Three Evolutionary Proposals for Reform of the International Monetary System

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It is an honor and special personal pleasure to participate in this conference in memory of Tommaso Padoa-Schioppa.

On multiple occasions over three and a half decades and with increasing effect, my life was touched by Tommaso Padoa-Schioppa. We first met when he was a visitor in the Division of International Finance at the Federal Reserve Board in the mid-1970s. A few years later, I was first treated to his insightful comments during meetings of Working Party Three at the Organization for Economic Cooperation and Development (OECD), which continued for years. As the Italian G-7 deputy in the 1990s, he was an active and imaginative collaborator in shaping short-term and long-term responses to the crises of that period. As chairman of the Basel Committee on Banking Supervision and Regulation, he coaxed and cajoled that group to agree to compile the Core Principles for Effective Banking Supervision, which was something that we at the Federal Reserve favored. As "Mr. Euro," while on the executive board of the European Central Bank in September 2000, he worked closely with us at the US Treasury on the first coordinated intervention in euro.[1] As a member of the advisory board of the Peterson Institute for International Economics, he graciously spoke at a conference on International

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[1] At the Peterson Institute for International Economics, Tommaso was known by the more all-encompassing title of Foreign Minister of the European Central Bank.

Monetary Fund (IMF) reform that I organized in September 2005. Finally, Michel Camdessus, Alexandre Lamfalussy, and Tommaso invited me to participate in his final project: the Palais-Royal Initiative (2011) on Reform of the International Monetary System. Pietro Catte (2011) is right: The report "both in its analysis and its proposals bear the unmistakable mark of his intellectual contribution." We were all very conscious that he was watching over us as we completed that report.

I did not share Tommaso's view that flaws in the international monetary system were a principal source of the global economic and financial crises of the past four years, or that the international role of the US dollar and a lack of discipline on US macroeconomic policies were major manifestations of those flaws.[2] However, Tommaso would say, "Let's start from where we are in agreement,"[3] and Tommaso and I agreed on three important points: the international monetary system can be improved; doing so requires a comprehensive vision; and macro-economic discipline is central to its improvement.[4]

In the balance of my remarks, I address three interrelated steps through which the international monetary system can and should be improved: surveillance, adjustment and reserve accumulation, and an institutionalized global swap network. These steps would not take us all the way to a comprehensive vision, but they are a doable evolution of the system. I am quite confident that Tommaso would favor the first two steps. I am less confident about the third, but two out of three is not bad.

Surveillance

Although Tommaso and I did not share the same starting points in discussions within the Palais-Royal Initiative group, he implicitly challenged me to think about a constructive approach to our common concerns about surveillance and policy cooperation. Consequently, at a conference in Paris on

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[2] On the last point, I argued with him that the US dollar's position today is far from unique. We already are living in a multicurrency world. At least four other advanced countries have sizeable multi-year current account deficits on which the markets have exerted no adjustment pressures: Australia, Canada, New Zealand, and the United Kingdom.

[3] Bini Smaghi (2011) recalled a similar statement: "If people are willing to discuss issues in a rational way and in good faith, I am confident a solution can be found."

[4] On macro-economic discipline, Tommaso (2010) writing about the flaws in the international monetary order, stated, "The fundamental flaw in that 'order' . . . lay in its failure to meet the global economy's vital need to be grounded in a degree of macro-economic discipline." I agree.

December 11, 2010 I suggested a framework for reforming IMF surveillance. Speaking after me, a week before his untimely death, Tommaso indicated that there might be something useful in what I had outlined. His comment encouraged me to write up my thoughts before the end of the year (Truman 2010b).

For Tommaso, talk was important, but strong institutions are essential. Bini Smaghi (2011) implicitly quoted Tommaso quoting Jean Monnet, “Nothing is possible without humans, but nothing is lasting without institutions.” The IMF is the central institution of international monetary cooperation. For Tommaso (Padoa-Schioppa 2006, 513), the key word for the IMF was “stability.”

Global stability has been distinctly absent in recent years in part because it requires a sharing of sovereignty. As Tommaso (Padoa-Schioppa 2006, 515) noted the ironic tragedy is that in recent years “one trend is a significant erosion of the reality of sovereignty” combined with the “hardening of the ideology of sovereignty, a growing nationalism, and a decline in the acceptance that sovereignty has to be shared.”

The principal missing element in the framework of IMF surveillance over the international monetary system today is a shared commitment to global economic growth and financial stability. My preferred starting point to approach this problem would be to amend the IMF Articles of Agreement to incorporate a formal obligation on each member to direct its policies toward this objective. The Articles today contain no such obligation; the only obligations are for a member to direct its policies at its own internal and external stability. However, for the moment, my preferred approach is not in the cards.

All is not lost! In Cannes, the G-20 expressed their recognition of the need for the better integration of bilateral and multilateral IMF surveillance via a new decision on surveillance—as

called for in the recent IMF triennial surveillance review.[5] However, mere recognition that the present IMF surveillance framework is inadequate is not enough. The G-20 leaders must throw the full weight of their countries in support of a robust and comprehensive decision to create the strongest possible presumption, if not an obligation, that the policies of countries should be directed at global economic and financial stability as well as their own domestic and external stability. They also should empower the IMF management and staff to call any country to account if they judge that country has not lived up to the established presumption.

On implementation, the IMF in its multilateral surveillance and the G-20 under the MAP should move toward the use of a broader set of norms for use in the assessment of all aspects of members' policies and performance, as I advocated in my comprehensive proposal for strengthening IMF surveillance (Truman 2010b). In my view surveillance norms should trigger closer examination of whether countries are living up to their obligations. Those norms should cover the full range of each country's policies and performance including current accounts, inflation rates, fiscal positions, reserves, and exchange rates. The G-20's MAP now fails to meet this test of transparent completeness. To outsiders, the MAP is a non-transparent black box. It generated very thin gruel in the Cannes Action Plan for Growth and Jobs. The number of new quantified commitments is zero.

In summary, the balance in IMF surveillance must be shifted away from discretion and toward rules. In Paris on December 11, 2010, Tommaso said the system cannot be based on

[5] The trilateral surveillance review (IMF 2011c) recommended "an integrated and balanced approach to global economic and financial stability" via an amendment to the IMF Articles or an "integrated surveillance decision governing both bilateral and multilateral surveillance activities."

rules alone. What is needed is a better balance between rules and discretion. He added that, in the exercise of discretion, international institutions are important because they help to intermediate political forces.

Adjustment and Reserve Accumulation

As noted earlier, I did not share Tommaso's diagnosis that the role of the dollar is the central problem in the international monetary system today. On the other hand, I was intrigued, as many others have been, by his airplane and flight analogy, "we can conclusively prove that we need a flying object; inventing an airplane is another matter" (Padoa-Schioppa 2010). In this spirit, the single largest distortion in the global economic and financial system today is global imbalances that are associated with the outsized increases in international reserves of a growing number of countries.

To address this problem, on an experimental basis, I favor annual Special Drawing Rights (SDR) allocations of, say, $200 billion per year for the next five years—a total of $1 trillion. The experiment should track whether such an approach significantly reduces the demand by countries to build their non-SDR international reserves and is associated with substantially reduced current account surpluses.

This would be a low-cost and low-maintenance experiment. In the present global economic and financial environment, I see little danger. The SDR mechanism provides countries with low-cost potential access to international credit. Access to such international credit is restricted. Should such access be used on a large scale, the chances of feeding an acceleration of inflation in the advanced countries are minimal and the net effects on the global economy would almost certainly be positive.

As an integral part of this proposal, and building on what I have proposed about increasing the role of norms on policies and performance in IMF surveillance, presumptive norms should be established for the level and rate of growth of countries' reserves. As a starting point, no country's international reserves should exceed, say, 25 percent of its three-year average level of GDP. In addition, once a country's reserves have reached that level, the presumption should be that no country's international reserves should increase annually by more than, say, 10 percent of its three-year average GDP. Countries exporting substantial amounts of non-renewable resources could be exempted from these presumptions, but only on the basis of a decision by the IMF executive board and increased disclosure about their investments.

After five years, if the results of my proposed experiment are positive in terms of reduced global imbalances and lower rates of accumulation of non-SDR reserves, the program should be continued, and the Articles should be amended to redistribute SDR allocations away from members whose rates of reserve accumulation violate the agreed norms toward other members, thereby introducing some incentives into the system.

An Institutionalized Global Swap Network

The international monetary system needs better tools to deal with threats to the globalized financial system. If the option of returning to comprehensive capital controls and other forms of financial repression is rejected, as I think it should be, the need for new tools becomes more pressing. The dominant lesson from the financial crises of the past four years is that the world is more financially integrated than anyone imagined two decades ago. The recent IMF spillover

reports clearly demonstrated the importance of financial linkages relative to real linkages, and they underscored the relevance of access to global liquidity.

The phenomenon of global liquidity is poorly understood as we noted in the Palais-Royal Initiative. An excellent report by a group of central bankers chaired by Jean-Pierre Landau was recently released by the Committee on the Global Financial System (CGFS 2011).[6] The Landau Report substantially clarifies the concepts, measurement, and policy implications of global liquidity. The Report distinguishes between private liquidity, which is primarily a concept associated with market conditions, and official liquidity, which is primarily associated with quantities and the ability of institutions to finance their operations and, in turn, support market liquidity.

The Landau Group addressed policy implications by sketching out three lines of defense: regulatory frameworks, domestic policies, and cooperative multilateral measures. Unfortunately, the recommendations are progressively vaguer with each line of defense. On cooperative, multilateral measures, the report recommends the status quo. I disagree. What we need is an institutionalized global swap network.[7]

Some of my former central banker colleagues prefer constructive ambiguity. They argue that permanent arrangements contribute to moral hazard behavior on the part of governments and private sector banks. My view is that the crises over the past four years have demonstrated

[6] The Landau Group's report responded to suggestion 9 in the Palais-Royal Initiative (2011, 11): "The IMF and the BIS should work together toward a shared analytical approach for better measurement and surveillance of global liquidity." The central bankers apparently chose not to acknowledge formally that the report of the Palais-Royal Initiative had predated the establishment of the Landau Group.

[7] More elaborate schemes have been put forward. In Truman (2008 and 2010a), I proposed a system of SDR swaps between the IMF and the central banks that issue international currencies with the IMF loaning the currencies to other central banks to support their financial institutions. See Farhi, Gourinchas, and Rey (2011), Obstfeld (2011), and Prasad (2011) for even more elaborate variations on this theme. In the present circumstances, simplicity is a virtue.

conclusively the high costs of such ambiguity. Central banks responded eventually but only after a great deal of economic and financial damage had been done. I agree with Obstfeld (2011) that predictability adds to stability and with his citation of the views of Richard Cooper (1969), writing in a different era, on the interplay between international monetary cooperation and the demand for international liquidity in the form of owned reserves.[8]

A second argument heard from central bankers is that they need to protect their independence and do not want to be drawn into external entanglements. The appropriate response is that in crisis situations, the central banks will have no choice and should prepare in advance as part of their own crisis prevention activities.

Central bankers also argue that they do not want to be commanded by the IMF to engage in lending to other central banks because it is an institution largely dominated by finance ministries and, therefore, inherently more political. Here we have unhealthy institutional rivalry.

Bini Smaghi (2011, 9) quotes Tommaso on this theme "independence [of central banks] should not mean institutional loneliness." Later in his essay (Bini Smaghi 2011, 12) he describes Tommaso's view of central banks "as complex and multifaceted institutions pursuing the public good along several interconnected paths." These comments give me some confidence that Tommaso would not reject out of hand my advocacy of an institutionalized global swap network.

Aside from the demonstrated objective need, I see the situation as follows.

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[8] The Obstfeld quotation from Cooper (1999, 600) is:

> The degree of . . . international cooperation . . . influences the amount of liquidity needed to finance imbalances in the face of temporarily divergent and conflicting national policies. The more cooperation, the more carefully coordinated national policies are in timing and nature, the lower the need for international liquidity to finance imbalances.

First, when a multilateral organization, such as the IMF, declares that the global economic and financial situation demands global cooperative solutions, a national central bank gains credibility and protection in responding positively to that declaration.

Second, it is possible to establish a global swap network that has the capacity to meet the demonstrated need and at the same time meet the concerns of central bankers. The global swap network could have three keys to unlock it.

The first key would be held by the IMF. Based on objective criteria, the IMF would declare a need for global liquidity to support the international financial system and recommend that central banks consider providing liquidity to private financial institutions in other countries via their central banks.

The potential recipient central banks should be limited to those of countries in the top tier of the comprehensive pre-qualification framework that I have proposed should be applied, as part of the Article IV review process, to all IMF members that potentially may need to borrow from the IMF, in other words to countries that potentially qualify for a flexible credit line (FCL). In time, this framework might be extended to countries that potentially qualify for a precautionary and liquidity line (PLL).[9] See Truman (2010a) for more details.[10]

The criteria employed by the IMF should be objective and linked to generalized global conditions, not country-specific circumstances, associated with heightened stress events. The

[9] Note that it is an open question whether either the United States or any of the countries in the euro area would qualify for an FCL today. This does not prevent their central banks from engaging in swap arrangements.

[10] My proposal for comprehensive prequalification implicitly values the virtue of addressing the stigma issue associated with borrowing from the IMF more highly than preserving the IMF's role as a confidential trusted advisor. In today's world, keeping good advice confidential is of questionable benefit. I am not concerned with turning the IMF into a rating agency as some argue.

thoughtful discussions in recent IMF documents (2011a, 2011b, and 2011d) provide a good start for the development of such criteria.

The second key would be held by the group of central banks that had previously established the global swap network. Participation in the global swap network would be pre-determined by the central banks based, for example, on the independence of the central banks and assessments of the stability of their financial systems. The central banks would meet and, using their own criteria, would agree or not with the IMF that there was a global need for liquidity that could and should be met by activating the network. The criteria used by the central bankers should be transparent, but they might differ from those used by the IMF. For example, they might give greater emphasis to financial conditions and the risk of global inflation.

The third key would be held by each individual central bank (or pair of central banks) deciding to respond to the decisions of the IMF and the central banks as a group with a specific swap operation or sequence of operations. Importantly, no central bank would be required to activate the third key, and central banks would retain the capacity to enter into swap agreements outside of the three-key framework.

Would national central banks come under pressure to use their third key? Certainly, but those pressures are there already. A structured approach, such as the one I have outlined, would establish the global context for activation of the global swap network and identify those countries that are most deserving of assistance.

In conclusion, I return to the words of Tommaso Padoa-Schioppa (2006, 516). Describing the decline in leadership, which has become more acute in the subsequent six years, he said,

"When there is a decline in leadership, it is precisely because there is a decline in the readiness to give by those who lead." He also (page 518) issued a warning: "To the sirens singing the song of complacency, I would answer that we are in a situation in which the incubation of instability is extremely slow, but the instability that may eventually erupt is extremely large."

We need leadership on reform of the international monetary system, and therefore we miss Tommaso Padoa-Schioppa. The potential adverse consequences of continued glacial action are serious. In the spirit of Tommaso's enlightened pragmatism, I have outlined three proposals for the evolution of the international monetary system.

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