Are Governments Regaining Control of the International Monetary System?

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I am very grateful to the organizers of this conference for having invited me to deliver a speech tonight. I suspect that the main reason for inviting me at this celebration of the 70th Anniversary of Bretton Woods had to do with my age and with the fact that I have been associated for a long time with the IMF. I was actually born before the Allied Nations International Monetary Conference was held at Bretton Woods on July 1, 1944, but I was only one and a half year old then and was not much interested in monetary affairs, yet. But when the US Government forced the collapse of the Bretton Woods regime on August 15, 1971, I was working as an economist at the IMF, just a few blocks away from the White House, where the decision was taken. I was quite shocked to witness the end – by the stroke of a pen – of one of the most ambitious and comprehensive experiments of international economic and financial cooperation in modern history.

I then took part as a junior member of the Italian delegation in the so-called Committee of 20 in the ensuing efforts by the IMF to revive the Bretton Woods regime. Almost five years were spent in highly complex and difficult negotiations, but to no avail. In the end, as is well known, the United States obtained what they wanted: a system based on floating exchange rates and on rather vague commitments to follow stability-oriented macroeconomic policies. Despite the valiant efforts conducted by Jacques de Larosière of the French Treasury and by Rinaldo Ossola of the Bank of Italy, European countries did not succeed in their objective of rebuilding an international monetary system based on rules that would ensure monetary and exchange rate stability through a balanced sharing of responsibilities between deficit and surplus countries. When negotiations were concluded with the Jamaica Agreement of 1976, the US Treasury Secretary, William Simon, dryly remarked: "All is well that ends."

For a few years, the new arrangements seemed to work well. But by the mid-1980s renewed tensions emerged in the relationship between the US dollar, the main European currencies and the yen. A coordinated policy action was mounted by the G7 countries in the context of the Plaza and Louvre Agreements. The overvaluation of the dollar was indeed corrected, but the exercise of policy coordination was abandoned soon afterwards as it allegedly had given rise to problems in other areas of the world economy, such as causing deflation in Japan. This was to me a hasty and unfounded conclusion reached by the G7 essentially for reasons of domestic political expediency. Be that as it may, episodes of international financial instability continued to plague the world economy in the 1990s, eventually leading to the global financial crisis of 2007 onwards. The response of the international community to the global crisis focused on strengthening regulation and increasing transparency in financial markets and transactions. New regulations in banking and finance have been introduced in the major industrial countries. New institutions to promote on a global scale harmonisation and transparency in regulation have been created.

But, going back to the question implicit in the theme of this conference: "have we regained control of the international monetary system?" Frankly, I do not think so and I shall try to explain why. Twenty years ago, at a conference celebrating the 50th Anniversary of Bretton Woods, Tommaso Padoa-Schioppa and myself argued that a "market-led international monetary system" had gradually replaced the old Bretton Woods system.[1] We argued that, under the new system, global financial markets determined the creation and distribution of international liquidity and the level of exchange rates. We believed it was essential for national and international monetary authorities to improve their understanding of the unwritten rules and conventions of the new market-led system and of their implications for the stability of the world economy. In subsequent work, I concluded that a key factor in the recurrent bouts of international financial instability had been the interaction between the monetary policies (both current and expected) of the major countries and the working of global financial markets.[2] Moreover, a central role in determining the intensity and the implications of this interaction had been played by the behaviour of exchange rates of these same countries.

Predictably, global markets have been guided in their operations by risk-and-return considerations, shifting the huge amounts of assets under their management in relation to changes in expectations regarding interest rates, exchange rates, and the creditworthiness of their counterparts, be they banks, corporations, or governments. In this constant reassessment of the appropriate combination of risk and return, markets tend to overreact, in some cases paying attention only to yields, in some other cases only to risks. Thus, markets can oscillate between two extremes:

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1 Tommaso Padoa-Schioppa and Fabrizio Saccomanni, Managing a Market-led International Monetary System, in P. B. Kenen (ed.), *Managing the World Economy. Fifty Years after Bretton Woods,* Institute for International Economics, Washington DC, 1994.

2 Fabrizio Saccomanni, *Managing International Financial Instability. National Tamers versus Global Tigers,* Edward Elgar, Cheltenham UK – Northampton, MA, USA, 2008.

one in which all assets are regarded as safe, including junk bonds and the like; and one in which all assets, with a few exceptions, are unsafe, irrespective of the yield they promise to pay to the investor. Bubbles can thus quickly develop, and burst equally quickly, in stock and real estate markets. Exchange rate movements tend to play an important role in market overshooting, as they respond with great speed and intensity to changes in the political, economic and social environment of individual countries. An investment in an asset denominated in a rapidly depreciating currency becomes quickly very risky and unsafe, even if the yield is very high. Conversely, an investment in an appreciating currency can become very attractive even if the yield is very low.

Developments in banking and financial regulation and supervision since the crisis have not significantly altered the functioning of the international monetary system. The pool of international liquidity managed by global intermediaries has sharply increased as a result of the expansionary monetary policies pursued by the Fed, the ECB and the Bank of Japan. Tighter regulation on banking, involving higher capital requirements, limits on proprietary trading, stricter risk management procedures, have not affected the volumes intermediated by financial markets: if anything, it has led to the further growth of the shadow banking system. The latest monitoring report by the Financial Stability Board (October 2013) estimates that shadow banking rose by USD 5 trillion in 2012 to reach the level of USD 71 trillion. Shadow banking represents 24% of total global assets and 117% of global GDP. I would expect these numbers to show further increases in 2013, as funds are shifted from the regulated to the un-regulated sector of the international banking system. The mobility of international capital flows has not abated. Large outflows were recorded from the euro area in connection with the sovereign debt crisis in 2010-11. Large inflows in Emerging Economies took place at about the same time pushing up their exchange rates and prompting accusations of a "currency war", allegedly waged by countries like the United States and Japan through their aggressive monetary policies. Again, huge outflows from emerging markets and inflows into Europe were recently recorded at the first hint of a very gradual and carefully communicated "tapering" of Quantitative Easing by the Fed.

Not surprisingly the Buttonwood column on *The Economist* of January 25, 2014 was entitled "The inevitability of instability". In fact the column reviewed two interesting analytical works, again with very relevant titles: the first one, by Marcelo Madureira Prates, of the Central Bank of Brazil, explains "Why prudential regulation will fail to prevent financial crises: a legal approach"; the second, by Lord Adair Turner argues that there is "Too much of the wrong sort of capital flow".

Are these indications that a new approach to the management of the international monetary system is in the making? I would hope so but I am too old to believe in fairy tales. The refusal of the US Congress to ratify even the modest institutional improvements agreed within the IMF at the inception of the crisis is a clear indication that a far-reaching reform of the international monetary system is not currently possible. Moreover, most academic economists still continue to argue that banking and financial crises can be avoided with stronger regulation and more effective enforcement.[3]

Of course, it would be good to have a system that would impose some degree of discipline on national economic policies, to be enforced in a uniform and symmetrical manner; that would act a global anchor to stabilize inflationary expectations and to ensure a monetary stance appropriate on a global scale; that would provide an internationally managed reserve asset to meet the demand for official reserves and whose value would not change as a result of the domestic policy objectives of any individual country. It would be good but it is not likely to happen any time soon. At the same time it is difficult to accept without some resistance a system that is bound to produce recurrent phases of "boom and bust"; that obliges countries to accumulate huge amounts of official reserves for precautionary purposes, thus imparting a deflationary bias to the world economy; that does not ensure adequate financing for the real economy and long term investment despite the abundance of liquidity. In the end, these flaws are likely to result in trade protectionism and financial fragmentation with a negative impact on the growth of output and employment, and with dangerous implications for political and social stability.

In conclusion, it is not easy to provide a concrete and positive answer to the question raised in this conference. Although, I am sure there will be many valuable contributions from the participants. As a former central banker and former finance minister, I have had the opportunity in my long professional career to take part in all the main fora of international cooperation, from the IMF to the BIS, the G20, the G7, the ECOFIN, the ECB. I am therefore fully aware of the limits that any reform proposal has to respect and will make only a couple of modest suggestions in terms of substance and of procedure.

On substance, I see no alternative to strengthening macroeconomic policy coordination among the main actors on the global scene as a way to promote stability in the international monetary and financial system. It is not easy to achieve, but we all hear politicians constantly repeating the mantra that global challenges require global approaches. It's about time to act in that direction. I think it would be essential to include exchange rate policies in the coordination exercise. I am not advocating a

[3] See, for example, Alan Blinder, *After the Music Stopped: The Financial Crisis, the Response and the Work Ahead,* The Penguin Press, New York, 2013; and Anat Admati and Martin Hellwig, *The Bankers' New Clothes: What's Wrong with Banking and What to Do About It,* Princeton University Press, Princeton, 2013.

return to fixed exchange rates, *à la* Bretton Woods,[4] but neither am I convinced that it is efficient to allow individual countries to pursue domestically oriented monetary and fiscal policies and then let the global foreign exchange market reconcile the inconsistency that is likely to result. Time and again this so-called "house in order approach" has proved to be unable to ensure international financial stability.

The foreign exchange market is considered to be the best approximation to perfect competition, but it is well known that foreign exchange is increasingly traded as a financial asset, *per se,* with little relation to the real flow of commercial and investment transactions between the currencies paired in the exchange rate. Exchange rate movements therefore may not necessarily reflect underlying changes in the economic fundamentals of countries and in their competitive positions. Moreover, the market is not immune from the risk of collusion among traders and manipulation. As reported in the *Financial Times* of February 17, 2014, nine major international banks are conducting internal probes into alleged collusion and manipulation charges in their trading centres in London, New York, Tokyo and Buenos Aires and the investigation could result in multi-billion dollar fines from regulators, as in the case of the Libor scandal.

In the end, an international agreement on some form of soft target zones for the major exchange rates may well be the best way to ensure that exchange rates provide a contribution to the adjustment of payment disequilibria without being themselves a factor of instability. A few years ago, in an important lecture on exchange rate stability, Paul Volcker stated: "My sense is that we will find success easier than feared by so many – that the market will more often than not respond constructively to a firm and intelligent lead by governments and that exchange rate stability will reinforce prospects for growth. One thing is for sure: without trying, we will never know".[5] Please note the carefully chosen adjectives: *firm* and *intelligent* lead by governments. Translated into the currently prevailing lingo, Volcker would seem to endorse a "forward guidance" approach to exchange rates. Indeed if the approach works for interest rates, I do not see why it would not work for exchange rates.

My second suggestion is on the procedural arrangements for policy coordination. In recent years important analytical work on this issue has been conducted both by the IMF and by the G20. Some degree of competition among institutions is apparently beneficial also in the field of international cooperation. The practical

4 Benn Steil, *The Battle of Bretton Woods,* Princeton University Press, 2013, recalls that, as early as 1941, J. M. Keynes felt that fluctuating exchange rates were not a viable alternative model for underpinning trade relations among nations and that "depreciation is a bad method which one is driven to adopt failing something better" (p. 140). Thus, the Bretton Woods regime would be more appropriately defined in subsequent years as a regime of "fixed but adjustable exchange rates".

5 Paul Volcker, *The Quest for Exchange Rate Stability: Realistic or Quixotic?,* The Stamp 50th Anniversary Lecture, University of London, 1995.

results of these efforts, however, have been modest so far, to say the least. A reconsideration of the respective roles of these two bodies may be in order. No doubt the G20 can provide the political leadership that is required in times of crisis, as was the case in 2009, and it should operate mostly at the level of Heads of State and Government. But the conduct of the exercise of policy coordination should be left entirely to the IMF and its policy making International Monetary and Financial Committee, where Finance Ministers and Central Bank Governors are involved. It is essential that this delicate task is entrusted to an institution endowed with the legitimacy deriving from its constitutional charter, the Articles of Agreement, namely an international treaty ratified by the Parliaments of the IMF member states.

These suggestions are far from implying a fundamental reform of the international monetary system. But their implementation would send to financial markets the signal that monetary and financial authorities are willing and ready to play a role in orienting the operation of the system towards stability, hopefully, with a "firm and intelligent lead".