Peterson Institute for International Economics

Policy Brief

NUMBER PB11-4 MAY 2011

The Outlook for International Monetary System Reform in 2011: A Preliminary Report Card

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Note: This policy brief has benefited from comments by C. Fred Bergsten, Steven R. Weisman, and John Williamson. None of them is responsible for what I have done with their comments.

Reform of the international monetary system was placed on the agenda of the Group of 20 (G-20) a year ago at the initiative of the incoming French leadership of the G-20. On November 4, 2011 in Cannes, France, the G-20 leaders will announce their conclusions and agreements after a year and half of intense dialogue and debate. This policy brief summarizes my preliminary rating of the expected results based on the evidence to date: a barely passing grade on substance but an A for effort. Neither final grade is locked in stone, however.

First, let's cover some preliminaries. The international monetary system is the set of obligations, rules, conventions, procedures, and institutions that shape the international economic and financial policies of governments in their interactions with other governments. The international monetary system is a subcomponent of the much larger international financial system, which is dominated by private-sector actors. The broader international financial system also has its rules, conventions, and institutions. It can be influenced, but not controlled, by governments and the formal arrangements of the international monetary system.

I applaud those who support a comprehensive review of all aspects of the international monetary system, rejecting magic-bullet approaches. The review is long overdue.

From this perspective, the links between the international monetary system and the global economic and financial crises of 2007 to 2011 are at best tenuous (Truman 2009a, 2010c). Thus, reforming the international monetary system by itself will have little impact on either crisis prevention or crisis management in the future. Therefore, (1) there is no pressing need to reform the international monetary system and (2) the system will, and should, continue to evolve as it has over the past four decades.

Nevertheless, I applaud the initiatives that have led to the current review of the international monetary system. I also applaud those who support a comprehensive review of all aspects of the system, rejecting magic-bullet approaches. The review is long overdue. The last review was conducted in the mid-1990s.[1]

1. In the wake of the Asian financial crisis some adjustments were made to what was then called the international financial architecture, such as the establishment of a set of international financial codes and standards and the

Another occurred about a decade before under the auspices of the G-10 countries. The most prominent effort was that of the Committee of Twenty (C-20) on Reform of the International Monetary System and Related Issues, which attempted to put the Bretton Woods international monetary system back together after its collapse in 1971. In the end, the C-20 sanctified floating exchange rates and made a number of other changes in the International Monetary Fund's Articles of Agreement that came into force in 1978. However, in the opinion of a substantial number of observers, the C-20 effort fell substantially short of a comprehensive reform of the international monetary system, which is one reason why the topic is a hardy perennial on the international economic policy agenda.

The current international monetary system reform discussion can be organized under five headings: (1) surveillance of the global economy and financial system, (2) international lender of last resort mechanisms, (3) capital flows and financial pressures, (4) the currency and reserve asset system, and (5) governance of the international monetary system. I use these five headings to provide an abbreviated, advance, preliminary report card on what we can expect in Cannes.

- Desirable reforms would receive an A whenever they are delivered and, in particular, if they are at least promised in Cannes.
- Feasible reforms would receive a B if delivered by the end of 2011.
- Unacceptable nonprogress by the end of the year would receive an F.

My expected end-of-year grading is based on the available evidence to date, which includes the communiqués of the G-20 ministers and governors, a slew of papers from the IMF staff and associated reactions and commentaries, discussions at the April 2011 meeting of the IMF's International Monetary and Financial Committee (IMFC), and numerous high- and lower-level seminars and conferences.

SURVEILLANCE OF THE GLOBAL ECONOMY AND FINANCIAL SYSTEM

With respect to surveillance and the associated issues of the adjustment of global macroeconomic imbalances, exchange rates, and financial stability, a desirable A-grade outcome of the discussions would embrace what I have advocated on IMF surveillance reform (Truman 2010e) and was implicitly endorsed by the Palais Royal Initiative (2011):

- IMF members would accept a formal obligation for ensuring the stability of the international monetary system—for global as well as national economic and financial stability—in addition to their current obligations focused on their own domestic and external economic and financial stability.
- Compliance by members with their expanded IMF obligations would be subject to ongoing reviews triggered by quantitative norms, in particular for the systemically important countries.
- Reviews of compliance by senior officials could potentially lead to consequences, teeth, or sanctions to give the surveillance traction.
- The strengthened surveillance would operate with enhanced accountability and transparency.

A feasible, B-grade outcome this year would be if the systemically important countries individually and collectively, broadly the G-20 and its members, (1) agreed that they have individual responsibility in their domestic economic and financial policies and performance for global economic and financial stability—a de facto obligation short of amending the IMF Articles of Agreement—and (2) coupled that agreement with an interim outcome from the G-20 framework for strong, sustainable, and balanced growth—the G-20 mutual assessment process—that included specific policy and performance commitments for which countries subsequently could be and would be held publicly accountable.

An unacceptable, F-grade outcome would be no further progress on surveillance and bland, soon-forgotten promises from the G-20 mutual assessment process.

Preliminary Rating. I expect that the results from Cannes will merit a barely passing grade. The G-20 should receive no credit for policy commitments that are either vacuous or even if concrete involve no follow-up on promises made. The results from Cannes may include some procedural progress encompassing the continuation of IMF spillover reports on how the policies and performance of the major economies affect other countries, a new multilateral surveillance report from the IMF, and marginal improvements in the transparency of the IMF's surveillance processes, for example, release of estimates of exchange rate overvaluation and undervaluation.

I am prepared to be surprised, but even these modest results are not assured. The principal reason why progress on surveillance will be limited is that there is not sufficient shared

creation of the G-20 finance ministers and central bank governors, but the basic outlines of the international monetary system were unchanged.

diagnosis of how to achieve global economic and financial stability and that lack of a shared diagnosis paralyzes the prospect for fundamental change.

INTERNATIONAL LENDER OF LAST RESORT MECHANISMS

International lender of last resort issues involve the conditional, but also the largely unconditional, provision of financial assistance to countries adversely affected by international financial crises, principally through the IMF.

A desirable A-grade outcome would include

1. agreement on a comprehensive prequalification approach to IMF lending that is applied to all countries as part of the Article IV review process;
2. agreement to provide the IMF with the capacity to allocate special drawing rights (SDR) temporarily in a systemic crisis;
3. establishment of a global stabilization mechanism through which the IMF can volunteer support to members under certain conditions;
4. establishment of a global swap network among central banks, linked to the IMF, and designed to support private financial institutions in a systemic liquidity crisis;
5. agreement that the IMF should borrow in the private international capital market to augment its financial resources in a crisis;[2] and
6. agreement on a robust framework of cooperation between the IMF and regional authorities on mutually supportive financial and surveillance activities.

A feasible B-grade outcome would include items (3) to (5) on this list—the global stabilization mechanism, the global swap network, and IMF borrowing in the private market.

An unacceptable, F-grade outcome would be to do nothing beyond the status quo, even recognizing the substantial, constructive evolution of IMF lending facilities over the past three years. I would mark down any agreement on arrangements between the IMF and regional groups, which may be likely, because those arrangements are likely not to live up to the comprehensive standard for such arrangements proposed by C. Randall Henning (2011) and to suffer from the deficiency described by Morris Goldstein (2011) in that they would envisage that the IMF would be the junior financial partner and, therefore, the junior substantive partner in such arrangements, undercutting IMF conditionality and leaving those countries that are not members of a regional group short of needed financing.

Preliminary Rating. I expect that the results from Cannes will deserve a grade of F. The reason is that, on the one hand, many countries continue to attach stigma to borrowing from the IMF, which leads them to downplay IMF-centered solutions, and on the other hand, many potential official lenders to and through the IMF are sufficiently concerned about moral hazard considerations that they will block further progress.

With respect to a global swap network among central banks linked to the IMF, the major central banks appear to be resistant to any arrangement that would impinge on their independence and to be allergic to any link between their so-called monetary operations and IMF decision-making. Their cry is leave it to the central bankers meeting at the Bank for International Settlements (BIS). They seem to be repeating the opposition to the IMF from central bankers when the IMF was founded in 1944 in the wake of the central bankers' dismal performance on international monetary cooperation before and during the Great Depression. Moreover, it is not clear why their respective national public opinions would be more supportive of arrangements involving the BIS over ones that involve the IMF as well.

CAPITAL FLOWS AND FINANCIAL PRESSURES

The management of international capital flows and associated issues of pressures on currencies and financial systems have reemerged on the international monetary system agenda. I say reemerged because the volatility of capital flows was on the agenda at Bretton Woods and also during the C-20 discussions.

With respect to the receipt and delivery of capital flows, a desirable A-grade outcome would be agreement to amend the IMF articles along the lines that I envisaged a year ago (Truman 2010a). Such an amendment would

1. establish the long-term objective of complete freedom of capital movements without an explicit timetable for doing so;
2. provide a guide for national policies in terms of the rights and responsibilities of both source and recipient countries, and
3. position the IMF staff and management to monitor compliance along the lines of my proposals for IMF surveillance reform (Truman 2010e).

2. I have elaborated on these five items in Truman (2010b, 2010d).

A feasible, B-grade outcome would build on the considerable progress that has been made over the past year in establishing a consensus on these contentious issues and include a broader shared understanding of the so-called push factors (Truman 2011). Whether such progress is embodied in a framework, code of conduct, or "coherent conclusions for the management of capital flows drawing on country experience," in the language of the April 15, 2011 G-20 communiqué, is not important. At this point, substance should dominate form.

An unacceptable F-grade outcome would roll back to the status quo ante of 2009—a free-for-all in which there is no shared framework for multilateral dialogue on these issues.

Preliminary Rating. I expect a B-grade outcome on this topic. Although some countries are jealously guarding their room to maneuver (aka national sovereignty) to impose restrictions on capital flows, the authorities in those countries know that nothing that is currently on the table in a B-grade outcome would fundamentally hinder them, unless they are hypersensitive to criticism that would occur even without a framework. They also know that if they are to gain greater scope to examine and criticize the policies they see as promoting capital movements, there must be a quid pro quo.

THE CURRENCY AND RESERVE ASSET SYSTEM

Some observers argue that the central problem with the international monetary system is that it is centered on a few reserve currencies that make up international reserves. Some would say a single currency: the US dollar. The strong version of this critique is patently false in my view (Truman 2009b).

From my perspective, with respect to the currency and reserve asset system, a desirable A-grade outcome would be

1. broad acceptance of the inevitable further evolution toward a multi-currency system;
2. broad acceptance also that the level and composition of the reserve assets are largely demand determined;
3. abandoning, after a full discussion as is under way in 2011, (a) creation a new outside international money based on the SDR, (b) official promotion of the private use of the SDR, and (c) specious arguments in favor of creating additional so-called safe assets, including via an IMF substitution account (of national currencies for SDR), which would offer highly perverse international adjustment incentives; and
4. agreement on regular, sizeable, annual SDR allocations that are firmly coupled with rigorous surveillance over reserve accumulation and associated incentives and disincentives (Truman 2010e, Palais Royal Initiative 2011).[3]

A feasible B-grade outcome would include (a) the first three items on the A-grade list, (b) a cosmetic agreement that the SDR basket should expand as other currencies qualify essentially on current terms, which are that the currency be extensively used in international trade and financial transactions, implying substantial capital account convertibility and exchange rate flexibility, and (c) endorsement of IMF borrowing in the private market but only to meet its liquidity needs, not to promote the private use of the SDR.

The resignation of Dominique Strauss-Kahn as managing director of the IMF has placed the governance issue on the agenda with high priority.

An unacceptable, F-grade outcome would involve only an agreement to continue to spin more wheels toward the objectives of creating a new outside international money, encouraging the private use of the SDR, and creating additional safe assets.

Preliminary Rating. I expect something short of a B-grade outcome from the G-20 leaders in Cannes: implicit acceptance of (1) and (2), agreement to study some or all of the elements of (3), and something on the composition of the SDR basket in terms of the path to its eventual enlargement that does alter the current trajectory.

GOVERNANCE OF THE INTERNATIONAL MONETARY SYSTEM

Governance of the international monetary system in the form of governance of the IMF, as the principal international organization responsible for the international monetary system, is not explicitly on the agenda of the G-20 leaders. The topic has been extensively discussed in recent years. Considerable progress has been made in some dimensions, in particular agreements on the future redistribution of IMF executive board chairs and voting shares. Two issues have not been resolved: the management selection process and the possible establishment of a ministerial-level body with explicit powers, replacing the IMFC, which formally

3. Palais Royal Initiative (2011) contains some proposals on the SDR with which I do not agree, but it also endorses the use of SDR allocations as a carrot and a stick in the international monetary system.

is only advisory. The resignation of Dominique Strauss-Kahn as managing director of the IMF has placed the first issue on the agenda with high priority.[4]

A desirable, A-grade outcome on governance would include

1. an agreement to merge the IMFC with the G-20 ministers and governors and convert the resulting body into one with formal powers with selection of its membership based on the constituency system employed to choose members of the IMF executive board and the IMFC, and
2. selection of a new managing director of the IMF via an open process with both the process and the result broadly supported by most members of the IMF.

A feasible, B-grade outcome would include only the second item. On my criteria, I would not require that the new managing director not be European, as has been the custom in the past, nor that the United States formally commit not to nominate a US citizen to be the next president of the World Bank. If the managing director did come from Europe, what is important is the openness of the process that produces that result and that the individual command the broad support of the IMF's membership.

An unacceptable, F-grade outcome would be if the vast majority of the members of the European Union, based on precedent or the perceived immediate needs of the eurozone, insisted that the managing director come from Europe and that view prevailed.

Preliminary Rating. I expect something close to a B-grade outcome.

BOTTOM LINE

In summary, based on the evidence to date, I expect that by the end of 2011, after a year and a half of consideration of reform of the international monetary system, the result will produce a barely passing grade on substance, below B on the inflated scale of grades today, but an A for effort. As long as the process achieves the A for effort via a thorough examination of the full range of reform issues, which will inform subsequent discussions, the shortfall on substance is not crucial, and I would welcome being proved wrong on substance. More would be desirable, but the international monetary system will continue to evolve.

4. The resignation, though not the surrounding drama, was not a surprise because Strauss-Kahn was expected to return to France to run for president.

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