International Chamber of Commerce
The world business organization

Reforming the international monetary system

Issue

The global economic crisis heralded, indeed accelerated, a transition towards a new world where emerging market economies play a large role on a par with advanced ones in driving global growth; a world that will be fundamentally multi-polar, and in which global monetary problems must be dealt with cooperatively.[1]

Analysis

The crisis caught many experts and policy-makers by surprise revealing vulnerabilities in the international monetary system. While these were principally in developed economies, their effects quickly spread to the entire monetary and financial system.

But the crisis highlighted the need for effective international policy coordination. The G20 is a powerful response in this regard.

While the global economy may have avoided the worst of the crisis via the injection of massive amounts of fiscal and monetary stimulus, several broad issues regarding the current international monetary system remain, including the set of rules, norms, and institutions that governs the world's currencies and the flow of capital across borders.

Dealing with these issues requires both fiscal and structural reform as one without the other is not sustainable in the long term. Structural reforms are critical at the micro level, including to encourage innovation and reduce youth unemployment.

In addition, G20 leaders should look to strengthen financial markets in emerging economies by developing capital markets and improving access to retail financial services in order to increase both domestic confidence and investment opportunities, both of which could stimulate consumption and help to offset global imbalances as well as reduce the risk of asset bubbles.

These are critical issues for business as increasing global economic imbalances could lead to currency wars, bankrupt states and trade protectionism. Moreover, persistent vulnerabilities remain in the international monetary system, including:

- Excessive economic imbalances, within both developed countries and developing countries. Currently, average government debt-to-GDP ratios in the G7 economies are at their highest level since the 1940s.

- Excessive exchange rate fluctuations. Since the beginning of generalized floating exchange rates in 1973, rates have failed to move consistently and have promoted imbalances.

[1] This paper draws extensively on the ideas contained in an article entitled "Beyond Bretton Woods 2" published in The Economist magazine of November 6th 2010; and on the report of the Palais Royal Initiative entitled ""Reform of the International Monetary System: A cooperative approach for the twenty first century, 8 February 2011.

- A need for more effective global governance to ensure that decisions are consistent and contribute to global stability. The International Monetary Fund (IMF), intended for this purpose, has not been able to achieve this task fully.

Recommendations

Excessive economic imbalances

Global liquidity conditions are influenced by monetary policy in major countries, exchange rates, and innovation and risk-taking behaviour in the financial sector. Liquidity can change due to many conditions, including perceptions.

Thus a global approach is particularly difficult. One item which the G20 leaders can act on is enhancing economic surveillance, to provide as accurate a picture as possible of economic flows and overall sustainable economic development of an economy. G20 leaders must take into account that their countries' domestic policies interact and affect global stability and have spill-over effects.

There also needs to be greater understanding and cooperation among central banks and finance ministries on macro policies that impact liquidity. Sounds macro policies combined with time-limited interventions and capital controls may be effective to protect countries from large and volatile (short-term) capital flows, though measures should not create distortions and not affect countries negatively. The development of internationally agreed guidelines in this area would be critical, as well as joint monitoring to insure that interventions are limiting and not distorting. Working with the private sector is critical in this regard.

Excessive exchange rate fluctuations

Renewed leadership by G20 leaders to promote international exchange rate coordination is particularly important to avoid currency wars. Countries need to conduct their economic and fiscal policies with a goal to ensuring that exchange rates are broadly in line with market fundamentals and global balance. It should be recalled that, while IMF members, under its Articles of Agreement, have the right to choose their respective exchange rate policies, they also have a stated obligation to avoid manipulating exchange rates to secure a competitive advantage.

G20 leaders could consider making countries' obligations more specific, perhaps through the use of benchmarks to identify instability and misalignment. G20 leaders could further develop/integrate a joint monitoring system along the lines of that for capital controls to monitor excessive exchange rate fluctuations.

Global governance

In light of the experience of the recent crisis, further steps should be taken to make the IMF more receptive to being a global lender of last resort ready to act in a reliable, rules-based fashion, and with appropriate protections to limit moral hazard.

Rather than try to create a global reserve asset, G20 leaders might achieve more by reducing the demand for reserves. This can be done by improving countries' access to funds in a crisis. The IMF's lending facilities have already been overhauled, so that well-governed countries can get unlimited funds for two years.

G20 leaders could develop a plan for rebalancing the world economy, perhaps with target ranges for current-account balances and real exchange rates, supported by peer review rather than explicit sanctions.

A rebalancing plan would address many of the tensions in the monetary system. But shifting the resources of surplus countries from exports to consumption will take time. Meanwhile, capital flows into emerging markets are likely to surge much faster.

There is also need for a more integrated architecture and decision-making structure in the international monetary system by developing a more formal framework for the relationship between G20 leaders and key intergovernmental financial institutions like the IMF. The IMF should play the role of neutral arbitrator in cases of exchange rate misalignments. It has the knowledge and authority to intervene more actively in disputes that cannot be mediated by individual countries. It also has a long track record of resolving various economic crises through multilateral coordination.

The economic crisis demonstrated that greater global coordination is needed. G20 leaders have taken the first steps in London and subsequent summits. It is essential that a reformed international monetary system should safeguard the gains of the past 65 years. We must ensure that whatever measures are taken preserve and indeed strengthen a system that maintains freedom of trade and current payments and that allows the benefits of financial globalization to be shared more widely.

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