# Modest Proposal for International Monetary Reform

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An ideal system of international payments should be characterized by stability and balance; stability in exchange rates and the absence of sudden crises and balance in the sense that individual national economies should suffer neither from the deflationary effects of chronic external deficits nor the distorting consequences of chronic external surpluses. Both requirements are essential to the efficient international movement of capital. Yet neither requirement appears to have been met by the current dollar-based reserve currency system. Recurrent crises in Asia, Latin America and Eastern Europe and chronic and growing US payments deficits (with their associated deflationary impact) are longstanding characteristics of the current system.

This paper argues that the problems just described are fundamental aspects of the present system and that, without reform, they will continue to plague the global economy. However, a simple set of institutional reforms would go a long way toward alleviating these difficulties. In order to understand the need for and nature of these reforms, we begin by analyzing the dynamics of the current system using a simple global

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Deficits are like hot potatoes—so long as some countries are in surpluses, the sum of the deficits of the other countries must add up to the value of their surpluses. If the US did not absorb these new surpluses they would migrate to other relatively weak economies like Russia, Mexico and Brazil (as they did). *In the absence of sufficiently high deficits by the reserve currency country, the whole reserve currency payments system is inherently unstable with a deflationary bias.*

Reserve accumulation represents a subtraction from global purchasing power. If the United States were to fail to offset this subtraction by aggressive consumption and government deficit spending, the consequences might well be a serious prolonged global recession. Yet as the United States does this, U.S. consumers, who are among the richest in the world, benefit at the expense of those (often much poorer) nations accumulating dollar reserves.

Thus, chronic and growing US deficits are an essential feature of the current system.

……… These structural surpluses exacerbate the basic imbalance at the heart of the reserve currency system. As Keynes noted deficits are self-limiting, as non-reserve countries run out of reserves. Surplus countries as long as they neutralize the domestic inflationary pressure of surpluses can go on forever. This is especially true in a flexible exchange rate world since surplus countries can always counteract the adverse consequences of rising pressure on exchange rates by selling their own currencies which they possess in unlimited supply.

……….

What we have ignored, of course, is the mutual interaction of domestic and international policies. They can be summarized as follows

(1) The efficacy and stability of the present system depends on continuing and growing US foreign payment deficits.

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(2) These foreign payments deficits exert a powerful deflationary effect on the US domestic economy which can only be offset by aggressive US government fiscal and monetary policy.

(3) These difficulties are exacerbated by chronic surplus countries whose behavior is difficult to control within the context of the current system.

(4) These surplus countries tend to export deflationary tendencies not only to the United States, but to other industrial economies.

This list elucidates many of the short comings of the current dollar reserve currency system. One final shortcoming of the present system should be noted. As the US increasingly becomes the deficit country of last resort, the world becomes increasingly awash in dollars. This is an unavoidable consequence of the present system and the economic behaviors of powerful participating nations.[19] Nevertheless, the flood of dollars inevitably undermines confidence in the value of the dollar which, in turn, contributes to exchange rate instability and concern in national economies about the value of their increasing level of dollar holdings. The result is an increased level of concern and potential instability that it would be useful to alleviate.

II. Equity

There is essentially a net transfer from developing countries to the richest country in the world, as the poor countries make low interest loans to the United States (often reborrowing some of the money at much higher interest rates.[22]) Obviously, these net transfers—which exceed **IV. A Simple Reform Proposal**

The primary goals of any international monetary reform should be to alleviate these problems by (1) decoupling reserve accumulation from the deficit positions of any reserve currency countries, (2) providing some means of disciplining surplus countries and (3) providing a more stable store of international value than the dollar or any other reserve currency. In addition, an international monetary reform should be equitable—with the benefits of any seignorage arising from reserves sharing equitably.

One way to do this would be to issue SDRs on a substantial and regular basis as a non-reserve currency source of international reserves. Current international reserves are about $3000 billion. Assuming the demand for reserves increases at the average rate of world trade (about 7%), an annual issue of $200 billion in SDRs would satisfy any demand for reserve accumulation without a US payments deficit. The reserves could be simply credited to the IMF accounts of current member countries in proposition to their current IMF fund positions. Since SDRs are valued as a weighted average of all convertible currencies their value is largely stable in the face of changing exchange rates. Thus, as SDRs become more widely available as a source of reserves, they might ultimately serve as a stable international unite of account for pricing international commodities such as oil.

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Finally, SDR allocations could serve as a basis for partially offsetting the externalities generated by chronic surplus countries. SDR allocations could be taxed at a rate of 50 percent (or some other appropriate fraction) per unit of current account surplus up to the full amount of a country's allocation. The resulting SDR taxes could then be used as a source of global financial aid to be distributed among developing countries (who might then be required to subscribe to a set "good government" principles- e.g. nuclear non-proliferation- to qualify for such distributions).

One could view the new reserve system as a form of cooperative mutual help. The international community would be providing entitlements to automatic "help" in times of crisis, allowing the country to spend beyond its means, beyond what international financial markets are willing to lend, as each country guarantees that the new reserve currency could be converted into their own currency.

**IV.1 Political Economy of Reform: Incentive Compatibility**

In the limited space available here, we cannot discuss the political economy of the reform. Suffice it to say that since the gains to all—including the United States—are significant (described more fully in the next section), there should be widespread support. But as an alternative, the reform could be implemented in a piecemeal manner, as a group of countries agreed to the new system, and agreed that those who join the system would gradually move toward holding only the new reserve currency

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and the currencies of other members of the "club" as reserves. If enough countries joined the "club" there would be an incentive for any country that currently is a reserve currency (and believes that it gains from being a reserve currency) to join the club too.

Here is how the club might work. Every year, each of the members of the "club" would contribute a stipulated amount to the GRF (global reserve fund), and at the same time, the GRF would issue Global Greenbacks of equivalent value to the country, which they would hold in their reserves. There is no change in the net worth of any country; it has acquired an asset (a claim on others) and issued a claim on itself. Something real however has happened: it has obtained an asset which it can use in times of an emergency. (And at the same time, it has agreed to let others call upon its resources in times of emergency.)

Normally, of course, except for the cost of holding reserves, these exchanges of pieces of paper make no difference. Each country goes about its business in the same way as it did before. It conducts monetary and fiscal policy much as it did before. Even in times of emergency, life looks much as it did before. Consider, for instance, an attack on the currency. Before, the country would have sold dollars (buying up its own currency) to support the value of its currency. (Whether such intervention makes sense is not a question which we address here.) And it can continue to do that so long as it has dollars in its reserves (or it can obtain dollars from the IMF.) Now, it exchanges the global greenbacks for conventional hard currencies to support its currency.[24] [25]

[24] There is an important detail: the exchange rate between global greenbacks and various currencies. In a world of fixed exchange rates (the kind of world for which the SDR proposal was first devised) this would

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not, of course, be a problem; in a world of variable exchange rates, matters are more problematic. So long as global greenbacks are held only by Central Banks, there is no real problem of speculation, so that the "official" exchange rate could differ from market exchange rates. One could use current market rates; alternatively, the official exchange rate, for instance, could be set as the average of the exchange rates over the preceding three years. In such a case, to avoid Central banks taking advantage of discrepancies between current market rates and the official exchange rate, restrictions could be imposed on conversions (for instance, such conversions could only occur in the event of a crisis, defined by a major change in the country's exchange rate, output, or unemployment rate.)

Because each country is holding Global Greenbacks, each no longer has to hold dollars or Euros as reserves, and for the global economy, this has enormous consequences, both for the (former) reserve currency countries, and for global economic stability. The deflationary pressure noted earlier would no longer be present, because each country would no longer have to "bury in the ground" some of its purchasing power. Reserve currency countries, whose "exports" of IOU's are matched by a current account trade deficit, would no longer face the systematic deflationary bias of net imports.

For a country like the United States which has been tempted to have large fiscal deficits because of the low cost of financing these deficits, the enhanced discipline would contribute to long term fiscal probity. If it ran huge deficits year after year, it almost surely would face higher and higher real interest rates.

**V. Cost and Benefits of a Revised System**

Such a system appears likely to benefit all participants in the global financial system. Superficially, the greatest "loser" would be the United States, which would at least

[25] We envision global greenbacks only being held by Central Banks, but a more ambitious version of this proposal would allow global greenbacks to be held by individuals, in which case there would be a market price for global greenbacks, and the government could simply treat the global greenbacks as any other "hard" currency.

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partially forego its monopoly on issuing paper claims for real goods and services. However, Britain enjoyed such a partial monopoly prior to Bretton Woods and Keynes rightly recognized that it represented a very mixed blessing. The benefits of seignorage were perhaps more than offset by the adverse consequences of chronic net foreign deficits through their deflationary effect on the domestic British macroeconomy. The United States has avoided many of these effects by running large, persistent government deficits to sustain full-employment, but that policy too has potential adverse consequences. Keynes's immediate solution for Britain's situation was to off-load the dubious benefits of reserve currency status on the United States. However, he ultimately envisioned a system similar to that outlined above (including discipline imposed on chronic surplus countries).

The Euro community, to the extent that it too envisaged becoming a reserve currency, might also be said to suffer. However, its recently ambiguous experience with the rise of the Euro appears to have qualified its enthusiasm for the chronic deficit position associated with reserve currency status.

Foreign central banks concerned with the stability of the value of their dollar holdings would benefit in three ways. First, the creation of SDR reserves would provide an alternative store of value which would at a minimum diversify their reserve holdings. At best SDRs would provide a far more stable store of value than any individual currency. Second, the issue of SDRs would reduce the demand for dollar reserves and reduce the current account deficit of the United States. This would reduce the continuing downward

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pressure on the value of dollar holdings (although there might be a significant interim adjustment in the value of the dollar). Third, an external source of liquidity should alleviate some of the pressure of competition to acquire reserves which should help stabilize international payment and exchange rate dynamics.

With the annual issuance of these new reserves, the adverse consequences of the fact that the sum of deficits equals the sum of surpluses would be broken: any country could run a deficit equal to its receipts of new reserves without worrying about a crisis.[26] The "hot potato" problem would be reduced, if not fully solved.[27]

The fact that each country receives annual emission of global greenbacks means that it can import more than it exports without facing an imminent crisis. So long as imports do not exceed exports by more than the emissions, its reserves are actually increasing, and so there would be little anxiety of a crisis occurring.[28] Because of the fact that under this system, the cost of holding reserves appears lower[29], reserves may be higher (especially for developing countries), so that even when imports exceed exports by more than the value of the emissions, crises may be less frequent.

26 Of course, the sum of deficits would still have to equal the sum of surpluses: this is an identity.

27 Clearly, our proposal does not solve all of the problems leading to global instability of the financial system. We have already called attention to the important asymmetries in policy responses (pro-cyclical in developing countries, counter-cyclical in developed countries). Countries with fully open capital accounts will still be afflicted with pro-cyclical private capital flows. Our proposal would reduce (though not necessarily eliminate) the necessity of developing countries creating offsetting reserves, with the associated costs already noted. One could go further, as Ocampo has done, in developing counter-cyclical allocations of global greenbacks.

28 Crises can also be precipitated by short term dollar denominated liabilities exceeding reserves (see Jason Furman and J. E. Stiglitz, "Economic Crises: Evidence and Insights from East Asia," *Brookings Papers on Economic Activity*, 1998(2), pp. 1-114, and the references cited there); but again, because countries are likely to hold more reserves, it is less likely that this too will occur.

29 In some sense, there is still an opportunity cost: if there were no restriction of the kind set forth in the previous footnote, then the country could have converted the global greenbacks into dollars, and used the dollars to purchase productive assets.

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The greater financial stability of developing countries would enhance their ability to issue debt in their own currency—thereby reducing at least exchange rate risks (one of the major sources of problems in developing countries).

All economies, not just the United States, should benefit from the reduction in the deflationary bias of the current system.[30] And clearly the way the deflationary bias is addressed is far more equitable than under the current system.

Finally, having a significant source of automatic purchasing power transferable to well-functioning developing economies would support economic development far more effectively than the current patchwork of national and multinational aid programs.

**V1. The Evolving Reserve System**

The essential requirement of a reserve currency is that it be a good store of value. This is why inflation has always been viewed so negatively by central bankers. But the credibility of a currency as a reserve currency depends also on exchange rates. For foreign holders of dollars, a weakening of the exchange rate is as bad as an increase in inflation. This is, in a sense, even true for domestic wealth holders; because of opportunity costs, even citizens of a country with a stable exchange rate may want to

30 By the same token, the annual issuance of SDR's would not be inflationary— it would just undo the existing deflationary bias of the current system.

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diversify out of holding assets denominated in that country's currency if there is high instability.
For most of the last part of the 20th century, US dollars have been used as the world's de facto reserve currency. But the current system is under threat from negative dynamics, as confidence in the dollar erodes, causing people move out of the currency; and as they do so, the currency is further weakened. While the huge fiscal and trade deficits of the Bush Administration have contributed to this weakening, the problem for the US dollar is partly inherent; the current Administration simply accelerated what would have eventually happened in any case. The reserve currency country naturally becomes increasingly indebted, because the ease of selling debt entices over-borrowing. Others want to hold T-bills; it is tempting to respond to the demand with an increase in supply. But eventually, debt levels get so high that credibility starts to be questioned.
This may well be happening today. Certainly there has been a major shift in thinking among central banks. Over the years, they have gone from thinking that a currency needs gold as backing to thinking that sterling is required to back their currency, to thinking that dollars should back their currency. But now, they realize what matters is wealth. They no longer rely solely on the dollar for their reserves, as they have realized that the dollar is not a good store of value, and are beginning to manage their reserves as a more diversified portfolio which is sensitive to risk and return. With multiple hard currencies to choose from, central banks may find it prudent to hold
- 43 - - 44 - reserves in multiple currencies—or even in other assets. And as the US dollar appears more risky, they will naturally continue to shift out of dollars – a process which is already well under way.[31]
But this shift out of the dollar reserve system is not necessarily a smooth one. Now, investors have to think not only about how other investors are thinking, but also about how central banks are changing their perceptions of risk and reserve policy.[32]

**VI.1. A Multiple Reserve Currency System?**

It is *not* a solution for there to be a two-reserve currency system. Some in Europe had hoped that the Euro would take on this role as a reserve currency. This has happened, at least to some extent, but it has not been good for Europe, or the world.
As the Euro becomes a reserve currency, Europe too then faces a deflationary bias. Given its institutional structure, a central bank focusing exclusively on inflation and a growth and stability pact restricting the use of expansionary fiscal policy, there are doubts about whether Europe is able to respond effectively to the consequences of having a reserve currency. If it does not, Europe, and the world, may face strong contractionary pressures.

[31] To the extent that motivation of holding reserves was to keep the exchange rate with the dollar low, countries may have limited scope for reallocating portfolios. They have to keep in dollar denominated assets. Even as they began to shift out of dollars, the emphasis on portfolio management to which we drew attention earlier has led them to move out of T-bills into other dollar-denominated assets. This, in turn, has raised other concerns, raised most forcefully in the context of the debate over sovereign wealth funds.

[32] Changes in central bank holdings, or market perceptions of central bank holdings, may contribute to instability; but in fact, central bankers are likely to be less volatile in their behavior than private market participants.

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Moreover, just like the bimetallic system was viewed as more unstable than the gold standard, a multiple reserve currency system may be more unstable—with rapid shifts from one reserve currency to another with changing perceptions.

Europe—and the world—should hope that it does not get its wish, to become a global reserve currency; but rather, that the world move to a new global reserve system, along the lines we have proposed.

**VII. Concluding Remarks**

It should be clear that the current global reserve system is not working well, that it is contributing to the current high level of exchange rate volatility, and that this volatility has adverse effects on the global economic system. It is essential for the functioning of the global economic system that the global financial system functions well. The global financial system and the global reserve system are changing rapidly but one should question whether they changing in ways which will enhance global economic stability.

Certainly events of the last decades give us reason to pause and reflect on the weaknesses of the existing financial system. We have witnessed repeated crises and high levels of global financial instability—in spite of the fact that we have (supposedly) increased our understanding of how financial markets work and created new financial instruments to manage risk and strengthened markets from an institutional perspective

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to help them perform better. The developing countries in particular have experienced enormous instability which has come at great cost to the people in those regions. Some of that instability is a result of instabilities in the global financial system and of the failure of markets to effectively shift risk to the developed countries which could, on a relative basis, bear it better.

There has been a great debate about allocating blame—the relative role of structural versus macro-economic factors. Here, we have highlighted one aspect of the global economic system which we believe has received too little attention—the global reserve system. We have suggested a simple reform to the global reserve system which holds out the promises of greater stability, higher output, and enhanced equity. It is, in some ways, an old idea—but perhaps an idea whose time has finally come. the value of the aid many of the poor countries receive from the U.S.-- have adverse consequences for their growth.