

Implications of the Euro's Crisis for International Monetary Reform¹

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January 2012

2011 was supposed to be when policy makers fixed the fundamental flaws in the international monetary system. The French government, on assuming chairmanship of the Group of Twenty, the club of systemically significant economies, placed international monetary reform at the top of its agenda for the year.

In the event, little was accomplished by the time the chair passed to Mexico at the beginning of 2012. This failure is widely ascribed to the deepening the euro-zone crisis and its disruptive impact on the international economy and its financial markets. Europe's debt and banking crisis diverted the attention of global policy makers. Rather than pursuing reform of the international monetary system, they directed all of their scarce intellectual and financial resources toward the more pressing problem of addressing Europe's woes.

But serving as a sink for scarce economic, financial and intellectual resources was not the only respect in which Europe's crisis had implications for the process of international monetary reform. In fact, the flaws in the euro zone are almost exactly analogous to the flaws in the international monetary system. And if, as is increasingly recognized, fixing the flaws in the euro zone will be hard, fixing the flaws in the international monetary system will be harder still, for both economic and political reasons. A growing chorus of skeptical observers insists that creating the euro was a mistake and that, given the obstacles to completing Europe's monetary union, the single currency should now be abandoned, either in part or entirely. But if the international monetary system suffers from exactly the same flaws, and if fixing them will be even harder, then what aspects of early 21st century globalization should they similarly insist on abandoning, either completely or in part?

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The problems of Europe's monetary union will not be news to aficionados of the theory of optimum currency areas. A first problem is the absence of an adequate adjustment mechanism to correct imbalances among member states. No longer possessing a national currency, members of the euro area are not able to resort to external devaluation to restore international competitiveness, while the alternative of internal devaluation (reducing wages and costs) is painful and slow. Since debts are no longer denominated in the national currency – they are denominated instead in the currency of the monetary union – the adverse balance-sheet effect of internal devaluation is akin to that of external devaluation for a country with foreign-currency-denominated debt. Internal devaluation for a member of the euro area, like external devaluation for an economy with an aggregate currency mismatch on its national balance sheet, may only aggravate the problem it is intended to solve. The result is to leave the heavily indebted, uncompetitive countries of the euro area between a rock and a hard place.

Given the difficulties of restoring competitiveness when it is lost and growing out from under a burden of excessive debts, Europe has sought, not unreasonably, to prevent these problems from arising in the first place. The Stability and Growth Pact and its associated Excessive Deficit Procedure were an effort to use external surveillance and sanctions to prevent budget deficits from rising to dangerous levels. The well-known reference value for activating the procedure was a budget deficit in excess of 3 per cent of GDP. But there were problems of incentive compatibility; when the two largest members of the euro area, Germany and France, were able to evade the application of the Excessive Deficit Procedure in November 2003, it became harder to credibly threaten other countries. There was no requirement of faster elimination of excessive deficits for countries with larger debts. There was no allowance for the

¹ Prepared for the session entitled "A New International Monetary Order?" at the Allied Social Science Associated Meetings, Chicago, January 6, 2012, and forthcoming in the *Journal of Economic Policy Modeling*.

fact that competitiveness problems could arise owing to the behavior of the private rather than the public sector – that there could be excessive accumulation of private debt and that problems of competitiveness could manifest themselves not in chronic budget deficits but in rising unit labor costs.²

The EU has now tried, once again, to correct these deficiencies. It has advanced six pieces of legislation – informally known as the “six pack” – to prevent and correct macroeconomic imbalances. It has agreed on an intergovernmental treaty with associated changes in national legislation to strengthen fiscal discipline. Rather than having member states vote to accept a recommendation by the European Commission that a country be required to take corrective action, the Commission’s recommendation will now be adopted unless a majority of member states votes against.³ There will be numerical benchmarks for debt reduction: countries with heavier debts will be required to take faster corrective action. “Debt brakes” (essentially cyclically-adjusted budget balance rules) will be adopted through national legislation. An Excessive Imbalances Procedure will address problems of competitiveness arising for reasons other than budget deficits. Countries will be graded according to their performance on a range of indicators affecting their competitiveness, and those receiving failing grades will be required to submit a “corrective action plan” and to make non-interest-bearing deposits or pay fines if they fail to submit an adequate plan or to meet its schedule and deadlines.

Only time will tell whether these strengthened rules and procedures will prevent major problems of competitiveness and over-indebtedness from arising. The failure of their predecessors to do so is one reason why many observers now skeptical. It is why they argue that the members of the euro area were reckless to abandon their own currencies and forsake exchange rate adjustment as a mechanism for restoring competitiveness.

This flaw in Europe’s monetary union has an obvious parallel in the problems of the international monetary system. The absence of an adequate adjustment mechanism is known in this context as the “n-1 problem” – that in a world of n currencies there are only n-1 exchange rates. If other countries evince “fear of floating” (Calvo and Reinhart 2002), the country to whose currency they peg has limited ability to adjust its exchange rate. If China, in its wisdom, wishes to peg the renminbi to the dollar, then there is little the United States can do about it. To be sure, there is more than this to the problem of global imbalances, just as there is more than the euro behind Europe’s problem of internal imbalances. But the parallel is there. Imbalances happen. And the ability to correct them through exchange rate adjustment is not always present.

The G20 has sought to address this by developing what Europeans call “the preventive arm.” In an effort to avoid and correct excessive imbalances, G20 countries at their Pittsburgh summit in 2009 agreed to the creation of a Mutual Assessment Process, under which governments provided information on their policies and the IMF aggregated this and checked it for consistency. Next, G20 summiteers agreed on a set of indicators and guidelines for budget deficits, public debts, private debts, trade balances, and net investment income flows. These indicators are to be used to determine the presence of large and potentially dangerous internal and external imbalances. Where such imbalances are identified, they will trigger independent, in-depth analysis of their causes and consequences by IMF staff and intensified scrutiny by G20 members of one another’s policies. All this is reminiscent of European arrangements but with the IMF playing the role of the European Commission.

There are, however, two differences. First, there is in the absence of concrete numerical guidelines. At the Seoul Summit in November 2010, the United States pushed for numerical targets for current account surpluses, but surplus countries, led by China and Germany, succeeded in blocking agreement on numerical thresholds that would automatically trigger reports and intensified scrutiny. At the next G20 meeting, in early

² The experience of Spain between 2001 and 2007 epitomizes the point.

³ This is known as “the reverse simple majority voting procedure.”

2011, China was able to block the adoption of numerical guidelines for the accumulation of foreign exchange reserves.

Second, there are no financial penalties or economic sanctions for countries not complying with the guidelines. There has been a wide variety of proposals for adopting them: for requiring the IMF to send a mission to a country in violation of the guidelines; for empowering the IMF to label a country a currency manipulator, thereby allowing the WTO to authorize the imposition of trade sanctions; and for SDR allocations to be made contingent on countries' conformance with the guidelines. In contrast to Europe, where further steps to impose mandatory penalties on countries violating the euro-zone's guidelines, the main thing that these ideas for strengthening the international monetary system have in common is that none of them is likely to be adopted.

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A second shortcoming of Europe's monetary union, recent events have revealed, is the absence of bank regulation at the level of the union. Banks are key mechanisms for transmitting shocks across member states, whether through the interbank market, their holdings of neighboring countries' sovereign debt, or their day-to-day lending activities. No one doubts that the cross-border externalities associated with these linkages are of first-order importance or that the effects are pronounced in an environment where there are no barriers to capital mobility and, until recently, currency risk was absent.

Yet supervision and regulation of the banking system in Europe remains a national competence. This creates a bias toward under-regulation, and under-capitalization in particular, insofar as regulators are sympathetic to the desire of national champions to attract business from abroad. It fosters neglect of the cross-border impact of national regulatory policies. If French banks invest excessively in Greek government bonds because of the risk weight attached to sovereign debt by French regulators and this in turn ends up feeding problems in Greece, this side-effect is not something that French regulators take into account. The European Banking Authority (EBA), which came into existence at the beginning of 2011, is designed to correct these incentive problems by laying down regulatory standards for the EU as a whole. But implementation remains in the hands of national regulators. And the incentives of national regulators and the EBA are not always aligned, as illustrated in recent stress-testing exercises.

Given time, one can imagine further centralization of regulatory authority at the EBA. National deposit insurance schemes could then receive a federal fiscal backstop. The EBA could be given resolution authority to take over failed banks, sell off their assets where possible, and manage what remains in public hands. But reaching agreement on this will not be easy. Proceeding with monetary union before that agreement was reached, it is now argued, was dangerously premature.

The problem in the international monetary sphere is, if anything, even more serious. There too banks act as a conduit for transmitting disturbances internationally, both when they borrow on the interbank market and when they invest in private-label securities (Shin 2011). While the capital and liquidity guidelines of the Basel Accord and the Core Principles for Effective Banking Supervision are designed to set minimum acceptable standards for supervision and regulation, implementation is at the national level, and there is nothing on the horizon remotely resembling a global regulator. There is no cross-border resolution regime for failed global banks and, aspirations to the contrary, little progress toward creating one. If pan-European banking without a pan-European regulator is problematic, then global banking without a global regulator is more problematic still.

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The euro area's third problem is an inadequate supply of emergency liquidity. National governments across Southern Europe have limited capacity to issue and, more importantly, redeem safe assets that can be

bought and sold at predictable prices (such being the definition of liquidity). The European Central Bank could in principle provide that liquidity, acting as a lender of last resort to governments, banks and markets. But for much of its history the ECB has been reluctant to do so for a combination of political, ideological and statutory reasons. A monetary union without a central bank prepared to act as a lender of last resort is not viable, it is argued. If Germany, in particular, is not prepared to allow the European Central Bank to address liquidity problems, it follows, then going ahead with monetary union was a mistake.

Problems with the supply of liquidity are prominent in the debate over the international monetary system as well. Once upon a time an outside asset, gold, accounted for a substantial fraction of international liquidity. It was widely accepted in international payments and convertible into domestic currency at a fixed and therefore predictable price; it was liquid, in other words. But given the fixed price and relatively inelastic supply of gold, it had to be supplemented, as the world economy grew, by an inside asset, the dollar, the currency of the only country with deep and liquid financial markets open to the rest of the world. But as foreign dollar claims grew large relative to U.S. gold reserves, the fixed dollar price of gold had to be abandoned. The price of gold having become less predictable, gold became less liquid in the relevant sense. It came to account for a progressively declining share of international reserves, and the global economy came to depend almost entirely on dollars for international liquidity.⁴

An inside asset is also, by definition, a liability. Dollar reserves are a liability of the U.S. government, whether directly, when a foreign central bank holds U.S. treasury securities, or indirectly, when it maintains deposits at a U.S. bank, which are liquid by virtue of explicit or implicit governmental insurance. Thus, the ability of the United States to meet the demand for international liquidity is limited by the fiscal capacity of the U.S. treasury to stand behind its obligations.⁵ This constraint on the smooth operation of the international monetary system binds when the global economy and the volume of international transactions grow faster than the United States, as in the present period characterized by the emergence of emerging markets. It binds even more tightly when other countries are seeking to augment their holdings of reserves as insurance against financial disturbances, past, present and prospective.

The obvious way of relaxing this constraint is for other large economies, in addition to the United States, to provide reserve assets and for the world to move toward a multiple-reserve-currency system.⁶ This brings us back to the problems of the euro, since the euro area is one of the few economies with the size necessary to supply reserve assets on a significant scale. As it stands, however, the euro area is not regarded as a reliable source of safe assets. The ability of some of its governments to stand behind their debt obligations is in doubt. Markets in government bonds remain segmented.

Similarly, the obstacles to China's emergence as a significant source of international liquidity are considerable. Though China is a large economy, its financial markets are underdeveloped. Bond market capitalization is barely a tenth that of the United States. As in Japan, the majority of government and corporate bonds are held to maturity by domestics, in this case banks and credit cooperatives. Trading volume as a share of the value of outstanding bonds is barely one per cent that in the United States and Europe. China is still a considerable distance, in other words, from having the kind of deep and liquid bond markets that have made the euro and, above all, the dollar attractive international and reserve currencies.

⁴ There, in one short paragraph, is the logic for the progression from the gold standard to the gold-dollar standard to the dollar standard. A full account would of course be longer and tempered by caveats. For example, there was in principle another possible equilibrium: secular deflation raising the real value of gold reserves, although this was problematic for both economic and political reasons. In addition, recent years have seen some increase in the share of gold in central bank reserve portfolios, reversing several decades of movement in the opposite direction, reflecting doubts about the security of other investments (more on this below).

⁵ The role of fiscal capacity as a determinant of international liquidity is a theme of Obstfeld (2011) and Farhi, Gourinchas and Rey (2011).

⁶ This remainder of this section draws on Eichengreen (2012).

Inducing private and official investors to hold a significant fraction of their liquidity in renminbi will require not just enhancing the liquidity of Chinese financial markets but limiting official interference in their operation. Chinese banks will have to be placed on a commercial footing where they feel no pressure to engage in policy lending. Residual doubts about the security of foreign financial investments in China will have to be removed. There will have to be a fundamental transformation of not just the country's development model but also its foreign relations, in other words. And fundamental transformations take time.

If each of the major economies faces challenges constraining their ability to supply additional international liquidity, then it is essential to utilize the available liquidity more efficiently. Insofar as transactions are staggered and shocks are less than perfectly correlated, reserve pooling has appeal. The observation that countries will seek to use their reserves at different times thus provides a rationale for the development of incipient pooling arrangements like the Chiang Mai Initiative Multilateralization (CMIM) and the Latin American Reserve Fund (FLAR). It is a justification for IMF lending facilities through which members can draw a multiple of their capital contributions.

But the limitations of the approach are equally evident. The appeal of liquidity is that it is liquid; it can be converted into real resources without delay. The appeal of own reserves is similarly that they can be accessed immediately, without conditions. The same is not always true of reserve pools. Participants are reluctant to provide resources without conditions for fear that the borrower may be unable to repay what it is lent. This creates uncertainty about whether access can be negotiated under acceptable conditions and is, inevitably, a source of delay. The IMF has sought to address this by creating a Flexible Credit Line under which countries with impeccably strong policies are able to borrow without being subject to conditions and under which they are prequalified for participation, eliminating delay. Problems here include stigma and, more fundamentally, the fact that the institution's responsibility to guard the resources of its members means that Flexible Credit Lines can be made available only to a subset of countries – the same subset that is presumably least likely to require emergency liquidity. The stigma problem might be addressed by allowing the Fund to unilaterally prequalify groups of its members. The reluctance to lend unconditionally has been partially addressed by creating a second facility, the Precautionary and Liquidity Line (previously the Precautionary Credit Line), for countries whose policies are almost strong enough for a FCL and attaching only limited conditions.⁷ But inevitably uncertainty and delay then creep back in.

These difficulties are if anything more severe in regional pooling arrangements. Negotiations over emergency loan conditions between neighboring governments are politically fraught. Although euro area governments initially sought to resolve the European financial crisis themselves, the delicacy of intergovernmental negotiations led them to call in the IMF when it became necessary to provide emergency loans to Greece, Portugal and Ireland. In the wake of the 1997-8 crisis, Asian countries created the CMIM to free them from again having to apply to the IMF for resources, but the difficulty of negotiating conditionality within the region led them to create an IMF link.⁸ Not only has there been no attempt to utilize the CMIM as of the time of writing, but the countries best able to make credible commitments (China, South Korea and Japan, for example) have been moving away from it by negotiating their own bilateral swap lines.⁹

Creating additional IMF Special Drawing Rights has also been suggested as a way of augmenting international liquidity. But SDRs, to be used, must first be converted into liquid assets. This must be done

⁷ The principal difference between the Precautionary and Liquidity Line and the Precautionary Credit Line being that the latter was only for countries with potential future needs at the time of approval while the former can also be extended to countries with actual needs (that may wish to draw the line immediately).

⁸ Countries seeking to access the CMIM must enter into an IMF program if they wish to draw more than a nominal amount of their entitlements, at the time of writing 20 per cent.

⁹ Where "countries in a position to do so" means countries with sufficiently strong finances and political links that there is little uncertainty about their ability and willingness to repay what they borrow.

through the good offices of governments, since there are no private markets in SDRs. When a country wishes to do so, the IMF first asks for volunteers.¹⁰ If willing governments fail to come forward, it then uses its so-called “designation process” to require national treasuries to provide national currencies in return. What they provide thus constitutes a claim on their fiscal capacity, like other treasury liabilities.¹¹ In this sense additional SDR issuance does not finesse the need for national fiscal backing for international liquidity.

Truman (2008) has suggested that SDR claims could instead be presented directly to central banks, which could provide high-powered money in return.¹² This would lend additional elasticity to the supply of international liquidity, since the Federal Reserve, the ECB and the PBoC would be providing additional dollar, euro and renminbi claims without at the same time creating additional obligations for their treasuries. But if done on a large scale, such operations could have significant implications for the balance sheets of the reserve-currency-issuing central banks, which would be exchanging their own respective currencies for a basket of foreign currency claims.¹³ The risk of exchange losses is likely to cause central banks to hesitate to proceed down this road. It is likely to cause their political masters to hesitate to pass the enabling legislation.

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The euro’s crisis thus highlights the issues that dominate the agenda for international monetary reform. Just as the euro lacks an adjustment mechanism for smoothly eliminating the imbalances between Europe’s north and south, the international monetary system lacks an adjustment mechanism adequate for smoothly eliminating global imbalances.¹⁴ The euro area may have a “symmetry problem” – surplus countries like Germany feel less pressure to adjust than their deficit counterparts – but the symmetry problem of the international monetary system is precisely analogous.¹⁵ The euro area may have lacked effective sanctions to prevent the development of dangerous imbalances, notwithstanding the fact that the legitimacy of such sanctions has been enshrined in a series of European treaties, but the idea that such sanctions could be adopted at the global level, whether through the G20 process or by amending the IMF’s Articles of Agreement, remains a pipedream. Just as supervision and regulation of banking systems remains a national competence in Europe, it remains a national competence globally. And just as the euro area has lacked a reliable supply of emergency liquidity, ensuring an adequate supply of international liquidity at the global level, whether via more efficient reserve pooling and more reliable central bank swap lines, the issuance of Special Drawing Rights directly to central banks or, most plausibly, the emergence of additional reserve currencies, is a major challenge for international monetary reform.

It is now widely acknowledged that the euro area’s current condition is untenable – that it will either have to move forward to correct the deficiencies in its monetary union or go back to national currencies. But precisely the same is true of the global and monetary and financial system. Either countries will find a way forward and succeed in correcting the deficiencies in the international system, or they will eventually conclude that they have no choice but to go back to being a less deeply integrated set of national economies.

¹⁰ SDRs may also be traded among governments directly.

¹¹ Think of this as the treasury drawing down its cash reserves or issuing additional debt. In the U.S. case, this is accomplished by the treasury issuing SDR Certificates to the Fed, which provides dollars in return. The Fed typically sterilizes the impact on the money supply, and the treasury commits to compensating the Fed for any exchange losses.

¹² See also the discussion of this in Obstfeld (2011).

¹³ As well as the portion of the basket constituted by their own currency.

¹⁴ Or so their striking persistence (as described by Chinn, Eichengreen and Ito 2011) would seem to suggest.

¹⁵ As described by Fiorentini and Montani (2009).

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