Toward a new International Monetary System

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Excellencies,

Ladies and Gentlemen,

Let me welcome you again this morning to this most timely and important conference and express my gratitude to the Guanghua School of Management, the ESSEC and the French Center for Studies on the Contemporaneous China for inviting me to open our reflexions around the critical question: is a new international monetary system feasible?

A most pertinent question, indeed! To which -let me be blunt- for fifteen years, the answer of the international community or at least of those who, more and more, pretended to speak on its behalf, was plainly negative. But things are dramatically changing. With the crises, the world has remembered that the Special Drawing Right (SDR) could be a useful instrument to face an almost universal liquidity squeeze; the G20 has initiated an impressive work to address the major flaws in the system, its regulation and machinery and, last but not least, the People's Bank of China, now one of the most prominent monetary institutions of the world, has proposed, through a recent declaration of Governor Zhou, a very important analysis and several suggestions about not only the needed reform of the international monetary system but also, and I quote: "*the kind of international reserve currency we need to secure global financial stability and facilitate world economic growth*".

This is not an easy issue to comment on.

But this is not a time neither for hesitations for all past or present actors to contribute to the debate. So, speaking on my personal capacity, I will try to provide you -this is the privilege of seniority- with some historical background on almost fifty years of attempts and failures at reforming the international monetary system and creating a central reserve currency. This will bring me to evaluate our new context and to formulate a few suggestions about possible steps for an orderly transition toward a resilient international monetary system of which a new SDR could be a central instrument.

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I - <u>50 years of attempts and failures for a basic reform</u>

Back to history first. Perseverance in efforts to reform the system and permanence in failures speak volumes about the importance but also the difficulty of this issue. A glimpse at the episodes of the last four decades of the last century provides nevertheless a few useful lessons.

Let me start by what was the contribution of my country to the discussions of the 60s. It is well known that the General de Gaulle took the initiative of denouncing what he called “the exorbitant privilege of the dollar”. This declaration had the merit of eliminating a major taboo from the international debates and its eloquence provided a remarkable eyes-opener to the international community. With the benefit of the passing of time, I would, nevertheless, recognize that this formula was a little bit too strong as it implicitly ignored the service the US were providing the world by issuing the needed universally accepted currency. It would be fair to admit also that this language contributed to unduly politicize a problem complicated enough in its technical dimensions.

Second remark and second great figure! The country issuing the reserve currencies - the USA- was in no way able to overcome the Triffin dilemma confronting them, namely to achieve their domestic monetary policy goals and to meet adequately other countries’ demand for reserve currencies. Relying essentially on the US, the world was, and still is, permanently exposed to situations of excess or scarcity of reserve assets.

Third, I see it as important to remember, contrary to a frequent misperception, that, already in the sixties, and the same was obvious at the time of the Committee of 20 in 1974 and at the end of the seventies, during the discussions of what was at that time the G 5, the US, before ending their support to the idea of a substitution account, contributed positively to the debate on the diversification of reserve currencies and, at least, implicitly recognized the misgivings for the world, including themselves, of the twin responsibility of a domestic monetary policy and of the provision of an adequate world liquidity.

This implicit recognition came as a surprise when in July 1965, the new Secretary of the US Treasury, Henry Fowler, launched the idea of an international conference aimed at improving the international monetary arrangements. Soon after, the Ministers of the Group of Ten were authorized to undertake “contingency planning” to “ensure that the future reserve needs are adequately met”: typically a language we could find today -and if it is not there- which should be introduced in the next communiqué of the G 20 in 2010! Unfortunately, all the subsequent international negotiation at that time didn’t achieved this objective. They only left us with a lesson of the highest importance, namely that if we are to work efficiently to build a new international monetary order, we must start from the recognition by all, including the US, of the importance -now more than ever- of a stronger international monetary system, properly secured by a universally accepted international reserve currency. Only this common recognition will allow each of the key actors -including the US- to renounce at least partially to the prevalence of their national preference stemming from their sovereignty, so allowing to sufficiently softening the iron constraints of the Mundell triangle of incompatibilities[1].

Fourth remark, it is clear that, if we are to succeed today -40 or 50 years too late-, we must be really mindful of what were the obstacles which finally prevented the international community to succeed on what should have been a fundamental reform, namely the politicization and the burden sharing of the exchange risk guarantee of a substitution mechanism.

As a matter of fact, these debates ended up with the creation of the SDR in 1969 to supplement the stock of official reserves, and the member countries of the IMF adopted the undertaking of the art. VIII-7 of the Articles of Agreement to make it the main asset of reserve of the international monetary system[2]. An undertaking they seem to have lost sight of soon after.

Clearly, the initial allocation of SDR 9,3 billion and the second allocation of SDR 12,1 billion which took place from 1979 to 1981, in the context of the second oil shock, contributed poorly to this objective. All subsequent efforts were paralyzed by several hurdles.

What were these hurdles? I have already mentioned the excessive politicization of the debates but there was more.

Not the least was the fact that the intensity of the earlier debates multiplied the a-priories and the mutual suspicions between the proponents of further allocations or changes in the features of the SDR, and the less convinced central banks and governments warning about potential inflationary effect and relaxation of the adjustment efforts. The unfortunate initiatives orchestrated by the UNCTAD to establish a link between the SDR and the development aid ended up also by exacerbating the antagonisms, while the debatable central concept of the “long term global need of liquidity” which had to be recognized by 85 % of the membership to allow an allocation was making almost impossible an agreement, as, even in front of severe liquidity problems, their long term character could always be challenged.

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[1] It is reminded that in a world of sovereign countries, there exists an incompatibility between three -normally desirable features- : a stable financial system, a real financial integration, and the prevalence of sovereign preferences.

[2] This article is worth recalling: “Each member undertakes to collaborate with the Fund and with other members in order to ensure that the policies of the member with respect to reserve assets shall be consistent with the objectives of promoting better international surveillance of international liquidity and making the SDR the principal reserve asset in the international monetary system” (art. VIII, sect. 7).

This created a frustrating situation for almost the two-third of the membership and of course for the Managing Director of the International Monetary Fund. At least, an "equity allocation" was decided in 1997 to provide with SDRs the 38 members countries (mainly from the Eastern countries of Europe joining the IMF in the 90s), but even this modest allocation of 21 billion SDRs had to wait till last September to be ratified. We were not able to gather the necessary support to alleviate the plight of the roughly one-third of developing countries and countries in transition that had an average reserve holding equivalent to less than eight weeks of imports -well below the three months of import coverage often considered reasonable as a rule of thumb. Indeed, many of these countries' reserve holdings were below that level. Many of these countries were pursuing strong reform programs supported by the Fund. However, to increase their reserve holdings beyond their current levels would have required either expensive borrowing in the market -to which many countries did not have access- or a compression in domestic demand, imports and growth prospects that would have been detrimental to their progress. I really believe that the Fund's shareholders, at that time, would have served the world better in adopting a more pragmatic attitude. This was not the case and the debates culminated during the Interim Committee meeting of October 1994 in Madrid when, after half a night of bitter debates, the proposal of the G7 of a modest allocation of SDR was judged insufficient and rejected[1].

The problem was that the exceedingly conceptual character of the debate around "the long term global need" blurred the perception of at least two dangerous consequences of the disorderly provision of world liquidity:

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1 This was interpreted by many as the end of the SDR. Wrongly! Of course for several years, the matter was a new "taboo" in the Executive Board of the IMF, but what I have called the Wallich principle, namely its potential usefulness for very unexpected situation, continued to be true, at least for a brief episode end of 1998.

As you may recall, beginning of October 1998, we were not far from a situation of a liquidity crunch following the LTCM catastrophe and the ominous situation in the New York market. These developments adding to the problems in Latin America and Russia could have been the kind of dramatic situation for which a lender of last resort must step in. The IMF would have done that but, in view of the tightness of its own liquidity situation at that time, the easiest approach for it would have been to consider a very substantial SDR allocation. Not 30, 50 or 60 billion, but perhaps 150 or 200 billion SDRs, to be allocated through a Fund-administered. I remember to have exchanged notes during a very gloomy meeting of the G7 in Washington, with the Deputy Secretary of the US, about the potential amount of this allocation. We weren't far away from an agreement. In the event, thanks to the wisdom of key central banks timely reducing interest rates, thanks to the fact that the IMF was able to announce rapidly a program that was successful in Brazil, and thanks to the first good news we had from Asia, the liquidity crunch subsided. I don't know if the staff of the Treasury Department of the IMF was remembering this episode when the present $ 251 billion allocation has been proposed, but I, for one, was not at all surprised by this decision.

1) The permissive conditions this was creating for the accumulation of huge balance of payments deficits in the US, and of sizable reserves in surplus countries, frequently disproportionate with their own needs;
2) The growing risk of sudden disruption of the value of the dollar due to a variety of potential causes, including national decisions on the currency composition of reserves.

The first of these consequences has clearly contributed, at least partly, to the present crisis due to the overabundant liquidities it has allowed, without any regulating institution empowered to protect the stability of the system. The world can no more accept the risk of the recurrence of a similar situation. As the global imbalances will stay with us over at least a few years more, shouldn't we try to get rid of this Damocles spade by giving high priority in the G20 agenda to the creation of an orderly mechanism of adaptation of the world liquidities to the changing global needs? The answer seems all the more positive as, de facto, a process of diversification of reserves has started under national initiatives[1], but nothing provides the assurances that it could continue at the desired pace and without disruptions.

All these reasons fully justify a bold reform of the international monetary system, and a deep reflection on how the SDR might help improve its functioning in the future. All the more as present, circumstances seem to open a remarkable window of opportunity.

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II - The 2010 window of opportunity

The present opportunities for launching a major reform are so obvious that I can be brief on that chapter. Let me mention three.

The crisis itself and the exceptional cooperation for ensuring that such a catastrophe doesn't repeat itself could suffice to create the proper climate for a bold undertaking. Many debates of the last decades have proved now -alas at a high cost- to be irrelevant. This seems to have been understood. With a remarkable pragmatism our leaders have adopted decisive steps to contain the most detrimental consequences of the crisis and to adopt the most comprehensive package of reforms of the world financial history. To address squarely the problem of the world reserve currency in parallel with the reform of

[1] It is noteworthy for instance to observe that in 2009, Russia has significantly increased its holdings of Euros while reducing its dollar reserves. In a similar vein, the recent purchase of 200 tones of IMF gold by India can be seen as an effort of diversification of its reserve assets. Other more discreet diversification initiatives can take place at any time…

the governance of the IMF must be part of this endeavor. The present momentum for cooperation and reform should help to avoid the hurdles of the past and to succeed.

This climate of cooperation and pragmatism has already led to the decision of allocating SDRs for the sizable amount of $ 250 billion. The size of the allocation is in itself a token of the readiness of the membership to give a new life to this instrument. This creates a golden occasion for its renovation. Add to it that several new suggestions are under consideration to ensure that the allocation serves effectively its purposes. I am happy to mention for instance that with the United Kingdom, my country has announced a joint proposal to each lend $ 2 billion of their SDRs to support IMF lending to low-income countries. Such initiatives, and I hope several other major countries may join in this effort, have the twin merit of contributing to alleviate the plight of the poorest countries, and also to develop the use of the SDR, exceedingly restricted so far.

In this context, the visionary remarks of Governor Zhou have contributed to a real sea change and are providing us with a particularly useful contribution. I don't need, I think, to offer you any summing up of his speech, as his ideas are very familiar to all of you. I would only underline his remarks about:

- the fact that the need to find a solution to the lack of an international reserve currency is more pressing than ever,
- the features of such an instrument, supplied flexibly enough to allow timely adjustment to the changing demand, disconnected from economic conditions and sovereign interest of any single country, offering "a stable value, rule-based issuance and manageable supply".

Clearly, if the G20 or the IMF governing body were to agree on this adaptation of the SDR, it could contribute in a major way "to achieve the objective of safeguarding global and financial stability".

This last objective is of a paramount importance. History would be unforgiving for the present generation of leaders of the world if they were to miss the present window of opportunity for agreeing on this instrument as a central piece of a comprehensive reform of the international monetary system. How could we, then, maximize its chances of success?

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III - Reforming the international monetary system

Even if a window of opportunity is open, obviously the task is immense and will require a very special spirit of cooperation all along the process. It will also require time and the appropriate timing of initiatives; the first ones could probably appear very modest, but if they are adopted with a clear vision of the expected end result, they could contribute to maintain the needed momentum to reach the basic objective. I would recommend to initiating this process of reform in three simultaneous and mutually reinforcing directions:

1. Developing a more important role for the SDR now;
2. Reexamining the potential usefulness and modalities of a substitution scheme to facilitate reserves diversification;
3. Promoting the needed changes in the governance of the International Monetary Fund.

1. Develop the role of the present SDR

This is an overdue initiative which should be developed in parallel with successive new allocations decided after if the world liquidity situation so requires.

One of the first steps giving a clear indication of the ambition of the reform, could consist in broadening the present basket of four currencies (US dollar, yen, euro, pound) to obviously the yuan, but also to the Indian, Brazilian and other major currencies. As suggested also by Governor Zhou, a road map could then be established:

- helping to go to an expanded use of the SDR beyond the official holders,
- transforming it in an accepted instrument of payment for international transactions,
- promoting in time the development of a private market,
- encouraging the renewed creation of financial assets denominated in SDRs,
- facilitating the determination of its value in that market and so enabling it to respond to the member country needs of reserve currencies and helping to prepare for the day when it could serve as an anchor for the system, and to become a full pledged world currency; in the same way as the ECU became the Euro, the SDR will then become the global reserve currency (GRE).

2. Addressing the need of a substitution scheme

A substitution scheme would be a very important instrument to help the off-market diversification of reserve holdings.

The bad memories of the abandonment of the project of a substitution scheme in 1980 shouldn't deter the authorities from revisiting this issue, remembering as a matter of fact how close they have been to an agreement in the earlier occasion. The key lesson of that unfortunate episode is that it is of a paramount importance to overcome the bone of contention of the distribution among members of the exchange risk which is inherent to such a scheme. Should the holders of dollar, should the US, should the IMF take this risk? At that time, a variety of solutions to find an acceptable system were proposed to, finally no avail. I ask myself if in view of the intrinsic difficulty of the problem, it would not be more expedient to adopt a fully multilateral approach by inviting the IMF, entrusted with enhanced responsibilities to monitor and promote the stability of the system and endowed with gold reserves and quotas, to accept to bear itself this risk, with the strong assurances of support from the membership -through appropriate pledges of quotas increases- if its own financial situation was endangered. Giving this responsibility to the IMF would be quite in line, with the strengthened role of surveillance it is invited to play in respect to key currencies. An even better system -but possibly more difficult to establish in the immediate future- would consist in shifting "to a system backed by real assets, such as a reserve pool" as suggested by Governor Zhou. I would personally recommend this solution as giving its full credibility to the new Fund to face these major responsibilities. I cannot agree more with Governor Jo when he suggests that "*entrusting part of the member countries reserves to the centralized management of the IMF will not only enhance the international community's ability to address the crisis and maintain the stability of the international monetary and financial system, but also significantly strengthen the role of the SDR*". Was not it, after all, the unprecedented bold approach of the founding fathers of the system in Bretton Woods as they intended to build up a brand new system?

All of this adds, of course, to the need of a major reform of the governance of the IMF.

3. The needed reform of the central institution of the system

Clearly among many other reasons, the need for ensuring the proper and orderly provision of liquidity to the system, together with the need for its strengthened surveillance, calls for a major reform of the IMF and of its capacity to regulate international liquidity. To advance it, many suggestions have been formulated so far and I would like to call your attention, in view of their comprehensiveness, to the set of proposals of the "Eminent Persons Group" appointed by the IMF's Managing Director, chaired by Mr. Trevor Manuel, the then Minister of Finance of South Africa, and of which I had the privilege to be a member together with Governor Zhou.

The Group was unanimously of the view that the IMF, thanks to its experience and the quality of its staff, must be entrusted with the task to steer this process of global monetary reform, continuing to be the machinery for collaboration to respond to the needs of the system during the next decades. The key reforms recommended to this effect are the following:

- The expansion of the Fund's surveillance mandate_beyond exchange rates to provide appropriate coverage of macroeconomic policies, prudential issues and financial spillover. The capital account would fall within the mandate[1];
- The activation of a very high political caliber Council made of ministers and governors, to provide a forum for coordination and to take the strategic decisions critical to global stability[2];
- An accelerated quota revision process, and an amendment to the Articles of Agreement that would eliminate appointed chairs, thereby allowing for the needed consolidation of chairs, including those of EU countries. This is critical to facilitate the rapid reconfiguration of the composition of the Council and the Executive Board to reflect current economic realities. And I am delighted that the Pittsburg G20 has already pledged a shift of at least 5% quota shares from the overrepresented countries to the less represented ones.

  These three first proposals are keys. Additional changes would contribute in a major way to the efficiency of the new Institution:

- The giving of most authority for conducting and completing member-specific surveillance to Fund management, together with strengthened accountability;
- The elevation of the Executive Board from day-to-day operational decisions to the role of giving advice on strategic issues to the Council, to delivering a critical supervisory function, including oversight and review of surveillance and responsibility, but with greater accountability, over lending and financial decisions;
- The lowering of the voting threshold on critical decisions from 85 percent to 70–75 percent -de facto eliminating any veto right- and consideration given to extending double majorities to a wider range of decisions, thus ensuring

1 This broadening of mandate was adopted unanimously by the then Interim Committee in Hong-Kong in 1997 but not implemented afterward.

2 The creation of this Council was decided On the occasion of the Jamaica Accord of 1976 but the date for its inauguration was left undecided.

that decisions affecting key aspects of the institution command the support of the majority of members; and

- The introduction of an open, transparent and merit-based system for the appointment of the Managing Director and Deputy Managing Directors.

For this reform to be a success, several other developments will certainly be of importance, for instance the pursuit of the present regional efforts for monetary cooperation such as Chen Maï. These initiatives shouldn't be seen as competing with a worldwide scheme but at the contrary, as contributing to its stabilization purposes. In the same vein, progress of the European countries in their efforts to speak on international monetary affair with a same voice would be a major contribution.

This being said let me end up by casting a few note of caution.

All these suggestions could appear relatively straightforward. Taken together they amount nevertheless to an ambitious program providing the system with the anchor and the institution it needs. This deep change will necessarily take time. The European experience with the creation of the Euro suggests a process very carefully phased out, making sure that every step is seen in the interest of each and every member country. This reform will be a long journey. This implies that for many years and possibly during all the next decade, the international monetary system could have to go through a transitory phase requiring a particularly careful handling. Success, nevertheless, implies that, from the outset, a critical mass of changes be introduced, taking full advantage of the present momentum.

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Now, Mr. Chairman, ladies and gentlemen, time has come to answer our question; is a new international monetary order feasible?

The answer is yes. And it is urgent. It is really difficult to imagine that a better window of opportunity could appear at a later moment. But the task will be huge. We will have to escape from the Triffin dilemma, to soften the Mundell iron triangle, and to square the circle of the substitution account guarantee. A dilemma, a triangle of incompatibilities, a circle to be squared. Huge task in no way amenable to quick fixes and calling for vision, determination and perseverance. Thank you to the founding fathers and to the People's Bank of China for inviting us to a visionary boldness! And now let's try hard to adopt the first steps of a reform so decisive to provide the world with sustainable perspectives of stability, development and peace.

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