The International Monetary System and Global Imbalances

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Abstract

In the aftermath of the global economic and financial crisis of 2007-09 and in the context of ongoing debates about the role of global imbalances as a cause of that crisis, attention has reverted to the desirability of reforming the international monetary system. This paper argues that today's international monetary system is not uniquely prone to global current account imbalances even though they pose potential problems for the stability of the international economy and financial system. The US dollar is not the only reserve currency. Its broader role as an international currency is much more important than its role as a reserve currency. Moreover, the US dollar's international role in either form does not force the United States to have current account deficits. The international monetary system should continue to evolve with the international financial system, but the case for radical reform has not been made.

Is the current international monetary system prone to prolonged periods of risky imbalances? As a graduate student and young academic, I witnessed the collapse of the Bretton Woods exchange rate regime and associated conventions governing the international monetary system at the time. I subsequently participated in the efforts of the Committee of Twenty on Reform of the International Monetary System and Related Issues to put Humpty Dumpty back together again. Thus, in words attributed to Yogi Berra: déjà vu all over again!

I start with a summary answer to the question of whether today's international monetary system is prone to prolonged periods of risky imbalances and with answers to eight other related questions. As a two-handed economist, my answers could be yes and no, or no and yes. Instead, I indicate with one word where I think the preponderance of the evidence and argumentation lies.

Q1 – Is the current international monetary system prone to prolonged periods of risky current account imbalances? NO.

Q2 – Were payments imbalances a major cause of the global economic and financial crisis of 2007-09? NO.

Q3 – Was a malfunctioning international monetary system a major cause of the crisis? NO.

Q4 – Are persistent imbalances a source of systemic vulnerability? YES.

Q5 – Are surpluses the inevitable counterpart to deficits of reserve-issuing countries? **NO.**
Q6 – Can persistent imbalances be prevented? **YES.**
Q7 – Is universal floating of currencies the solution to persistent imbalances? **NO.**
Q8 – Should countries in persistent surplus be taxed, as in Keynes' original scheme for Bretton Woods? **NO.**
Q9 – Is the current international monetary regime better than the gold standard, interwar system, and Bretton Woods? **YES.**

The remainder of this paper expands on the answers to these questions.

Is the current international monetary system prone to prolonged periods of risky imbalances?

My short answer is no. The structure of the current international monetary system does not make it more prone to prolonged imbalances than any other feasible system, nor are the imbalances that do occur inherently more risky than those that would be inevitable in another feasible system. The word feasible is important. I mean feasible in the realistic, practical, political sense not in the sense of an imaginary, unconstrained, technical construction.

The current system does involve imbalances, by which I mean current account positions that persist and are large enough in terms of surpluses or deficits to affect the stability and performance of the system as a whole.[1] However, policymakers do not agree upon the identification of such imbalances in real time or even ex post.

International payments balances, as well as those classified as imbalances, reflect the macroeconomic policy choices of countries, in particular, the systemically important countries. Those choices involve primarily monetary, fiscal, and exchange rate policies. Those policies condition the functioning of the international economic and financial system. Payments imbalances are endogenous to the functioning of that system. Whether large, persistent deficits or large, persistent surpluses are risky for the system as a whole, qualifying them as imbalances depends on the general economic and financial circumstances in which they arise. I would hesitate to generalize.

My negative answer to this question should not be interpreted as endorsement of the current system as ideal. The functioning of the system can be improved and possibly elements of its structure as well. Any such evolutionary improvement would have to be based on a consensus among the systemically important countries about how the system does operate and should further evolve—a

[1] Balances and imbalances can be measured as trade transactions in goods and/or services, current account transactions, basic balance transactions (including the current account and parts of the financial accounts), reserve transactions (also known as the overall balance), what was once known as the official settlements balance (the change in gross reserves less the change in liabilities to official holders with signs reversed), etc. In practice, each of these concepts has some merit, but most of the current discourse involving the systemically important countries focuses on current account balances.

consensus that is lacking now. Moreover, any new consensus would have to be constantly renewed via a robust, peer-review process.[2]

Were payments imbalances a major cause of the global economic and financial crisis of 2007–09?

Absent the global economic and financial crisis of 2007–09, the issue of the international monetary system and its possible connection with payments imbalances would not have arisen. Therefore, one should first ask whether payments imbalances were a major cause of the global economic and financial crisis. My answer is no. Global payments imbalances at most played a minor role in the crisis.

In its starkest form, the alternative interpretation of the causes of the crisis is that the existence of global, current account imbalances—in particular when they were manifested in the buildup and recycling of official foreign exchange reserves—distorted the macroeconomic environment and contributed importantly to the crisis. In other words, global imbalances contributed to macroeconomic policy choices that, in turn, were a major contributor to the crisis.

I disagree with this alternative interpretation. Macroeconomic policies, in particular easy monetary and profligate fiscal policies in a wide range of countries, contributed to a benign economic and financial environment that was too good to be true and to lax lending and credit standards in many countries. In that sense, the crisis and the imbalances were jointly determined by macroeconomic policy mistakes.[3]

I would note, however, that most observers blame the crisis on regulatory and supervisory failures or flawed incentives in financial systems, domestic and international, and relegate macroeconomic causes, in either interpretation, to the margin.

Was a malfunctioning international *monetary* system a major cause of the crisis?

This question is also is central to the discussion of the topic of the international monetary system today. My emphasis is on the word monetary. The international *monetary* system is not the same as the international *financial* system. The distinction is very important today. A malfunctioning international *financial* system contributed to the crisis, and may have been a major cause, but a malfunctioning international *monetary* system was not a major or a minor cause of the crisis.

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[2] See, for an elaboration on this thought, Truman, Edwin M. 2009. *The International Monetary Fund and Regulatory Challenges*. Washington: Peterson Institute for International Economics Working Paper 09-16.

[3] See, for an elaboration of this view, Truman, Edwin M. 2009. Lessons from the Global Economic and Financial Crisis. Keynote address at Conference on G-20 Reform Initiatives and Implications for the Future of Regulation Seoul, Korea (November 11). Available at www.piie.com.

The international *monetary* system is the set of rules, conventions, and institutions that govern and condition official actions and policies affecting the international economy and financial system: exchange rate regimes, intervention policies, the size and composition of reserve holdings, mechanisms of official financial support, etc. The international *monetary* system exists within the international *financial* system, which today is dominated by private—not public—actors and their balance sheets.

Under the gold standard and under the Bretton Woods regime, the international monetary system strongly conditioned the functioning of the international financial system. If private agents had an excess of US dollar assets at prevailing interest and exchange rates, they could sell them to the monetary authorities, which might or might not exchange them for gold. The authorities might or might not adjust their policies as a consequence. Today, if private agents have an excess of US dollar assets, they sell them in the market and asset prices (exchange and interest rates) generally adjust. The international financial system takes care of itself largely without the direct intervention of the authorities of the major advanced countries.

Today, assets in the international financial system are predominantly held by the private sector, which was not always the case. In the case of international holdings of dollar assets, official holdings as of the end of 2008 were less than 15 percent of the total by a conservative estimate.[4] By extension, total international assets in all currencies are six times official foreign exchange reserves in all currencies. A reasonable guess is that in 1970 the ratio was two or maybe less.

It follows that, today, changes in the international *monetary* system are unlikely to have much effect on the functioning of the international *financial* system unless the financial system is changed as well. In the wake of the crisis, changes in the international *financial* system are necessary and desirable, much more so than are changes in the international *monetary* system. However, that is not the focus of this paper.

Are persistent imbalances a source of systemic vulnerability?

Persistent imbalances in current account positions (or cumulative positions known as international investment positions) are a potential source of systemic vulnerability for several well-known reasons.

First, if the imbalances are artificially sustained—by fixed exchange rates, by governments borrowing directly in international markets rather than via foreign private investors voluntarily purchasing assets issued in domestic markets, or by other means—the dam may break. If the country is large enough, the consequences for the global economy and financial system may be severe.

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[4] Total international dollar assets in this calculation include all financial claims on the United States plus other international financial assets denominated in US dollars in the form of bank deposits, money market instruments, and notes and bonds issued outside the United States. The total does not include international contracts denominated in US dollars such as for the sale or delivery of agricultural products, gold, other natural resources, or goods and services.

Second, persistent imbalances can lead to retaliatory trade actions that put at risk the stability and efficiency of the international economy.

Third, when a country's imbalance is no longer expected to persist, domestic and foreign investors bail out of their claims on the country in question with broad, potentially disruptive effects—often mislabeled as sudden stops.

Fourth, persistent imbalances, in particular surpluses that are artificially sustained, distort the relevant domestic economies as well as the international economy and become more entrenched with each passing year and decade as we have seen in the cases of Japan and Germany.

Are surpluses the inevitable counterpart to deficits of reserve-issuing countries?

I strongly disagree with the argument that an increase in the demand for international reserves in the form of US dollar assets is the cause of the US current account deficit. I also disagree with the related argument that current account surpluses necessarily result in counterpart deficits for the so-called reserve-issuing countries. A stronger version of this line of reasoning is that as a result of the US current account deficit, US fiscal policy has to be more expansionary to sustain US growth. Thus, the demand for international reserves drives the US twin deficits. This line of argumentation sometimes is linked with the so-called "exorbitant privilege" that the United States is said to have because it "issues" a reserve currency and/or with the so-called Triffin dilemma. I think that all four aspects of the argument are fundamentally wrong.

First, let's look at some facts.[5] Since the breakdown of the Bretton Woods system, US policy did not ordain the dollar's role in the monetary system or the financial system. Moreover, the US dollar is the major, but not the only, reserve currency in the system. Since the creation of the Euro, through the first quarter of this year, foreign exchange reserves increased by about $5.1 trillion of which about two-thirds was in US dollars.[6] However, $1.7 trillion of this increase was in claims on the euro area, Japan, and Switzerland—an amount roughly equal to the entire stock of foreign exchange reserves at the end of 1998. Each of these countries or economic areas had cumulative current account surpluses over the period. Where is the link between demands for reserves in these particular currencies and the current account *deficits* of the economies issuing those currencies? Missing![7]

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[5] I elaborate on these facts in It's Time to Recognize Reserve Currency Realities. 2009. Peterson Institute for International Economics Real Time Economic Issues Watch (July 27). Washington. Available at www.piie.com.

[6] According to IMF COFER data, the dollar's share has not changed much over this period despite the fact that the share of total reserves held by emerging and developing countries has increased and those countries on average report that they hold a smaller proportion of their reserves in dollar assets.

[7] It is possible that the demand for euro, for example, pushed the euro area toward current account deficit, but it did not push the euro area into deficit as is required by the basic argument.

Second, we know that fiscal deficits and external deficits may be linked depending on other economic and financial conditions, but they are not hard wired. Moreover, when the two deficits are linked, the causality normally is posited as going the other way. Current account balances are endogenous to the dynamics of the overall economic and financial system. A country's recorded, ex post current account position must simultaneously satisfy three relationships: the difference between net domestic saving and net domestic investment, the difference between domestic production (output) and domestic demand (often referred to as absorption), and the difference between the net change in the demand for domestic assets by the rest of the world and the supply of those assets from the United States.[8] It follows that while changes in exchange rates are important determinants of the current account balances, so also are fiscal and monetary policies along with structural changes and trends in the domestic and global economy and financial system. It also follows that a large country has the capacity through the application of its own policies to achieve, within a reasonable range, its preferred current account position regardless of changes in the net demand for a particular category of assets (government securities) by a particular set of investors (foreign monetary authorities).

Third, the euro area appears to be enjoying an "exorbitant privilege" in the sense that the term was originally used in the 1960s. On a substantial margin, the euro area is attracting short-term low-yielding investments in euro liabilities and recycling those funds into presumably higher-yielding assets in countries outside the euro area. That was the pattern for the United States in the 1960s as throughout the period that the United States recorded trade and current account surpluses. The privilege involved acting as a bank in the framework of Despres, Kindleberger, and Salant earning more on its assets than it pays out on its liabilities.[9] The privilege did not lie in providing cheap financing for the US current account deficit or in possibly lowering US borrowing costs.[10]

Fourth, Robert Triffin was concerned about the supply of the outside asset in the international monetary system, which was gold, and whether the buildup in short-term official

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[8] Truman, Edwin M. 2005. *Postponing Global Adjustment: An Analysis of the Pending Adjustment of Global Imbalances*. Peterson Institute for International Economics Working Paper 05-6 (July). Washington. Available at www.piie.com.

[9] The modern literature on this subject asks the question whether the United States continues to earn more on its foreign investments than it pays on external liabilities. Thus, the focus is on the US investment position as a whole, not on a single class of assets or liabilities or on the cost of servicing government debt issued by the US Treasury. See Curcuru, Stephanie E., Tomas Dvorak, and Francis E. Warnock. 2009. *Decomposing the US External Returns Differential*. NBER Working Paper 15007 (June). Forthcoming in the *Journal of International Economics.* See also Gourinchas, Pierre-Olivier and Helene Rey. 2007. From World Banker to World Venture Capitalist: US External Adjustment and the Exorbitant Privilege. In *G7Current Account Imbalances: Sustainability and Adjustment*, ed. Richard H. Clarida. Chicago: University of Chicago Press.

[10] Moreover, as we learned from James Tobin, whether changes in supply and demand of assets raises or lowers the yield on those assets depends on the parameters of the portfolio balance model. The model is meaningless in the absence of some degree of asset substitutability.

claims would lead to a run on gold, breaking the bank.[11] The Triffin dilemma was not about the risk of reserve diversification; in fact, Triffin referred to key currencies in the plural. The appropriate analogy today is whether the buildup of reserve and short-term capital claims on the United States can be satisfied by real goods and services produced by the United States. The answer is yes. The disruptive effects on the US and global economy might be quite severe, depending on the timeframe involved, but that risk is not generally identified as among the largest risks to the system today.

Finally, the United States is not only country that, under most circumstances, can and does pay little or no attention to how its current account deficit is financed. All the major advanced countries experience massive capital inflows and outflows. In the 12 months ending with September 2008, gross transactions by foreign residents in US securities were $65.3 trillion. (In the subsequent 12 months, the figure was $40.3 trillion, still almost three times US nominal GDP.) These were not securities "issued" to foreigners. Foreign private and official participants in the international financial system voluntarily buy (and sell) those US securities. Foreign private (and to a lesser extent official) participants in the international financial system similarly, voluntarily buy (and sell) the securities of many other countries denominated in their own currencies.

Distinctions among countries are not as simple as distinctions between those countries that issue liabilities that end up in other countries' foreign exchange reserves or private balance sheets and those that do not. Many other countries are in the same position as the United States, including countries like Australia, New Zealand, Spain, and Portugal with substantial current account deficits, but also countries like Brazil, Mexico and Korea that sometimes have deficits. In the limit, of course, no country can ignore build-ups in its external liabilities or its negative international investment position. But today there is a continuum of countries—not just one country that issues assets that end up in official reserves and all the other countries that do not.

Can persistent imbalances be prevented?

Returning to the issue of current account imbalances, they can be prevented, or more appropriately, limited through the application of exogenous policy instruments in the form of monetary, fiscal, and exchange rate policies. In other words: adjustment policies. Doing so in a coordinated manner presents multiple challenges.

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[11] Robert Triffin summarized the issue in the introduction to the revised edition of his classic, "Gold production is unlikely to increase sufficiently in the foreseeable future to provide an adequate supply of liquidity to an expanding world economy; and the haphazard use of national currency holdings as a supplementary form of reserves cannot but undermine, more and more dangerously as time goes on, the key currencies used for this purpose and, by way of consequence, the world monetary superstructure erected upon them." (Triffin, Robert. 1961. *Gold and the Dollar Crisis*. New Haven: Yale University Press). Triffin, reflecting the perceived lessons of the interwar period, did not favor a move to floating exchange rates or substantially greater exchange rate flexibility as a solution. For this reason, the "superstructure" was important to him.

The first challenge is that often there is no consensus on which countries' surpluses or deficits qualify as imbalances that need to be adjusted because they threaten the stability of the system as a whole. My colleagues at the Peterson Institute for International Economics concluded last summer that the projected deficits of three countries needed to be altered in the medium term by at least two percentage points of GDP: those of Australia, South Africa, and the United States. They identified six countries on the other side: China, Malaysia, Singapore, Taiwan, Sweden, and Switzerland.[12] (Because their focus was exchange rate adjustments, my colleagues did not include any of the very large imbalances of countries in the euro area.) My point is that several of these nine countries would not agree that their external positions need to be adjusted.

The second challenge is that the various country authorities and their advisors do not agree about which instruments should be used to address any imbalance once it is agreed that there is one.

The third challenge, of course, is that even if the first two challenges are met, often there is no consensus on which countries should act—the familiar asymmetry of the adjustment process.

Is universal floating the solution to persistent imbalances?

Universal floating is not the answer to persistent imbalances. If the exchange rates of all countries floated, or if foreign exchange market intervention were only occasional, that would help to address some, but not all, of the problems associated with persistent imbalances.

However, such a solution, while intellectually attractive, is not politically feasible at this time. The authorities of many countries would not be comfortable with such an imposed solution. On the other hand, in today's world, the very definition of the opposite of a floating exchange rate is ambiguous. Most major currencies float either freely or substantially freely. Consequently, the opposite of a floating exchange rate is not a pegged exchange rate. It follows that, in terms of their nominal effective exchange rates, all currencies either float or are in an intermediate regime. The nominal effective exchange rate is the appropriate economic metric. Don't tell exporters in Germany and France that their currency is not floating!

It is relevant to the anticipation of future trends that attitudes and policies among the major advanced countries have changed dramatically since March of 1973 and the advent of generalized floating of the major currencies. Official intervention in the foreign exchange markets by the authorities of these countries has gradually come to a stop.[13] The authorities of these countries are

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[12] Cline, William R. and John Williamson. 2009. *2009 Estimates of Fundamental Equilibrium Exchange Rates*. Peterson Institute for International Economics Policy Brief 09-10 (June). Washington. Available at www.piie.com.

[13] Japan was the last major advanced country to abandon large-scale foreign exchange market intervention in March 2004.

not likely to resume sustained, large-scale intervention.[14] One notable consequence of this evolution is that one has not observed the increases in international reserves by these countries that characterized the earlier post-Bretton Woods years. But that progress, which I think is the relevant word, was slow.

Nevertheless, troublesome current account imbalances might continue to persist even if all significant currencies were floating against each other. One reason is that we know that floating exchange rates do not guarantee either near-zero current account positions, assuming that is the policy objective, nor a smooth adjustment processes economically, financially, or politically to any imbalances that do emerge.

A second, related reason is that exchange market intervention and the accumulation or decumulation of foreign exchange reserves for many countries is not the only, or even primary, way countries can affect their exchange rates. Other macroeconomic policies have effects on exchange rates as well even though those effects are not well parameterized.

Should countries in persistent surplus be taxed, as in Keynes's original scheme for Bretton Woods?

Taxing countries in persistent current account surplus or for excessive accumulation of foreign exchange reserves is also not a feasible answer.

It was not only Keynes who made such suggestions for countries with surpluses. The United States, in a proposal to the Committee of Twenty to improve the adjustment process and its symmetry, suggested one indicator could be excessive reserve accumulation.[15] In that proposal, if the indicator did not trigger adjustment actions by the country, penalties could be applied to the country such as taxes on excess reserve accumulations, loss of scheduled special drawing rights (SDR) allocations (in the context of regularly scheduled allocations), or general import taxes or surcharges could be authorized. The United States had no takers in 1973. The last approach has been revived recently, though it would involve the WTO along with the IMF.[16]

It would be nice to employ rules-based incentives to discourage persistent surpluses as well as deficits in order to make the adjustment process more balanced and symmetrical. I do not believe

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[14] This statement is not intended to suggest that the authorities of these countries never will, or should not, intervene at all in exchange markets in the future. It is merely to record the fact that their revealed preference in recent years has been not to operate in foreign exchange markets at all and to suggest that in the future any such intervention is not likely to persist for sustained periods.

[15] Council of Economic Advisors. 1973. US Proposals for Using Reserves as an Indicator of the Need for Balance of Payments Adjustment, Supplement to Chapter 5. In *Economic Report of the President*. Washington: US Government Printing Office.

[16] Mattoo, Aaditya and Arvind Subramanian. 2009. From Doha to the Next Bretton Woods: A New Multilateral Trade Agenda. *Foreign Affairs* 88, no. 1: 15–26.

that such an approach is politically feasible. If it were acceptable to all the systemically important countries, it is not clear that the formalization of penalties would be necessary. It might be argued that countries would act more responsibly in the shadow of such penalties, but it also might be argued that when the time came, the penalties would not be applied as many think now is the case with the milder name-and-shame penalties associated with IMF members' foreign exchange policy obligations.

Is the current international monetary regime better than the gold standard, interwar system, and Bretton Woods?

The current international monetary regime evolved from the gold standard, the experience of the interwar period, and the unsustainable constraints of the Bretton Woods regime. That has been an appropriate, positive evolution from which most countries have prospered. To deny that the evolution of the international monetary system has been constructive, or to argue that it was anti-Darwinian in nature resulting in a dysfunctional nonsystem, is like arguing for dismantling the internet because it is used to recruit terrorists.

Reversion to some prior international monetary system, or a new, more automatic and more rigid system, is not going to happen primarily because the supporting conditions are not present today. The gold standard system's partial success was possible because at the time the dominant economic philosophy favored very limited government intervention in economies. The Bretton Woods system was supported by a belief that floating exchange rates damaged international trade and domestic prosperity and that system was backed by the effective, widespread use of restrictions on private capital movements of all types that it would be difficult to replicate today. The genie, if not the genius, of international financial globalization cannot easily be put back in the bottle.

The current international *monetary* system has evolved in the context of a changing international *financial* system. The process of evolution has not been pretty, in part, because it has been uneven and many of the necessary supporting institutions, both national and multinational, have not kept pace. International financial crises have occurred. However, such crises are not unique to the last several decades as has been amply documented. Whether they have been deeper, more destructive, or had a higher incidence is not entirely agreed. If they have been, the fault lies in the evolution of the international *financial* system and its supporting institutions not in the international *monetary* system.