, at least at its inception, supposed to play an important role in the running of the system;
4) reserve arrangements;
5) liquidity provision; and
6) the rules and norms that govern these aspects.

The IMF's Articles of Association state that a key purpose of this system is "to facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members…", and "…to promote exchange stability, to promote orderly exchange arrangements amongst members, and to avoid competitive exchange depreciation". The system is also supposed to facilitate an orderly adjustment to shocks.

Even a cursory familiarity with the current themes of 'the financial crisis', 'large exchange rate fluctuations', 'sharp falls in the volume of international trade', 'currency manipulation' and the 'output drop in the crisis' immediately establishes that there is a dissonance between these objectives the state of the world today. While some of these themes are strongly influenced by drivers such as the actions of private financial actors that lie beyond the global monetary system, enough problems can be pinned on the prevalent global monetary order to make a strong case for having a debate on its reform. This is the context of the French G-20 having made the reform of the global monetary system one of its central planks.

2. A BRIEF HISTORY AND THE PRESENT

The past century has seen broadly three main global monetary systems

1) the gold standard (until 1933);
2) the Bretton Woods System (1946-1973); and the
3) current post Bretton Woods system that has prevailed since.

Under the gold standard, participating countries made a commitment to fix the prices of their domestic currencies in terms of a specified amount of gold. National money was freely converted into gold at the fixed price, at least in theory. The whole currency issuance of countries had to be backed by reserves of gold of which there was only a limited amount. The economic turmoil during the Great Depression led countries to hoard the gold they had and engage in competitive devaluation for the purpose of being able to export their way out of depression.

However, since countries can not export to Mars, this 'fallacy of composition' thinking only made the depression worse through a deflationary spiral and the US ended the gold standard gradually ceased to be operational from 1931 and in 1933 the US forbade private ownership of gold and put the last nail in its coffin. The world fragmented into de facto currency zones where countries that lay in the sterling zone traded mostly with each other as was the case for other zones.

Close to the end of World War II, the allies convened a meeting at Bretton Woods in the US where delegates set up a system of rules, institutions, and procedures to regulate the international monetary system. The chief features of this system were an obligation for each country to adopt a monetary policy that maintained the exchange rate by tying its currency to the US dollar. The IMF was set up to provide support in the face of temporary imbalances in payments. The original currency of choice was a new bancor (the name of a kind of a world currency) that was dropped in the face of US objections. The US also agreed to link the dollar to gold at USD 35 per ounce and to honour foreign central bank requests to exchange dollars for gold.

This system, which became operational in 1946, continued till the early 1970s when its own internal contradictions led to its collapse. One of these was the so called Triffin dilemma that suggested that as the final provider of liquidity and reserve assets to a growing world economy, the US would need to increase the supply of dollars beyond what was backed by the near stagnant gold reserves so the relative value of the dollar would erode. It could choose not to provide the liquidity the world economy needed or the reserve assets other states demanded but this would lead to a global contraction. By 1968, the attempt to defend the dollar at a fixed peg of USD 35/ounce had become increasingly untenable and gold outflows from the US accelerated.

Another attempt to hold the dollar's peg against gold was the introduction of Special Drawing Rights that were set as equal to one US dollar, but were not usable for transactions other than between banks and the IMF.

By the early 1970s, as the Vietnam War accelerated inflation, the United States as a whole began running a trade deficit and a more flexible exchange rate was introduced but still the official rates could not be defended against speculators. In February 1973 the Bretton Woods currency exchange markets closed, and by March 1976, all the major currencies were floating.

The system that has prevailed since then has been largely a mixed one where fixed and floating currencies coexist with many shades of grey in between such as 'crawling pegs' or 'dirty floats'. For a number of reasons, the US dollar continues to be the dominant currency despite the fact that it does not have an official role anymore. A whole range of national systems use different kinds of capital controls. The IMF plays an important but not central role in this system as a crisis funds provider of last resort that falls far short of the lender of last resort function that central banks play in domestic economies.

As highlighted at the end of the previous section, a growing consensus is emerging that this current shape of the monetary system is not fit for purpose. There are a number of concerns, some longer term and some more immediate. These are the subject of the next section.

3. WHAT ARE THE PROBLEMS FACED BY THE CURRENT SYSTEM?

Before examining problems with the current system, it would be useful to look at what a well-functioning system ought to do. First, it needs to be stable i.e. not exhibit too much volatility. Second, it needs to offer a reliable store of value that countries can be use to save. Third, it needs to be efficient in a way that cross border payments, and other functions can be performed at minimum cost. Fourth, it needs to be fair so no one country or a group of countries enjoys an advantage over others.

Excessive volatility

There is a near consensus that the system has not delivered stability. There is far too much fluctuation of exchange rates than is justifiable on grounds of fundamentals. Exchange rates are volatile not just in the short term but can stay misaligned for long periods of time. This hampers long term planning and a smooth flow of trade and commerce. Related to this is the problem of the scale and volatility of capital flows. Financial crises have become more frequent since the collapse of the Bretton Woods arrangement and people justifiably agree that a system in which economies face floods (as now) or droughts (1997-98, 2008) of capital is unstable.

Global foreign exchange trading volume now exceeds USD 1,000 trillion annually, a large multiple of all fundamental anchors such as global GDP, trade or capital flows. While some of the excess volume is attributable to the need for hedging, much can be pinned down to speculation. The increasing volatility of exchange rates makes speculation more attractive but this increased speculation in turn, under a number of circumstances, increases volatility further. These trading volumes also make any form of exchange rate management that countries may want to use much harder.

An unfair advantage?

The continuing dominance of the US dollar despite the fact that the US economy is now only 24% of World GDP is starting to cause frictions. The dollar is on one side of at least 80% of all foreign exchange transactions (means of exchange), is the currency of choice for more than 60% of the world's official reserve holdings (store of value) and is the currency for pricing the vast majority of the world's commodities and the standard choice for trade transactions (unit of account).

This has been questioned both on the grounds of fairness – does the US enjoy an 'exorbitant privilege'? Why should the rest of the world be vulnerable to US domestic monetary policy? And on the grounds of stability – i.e. the use of the US dollar as store of value is problematic because, as suggested by the Triffin dilemma, the currency will be debased and will lose value. This came true partly as the demand for dollar denominated AAA assets led to an oversupply of increasingly dodgy CDO and agency assets.

Absence of lender of last resort

The fact that there is no international lender of last resort means that if a country faces a balance of payments problem, it cannot reliably know that any entity will come to its aid. The IMF, the institution that is closest to fulfilling this role, suffers from a number of shortcomings. The first is that IMF resources have not kept up with the rapid expansion of cross border trade and capital flows. The second is that the IMF does not provide automatic assured access to liquidity but its programs are contingent on board approval and come with heavy conditionality. The third that approaching the IMF is politically difficult as it is seen to not represent a fair balance of economic power but is dominated by advanced countries.

Excessive reserves

In the late 1990s, much of East and South East Asia experienced a sharp reversal of capital inflows that resulted in the Asian crisis. Support provided by the IMF came at the cost of heavy conditionality and austerity measures that were even then politically unpopular with the leaders and the population. In retrospect, the IMF has come in for even more criticism. The lesson that a number of countries, especially in Asia, took from that experience was that they needed to insure themselves against a recurrence of such a scenario. This was the trigger for a scale change in the accumulation of reserves by developing countries which now exceed USD 6 trillion having increased from about USD 1 trillion in 2002.

This amount exceeds what would be needed for an insurance motive alone and is highly inefficient since the build-up has driven capital from poor countries to richer ones with costs to both. This depresses much needed investment in developing economies and the resultant flow of excess liquidity into the US provided the cheap credit that fuelled the crisis. This is both inefficient and unfair.

Growing imbalances

Last but not least is the related problem of persistent economic imbalances and the now increasingly rapid but volatile flow of private investments into emerging economies both of which result from the inadequacies of the global monetary system.

Here, the lack of a globally agreed rulebook means that each country is seeking to react to the economic circumstances it faces in a way that seems sensible from its own perspective. China is keeping its currency depressed. The US is running an ultra-loose monetary policy. Japan and Switzerland have intervened in their foreign exchange markets. Brazil has introduced a tax on inflows and countries such as Korea, Thailand and Taiwan have introduced other forms of restrictions in their capital account transactions. The only thing that is clear is that uncoordinated action is suboptimal and that unless checked, policies being pursued by countries may lead to a real outbreak of ‘currency wars’ which would be disastrous for the world economy.

4. IS THERE A BETTER ALTERNATIVE?

This of course begs the question of whether there is a better alternative. Let us start by looking at the main elements that make the global monetary system and the main choices being discussed for each of these. It would also make sense to look at the alternatives through the lenses of efficiency, stability, fairness and ease of implementation.

Which currency?

The first requirement is to choose which currency, if any, should serve as an anchor and whether it should be purely a fiat currency or be linked to something more tangible. There is a widespread feeling that the US dollar enjoys a disproportionate advantage from being the de facto reserve currency of the world. As US investments abroad are in non-dollar currencies and as the US dollar has steadily lost value against many of these (see the discussion on the Triffin dilemma above), this has produced large capital gains for the US that are currently estimated to be close to USD 1 trillion.

Beyond this, McKinsey has estimated that the annual benefits enjoyed by the US from being the reserve currency are rather small USD 40 - USD 70 billion or about 0.3% to 0.5% of GDP. The benefits from seigniorage and a lower than normal interest rate are eroded by the negative impact of a higher rate for the dollar, than is justifiable by fundamentals alone, on exports.

Using the same methodology, McKinsey has estimated the benefits to the euro area of being the secondary reserve currency are negligible at close to USD 4 billion per year. More important, it estimates that the increasing importance of the Euro as a reserve currency would perhaps be net negative for the euro area, in particular because of the already over-valued exchange rate of the Euro. Moreover, given the on-going crisis of competitiveness faced by countries such as Spain, Greece and Portugal what the euro area really needs is a 20%-30% fall in the exchange rate of the Euro. Hence, it seems inadvisable for the EU authorities to make an active pitch for a more important international role for the Euro. Moreover, it is quite clear from the on-going crisis, that the Euro is not quite ready to replace the dollar as THE international currency of choice.

The main alternatives to the dominance of the US dollar are

1) a multiple reserve currency regime;
2) another national currency to replace the dollar;
3) the use of Special Drawing Rights (SDRs);
4) the introduction of a new international currency.

Of these, the world is already moving, slowly but surely, towards number 1. There may be a case for accelerating this, but any policy pronouncements on this could trigger financial instability. No matter which other national currency replaces the US dollar, it will end up facing the same problems as the dollar has. Moreover, the US with the world's largest economy and deepest financial markets continues to be the most suitable provider of a nationally based reserve currency. A greater role for SDRs is currently being discussed in earnest and while a good case can be made for this a lot depends on the details of the proposal. There may be a strong case for the introduction of a new fiat currency such as the bancor first suggested by Keynes but this would need enormous political will which seems to be lacking at present. This hurdle also limits any serious discussion of interesting proposals such as linking currencies to carbon emission quotas.

The discussion on SDRs, linked intimately to the discussion on the institutional role of the IMF, centres on possibilities for 1) expanding the issuance of SDRs 2) whether this should be automatic, ad hoc or contingent on the occurrence of a liquidity crisis where SDRs would

be issued temporarily to provide global liquidity 3) the role of SDRs not just as a reserve asset but also an unit of account 4) the possibility of transforming SDRs into a new super currency that will also be used for private sector transactions.

Fixed or floating?

The shape of any global monetary system has to deal with the 'trilemma' of economics which states that if capital flows freely across borders, countries must choose between fixing their currencies and controlling their domestic monetary conditions since they cannot do both. The Euro area has taken the path of fixing its currencies and the resultant loss of monetary policy space has been one of the contributors to the on-going Euro crisis. China uses capital controls in order to both fix its exchange rate and manage domestic monetary conditions. Countries such as the UK have chosen to float their exchange rates in order to maintain control of monetary policy.

This begs the question of where the monetary system should stand on the

1) free movement of capital vs. capital control debate and on the
2) floating vs. fixed exchange rate debate.

The received wisdom at the IMF used to be that countries should all move towards full capital account liberalisation with floating exchange rates but this has now been questioned not just by the emerging economies but also by the IMF itself. The evidence is mixed and, at least unless radical reform is contemplated, does not offer a clear choice beyond saying 'it depends'. While both issues of capital mobility and fixed vs. floating are on the agenda of the French G-20 presidency, the very different positions that members of the G-20 have on these issues are unlikely to produce clear reform ideas.

Rules of the game

That having been said, some new principles or rules of the game are at least being discussed. These include

1) an agreement to keep free mobility of capital and flexible exchange rates as a distant long term goal;
2) a possible discussion on giving more legitimacy to intermediate 'crawling peg' or 'band' regimes that lie somewhere between fixed and floating;
3) an endorsement by the IMF, subject to certain rules of the game, of the use of capital management techniques such as transaction taxes and prudential regulations to manage excessive flows of capital.

The other rules of the game that will be discussed are

1) how best to tackle the build-up of excessive and unsustainable imbalances; and
2) how best to introduce a greater symmetry between deficit and surplus countries (for more on both please look at the accompanying policy brief "Global Imbalances and Global Governance").

The first discussion relates to both the need for a lender of last resort and to the questions of fixed vs. floating and to more rules for surplus countries.

IMF reform

As discussed earlier, the inadequate size, excessive conditionality and a perceived lack of legitimacy hampers the IMF's operation as a lender of last resort that is needed to reduce the incentives for countries to build up excessive reserves. IMF resources have been tripled

already and other issues such as a further expansion of resources including through quota increases, more SDR issuance and even allowing the IMF to issue bonds are being discussed. Also being discussed is the possibility of linking the size of the IMF to growth in world trade, capital flows and GDP. Another possibility is to have a greater role for regional facilities, central bank swaps or reserve pooling all with a view to expanding the size of the global safety net with the IMF at the centre.

The discussion on reducing conditionality to make use of the IMF more politically acceptable includes both the introduction of new ex ante credit lines and facilities as well as the enabling of automatic access but only in the event of the occurrence of a systemic crisis. The legitimacy discussion, particularly relevant for large emerging economies which rightly see the IMF as being dominated by advanced countries, is linked strongly to the question of motivations for the build up of reserves by these economies.

A way of tackling the two issues simultaneously would be to have a grand bargain offering emerging economies much greater vote and voice share in exchange for them making substantial commitments that can help expand the size of the IMF and agreeing to limit any further accumulation of reserves.

Enforcement of rules

The IMF's institutional role is also being discussed in the context of its role in surveillance of exchange rates, macroeconomic policies, global imbalances and the management of capital accounts. The problem thus far has been two fold. One, that there is an asymmetry between surplus and deficit countries in the sense that markets only exercise pressure on deficit countries. This is further exacerbated by the fact that the IMF only has real leverage on countries that borrow from it (or may need to borrow soon) which, to the large part, run deficits. In the EU the institutional construction and power balance is such that surplus countries can and do ignore any calls to change policies.

It would be useful for the IMF to be given more teeth and credible enforcement powers but this, as has been demonstrated in the case of the EU and the Stability and Growth pact, is very hard. Ideas on fines, interest free deposits, name & shame and other sanctions are being floated but have little chance of being agreed to. In particular, surplus countries are likely to keep resisting any serious pressure to change policy. Keynes's idea of an International Clearing Union, which presents and elegant solution to this asymmetry, is being increasingly referred to but more as an idealised solution rather than something that is politically feasible. The US idea of imposing limits on current account imbalances, both surpluses and deficits, has more traction and may be adopted in some non-binding way as a reference point.

Other ideas

Other ideas on reducing the size and speed of transactions in foreign exchange markets are also in the play including an idea for a Tobin Tax but are unlikely to get very far in the current political climate. Financial reforms on derivatives and high frequency trading etc being enacted in any case under the financial reform agenda might have a useful effect on the foreign exchange market but the FX markets are not a focal point for regulatory reform.

UNCTAD's idea of targeting the stability of real effective exchange rates is very promising and elements from that may make it into the surveillance framework being discussed at the G-20 but the proposal is unlikely to be adopted in a more substantial way.

5. CONCLUSION

Few sensible people, if given the choice to design a global monetary system from scratch, would choose one that resembles the 'non-system' that the world is saddled with today. This is the end result of path dependence, entrenched interests, unanticipated developments in technology and finance and most of all the lack of political will for substantial reform. Though most agree that the system is not fit for purpose, finding an agreement, across a diverse set of countries with different interests, for bold change seems politically doomed. Good ideas for reform such the proposals from Keynes for bancor and the International Clearing Union are fashionable again but remain out of political reach. The French G-20 discussion on the issue is likely to result in useful but not optimal changes.

In summary, there is likely to be some expansion in the role of SDRs though some of the more ambitious or innovative suggestions will not have enough backers. This will be accompanied by a statement on the continuing importance of the US dollar in order to make sure the markets do not react in a sudden self-defeating way. IMF surveillance and reporting will be made stronger but will still lack teeth. An agreement may be reached on a further expansion of the IMF's capacity, new instruments to provide liquidity and even a change of quota share but the reforms will still fall far short of making the IMF a true lender of last resort. There may be an agreement on how to improve the coordination and functioning of a global safety net where regional and global arrangements work in a more coordinated manner.

There may also be some agreement on tackling excessive misalignments of exchange rates through co-ordinated action. It is also likely that there is an agreement on broad principles for capital account management for emerging economies. The surplus-deficit country problem may be addressed partly by an agreement to use current account balances as a benchmark against which adjustment needs to be coordinated and a bigger role may be agreed for financial and prudential regulation to better manage and control the large foreign exchange market. It is even possible that an agreement of some kind may be reached on an international transaction tax but it will be from the perspective of revenue raising not improving the functioning of the global monetary system.

In short, there is a possibility for a series of useful incremental reform to be enacted but a radical makeover of the global monetary system in not on the cards, YET.

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WHY THERE WILL BE NO 'NEW GLOBAL SYSTEM'

BRIEFING

by Charles Wyplosz, The Graduate Institute, Geneva

Abstract

International trade and financial movements require an international system that defines how exchange rates are set, which currencies are used to pay for these exchanges, how external disequilibria are dealt with, how free capital movements are and how to deal with countries that do not play by the rules.

Even when money was metallic, some rules were needed. The invention of paper currency – one of the great inventions of mankind – has radically changed the situation but the radical nature of this invention is not always appreciated. Nostalgia for "the good old times" does not lead to desirable solutions.

The current state of play is often described as a non-system. This is only partly accurate. It is true that there is no recommended exchange rate regime and that the dollar is the *de facto*, not *de jure*, international currency. On the other side the IMF exercises a number of important systemic functions. In addition, the WTO has been granted some supra-national powers in the area of international trade.

Although the current arrangement suffers from some weaknesses – and for much undeserved criticism – there is little scope for a serious change for one solid reason: the absence of any workable alternative. For years and decades to go, there is no substitute to the US dollar and no scope for the setting-up of a world central bank that would issue a world currency. Different countries have different needs for their exchange rate regimes.

The crisis is not the result of a poor global monetary system. However it has shown how poorly banks were regulated and how ineffectual bank supervision was. More than three years after the onset of the crisis, few countries have put in place any relevant legislation and, where new laws/rules have been adopted, they are clearly insufficient.

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1. THE NEED FOR A SYSTEM

Even without financial markets, the world needs some international arrangement to carry out international trade. At the most obvious level, exporters and importers must have access to a cheap and reliable way of changing currencies. In addition, trade exchanges are unlikely to be continuously balanced. Each country, therefore, is bound to go through periods of surpluses and other periods of deficits, the lengths of which are both variable and largely unpredictable. This implies that during periods of surpluses, a country will have to accumulate assets against foreigners while it may have to borrow during periods of deficits. This can be achieved by accumulating sufficient stocks of reserves in some form that can be safely disposed of, or access to borrowing facilities, or both. Adding financial transactions merely reinforces the need to change currencies and possibilities of large imbalances, but it does not change the nature of the issue.

An international monetary system must deal with five main issues:

- How are exchange rates determined? They can be set by national authorities subject to an international agreement, they can be left to market forces, or they can managed with varying degrees of control.
- What currencies are used in international transactions? An agreement may favour one or more national currencies, there can be a world currency or there may be no agreed upon currency.
- How are disequilibria dealt with? There can be international mutual supports (as in the European Monetary System), possibly including an international lending agency (such as the IMF) or ad hoc support (like the swaps offered during the crisis by the US Fed and the ECB).
- What is the regime of capital movements? The principle may be that no restrictions be imposed, that countries can impose limits, with or without international authorisation. The current system sets the principle of free capital mobility but countries are relatively free to establish controls.
- What sanctions against countries that do not abide by their commitments? Currently, countries that do not honour their commitments are not eligible to IMF support and cannot vote in the IMF.

2. PREVIOUS EXPERIENCES

The problem has long been partly obfuscated by the use of metallic monies. If, for instance, all countries use gold coins (and bullion), importers can pay with their own coins, which are then minted (at a standard cost) in the importer's country. In short, trade – and financial flows – is simply done by "changing the face on the coin". The only requirement is that the quality of gold be guaranteed or easily verifiable, which was not always the case and was a source of problems in the "system". Things were in fact even more complicated because some countries used gold coins, other silver coins, some even both. This meant that the relative values of gold and silver be sufficiently similar and stable. That it was not always the case opened the way for Gresham to become a lasting celebrity. In fact, international disagreements on the relative values of gold and silver became a periodically-acute in international relations during the 19th century. The gold standard was meant to solve the issue. The system needed nothing more than using only gold and guaranteeing the content of coins.

But the gold standard was in its early stage when its mortal enemy came into the picture. The extraordinary powerful invention of paper money, which very slowly started to circulate alongside gold, called again for a system. Lacking understanding and imagination, policymakers sought to retain the gold standard that they had become accustomed to.

The gold exchange standard established that paper money was only a dematerialised representation of gold. The system required that each issuer of paper money guarantee the full exchange of its notes into gold. This, in turn, implied that notes be fully backed so that redemption – an interesting expression – was beyond doubt. Official gold reserves were just the other side of the coin – pun intended – of paper money. It soon transpired, however, that full backing was not really needed since only a small proportion of notes were being redeemed, at least in normal times. This was too good to be ignored and, by the late 19th century, full backing promptly became a historical relic as governments instructed their newly-created central banks to print more paper. Of course, less than full backing opened the door to recurrent crises of confidence, and therefore to the need for international agreements. There were many such agreements during the interwar periods, all of which failed.

The Bretton Woods agreement essentially aimed at replacing gold with the US dollar, the gold value of which the US authorities pledged to guarantee. Countries had to stock up dollars to guarantee their paper monies while the US had to stock up gold. It was still the same system, just a bit more complicated because it had two levels. It did not work any better because neither the dollar nor the other currencies were fully backed. Crises had to occur, and they did until the system collapsed. The IMF had been put in charge of surveillance, with the task of limiting asocial behaviour in the form of lavish paper money expansion, but sovereign countries cannot be prevented from being asocial.

The collapse of the Bretton Woods system forced a major intellectual effort. First came the recognition that monies do not have to be backed by gold, or the dollar, or anything. The realisation that paper monies only need to be backed by the trust of those who hold them represents the last step in this historical invention, a notion that it took mankind more than two centuries to grasp. In fact, it has not yet been universally grasped: recurrent calls for a "new Bretton Woods" or "a return to gold" betray the difficulty that many (often informed) people have to fully master this discovery. The second major implication is that there is no need for any system, but that social good behaviour is desirable. This idea is pursued below.

3. CURRENT STATE OF PLAY

The current non-system, as it is sometimes wrongly called, rests on several pillars.

First, monies are as good as their central banks. A central bank can make its money valuable by guaranteeing its purchasing power, which means keeping prices adequately stable. The logic is that the value of the currency is left to the appreciation of its holders, i.e. that the exchange rate floats freely.

Alternatively, a central bank can guarantee the value of its money by promising to exchange it freely into another (presumably valuable) currency. This second option means adopting a reasonably fixed exchange rate and requires holding a stock of reserves large enough to meet normal requests for redemption. Since no central bank is likely to ever fully back its money, for century-old reasons, this arrangement is prone to confidence crises.

The ability to adopt the first solution depends on the possibility of establishing a "good" central bank. In practice, this governance issued is solved by cutting the links with all those who have an interest in printing more money than is compatible with price stability. The likely culprits are governments – this is easier than raising taxes – and banks – they are part of the money printing machinery and share in the profits. Central bank independence, however, requires strong political institutions. In fact, the crisis has shown how fragile and subtle independence is. The Hungarian example is crude, others are more subtle. The current purchases of public debts by the Bank of England and the ECB are suggestive of the

many indirect ways in which cash-strapped governments can reduce the options left to central bankers.

Most countries are currently unable to reach a quality of governance sufficient to let their currencies rest on their central bank credibility. With different degrees of rigidity, they tie their currencies to other moneys. They need to accumulate reserves but, short of full backing, they are exposed to confidence crises. Since these crises can be devastating, and yet can *never* be *completely* ruled out, these countries need an insurance mechanism. This is where the old Bretton Woods system comes into play. It has left us with the IMF, an institution designed to provide emergency help when a confidence crisis hits a country's currency. This is a first reason why it is misleading to describe the current arrangement as a non-system.

The second reason why we do, in fact, have a system is that we have institutions devoted to promoting good social behaviour. Good social behaviour means that a country does not undermine other currencies, intentionally or not. Examples of asocial behaviour abound, of course. It is asocial to weaken one's currency to gain a competitive advantage in trade. It is also asocial to trigger a crisis of confidence that may have collateral impact on other currencies. Furthermore, countries whose currencies are being used as a peg by others are usually not asked permission to that effect, so they may feel that they have no responsibility toward their unwanted fellow travellers. Yet, when travellers happen to get lost together, good social behaviour – if not self-interest – calls for some concern toward everyone else's well-being. The IMF, which was initially designed to monitor compliance with the requirements of fixed-exchange rate commitments, has been tasked with conduction surveillance of its member countries. It often acts as an advisor to individual countries, but it is also required to evaluate potential asocial behavior. In addition, the WTO is in charge of preventing asocial use of trade, including through a tribunal.

4. CRITICISM OF THE CURRENT ARRANGEMENT

1. For those who like the neatness of fixed exchange rates, the current system is messy. Some countries let their currencies float freely, others tie them rigidly, most limit the degree of flexibility of their exchange rates as they see fit. This is why the arrangement is called a non-system. As noted above, however, the large variety of exchange rate regimes reflects the large variety of governance potentials and the relative stage of economic development. Like all freedoms, this freedom can be misused by some countries, but this is not a convincing argument for attempting to impose a single exchange rate regime on all countries. Indeed, some countries do well with a flexible exchange rate while others successfully fix their exchange rates.

2. The dominant role of the dollar is often seen at best as an exorbitant privilege and, at worst, as the proof that the current arrangement only serves the interests of the US. This view is deeply flawed. First, what does the exorbitant privilege bring about? It is usually associated with seigniorage, the fact that a central bank makes a profit by printing at almost no cost money that it then sells at face value. As the dollar is bought worldwide, the US Federal Reserve indeed reaps seigniorage revenues. Current estimates suggest that half of the dollars printed in the US are actually held outside of the US. This means that total "sales" of dollar paper amounts to some USD 450 billion, a huge amount, about 6.3 % of current US GDP. But note that these dollars have been sold over the many years since the end of World War I, which means an average of USD 7 billion per year, or 0.05 % of current US GDP per year. If the US wants to retain the international role for the dollar, there must be other reasons.

Among the other reasons, in addition to the undoubtedly important political and symbolic aspects, it is true that US firms, banks and citizens can carry out considerably more economic transactions without worrying about exchange rate risk. It is also true that the

US government can probably run up its debt further than most others, but this does not mean that there is no limit. We may find out about these limits in the not-too-distant future. If we do, we will discover how dangerous for the world it is to have the financial centre of the core of world finance misbehave.

3. Critics sometimes believe that the US political might is the reason for the dollar predominance. This is most unlikely because the pre-eminent role of the dollar is not institutional. In contrast to the Bretton Woods system, in the current "non-system" no one imposes the dollar on anyone else. Dollar holders are willing holders. They can, if they wish, hold other currencies. As argued in Section **Error! Reference source not found.**, there is currently no competition. The dollar dominates partly because of historical reasons ("it's here"), partly because it is a good enough currency to have seen off potential challengers.

4. Those who recognise the previous argument still consider that, even though the current system does not imply the dollar's dominance, it does not do anything to limit it. This view must establish, however, that the dollar dominance has a detrimental impact on the world economy. Seigniorage is certainly seen as unfair, but that does not imply that the dollar dominance exerts a negative impact on the rest of the world.

5. The importance and massive influence of US financial markets is sometimes associated with the dollar dominance. Coupled with the inherent instability of financial markets, this observation is meant to imply that reducing the role of the dollar would benefit the world and it would reduce the size and influence of financial markets. This view misses the point that the dollar dominates because the US houses the world's largest financial markets as much as the US financial markets make the dollar the dominant world currency. This (vicious or virtuous, a matter of judgment) circle stands to be broken if the US markets were particularly unstable, the result of poor regulation. We have had a taste of this possibility following the subprime crisis and the collapse of Lehman Brothers. The US authorities well know that they need to take remedial action if they want to preserve the pre-eminence of their financial markets and of their currency. Although the measures taken so far are not sufficient, they are generally more extensive and better thought through than those taken elsewhere, especially in the euro area where serious reform is still on the to-do list.

6. A related criticism is that the global imbalances represent a threat to the world economy. Some have argued that the combination of large current account disequilibria and of exchange rate misalignments lie at the root of the crisis. This view is held by a dwindling minority of economists. Similarly, the view that the dollar status makes it possible for the US to operate large deficits is, at best, a conjecture. Equally plausible is the view that the rest of the world acquires US assets because of the depth and breadth of US financial markets.

7. In the end, the serious criticism is that the dollar dominance implies that instability of US monetary policy may have detrimental effects, as was made clear by the very recent debate on QE2. This imposes a responsibility on the US monetary authorities, and they mostly reject it. "Our currency, your problem" is the most severe indictment against the current situation.

5. ABSENCE OF ANY ALTERNATIVE

The current system is the outcome of the 1971 collapse of the Bretton Woods system when the absence of any available alternative left the world with no agreement on any of the five issues indicated at the beginning of this note and re-examined below. Exactly forty years later, the situation has not changed. Debates have never stopped and proposals have been regularly made, but there does not seem to be any appealing blueprint.

1. Section 4. explains why different countries have different preferences regarding their exchange rate regimes and why this is perfectly logical. There is no scope for an international agreement to a single regime.

2. The dollar is the international currency by default. Its role is up to challenge. The euro has made modest gains over the role of the Deutsche Mark. Its financial market instruments – in particular marketable sovereign debt instruments – amount to about one sixth of Treasury marketable debt. The situation would change radically should there be an agreement to issue a "European debt" as is currently debated. In the long run, the Chinese RMB stands to challenge the dollar, but this is likely to take a long time, a matter of decades, not years. Indeed, China must first liberalise its internal financial market (e.g. most banks are state-owned) and allow capital to move freely in and out of the country.

There are frequent suggestions that the IMF's Special Drawing Rights (SDRs) could see their role expanded. These suggestions miss the fact that the SDRs are not a currency. A currency circulates among users and is used to make transactions. The more people use it, the more "important" it is. SDRs are exclusively used among the 187 central banks that are members of the IMF. For the SDR to become a currency, the IMF would have to become a central bank, with the exclusive right to issue SDRs and SDRs would have to be usable by private parties. Setting up a world central bank is entirely possible and its currency could earn a major role. However, considering how difficult it has been to create the ECB – while retaining national central banks – should alert us of the magnitude of that challenge.

3. The most important surviving element of the Bretton Woods system is the IMF, whose role is to provide support to countries that face external difficulties. The mode of intervention of the IMF has been criticised, often for good reasons, but this should not conceal its unique capacities. The IMF can and should be improved – its governance is now slowly evolving – but it does not have to be reinvented.

4. During the 1990s, pressed by its largest shareholders, the IMF sought to ban capital controls. Chastised by the Asian crisis of 1997-98, the IMF now admits and occasionally even supports the use of capital controls. In recent months, for instance, several emerging market countries (Brazil and some East Asian countries) have established or strengthened capital controls. Thus to the freedom of adopting particular regimes corresponds the freedom of imposing restrictions to capital mobility. Because such actions can be used to the detriment of other countries, some global surveillance is required. This is one task of the IMF.

5. The IMF has little available means to impose sanctions on countries that misbehave. Its power is strong only when countries need help and apply for support. Beyond that, the IMF oversees its member countries through the Article IV process. It makes recommendations and, with the country's approval, posts them on its website. Its influence is sizeable on small countries that are prone to requiring support; it is negligible with large countries.

6. NON-SYSTEMIC IMPROVEMENTS

While it is good to keep asking the same questions and to try to resolve problems that have been kept untreated so far, the current interest into a reform of the international monetary system could well distract policymakers from far more urgent and potentially issues. Given that there will be no "new global system", efforts can be more usefully expanded to improve the current "non-system".

The crisis is not the result of a poor global monetary system. However it has shown how poorly banks were regulated and ineffectual bank supervision was. More than three years after the onset of the crisis, few countries have put in place any relevant legislation and, where new laws/rules have been adopted, they are clearly insufficient. Basel 3 includes much of what is to be done, with the exception of still to be agreed upon measures to deal with banks deemed too big too fail. Yet, the process of translating Basel 3 into national law has not started in most countries.

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