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A More Balanced International Monetary System

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As US gold holdings eroded in the 1960s, Robert Triffin argued for a transformation of the Bretton Woods monetary agreement into a multilateral system. In his view, "…the alternative to the gold standard is not a dollar standard unilaterally run and managed by the United States alone, but a true international standard, calling for concerted decisions and management by all participating countries" (Triffin, 1968, p. 187). Subsequently, he warned that the dollar standard that emerged after 1971 was not only unsustainable but "scandalous" – that, "Ironically, the richest and the most capitalised country in the world is actually being financed by the poor countries through the creation of international monetary reserves" (Teunissen, 1987, p. 376). Triffin had promoted European monetary union throughout his career and, in an interview in 1987, noted it would help Europe delink from the dollar. But he did not consider the EMS the final solution to the problem. Meaningful reform would need to include the United States (ibid.).

After Triffin's further criticisms in the early 1990s, there was relatively little discussion of this most basic element of the global system: the choice of the means of payment in cross-border transactions. Triffin's warning that the monetary system itself would create mounting global imbalances was ignored in favour of a more narrow focus on US fiscal deficits and more recently, undervalued Asian currencies. Nevertheless, there is renewed awareness that, as Triffin argued, the international reserve function of the dollar-based key currency system creates a uniquely ironic imbalance in the global economy as the current account surpluses of emerging economies are loaned to the US to

finance the public and private borrowing that supports its growth.

For example, Mervyn King, Governor of the Bank of England, points out that capital has flowed "uphill" from poor to rich countries (King, 2006, p. 8) and Lawrence Summers agrees, noting that "the majority of the world's poorest people now live in countries with vast international financial reserves" (Summers, 2006, p. 8). Meanwhile, the spillover effects of the investment of emerging economies' current account surpluses in US and other major financial markets assure that some portion is recycled back to the emerging economies in the form of private foreign acquisition and ownership of their financial assets and productive facilities.

From this perspective, one of the more pressing issues in dealing with global imbalances is to find ways to recycle these countries' savings back into their own economies in support of development strategies that increase demand and income more equitably across their household and business sectors and reduce dependence on exports for growth. So far, however, most prescriptions for dealing with imbalances shun what King calls "more idealistic aspirations" (King, 2006, p. 8) in favour of changing IMF governance and strengthening its role in surveillance (Williamson, 2007). Summers, on the other hand, argues that it is time for some form of scrutiny of international investment – time for the IMF and World Bank to think about ways to contribute to deploying the funds of emerging market countries rather than lending to them. He proposes a more ambitious undertaking "than simply providing surveillance and monitoring"; one that would support emerging markets' investments by creating "an international facility in which countries could invest their excess reserves without taking domestic political responsibility for the process of investment decision and ultimate result." (Summers, 2006, p. 8)[1]

Shortly before Summers presented his proposal in March, I presented a revised version of an earlier proposal (D'Arista, 1999) for redirecting the flow of capital back into developing economies at the FONDAD conference. In the following pages, I present a further revised version of the proposal. It describes the kind of institutional framework that might be used to create a global development facility.

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[1] Assuming that this would provide more income than current investments in US Treasury securities, Summers advocates charging emerging economies a 100 basis point fee for the service and using the proceeds for global public goods, multilateral grant assistance or debt relief.

1 Creating a Public International Investment Fund for Emerging Economies

With the phenomenal growth of institutional investors' assets over the last two decades, foreign portfolio capital has become an important component of inflows into the evolving securities markets of emerging economies. In most cases, however, these inflows tend to change prices and exacerbate volatility in secondary markets rather than provide long-term financing for economic expansion, while outflows often trigger or intensify currency crises. Moreover, many developing countries that need long-term financing for infrastructure and other basic components of development strategies do not have markets that can absorb foreign portfolio investment flows nor the credit standing to attract them. What is needed is a new channel for portfolio investment to provide flows that are stable, in amounts appropriate to the size of a country's economy and directed toward the goals of development rather than solely toward the short-term profits of investors.

Such a channel could be constructed by creating one or more closed-end funds for emerging market investment as a separate institution under the Bretton Woods umbrella.[2] These funds would issue their own liabilities and use the proceeds to buy stocks and bonds of private enterprises and public agencies in a wide spectrum of developing countries. They would be marketed both to institutional investors in advanced economies and official investors from emerging economies and their liabilities would also qualify as international reserves, guaranteed by a multinational agency and its member countries. Investing the reserves

[2] Unlike open-end mutual funds that must buy back an unlimited number of shares in response to investors' demand, closed-end investment pools issue a finite number of shares that trade on stock exchanges or in over-the-counter markets and are only redeemed at the initiative of the fund itself. This structure would allow the prices of shares to fluctuate without triggering destabilising purchases and sales of the underlying investments. The structure could be made more suitable for long-term investors such as pension funds by requiring that 10 to 20 percent of the value of shares sold to investors be used to purchase and hold government securities of major industrial countries in amounts roughly proportional to the holdings of the funds' shares by residents of those countries. This would give investors a partial guaranteed return, denominated in their own currencies, and capital backing in addition to the guarantee of the multilateral agency and its member countries. Moreover, the introduction of these securities would benefit both private and official investors by adding more low-risk instruments with long maturities to the menu of assets in international financial markets.

of developing countries in these funds would redirect external savings back into the economies of the countries that own them rather than into the financial markets of strong currency countries.

International closed-in funds would provide additional benefits as well. They would encourage the development of securities markets denominated in local currencies in poor and middle-income developing countries, would reduce the need for capital controls if countries chose to accept foreign portfolio investment only through this channel, and would help pension plans in developing countries diversify their portfolios while minimising country risk and transactions costs.

A more important contribution of these funds, however, would be their inauguration of a meaningful shift into a non-national reserve asset and the phasing out of a system in which the choice of financial assets as reserve holdings centres on a few countries whose wealth supports the strength of their currencies.[3] Encouraging developing countries to hold these securities as reserves would provide them with a *multilateral* guarantee from industrial countries and, in time, from wealthier emerging economies.[4]

Given the focus on development, a major function of the funds should be to finance infrastructure that is both commercially and socially useful. Both criteria would be met by projects that build and improve roads, construct or renew sewers and extend electrical grids and communications systems. But these projects must be initiated in remote areas as well as cities and towns. Other areas qualifying for financing should include systems to provide health care and clean water, projects for cleaning up polluted areas and restoring and preserving forests; investments in renewable energy and transportation and in local institutions that will provide funding for communities to design and build their own affordable housing.

These and many other similar investment areas are among those that fail to attract financing in the marketplace in both developing and

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[3] Wealthy countries, too, could hold these securities as reserves and avoid the credit-generating effects their reserve investments impose on other advanced economies. The credit-generating capacity of reserve assets could then be utilised multilaterally to benefit a wider group of countries – developed and developing – and moderate the constraint on demand that imbalances in external savings have created.

[4] The institutional guarantee would be the same as the existing guarantee for World Bank liabilities, but the capital investment in the government securities of advanced economies would enhance that guarantee and provide a partial hedge against exchange rate risk.

advanced economies. For example, the US found it necessary to undertake a wide range of public-purpose market innovations in the 1930s – most notably the Reconstruction Finance Corporation and the Tennessee Valley Authority – and continued adding new strategies into the 1970s, including the development of the secondary mortgage market. These and numerous other examples from other countries underscore the need for governments to take the lead in laying the institutional groundwork for financing productive economic and social investments. Another indication of that need is the fact that, even in many advanced economies, investments in renewable energy, infrastructure, the environment, transportation and affordable housing are seriously underfinanced.

Structuring a channel to attract portfolio investment for such purposes need not reinvent the wheel. Mechanisms and potential assets already exist in the marketplace and the authority to manage these funds is wholly consistent with the World Bank's original mandate to facilitate private investment in developing countries. Moreover, the Bank's experience in issuing its own liabilities in international capital markets would expedite the start-up of one or more closed-end funds which could then be transferred to a separate institutional structure created for the purpose.

But, like other Bretton Woods institutions, these public sector funds must be required to operate in a far more open, accountable and responsive fashion than is the current norm. Properly structured to include collaborative decisionmaking by both the managers of the funds and the countries in which investments are made, they could make a significant down payment against the democratic deficits that characterise private portfolio investment decisions as well as governance and policymaking at the international institutions.

2 Reforming the International Payments System

The above proposal – to use multilateral credit liabilities as reserve assets – is evolutionary in nature and, while it addresses a critical flaw in the current international monetary system, an equally critical one – the means of payment – would still need to be addressed. Permitting the continuation of a key or strong currency regime for cross-border transactions tends to perpetuate the export-led growth paradigm by requiring the majority of countries to shape their economies to ensure

that they can earn – or borrow – key currencies to conduct external trade and investment transactions. It also requires the key currency country to import more than it exports to meet the demand for its currency and to accept the resulting current account deficits and build-up in debt. The global economy can only regain balance if every country is able to use its own currency, backed by the wealth created within its own borders to participate in the global economy.

One way to achieve this objective would be to mine John Maynard Keynes' Bretton Woods proposal to create a new institutional framework. While Keynes' overall proposal was designed for a very different world, the basic structure in his concept – an international clearing agency (ICA) – could be revised to serve as the institutional platform for a new global payments system that would foster egalitarian interactions and more balanced outcomes.

The new ICA would clear transactions denominated in members' own currencies by crediting and debiting their clearing accounts. These clearing accounts would, in fact, constitute the international reserves of the system, held for the member countries by the ICA and valued using a trade-weighted basket of all members' currencies. Thus the clearing process would change the ownership of reserves and reinstate the original intent of the Bretton Woods Agreement to maintain public control of international payments. It would also permit exchange rate adjustments over a set period of time in response to changes in reserve levels, preserving the valid role of market forces in shaping currency values through trade and investment flows while ensuring that speculators would no longer dominate the process.

A revised ICA proposal could also reintroduce former US Under-secretary of the Treasury Harry Dexter White's Bretton Woods proposal to authorise the International Monetary Fund to engage in open market operations. It would do so by permitting the new clearing agency to acquire government securities of its member countries as backing for its reserve holdings.[5] This would give the ICA means and authority to conduct open market operations at the international level, enabling it to help national authorities correct imbalances and promote stability by altering holdings of international reserves relative to national central

[5] In the US, the Federal Reserve had developed open market operations as a counter-cyclical policy tool in the 1920s, but it was not widely used by other central banks at the time of the Bretton Woods negotiations and the White proposal was dropped from the agreement.

bank reserves invested in domestic assets. When approved by a super-majority of its member countries, the ICA's money creating powers would also allow it to operate as a true lender-of-last resort – a role the IMF cannot play given its dependence on taxpayer contributions. In this capacity, the ICA could assist a national central bank in supplying liquidity by buying government securities from residents in the national market and augmenting the country's supply of international reserves.

Membership in the ICA would be open to national central banks of all participating countries and branches of the clearing agency would operate in every major financial centre across the globe. The Agency would be governed by a rotating executive committee that would at all times represent half the world's population and half its total output. Its role in clearing members' payments in their own currencies ensures that it would not infringe on their sovereignty as an international central bank that issued a single currency would do.[6] The conduct of national monetary policy and decisions about preferred exchange rate regimes would remain the prerogative of national authorities. But the ICA's ability to create and extinguish international reserves would give it the power to change the availability of liquidity at the global level. The absence of and need for that power has been increasingly evident throughout the post-Bretton Woods era as crisis after crisis has underscored the inadequacy of the current institutional framework.

This is a brief sketch of a proposal that attempts to incorporate the still-valid objectives of the Bretton Woods Agreement for an open international trading system while reforming the institutional framework to promote stability and more egalitarian participation by all

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[6] In the previous chapter, John Williamson referred to the ICA proposal as "an alternative design for a symmetrical system, which has zero chance of adoption [because]…it would require countries to give up too much of their sovereignty". This characterisation implies some misunderstanding of the structure and role of the proposed ICA – in particular, that it would not issue the means of payment but only administer the process by which cross-border payments alter the reserve accounts of member countries. Indeed, the proposed ICA was designed to enhance sovereignty by allowing all countries to use their national currencies to make international payments and by reducing the influence of speculative capital flows on policy decisions at the national level. The only choice member countries would lose would be their ability to decide how to invest their international reserves since their reserves would automatically be invested in their own national liabilities.

countries in the global economy (D'Arista, 1999). No doubt other, better systems could and will be designed. But they, too, must incorporate a more egalitarian payments system as well as more democratic governance of its institutional structure.

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