9

The Future of the International Monetary System

John Williamson

Avinash Persaud (2005) has argued that the world never has room for more than one key currency at a time. I find his argument convincing as regards some international roles of a currency, but not all. I doubt if we shall ever witness a world in which more than one currency is widely used for intervention in exchange markets, in setting the prices of commodities, or in complex transactions. On the other hand, I would expect to see continued use of a range of currencies for denominating the prices of manufactured exports, and for holding reserves. There are after all significant benefits from holding a well-diversified portfolio, and in an age when transactions costs are rapidly diminishing I would be surprised if central banks were not prepared to incur these when they need to mobilise some of their reserves for use in intervention, even if the intervention itself is always in the dominant international money.

Thus, my expectation is that we shall continue to see a single currency dominating the international system, alongside several other currencies being used internationally for specific purposes. In considering the first question we have been asked to consider, "Will the US Dollar Remain the Key Currency of the System?", the first step is to ask what the contenders for role of the key currency may be. For the next 25 years, which I take it is the sort of time horizon in which we are interested, the only two alternatives to the dollar worth considering seem to me to be the SDR and the euro. The RMB or even the rupee may be candidates one day, but not for the next 25 years.

I devoted two of the best years of my life, 1972-74, to an attempt to build a more symmetrical international monetary system based on the

SDR. I was then the most junior IMF employee whose duties were principally regular participation in the work of the Committee of Twenty. I wrote up my experiences in a book whose title I invented during the second meeting of the Committee, *The Failure of World Monetary Reform* (Williamson, 1977). I concluded that the attempt to build a symmetrical SDR-based monetary system had failed for a very basic reason, namely because most countries were so attached to that quaint social institution we call national sovereignty. Jane D'Arista has proposed an alternative design for a symmetrical system,[1] which has zero chance of adoption, for the same reason: that it would require countries to give up too much of their sovereignty. None of these grand designs for an SDR-based or more symmetrical system has the slightest chance of going anywhere unless and until there is a sea-change in popular attitudes on this question.

It follows that only a real currency can hope to challenge the US dollar, and the euro is the only plausible candidate. As stated above, I think it quite likely that the euro will play a larger role in some of the functions of an international currency. For example, I would expect most manufactured exports from the euro area, and from other countries closely associated with the euro area such as those in Eastern Europe, to be denominated in euros. I expect many bond issues to continue to be denominated in euros. And I expect the proportion of international reserves to be held in euros to increase somewhat, especially as expectations of a further depreciation of the dollar in terms of the euro gain ground. What I find most unlikely is that the euro will displace the dollar in intervention, in denominating the price of homogeneous commodities, or in regular international transactions. In other words, I do not expect the US dollar to be displaced from its role as the key international currency in the next quarter century, even if and when it ultimately undergoes another bout of severe depreciation.

Does that also imply that I see no possibility of building a more balanced international monetary system? No. What it does suggest is that a new system would have to be based on increasing the effectiveness of the IMF while respecting the bases of national sovereignty, which I take as implying floating exchange rates and inflation targeting,[2] rather than on

---

[1] See the next chapter in this volume.

[2] Or internal balance, which those of a Keynesian disposition may find a more comfortable formulation, though personally I doubt if there would be large practical difference.

a change in the international monetary unit. I think it is clear that a pre-condition for increasing the effectiveness of the IMF is a change in IMF governance, with the effect of increasing both the voting power (quota shares) and representation (chairs in the IMF Board) of Asia at the expense of Europe. Admittedly, the reluctance of the US Congress to increase the US quota stands in the way of consummating this change quickly, but the world's reaction to George W. Bush's attempt to veto Kyoto has already shown that the United States no longer runs the world. It is a change that is rapidly becoming inevitable, and the biggest question is whether Europe will take the lead in pressing for this change and thus strengthen its role in the IMF, or will put up a hopeless defensive resistance that will merely erode its global monetary standing.

There still seems to be an unwillingness to take actions to adjust the current global imbalances, despite their evident unsustainability. The likely result of this sort of obstinacy is a global recession. We do not know what will precipitate the end of the capital inflow to the United States, for shocks are typically unforeseen, but let me sketch one possible scenario. Suppose that the US were to elect a president who recognised that its current account deficit was a problem that needed to be fixed, and who therefore proposed a US contribution that started by raising taxes by 2 percent of GDP levied on those who could afford to pay them. It is not beyond the realm of possibility that those who would be affected would retaliate by shifting some of their money abroad (capital flight), perhaps aiming to put some of it where the taxman would be unlikely to find it. Once such a run started, it might well continue until the dollar had depreciated another 20 percent or 30 percent against most currencies. Such a dollar depreciation would be inflationary in the United States, but at least any demand loss engendered by the collapse of confidence would be offset by the expansionary expenditure-switching effect of the dollar's depreciation. In the rest of the world both income and substitution effects would decrease demand, so a recession would be all too likely, especially if so many countries are still pretending that they are powerless to increase demand.

I do not believe that it had to be like this. The IMF needs a rulebook that commits it to active surveillance of the macroeconomic policies of its systemically important members, based on regular calculation of a set of mutually consistent reference exchange rates believed to be compatible with a generally acceptable set of current account balances (see Williamson, 2006). Application of such a rulebook would have pre-empted the emergence of the large US fiscal deficits and substantially undervalued Asian currencies that together generate the present global imbalances. Even now it would be easy enough to design a set of policies that would promise to reduce the imbalances to less threatening levels, but at this stage, and without any international obligations to seek balance, there seems no hope of inducing the major countries to take any note. Certainly, I would have expected China to respect any well-specified international obligations that it had incurred on entering the Fund, although I accept that it is a different matter to expect it to agree to institute now changes that would unquestionably have the effect of requiring it to revalue.

Does this imply that there is no hope of the world moving to a system of surveillance based on reference exchange rates such as I have sketched above? That is slightly too pessimistic. One can distinguish three circumstances under which such a change might occur:

First, this change might occur in the same sort of situation as that in which past major changes in international monetary arrangements have been effected, namely in the wake of a crisis. So if and when the doomsday scenario described above materialises, I hope that a system along these lines may emerge from the rubble.

Second, it is conceivable that the world might change in such a way that the major players who would currently see their interests threatened by adoption of such a system would no longer feel themselves threatened. For example, China may suffer an inflation sufficient to eliminate its current undervaluation, and the United States may get a president with the guts to raise taxes (without that provoking capital flight).

Third, in principle there is the possibility that the major powers might decide to adopt such a system of surveillance (and the consequential policy changes) with the intention of heading off the crisis that is otherwise likely. I regret to say that this conference has reinforced my prior suspicions that this is extremely improbable.

References

Persaud, Avinash (2005), "The World's Dominant Currency: When Currency Empires Fall", mimeo, January 3. www.whiskeyandgunpowder.com/Archives/2005/20050103.html

Williamson, John (1977), *The Failure of World Monetary Reform, 1971-74*, New York University Press, New York.

——— (2006), "Revamping the International Monetary System", In:

Edwin M. Truman (ed.), *Reforming the IMF for the 21st Century*, Special Report 19, Peter G. Peterson Institute for International Economics, Washington D.C.