

REFORMING THE INTERNATIONAL MONETARY SYSTEM¹

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ABSTRACT

This paper looks at the financial crisis from the point of view of global intermediation, arguing that it is in crisis. Its main fault lines were exposed as early as the Asian crisis and the dotcom debacle. The global economy only recovered from those in a dysfunctional way: by creating a credit boom in the US after the 2001-2 recession. In the aftermath of the financial crisis the threat of global financial disintermediation has now reemerged, and the challenge for policy intervention today is to revive global intermediation on a sound footing. This in turn requires a new international monetary system that can address the problems embedded in the current system. This paper discusses current arguments for and against reviving a multicurrency system and old and new proposals for an enhanced role for special drawing rights (SDRs). In addition, it offers two new proposals: one for international development funds whose liabilities would carry a multilateral guarantee and could be used as reserve assets for both new and existing holdings of currency reserves, and another that would create an international clearing agency (ICA) to process payments in all member countries' currencies by debiting and crediting reserve accounts held by the ICA.

Introduction

There is by now a general consensus that the financial liabilities the US has been amassing on account of its large trade deficits poses a general threat for the US as well as the world economy. However, explanations as to how and why these deficits pose a threat differ markedly as to whether global imbalances are read from the current or the capital account side of the balance sheet. In the former case, the problem begins with overspending in the US and persists because of the policy exchange rates pursued by at least some of the countries running trade surpluses. The former causes trade imbalances to emerge in the first place while the latter prevents market forces from correcting them. For remedy, it points to measures that can on the one hand enhance exchange rate flexibility and on the other curtail spending in deficit countries like the US while raising it in the surplus countries like China. Prior to the crisis US overspending would usually be blamed on government budget deficits, but now the failure of macroprudential regulation to detect and prevent excessive credit growth seems to have become another culprit. This way of looking at the problem implicitly presupposes that asset trade is auxiliary to world trade in goods and services, i.e., an *international* economy consisting of national economies with their own distinct systems of financial intermediation that is interconnected mainly through goods trade.

A very different picture emerges however when the issue is looked at from the capital account side which, in our view, is more consistent with an emergent *transnational* global economy that is characterized by a decreasing ‘home bias’ in the portfolio decisions of wealth owners around the world. As is well known, the expansion of cross border financial transactions began to outstrip the expansion of goods trade as early as the 1970s, and their increase since the 1990s has simply been spectacular and – though, faster in some groups of countries and slower in others - worldwide. We live in a world that is interconnected first and foremost through financial flows and, thus, the notion of global financial intermediation is far from an empty supposition today. In this new world, it is misleading to assume that asset trade is still auxiliary to trade in goods.

However, global intermediation is in crisis. Its main fault lines were exposed as early as the Asian crisis and the dotcom debacle. As recycling funds back to the rest of the world from the US became harder, global intermediation could only be revived in a lopsided way by a credit boom in the US after the 2001-2 recession, which eventually wrecked the balance sheets of US households and banks. Following the financial crisis global financial disintermediation has emerged as a real threat and that is why the challenge of policy intervention today should be to revive global intermediation on a sound footing.

In Part I, below, we discuss why and how global intermediation has come under stress, and the nature of the political and economic impasse the world economy is in today. In Part II, the different proposals that have so far been advanced to reform the international monetary system are critically discussed in terms of both their real world relevance and their effectiveness in reviving global intermediation on a sound footing. That is followed by a discussion of a set of proposals of our own which we believe are viable in the current environment. We end with a few concluding remarks.

Part I: The Current Impasse

I.1. Rise of Global Financial Intermediation

Looked at from the point of view of the capital account, three salient traits of the global economy can be said to define its current predicament. One is the “exorbitant privilege” the US enjoys on account of the fact that the dollar is the international reserve currency.² This has historically given rise to the need for large US trade deficits as a requirement for reserve accumulation in the rest of the world, which posed a threat to the confidence in the dollar as Triffin had recognized in the 1960s. The second is a global system of financial intermediation in which the US’ role as the world’s banker³ has evolved over time, such that the US now issues not only the reserve currency but, increasingly, interest bearing short term liabilities that provide liquidity to the rest of the world to back higher yielding long term investments in other countries. This makes currency mismatch a pervasive problem, creating the potential for exchange rate volatility to destabilize the international credit system. Finally, the US remains the safe haven and thus the destination for the ‘flight to quality’ in the world economy as has been evident during and after the crisis.

We assume that the first trait is relatively well-known⁴ and thus start our discussion with the second trait, which is the key to understanding how “home bias” waned and a new system of global intermediation began to take shape by the 1990s.

Two distinct forms of intermediation at the global level can be distinguished in the early post WWII era. One involves long term US investment abroad with foreign borrowers owing debts directly or indirectly to US banks whose liabilities are held by US based creditors – the holders of bank deposits who would normally want to stay in dollars. Since banks’ receipts and deposits are both denominated in dollars, currency mismatch is not here an issue of concern. US short term borrowing throughout the same period is the second form of intermediation. Here the roles are reversed between foreigners and US entities. Debts are still denominated in dollars and banks receive dollar payments, but now creditors are foreigners who need to be induced to hold their deposits in dollars since they have no specific reason to do so. While the first form of intermediation is larger and more important than the latter during the early part of the post WWII era, the latter acquires an importance comparable to the former by the 1980s, turning currency mismatch in the banking system into a potential problem.

Beginning with the 1990s, the two forms of intermediation are intertwined as short term borrowing becomes increasingly the source of funds that finance a rising proportion of US long term investment in other countries. In other words, the US progressively begins to function like a *hedge fund*, issuing short term liabilities to foreigners to finance riskier, higher yielding long

² The term is often used more broadly to refer to the fact that the US earns a higher return on its international assets than its liabilities to foreigners. The folklore has it that it was first used in a speech given by President De Gaulle, though Valéry Giscard d’Estaing might actually have been the one who coined the term when he was the Finance Minister in 1965 (Gourinchas & Rey 2007).

³ The term originates from Kindlerberger (1965).

⁴ Our version of monetary history and complications caused by the Triffin Dilemma and its relevance for today can be found in D’Arista & Erturk (2010).

term investments in the rest of the world. During this time the overall US current income account deteriorates as US entities begin to get an ever smaller share of interest income from total dollar denominated debts worldwide. Even though the US net asset position eventually turns negative in the new century, its net income flow in the current account remains positive - a fact consistent with its role as the world's banker/hedge fund - and even rises more recently.⁵ These changes do not cause a reduction in other countries' demand for dollars. On the contrary, they imply that the rest of the world needs more dollars, not only to trade and service debt, but also to invest their surplus funds.

This emergent system of global financial intermediation had the following hallmarks: First and foremost, the liabilities that financed the dollar-denominated long term debt held by borrowers in mostly developing economies were now held increasingly by foreign entities that had no special preference for dollars. Thus, international banks now routinely relied on massive currency swaps to rollover funding positions in dollars, turning currency mismatch, only a potential problem in the 1980s, into a pervasive one by the 1990s. Second, financial liberalization around the world turned variable price assets into the main conduit for capital flows. Compared to the fixed price bank loans of the 1980s, such variable price assets blurred the distinction between borrowing and the sale of equity, making long term investment much easier to reverse and speculation less costly. Finally, central banks lost a good part of their ability to control credit expansion in their respective countries. This was true not only in the periphery but in the US as well - though countries that resisted capital account liberalization fared considerably better.

I.2. Global Financial Intermediation under Distress

Any system of financial intermediation requires that new liabilities can be issued with ease to retire maturing debt. That is a salient aspect of financial intermediation. However, as banks and financial institutions around the world have come to hold vast quantities of dollar denominated assets against liabilities that need not be in dollars, they have increasingly exposed themselves to the risk of currency mismatch. The elevated level of the risk became only apparent during the global financial crisis when international banks ran into severe difficulty in rolling over their funding positions.

For instance, European and Japanese banks which accumulated massive amounts of dollar denominated assets since the late 1990s normally relied on short term foreign currency swaps to hedge their dollar exposure off balance sheet, with wholesale borrowing in the interbank market a lesser second option.⁶ During the financial crisis as the FX swap market came under stress (Baba and Packer 2009), and the interbank market seized up, banks had to scramble to rollover their short term funding positions at a time when the market for many of their dollar assets such

⁵ The increase in net US current income in recent years has largely been due the substantial capital gains in US assets abroad due to the depreciation of the dollar. See, Lane & Milesi-Feretti (2008) for a detailed discussion of these valuation effects on the US external position. The improvement of the US net income position in its current account after its net asset position had turned negative has also given rise to the mistaken notion that its overall external deficit is illusory (Hausmann & Sturzenegger 2006).

⁶ "The outstanding stock of banks' foreign claims grew from \$10 trillion at the beginning of 2000 to \$34 trillion by end-2007, a significant expansion even when scaled by global economic activity" (McGuire and von Peter 2009).

as structured mortgage-based securities dried up.⁷ This meant a completely unexpected effective lengthening of maturity of their assets, just as that of their liabilities shortened. The crisis only subsided after international swap agreements with the Fed enabled central banks to break the logjam by lending dollars on demand to banks in their respective countries (McGuire & von Peter 2009; Obstfeld & Shambaugh 2008).

During this episode the Federal Reserve had successfully stemmed the spread of the liquidity crisis by effectively acting as the lender of last resort on a global scale. Yet, the insolvency crisis persists. The overall viability of the system is still dependent on the Federal Reserve holding on to a massive volume of assets it accepted as collateral since the crisis whose market value has not recovered. In fact, it is entirely possible that fresh injections of liquidity and a further lengthening of the Federal Reserve's balance sheet will be required to deal with future funding difficulties banks might experience both in the US and elsewhere. Past a certain threshold, however, such injections pose the risk of further undermining confidence and thereby increasing the flight to safety, which would only necessitate new, larger rounds of liquidity injections that might eventually undermine the reserve asset itself.

This seems to be the gist of the constraint monetary authorities are facing in the US today. It used to be thought that the exceptional ability to issue liabilities in its own currency makes the US immune to the potential conflict between domestic policy objectives and international payment obligations that so often bedevils policy makers in other countries. Even if applicable in good times, this proposition can hardly be said to apply today. It is evident that US economic policy autonomy has been shrinking rapidly and is likely to continue to do so, though it remains doubtful how well that is recognized by policy makers today.

Until recently the destabilizing effects of currency mismatch and exchange rate instability were mainly felt in emerging economies. Throughout the 1990s it was primarily (though not exclusively) the emerging economies that were plagued by sudden stops and abrupt capital flow reversals that preceded currency crises. With the benefit of hindsight these episodes can be seen as the early signs of trouble for global intermediation as a whole, and thus a precursor of the financial crisis that eventually hit the US and other advanced countries in the core.

In what is to follow we look at the gross flows of funds in and out of the US as a circular flow. Accordingly, we organize the US balance of payments data⁸ on the assumption that all incoming funds into the US were in the nature of short term borrowing,⁹ which in turn were used to make investments in other countries either directly through FDI or indirectly through the purchase of foreign securities. Thus, we lump together the outflow of FDI from the US and private US purchases of foreign securities, and call it, for the purposes of this discussion, *US long term investment*.

⁷ At the same time, money market funds which European banks were also using for their funding needs in recent years had contracted drastically following the failure of Lehman Brothers (Baba et al 2009). Yet another complication was the withdrawal of dollar reserves emerging market central banks kept with commercial banks to help their own banks experiencing funding difficulties.

⁸ We use seasonally adjusted, quarterly data: Table 1. US International Transactions, released by the Bureau of Economic Analysis on September 16, 2010.

⁹ That is with the exception of FDI. Thus we lump together officially and privately owned US assets by foreigners, Lines 56 and 63, respectively, but deduct Foreign Direct Investment by foreigners in the US (Line 64).

A clear periodization is evident in the time-series of the gross flows as defined, where it is possible to identify synchronized cyclical turning points. For instance, when we look at *US Long Term Investment* (Graph 1) we observe a steady rising trend that is, though interrupted by a sharp increase in volatility at the time of the Asian crisis, not reversed until it reaches its pinnacle in 1999(2), a year before the burst of the dotcom bubble and the steep fall in the stock market. We then observe a declining trend that is only reversed after the end of the 2001-2 recession, which also coincides with the turnaround in the stock market. The third phase is the period of the housing bubble that reaches its apex prior to the outbreak of the financial crisis and again precedes the turning point in the stock market by almost a year as in the first turning point. A similar periodization is also evident in the gross inflow of funds into the US (Graph 2), especially when official flows are deducted (Graph 2b). As it can be seen in Graph 2c, there is a strong inverse correlation between official and private flows, especially, after 2000.

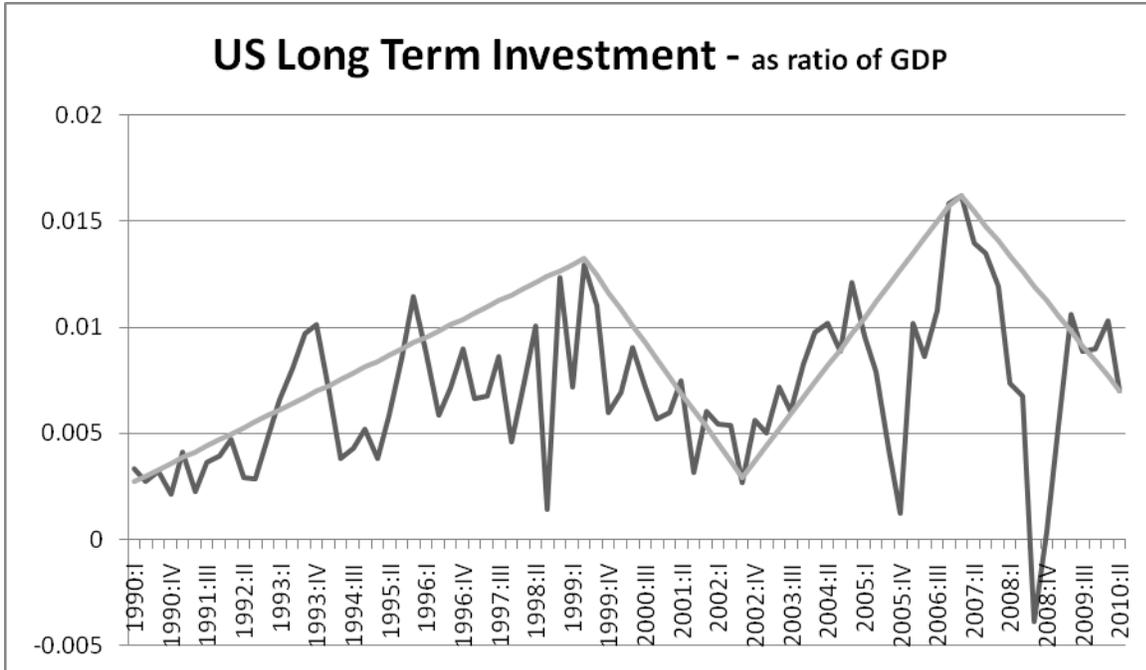
The dates of the turning points for these two series are summarized in Table 1.¹⁰ Of course, it is too early to tell if the bottom in the fourth turning point in Table 1 marks indeed the end of a declining trend. It might be more likely that the declining trend is still continuing as depicted in Graphs 2 and 2b. It is also interesting to note that the US current account is not synchronized with the turning points in the gross flows, except for the third turning point associated with the financial crisis – and, possibly, the fourth if there is one. The first two turning points in the gross flows appear only as inflection points in the current account time series (Graph 3).

Table 1: Turning Points in Gross Flows of Incoming and Outgoing Funds

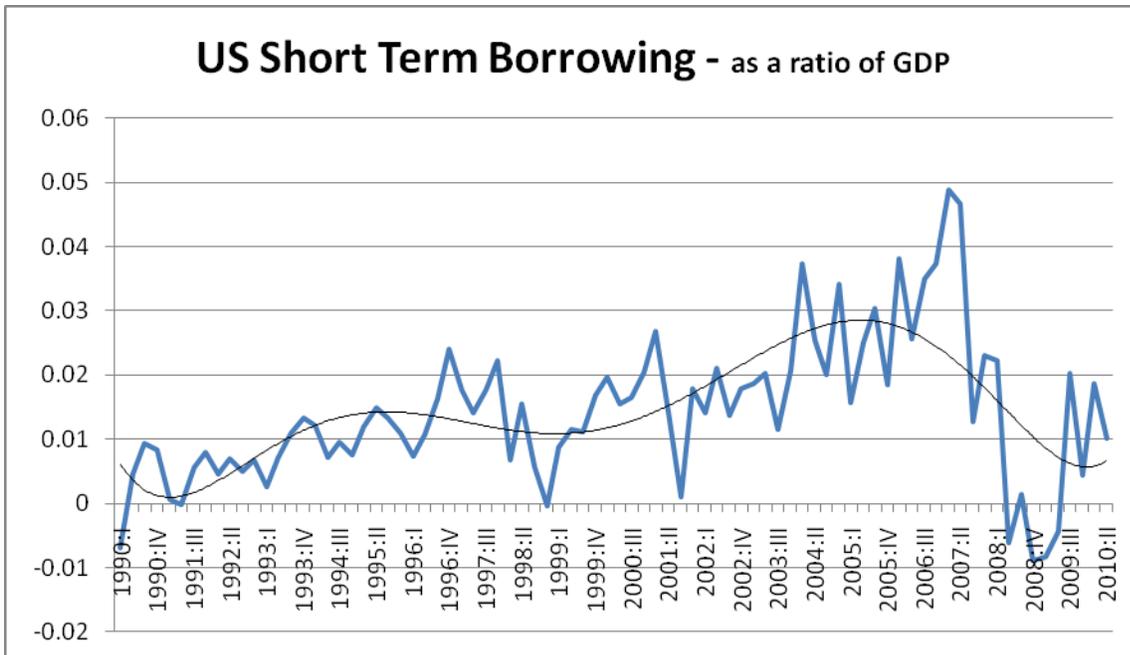
Turning Points	LTI	STB (Pr)	S&P Index
1. Peak	1999(2)	2001(1)	2000(2)
2. Bottom	2002(3)	2003(2)	2002(3)
3. Peak	2006(4)	2007(2)	2007(3)
4. Bottom (?)	2008(3)	2009(1)	2009(1)

¹⁰ The first column refers again to “US Long Term Investment” (Lines 51+52), while the second column refers to US private “short term borrowing” (Line 63) only. The third column gives the dates of turning points in the S&P Index of the NY Stock Exchange.

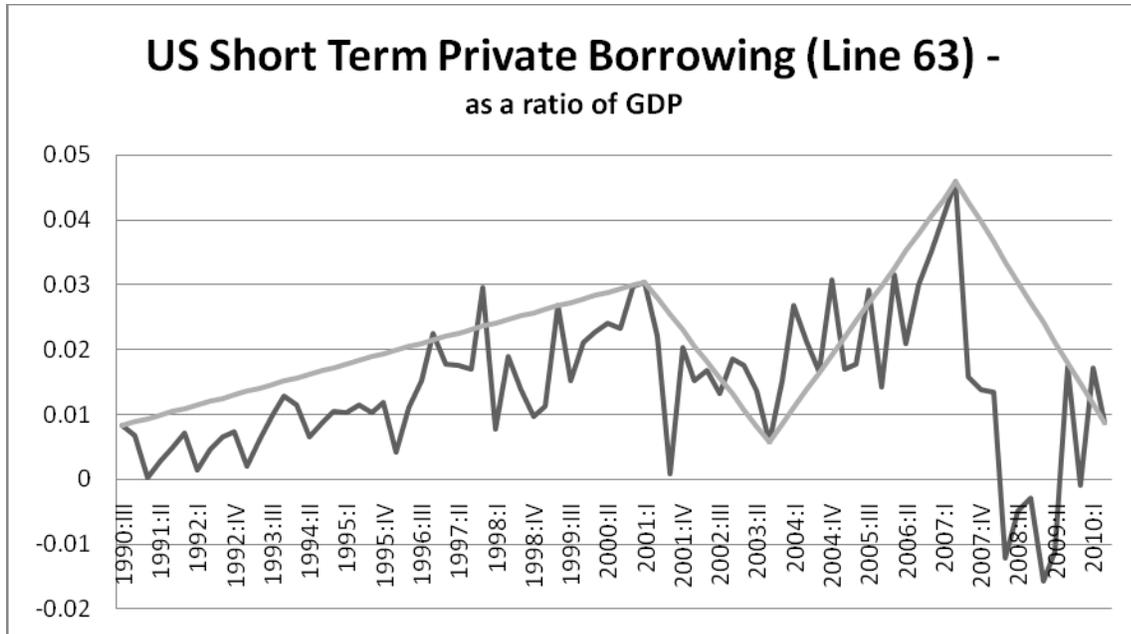
Graph 1:



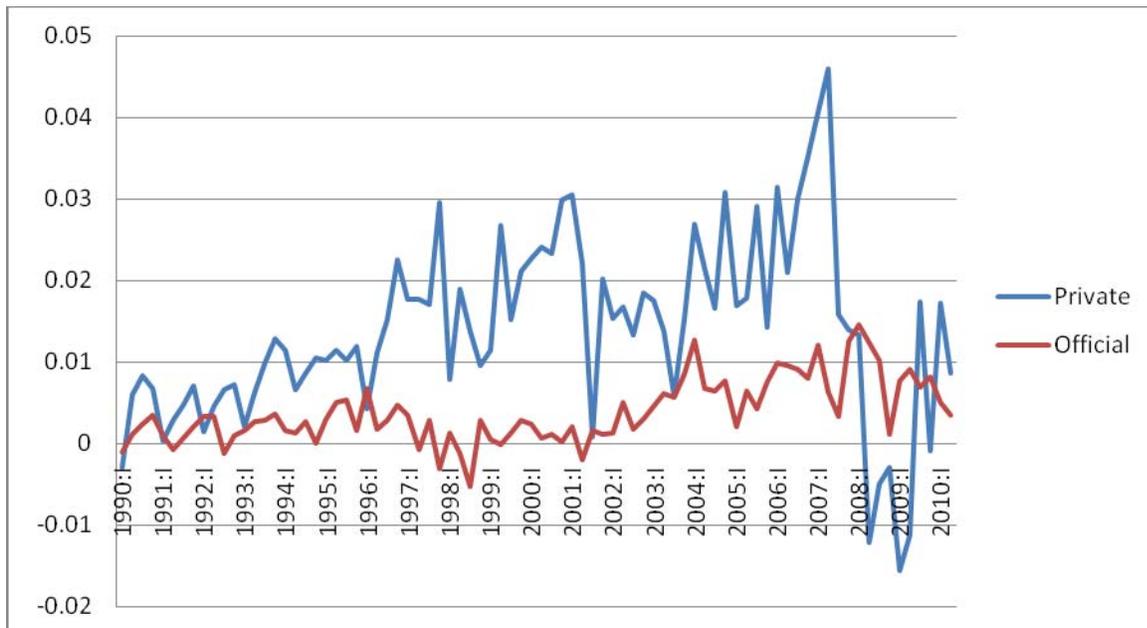
Graph 2:



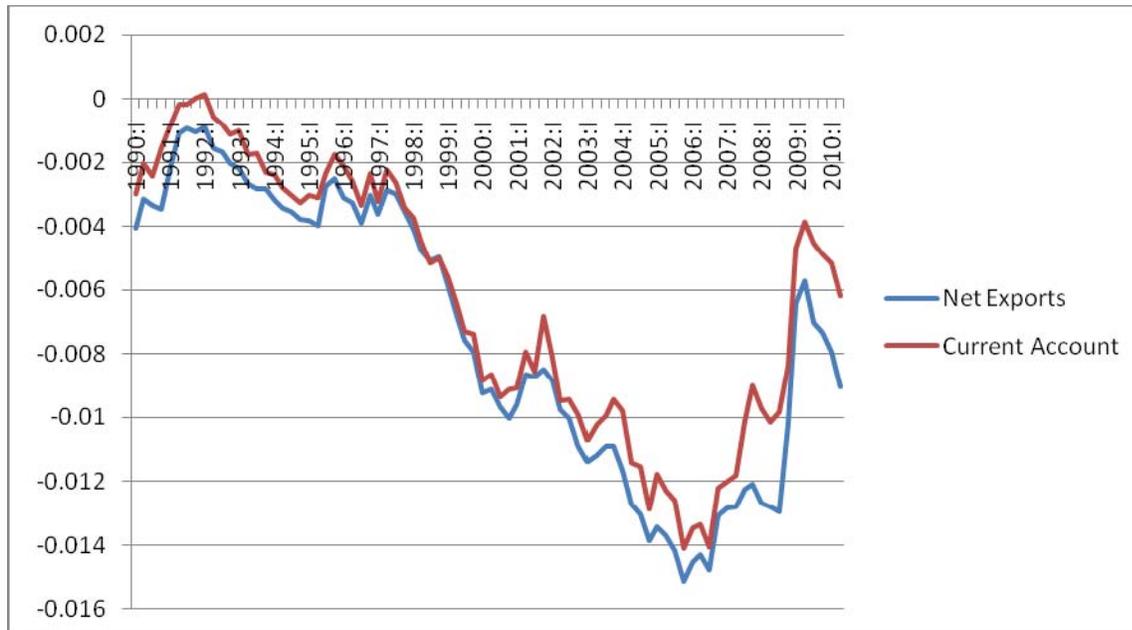
Graph 2b:



Graph 2c: Official (Line 56) and Private (Line 63) Flows into the US



Graph 3: US Current Account Balance and Net Exports



Looking at the data, we suggest that global intermediation suffered its first setback following the Asian crisis and the ensuing dotcom debacle. In this system the only way countries could acquire the reserve asset (dollars) was by running trade surpluses or borrowing. Dollars accumulated unevenly in the hands of a few successful exporters - first Japan and Germany, then China, the oil exporters and a few others.¹¹ Less successful exporters on the other hand had to compete against each other in making themselves more hospitable to foreign investment as attracting foreign capital became their only option to avoid deflation. The US in the middle attracted surplus funds from the first set of countries by issuing short term debt and dispersed it to the latter group by buying higher yielding assets, which here we call 'long term investment' for short.

This process of intermediation was however interrupted roughly around the dotcom debacle when both the outgoing long term investment as well as the short term borrowing fell steadily - Graph 4 reproduces the linear trend lines from Graphs 1 and 2b above to make this easier to track. This was in part the result of the collapse of investment after the Asian crisis in the region (Felipe, Kintanar, and Lim 2006)¹² and the broader cumulative effect of rising risk of contagion due to currency crises. Throughout the 1990s, as it is well-known, the emerging economies that

¹¹ Incidentally, the prevention of currency appreciation was quite often the *sine qua non* of their success, The link between an undervalued real exchange rate and growth shows up clearly in cross-country regressions (Rodrik 2008). Also, Japan is a case in point. Its currency appreciation against the dollar led to falling exports, culminating in a long period of stagnation. .

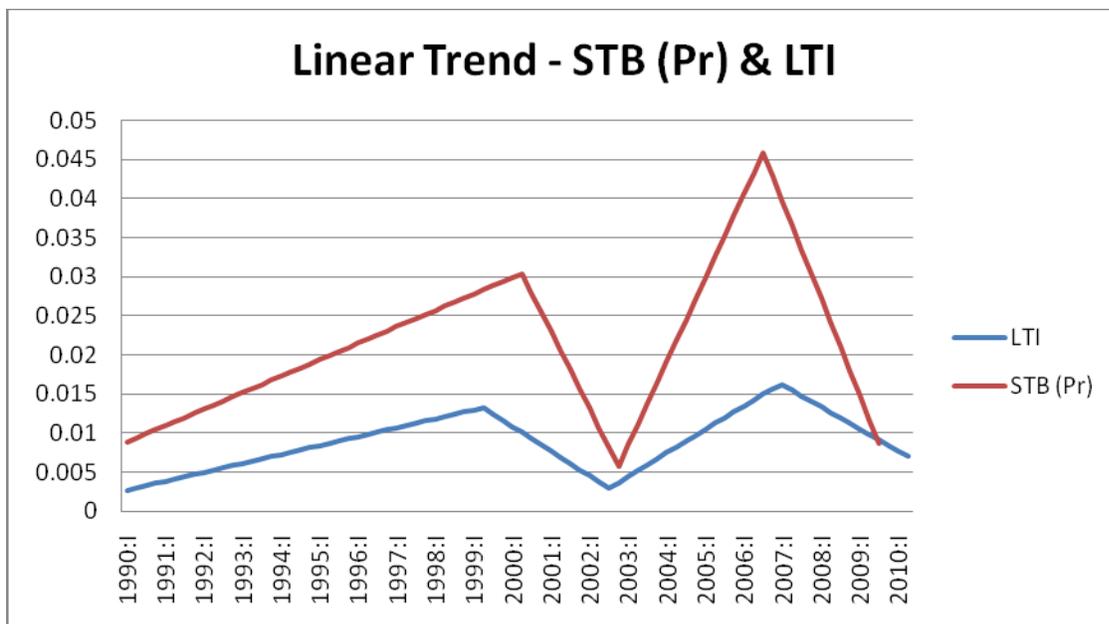
¹² For a broader explanation of the global decline in investment, see Pagano & Rossi (2009)

were the recipient of significant capital flows quite often experienced unsustainable credit and consumption booms that ended almost invariably in abrupt capital flow reversals and crisis.

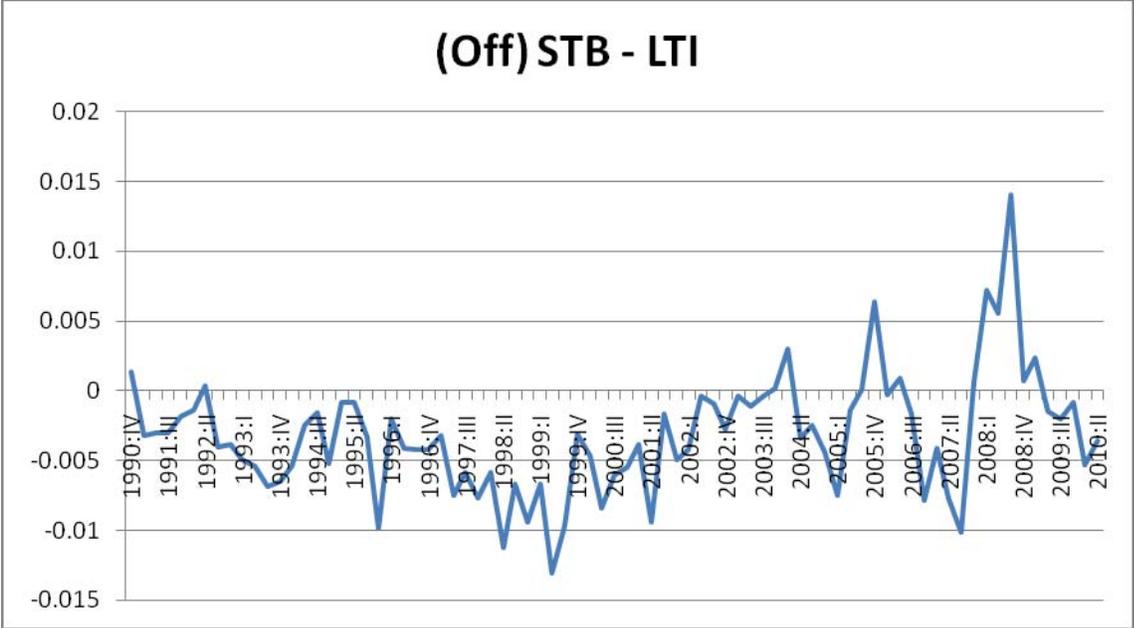
The US recovery towards the end of 2002 appears to have jumpstarted global intermediation, thanks in part to the steady increase in official incoming funds during the interim (Graph 2c). However, this second period of intermediation associated with the US housing bubble was comparatively less effective in dispersing funds out of the US than the first. In the 1990s, incoming funds rose faster than outgoing funds, yet the rate of growth of both were comparable. By contrast, the rate of increase in the outgoing funds lagged far behind that of the incoming funds in the period after mid-2002 (Graph 4). This suggests that Bernanke's (2005, 2007) 'savings glut' was not only the result of an increase in incoming funds, but also the failure of outgoing funds to increase in tandem. In other words, global intermediation during this period has become increasingly lopsided as a significant portion of potential "long term investment" turned inward, in part because of the greater reservoirs of creditworthiness in the US. But, of course, that also meant that the epicentre of debt build up also shifted onto the US with all its ill-effects that became all too familiar.

Another contrast between the two periods of intermediation is the growing relative importance of official incoming funds relative to outgoing funds, which can be interpreted as yet another sign of dysfunction. Graph 5 shows the relative magnitude of official incoming funds in relation to outgoing funds falling steadily till around the Asian crisis and rising thereafter, in successive bursts that reach a higher peak each time. Again we observe an inverse relationship between private and official incoming flows - the dips in the latter part of the trend line in Graph 5 correspond to periods when private flows pick up and *vice versa*. Another important contrast is of course, how in the latter period following the 2001-2 recession, official flows begin to exceed in size periodically the total of outgoing funds, with a margin that increases over time.

Graph 4:

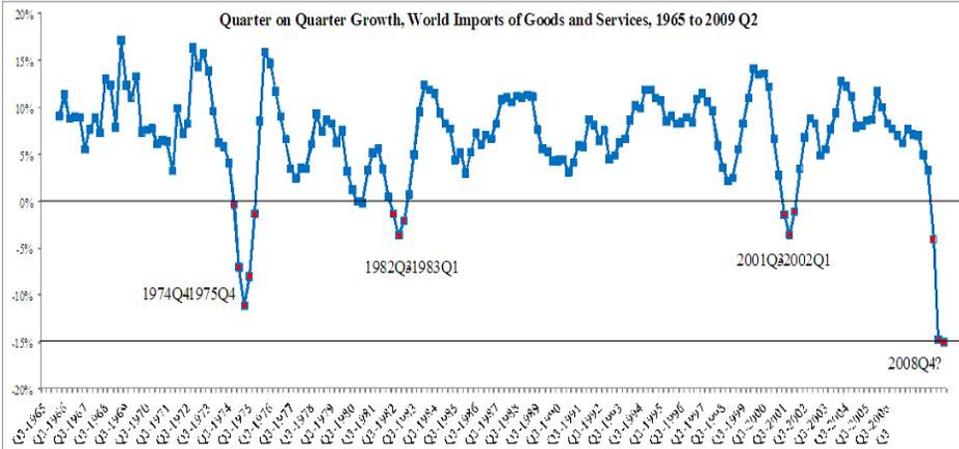


Graph 5: Ratio of Official Inflows to Outgoing US Long Term Investment



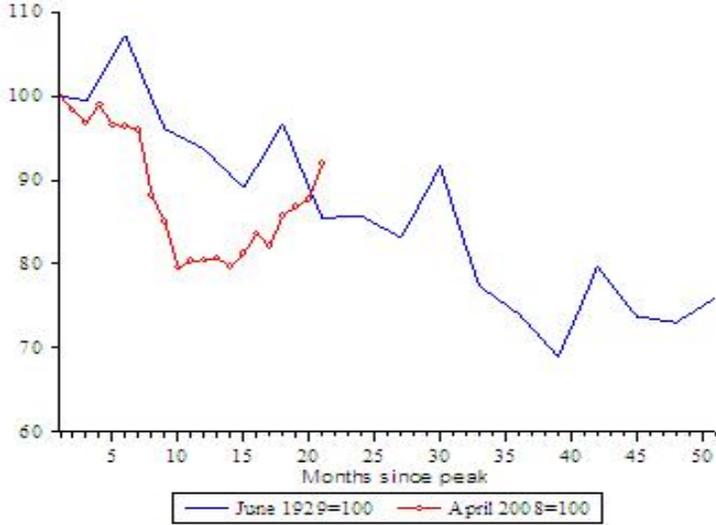
After the financial crisis, the threat of disintermediation became most evident in the dramatic collapse in global trade (Graph 6), which has been 20% below its previous peak - steeper than the contraction experienced during the Great Depression (Graph 7). With the revival in world industrial production world trade continues to recover, but still remains below its previous peak in the beginning of 2008 (Eichengreen & O'Rourke 2010). The growing importance of local currency bond markets in emerging economies, which have doubled in size since 2000, has been another sign of global disintermediation (Dalla & Hesse 2009).

Graph 6: Contraction of World Trade



Source: Baldwin & Taglioni (2009)

Graph 7: World Trade Now and During The Great Depression



Source: Eichengreen & O'Rourke (2010)

1.3. Currency Reform?

International currency/payment reform can potentially reverse the trend towards disintermediation, and repair the confidence in the reserve asset. In our view, it might become politically viable in two different ways.

One is through the enlightened leadership of the US and international cooperation perhaps at the level of the G20. This route appears unlikely today given the lack of interest on the part of policy makers in the US. The other route might be more indirect, involving the roundabout impact the rising cost of inaction could have on decision makers and the policy debate, especially in the US where arguably the full implications of the current impasse - 10% plus unemployment and stagnation for years to come - have not yet been fully factored into the political equation.

However, it is also entirely possible that US policy makers might respond in a shortsighted way to their growing inability to revive aggregate demand neither by asset purchases nor increased government spending, seeking solace in a weak dollar. In fact, barring international reform, a collapse of the dollar and a slide into a multicurrency system can be said to be in the US interest – analogous perhaps to going off the gold standard in 1933 – as it could free its hand to reflate its economy. The dynamic that can bring this about can be quite similar to what is described in the second generation currency crisis models. In the European crisis of 1992-3, the conflict speculators perceived between fixed parities and changes in the direction of macroeconomic policies that appeared likely in the light of unexpected economic developments was perceived to be the main problem. Speculators attacked the currencies of those countries they thought could gain more from abandoning fixed parities than defending them. Governments ended up *ratifying* these speculative attacks by changing course, even though their original policies would have been viable had it not been for the attack on the currency.

On the other hand, a collapse of the dollar and slide into a multicurrency system is hardly in the best interest of developing countries. From their point of view, the challenge is to put to use their large reserves of dollars to revive a form of financial intermediation that can assist development. If this cannot be achieved globally because of the intransigence of the US, regional efforts to establish monetary unions in Latin America and South East Asia can perhaps provide a second best solution.

Part II: Paths to Reform

There is considerable variation in views on the kinds of reform proposals that should be adopted and about the urgency with which they should be undertaken. The United Nations Report of the Commission of Experts sees a new global reserve currency as “an idea whose time has come” and takes the view that it is imperative that the international community begin working on such a proposal (UN 2009). The Commission and other analysts find the continuation of the current system – the use of assets denominated in national currencies as international reserves – objectionable because it has contributed to global imbalances and inequities by channeling capital flows to countries that issue reserve currencies.

On the other hand, some believe that the current system may simply evolve over time as preferences for longer-term investments reduce the need to hold short-term liquid assets (Feldstein 2009). Staff economists at the International Monetary Fund think the timeframe and tradeoffs for implementing reforms suggest “that the current system, suitably strengthened, may endure for some time longer” even though recurring bouts of instability indicate “a need to look for durable remedies”(Mateos y Lago et. al., 2009). While these economists do not argue that the current system should continue, the statement reflects the skepticism of some about the ability of those who favor moving to a new system to implement far-reaching reforms.

Meanwhile, many also assume that shifting from a key currency system by increasing the number of currencies used to acquire international reserve assets would add diversity and stability. But even those that accept such a solution as inevitable caution that it will require deep and liquid financial markets for added currencies, their wide use in private sector transactions and the willingness of the issuing countries to allow investments in national financial assets on a scale necessary to accommodate the demand for reserves (ibid.).¹³

Others oppose shifting to a multicurrency system, arguing that, in addition to increasing exchange rate volatility, international reserves denominated in any national currency couples reserve accumulation to the deficit position of a reserve currency country and is therefore inherently unsustainable (Greenwald and Stiglitz 2008; Ocampo 2009). Nevertheless, the shift from a key currency system to a multicurrency system is likely to take place if coherent and coordinated action to reform the system is not taken.

The following sections describe and analyze the three main paths toward reform that are currently under discussion. The first section looks at previous experiences with multicurrency systems and describes the problems such systems have caused in the past. The second section outlines the various proposals for a non-national reserve system based on increased issuance of special drawing rights (SDRs) and the third explores proposals for the creation of new non-national reserve assets not based on the SDR and issued by international agencies other than the IMF.

II.1. Reviving the Multicurrency System

Advocates of a multicurrency reserve system are reinventing an old wheel. Such a system came into being after the collapse of the Bretton Woods agreement in the early 1970s, involved most of the currencies of Western Europe and persisted until the dollar strengthened and reemerged as the key currency in the 1980s. During this period, one of the major problems with such a system was glaringly evident as shifts from one currency to another increased exchange rate volatility and disrupted trade. Central banks in the industrial countries responded by intervening in foreign exchange markets to support the dollar and prevent the appreciation of their own currencies. The

¹³ This could be an especially difficult problem if there were a larger demand for euro reserves since the assets preferred by reserve holders are government securities. While all such securities in the euro area are denominated in the same currency, perceptions of credit-worthiness vary and could concentrate investment in a few countries. Greenwald and Stiglitz (2008) argue as well that the EU’s growth and stability pact tends to restrict expansionary policies and that the failure of governments in whose securities reserves are invested to respond effectively would result in strong deflationary pressures.

result was a 65 percent increase in global reserves in 1971 with an additional buildup throughout the decade that contributed to global inflation and severely weakened, rather than strengthened, the dollar (Dam 1982).

The effects of central bank intervention in currency markets seem not to have been well understood in this period since the outcome was not what was intended. A key element in a currency-based international monetary system is that foreign exchange reserves are holdings of interest-bearing credit instruments that expand credit in the country that issues the currency in which they are invested. Thus when a central bank bought another country's currency to push up that currency's value, it invested its holdings in credit market assets such as bank deposits or government securities issued by that country and thus added to the recipient country's credit supply.¹⁴ Assuming the acquired currency had fallen in value as a result of expansive monetary or fiscal policies, intervention would have the pro-cyclical effect of augmenting that expansion. Thus the 1970s, a decade of intervention, was also a decade of global inflation.¹⁵

A far more serious example of the problems inherent in a multicurrency system relates to the damaging, deflationary consequences of the extinction of reserves that occurred in the 1930s. While some foreign exchange reserves had been held by central banks before World War I, the movement of gold to the U.S. during the war and the decline in gold production made it impossible for European countries to acquire sufficient gold reserves to regain convertibility for their currencies. At a monetary conference in Geneva in 1922, many accepted the recommendation to use foreign exchange reserves to economize on gold.¹⁶ The Bank of England resumed gold convertibility in 1926 (at the pre-war rate) and persuaded some other European countries to do the same. Nevertheless, most industrial countries continued to rely on acquiring holdings of foreign exchange assets to build up their reserves and, by the end of the 1920s, foreign exchange reserves constituted about 42 percent of total reserves of 25 countries (Grubel 1977).

As Germany went into recession in 1929, the Bank of France sold its holdings of Deutsch mark assets and forced Germany to suspend convertibility. Then, with economic conditions deteriorating world-wide in 1931, the French central bank began to convert its existing stock of foreign exchange reserves into gold. Other countries sold their holdings of sterling on fears that France's sales would force the U.K. to suspend convertibility and, after they had precipitated a run on the Bank of England, it did suspend convertibility on September 21. Unable to dispose of sterling, many of these countries converted other holdings into dollars and, since the dollar

¹⁴ Before the Smithsonian Agreement in 1971, some countries held foreign exchange reserves as deposits in international banks in the external ("euro") markets. Recognizing the explosive growth in credit denominated in currencies held outside the issuing country and the damaging impact on national monetary policies, the industrial countries agreed to invest foreign exchange reserves in the government securities of the issuing country.

¹⁵ Conversely, when intervention was undertaken to dampen the value of a currency, the intervening central bank sold its holdings of that currency, withdrawing funds from that country's credit markets, causing interest rates to rise and, contrary to the original intention, raising the value of the currency. The sell-off of dollar assets by European central banks in response to the stronger dollar in the early 1980s helped push US interest rates and the dollar higher than would have been the case absent intervention.

¹⁶ There was no formal international agreement but some countries acted legislatively on this recommendation at the national level and many others simply resumed the practice of buying foreign exchange from their own financial institutions (Grubel 1977).

remained convertible, exchanged dollars for gold. From mid-September to the end of October 1931, the Federal Reserve lost \$755 million of gold - \$350 million taken by France and the rest by Belgium, Switzerland and the Netherlands. In a futile attempt to reverse these losses, the Fed raised the discount rate from 1 ½ to 3 ½ percent – a move that is generally viewed as deepening the U.S. depression and that of the much of the rest of the world (Kindleberger 1984).

The multicurrency system of reserve holdings became a critical channel for the transmission of economic collapse in the 1930s. Between 1929 and 1931, foreign exchange reserves fell from 42 to 27 percent of total reserves and fell further to 8 percent by 1932. The contraction in international monetary reserves put severe downward pressure on money stocks and credit in national economies and contributed to a sharp contraction in cross-border trade and investment (Grubel 1977).¹⁷

More recently, the growth in carry trade transactions as channels for capital flows has introduced some elements of a multicurrency system with significant effects for reserve accumulation. Borrowing in a low interest rate currency for investment in higher yielding assets denominated in another currency increases exchange rate volatility by depressing the funding currency and causing the currency in which the funds are invested to appreciate. Since the mid-1990s, the yen, euro and dollar have all been used at various times as funding and investment currencies in carry trades with higher-yielding emerging market assets periodically attracting large shares of investment as well.

As has been frequently noted, rising inflows of investment into emerging markets have augmented reserve accumulation. Moreover, the build-up in reserves has, in turn, fueled the rise in private capital flows by feeding liquidity back into national and external markets. For example, the Bank of Japan's decision in March 2005 to offset its mounting stock of dollar reserves by relaxing restrictions on bank lending in yen precipitated an even more massive build up in yen/dollar carry trade positions than occurred before the collapse of the Long Term Capital Management hedge fund in 1998. As the buildup in these positions depressed dollar interest rates, the search for higher yields resulted in historically high capital flows to emerging economies in 2006 and 2007 that further expanded their holdings of dollar reserves. The bloated balance sheets of global financial institutions mirrored this expansion and were a significant contributing factor in precipitating the crisis as banks lost access to the immense volume of credit needed to support their carry trade positions. The collapse in the availability of funding for carry trade positions precipitated a contraction in lending that spread throughout the global financial system.

If left to market forces, changes in the current system are likely to involve a diversification of currencies in reserve holdings as well as in private international investment. But, given previous experiences with multicurrency systems, it is doubtful that such a development will bring

¹⁷ Eichengreen (2009b) agrees that the erratic shifts that occurred in this period destabilized and ultimately destroyed the interwar reserve system. However, he sees the lesson as a positive one. In his view, having more alternative currencies in a system puts pressure on policymakers to maintain investor confidence and, he says, “that’s not a bad thing.” Such an optimistic view of the ability (or willingness) of policymakers to respond to such pressures – especially when speculation is the driving force they face – is not supported by the evidence of responses in the 1930s or in more recent times.

stability or avoid further and larger crises. Thus, consideration of alternative monetary systems would seem both reasonable and urgent.

II.2 The Role of the SDR: Old and New Proposals

There have been sporadic calls to revive issuance of SDRs since the IMF staff study in 1987 and they have grown more frequent since the onset of the financial crisis.¹⁸ The proposal for a substitution account – first offered in the late 1970s when the weakening dollar raised alarms – has also been revived (Kenen 2009). But the most recent discussions move beyond earlier ones to explore ways to create a new SDR-type global currency. All these proposals put forward useful ideas about how to move a non-national reserve asset that is already in existence into the center of the international monetary system. To those who see the current system as inherently unstable and inequitable, expanding use of the SDR seems the most feasible next step in the process of reform.

The substitution account, for example, looks to a way to cushion a potential sharp fall in the value of the dollar that would erode the value of global reserves and precipitate a further sharp contraction in the global economy. As proposed in the late 1970s and currently, it would create a means to convert dollars into SDRs. As a result, the IMF would exchange holdings of U.S. Treasury bills for SDRs and pay interest on the SDRs from interest received on the T-bills. This transfer would not incur a cost to the U.S. since the Treasury would be paying interest on its securities in any event and without regard to the identity of the holder of its debt. But the U.S. could potentially incur a large cost if the objective of creating the account – to maintain the value of dollar reserves – were met in that it would lose its ability to lower the real value of its debt if need be through the depreciation of its currency. The substitution account was not adopted when first proposed in the late 1970s because the U.S. was unwilling to accept the burden of guaranteeing the value of the dollars held in the substitution account on a par with an SDR backed by 16 currencies at that time. Later, when the dollar strengthened sharply after the crisis, interest in SDRs soon abated (Helleiner 2009).

Current discussions of the substitution account propose sharing the exchange rate risk (Kenen 2009; IMF 2009). But that could lead to inequities if all IMF member countries shared the risk in proportion to their quotas in the Fund since the largest holders of dollar reserves would benefit the most and would be subsidized by other countries. If, however, the risk were shared in proportion to the size of countries' reserve holdings, the larger holders would bear most of the risk and therefore gain no benefit. Sharing the risk would have been more feasible at the end of the 1970s when a larger group of industrial countries held the majority of dollar reserves. The more concentrated pattern of holdings today makes agreement on a substitution account less likely.

New SDR allocations. Following the lead of the G-20, the IMF initiated a new allocation of SDRs in mid-2009 that raised their share in non-gold reserves from 0.5% to 5.0%. A call for a new issuance had been made by the governor of the Chinese central bank, Zhou Xiaochuan, who also proposed that the SDR basket be expanded to include the currencies of all the major economies weighted in terms of GDP, and that it be backed by real assets such as a reserve pool

¹⁸ For a discussion of the origin and history of SDRs, see IMF 1987 and D'Arista 2009.

that would allow subscription and redemption by investors as desired (Helleiner 2009). While the new allocation has gone forward, some see it as a marginal accomplishment in terms of the goal of instating the SDR as the primary reserve asset unless some of the limitations inherent in SDR issuance can be overcome.

Among the major limitations is that the SDR is not liquid; it cannot be openly traded for national currencies and buying or selling SDRs for national currencies requires the consent of the countries issuing those currencies. Thus SDR reserves cannot be used to counter a run on a country's currency or buy needed imports in the event of an economic downturn or natural disaster. Proposals to increase liquidity include establishing a settlement system between the SDR and other currencies and encouraging countries to peg to and invoice in SDRs. But some note that increasing its role and usefulness will also require encouraging, promoting and/or subsidizing private sector use of the SDR (IMF 2009).¹⁹

Barry Eichengreen argues that because liquidity requires a critical mass, SDRs should be issued and redeemed not only by the IMF but by governments and private banks and be used in transactions by non-financial business. He suggests that the IMF take on the role of market-maker, buying and selling SDRs at spreads comparable to spreads on the dollar. What he calls the "commercialization" of the SDR is, in effect, a proposal to give it the central role in the international payments system as well as the reserve system. But, as he concedes, ensuring the mass trading required for a viable reserve currency would require that the IMF become a global central bank and lender of last resort (Eichengreen 2009a IMF). Such an evolution would obviously require time. Thus, in Eichengreen's view, the dollar will remain "first among equals" into the future – in part because the market for U.S. Treasury securities is the "single most liquid government bond market in the world" (Eichengreen 2009b).

Jose Antonio Ocampo (2009) accepts that view in the sense that he advocates concentrating on reforming the global reserve system rather than the broader international monetary system while continuing use of the dollar for international payments.²⁰ His major concern is to align SDR issues with support for development, giving larger allocations to those with the highest demand for reserves and allowing the IMF to use unutilized SDRs to buy bonds from developing countries.²¹ He also proposes that allocations be countercyclical – loaned during crises and automatically extinguished when loans are repaid – and that unused allocations be treated as deposits that can be loaned to countries in need. Included in his outline of new provisions is the suggestion that generous overdraft or "drawing" facilities be created that can be used on an unconditional basis by all member countries and that the IMF be authorized to suspend the right of countries with large surpluses or excessive reserves to receive SDR allocations.

¹⁹ The idea is to encourage denomination of international trade and investment transactions in SDRs with settlement in one of the component currencies – a strategy used in Europe when the ecu was the unit of account before the introduction of the euro.

²⁰ Allowing the dollar to remain the means of payment would, however, perpetuate many of the existing problems surrounding the buildup of dollar liabilities. If used in transactions (and held as reserves) by the foreign *private* sector, foreign holdings of dollars would continue to create distortions in capital flows as U.S. credit markets would continue to be the center for the temporary investment of funds used in payments.

²¹ Similarly, George Soros has proposed that rich countries give their unutilized SDRs to poor countries (paying the current rate (0.5%) on SDRs that are released into circulation) to relieve debt and finance low carbon investments. His proposal would use the IMF's \$100 billion gold reserve to guarantee repayment (Harraban 2009).

A similar proposal for penalizing surplus countries was made by Bruce Greenwald and Joseph Stiglitz (2009). Advocating substantial and regular issuance of SDRs,²² they propose that allocations made in proportion to current IMF positions be taxed at a rate of 50 percent per unit of current account surplus up to the total of a country's allocation and that the tax be used for global financial aid. Their proposal deals with the liquidity problem by requiring each member country to guarantee that it would convert SDRs into its own currency. Alternatively, they suggest that a group of countries could form a new system to which they make annual contributions in their own currencies and receive "global greenbacks" in return.²³ Such a system would facilitate convertibility, provide an asset to use in a crisis and ensure the availability of resources for all members of the group. It could be initiated at a regional level and, as Ocampo (2009) and the Report of the UN Commission of Experts (2009) also note, would serve as a means to build a new monetary system from the bottom up.

Under the Greenwald and Stiglitz plan, global greenbacks would be held by central banks but the authors note that "a more ambitious version" would allow them to be held by individuals. Thus they, too, acknowledge the need to forge a link between reserve assets not based on national currencies and the currencies used in private international transactions. But here and in earlier work by Stiglitz (2006), the institutional arrangements that would be required are not spelled out.

Modifying SDR proposals Chapter 5 of the Report of the UN Commission of Experts (2009) contains many elements of the above proposals but is structured to provide a new global reserve currency that could be managed by the IMF or by a new institution, a "Global Reserve Bank". In one version of this proposal, the contributions of all members in their own currencies would serve as backing for the global currency and thus would constitute a world-wide system of swaps among central banks. In an alternative version, the international agency would issue the global currency to member countries like the IMF issues SDRs with no backing other than the commitment of member countries to accept it in exchange for their own currencies. A third version would designate these issues of the global currency as deposits in the Global Reserve Bank and authorize the Bank to use them to buy government securities or lend them, providing backing for the global currency in the same way national currencies are backed by the assets of national central banks.

Under this last institutional arrangement, interest on the deposits created and allocated by the Global Reserve Bank would be paid out of the interest on loans or government bonds to encourage member countries to hold reserves with the Bank. New issues would be allocated according to the size of member countries' GDP or their needs but allocations would be penalized to discourage countries from running large surpluses that are not used to increase global demand.²⁴

²² Greenwald and Stiglitz suggested that, given global reserves of about \$3 trillion in 2008 and an average rate of growth in trade of 7%, annual issues should amount to \$200 billion.

²³ The authors do not discuss how the currencies contributed to the agency would be invested or how they might affect credit in national economies.

²⁴ Several fall-back proposals offered in the UN Commission Report include the basic one of increasing SDR issuance on a regular or countercyclical basis, providing all financing for crises in SDRs and extinguishing them as

The UN Report suggests some of the elements needed to make a non-national currency reserve asset effective. One is that, like a system based on national currencies, the institution that issues the asset must have the authority to create credit and must use some form of backing that can channel credit to the recipients. In short, unlike the IMF whose function is more like that of a Treasury operation dependent on taxpayer funds, the institution must be a monetary agency. As such, it would have the potential to evolve in time into a global central bank issuing liabilities in sufficient amounts and with sufficient credibility to be used by both public and private sectors of the global economy for transactions as well as a unit of account and store of value. But, as Eichengreen points out, it will take time for that to come about.

Meanwhile, what other arrangements might work in the interval to accomplish the goals put forward in the recent proposals described above? The following draws on those proposals to offer the outline of a modified SDR-type plan that might be effective as a transition vehicle toward a new system:

- The international agency would issue a reserve asset to member countries' central banks in exchange for their countries' government securities. Those securities would serve as backing for the reserve asset.
- The value of the reserve asset would reflect the aggregate market value of all members' currencies. The amount of reserves issued to a given country, however, would be determined by its shares of global population, trade and output. The governance of the international agency should reflect those same weights.
- The international agency could provide liquidity to member countries by exchanging government securities with central banks for currencies or selling them to private or public investors.
 - For example, the agency could sell the government securities of country A to investors in exchange for the currency of country A or that of any other country at its discretion. It could then exchange the currency acquired with the government or central bank of country B in exchange for that country's reserve assets.
 - In such transactions, country A's reserve balance would be unaffected and the agency's holdings of country B's securities would remain unaffected. However, the agency would now have a loan to country B on the asset side of its balance sheet and a liability to country A for the securities sold. When the loan by country B is repaid (in country A's currency), the proceeds would be used to reconstitute the agency's holdings of country A's securities. Thus there would be no change in the value of the agency's balance sheet and no expansion of global liquidity.
- New issues of reserve assets would, however, expand credit in member countries and expand global liquidity. Redemptions of countries' holdings of reserve assets by the international agency in exchange for their government securities would contract credit.

loans are paid back, and investing some of the SDRs in bonds issued by regional development banks. The UN Report also advocates using these proposals in regional arrangements.

Thus the international agency would have countercyclical powers to issue and redeem reserve assets.

One advantage of this modified system is that it fosters development by absorbing Treasury debt in exchange for reserve assets that can back credit expansion in the domestic economy. Thus it enables countries that have not been able to engage in fiscal stimulus in this or any other downturn to do so. In addition, it can supply the means of payment for international transactions to countries that do not issue widely tradable currencies and can respond as a lender-of-last-resort in currency crises. Finally, it moderates the intrusion on national sovereignty of a new regional or global currency based on the concept of the euro. Countries would still use their own national currencies at home but would be able to acquire international reserves without borrowing from foreign private financial institutions or earning reserves by curtailing domestic demand to promote export-led growth.

II.3. Building Alternative Global Reserve and Currency Systems

Eichengreen's evolutionary path toward the commercialization of the SDR would, as he notes, move the system toward the creation of a global central bank and lender-of-last-resort. It could also lead to a single currency for the global economy that many would find unacceptable. There is, however, the potential to create other paths that move beyond the particular SDR-type institutional and instrumental structure and they, too, should be explored. To further that exploration, the following reform proposals are offered in the hope of expanding the menu of options and enlarging the debate.

Creating a public international investment fund for emerging economies. The spillover effects of the investment of emerging economies' current account surpluses in the U.S. and other major national and international financial markets assured not only that these poorer countries would be financing the rich but that some portion of those funds would be recycled back to those same creditor economies in the form of foreign acquisition and ownership of their financial assets and productive facilities.²⁵ In other words, the way savings are channeled back into these countries is one that tends to undercut the potential for those savings to support development.

With the phenomenal growth in the assets of institutional investors in developed countries in the 1990s, portfolio investment replaced bank lending as the dominant channel for inflows to developing countries. As discussed above, many developing countries that need long term financing for infrastructure and other basic components of development strategies do not have markets that can absorb foreign portfolio investment flows or the credit standing to attract them. Others may be overwhelmed by investment flows up to the point when the currency appreciation that it promotes prompts outflows and triggers a currency crisis. Portfolio investment is mostly short term; it tends to change prices and exacerbate volatility in secondary markets rather than provide the long-term financing needed for economic expansion. Moreover, both portfolio and direct investment by foreigners necessarily entails the need for returns to reward the individuals and institutions that have acquired ownership of these assets. Thus the investment of these flows

²⁵ See the discussion of the round-robin character of capital flows in D'Arista and Griffith-Jones (2006).

is directed in ways that encourage and facilitate export strategies that increase the accumulation of external currencies.

In view of this aspect of the reserve accumulation process, one of the more pressing issues in dealing with global imbalances is to find ways to recycle the current account surpluses of developing countries back into their own economies in support of development strategies that increase demand and income more equitably and reduce dependence on export-led growth. What is needed is a new channel for portfolio investment to provide flows that are stable, in amounts appropriate to the size of a country's economy and directed more toward the goals of development than short-term profits for investors.

Such a channel could be constructed by creating one or more closed-end funds for emerging market investment as a separate institution under the Bretton Woods umbrella.²⁶ These funds would issue their own liabilities in a variety of national currencies and use the proceeds to pay for stocks and bonds of private enterprises and public agencies denominated in local currencies in a wide spectrum of developing countries. The funds' liabilities would be marketed both to private institutional investors in advanced economies and official investors from emerging economies and they would also qualify as international reserves, guaranteed by a multinational agency and its member countries. Investing the reserves of developing countries in these funds would redirect external savings back into the economies of the countries that own them rather than into the financial markets of strong currency countries. Moreover, their closed-end structure would ensure that long term funds would be provided and that sales of the funds' liabilities by investors would not force redemptions that would disrupt development projects.

Like proposals for additional issues of SDRs, a major objective of these investment funds is to inaugurate a meaningful shift into a non-national reserve asset and phase out a system in which the choice of financial assets as reserve holdings centers on a few countries whose wealth supports the strength of their currencies. One incentive for developing countries to hold these securities as reserves is that they would provide a multilateral (rather than a unilateral) guarantee from industrial countries and, in time, from wealthier emerging economies.

Reforming the international payments system. The above proposal – to use credit liabilities of a public multilateral institution as reserve assets – is incremental in nature. While it addresses a critical flaw in the current international monetary system, an equally critical one – the means of payment – would still need to be addressed. Permitting the continuation of a key or multicurrency regime for cross-border transactions would perpetuate the export-led growth global paradigm by requiring the majority of countries to shape their economies to ensure that they can earn – or borrow – reserve currencies to engage in external trade and investment. It also requires reserve currency countries to import more than they export to meet the demand for their currencies and accept the resulting current account deficits and build-up in debt. The global economy can only regain balance if every country is able to use its own currency, backed by the wealth created within its own borders, to participate in the global economy.

One way to achieve this objective would be to mine Keynes' Bretton Woods proposal to create a new institutional framework. While Keynes' overall proposal was designed for a very different

²⁶ For a discussion of the benefits of a closed-end fund and other details of its structure, see D'Arista 2000.

world, the basic structure in his concept – an international clearing agency (ICA) – could be revised to serve as the institutional platform for a new global payments system that would foster egalitarian interactions and more balanced outcomes.

The new ICA would clear transactions denominated in members' own currencies by crediting and debiting their clearing accounts. The clearing accounts would, in fact, constitute the international reserves of the system, held for the member countries by the ICA and valued using a trade-weighted basket of all members' currencies. Thus, the clearing process would change the ownership of reserves and reinstate the original intent of the Bretton Woods Agreement to maintain public control of international payments. It would also permit exchange rate adjustments over a set period of time in response to changes in reserve levels, preserving the valid role of market forces in shaping currency values through trade and investment flows while ensuring that speculators would no longer dominate the process.

A revised ICA could reintroduce Harry D. White's Bretton Woods proposal to authorize open market operations by an international agency (Boughton 2006).²⁷ It would do so by permitting the new clearing agency to acquire government securities from its member countries to back their reserve holdings. This would give the ICA means to buy or sell these securities to help national authorities correct imbalances and promote stability. In addition, when approved by a super-majority of its member countries, the ICA's money-creating powers would allow it to operate as a true lender-or-last resort – a role the IMF cannot play given its dependence on taxpayer contributions. In this capacity, the ICA could assist a national central bank in supplying liquidity by buying government securities from residents in the national market and augmenting the country's supply of international reserves or, conversely, help restrain a boom by selling back its holdings of the country's debt and extinguishing reserves.

Membership in the ICA would be open to national central banks of all participating countries and branches of the clearing agency would operate in every major financial center across the globe. The Agency would be governed by a rotating executive committee that would at all times represent half the world's population and half its total output. Its role in clearing members' payments in their own currencies would ensure that the ICA would not infringe on their sovereignty as an international bank that issued a single currency would do. The conduct of national monetary policies and decisions about exchange rate regimes would remain the prerogative of national authorities.

But the ICA's ability to create and extinguish international reserves would give it the power to change the availability of liquidity at the global level. The absence of that power has been increasingly evident throughout the post-Bretton Woods era as crisis after crisis has damaged the global economy and underscored the inadequacy of the current monetary framework. The establishment of an international monetary authority to conduct countercyclical operations was never more needed than it is now.²⁸

The complementarity of payment and development reserves. As discussed above, there have been longstanding efforts to link reserve creation with development objectives. But few

²⁷ This proposal is also incorporated in the modified SDR plan described above.

²⁸ For an expanded discussion of the ICA proposal, see D'Arista 2000.

proposals have attempted to incorporate development objectives into a structure that would link reserve creation to the payment system. The two proposals outlined above are complementary because each is structured to support economic development and because having two structures that can create non-national reserves accommodates the different strategies needed for investing stocks and flows of international reserves held by public and private sectors in economies at all stages of development.

For example, one role for the closed-end investment fund is to shift stocks of reserves held by all countries into a channel that would recycle their aggregate accumulated savings into investments supporting development. During the initial stages of monetary reform, the fund would function like a substitution account with a multilateral guarantee and with income from a diversified portfolio of investments. It would, therefore, overcome some of the problems past and current proposals for a substitution account have posed in terms of the burden on the key currency country and/or the inequitable subsidy given to countries with large reserve holdings.

Another role for the investment fund would be to provide an opportunity to diversify the burgeoning volume of assets held in private pension funds in both developing and advanced economies with, again, a multilateral guarantee as to the soundness of the investment channel and its insulation from speculative activity.²⁹ Similarly, it would offer a marketable, non-national asset to financial and non-financial firms that now hold reserves and working balances used for cross-country trade and investment in the external (euro) markets for national currencies. While accommodating these needs of private firms would become superfluous in most countries with the establishment of the ICA, it would take some time to build deeper and more resilient markets in many developing countries and holdings of stable, guaranteed reserve assets by private firms would help build confidence in those markets.

In short, the closed-end investment fund would remain an effective channel for investing stocks of assets acquired through trade, investment and the pooling of savings that are not denominated in the investor's home currency. The range of investments of the fund could be expanded to include funding for infrastructure, renewable energy, multinational development and other public interest projects that tend to lack access to private credit sources. While investment in the fund would be voluntary and a lower level of return might not suit all private sector investors, the multilateral guarantee would be especially attractive to pension funds

But as valuable and needed as the investment fund would be, it cannot provide the framework for an international payment system. A payment system must be structured to accommodate the short-term, real-time flows that finance balance of payments surpluses and deficits. As we have learned from previous experience, it must be designed to prevent the build-up of persistent imbalances, provide assistance to countries struggling with either economic disruptions or natural disasters, and be able to rectify excessive expansions and contractions in global liquidity. Given a century in which national central banks have evolved into institutions with tools to adjust imbalances in their domestic economies, it is time to build an international platform to incorporate those tools and objectives. However, since the primary role of national central banks is to facilitate payments and ensure macroeconomic stability, many nations have found it necessary to rely on other public institutions to support development. In the end, both payment

²⁹ For a discussion of the growth of pension funds in developing and emerging economies, see D'Arista 2006.

and investment institutions are needed to promote economic growth and stability – a complementary arrangement reflected in the original Bretton Woods institutions that must be revitalized to meet the current crisis and reduce the odds of a recurrence.

II.4. The Outlook for Reform

Whatever their limitations, the fact that the institutional and instrumental structure for issuing SDRs already exists suggests that this framework would present fewer barriers in terms of moving toward an international reserve asset not based on national currencies. In fact, as noted, there has already been a substantial new issue of SDRs in 2009 although its effectiveness is as yet not apparent.

An alternative proposal to increase the share of non-currency reserves in the system and directly support development that could be easily implemented under the existing institutional framework would be the creation of the closed-end international investment fund discussed above. The World Bank already has authority to issue its own liabilities and borrowing to invest in the assets of developing countries is consistent with its mandate to facilitate private development in these countries. Moreover, the World Bank was already moving in that direction in the 1990s when it encouraged and sponsored private investment funds in emerging market economies. The failure of that initiative was at least partly due to the fact that the focus was more on fostering privatization than supporting development. In addition, having bowed to the wishes of private investors, the World Bank agreed to open-ended as opposed to closed-end funds which exacerbated the procyclical effects of portfolio investment flows.

But the more ambitious SDR proposals and the proposal for an international clearing agency discussed above would require changes in the characteristics of the instruments and the institutional structure of the existing international monetary agency. As a result, they would necessitate approval of a new international agreement by national legislative bodies. Because such proposals move toward reform of both the international reserve and payments systems, the policy coherence and international cooperation needed to reach agreements on such changes would be a considerable undertaking. Like the decision for new SDR issuances, the most likely forum for initiating discussions of such far-reaching steps would be the G-20. Nevertheless, failure to take those steps – to focus only on the international reserve system – will, in our view, result in a shift to a multicurrency payments system that, given the size of private international capital flows, will intensify the problems that now exist under the key currency system.

III. Conclusion

The world economy is at an impasse, and policy makers are at a crossroad in terms of how they respond to the challenge it poses. A win-win solution would require deepening international cooperation and new institutions that would make many of the reform proposals discussed above politically viable. However, inertia and shortsighted policy decisions on the part of the rich and powerful nations, especially the US, might instead push us towards an outcome inferior to what is within reach for all. However, even then, the increased economic power of emerging economies and their financial clout means that they might be able to have much greater influence

over their own destiny today than was ever possible before, provided that they manage to act in tandem through global or regional fora.

In a nutshell, the policy challenge emerging market and developing countries face involves the need to address two related but separate problems. One is the challenge of reviving financial intermediation in a way that channels investment throughout the world to promote development and stability. The other is to be able to participate in global trade and investment without having to amass someone else's currency – a requirement that, in the past, forced them to either over-borrow or promote exports at the expense of all else. The large dollar reserves in the hands of emerging economies give them some breathing room from the constraint posed by the latter challenge while providing them with the means to address the former. In fact, any success in financial intermediation that channels investment towards development globally – or at least regionally - can make it easier to reform the international monetary system.

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