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UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT  
GENEVA

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# TRADE AND DEVELOPMENT REPORT, 2009

## *Chapter IV*

### REFORM OF THE INTERNATIONAL MONETARY AND FINANCIAL SYSTEM



UNITED NATIONS  
New York and Geneva, 2009



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**Chapter IV**

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## REFORM OF THE INTERNATIONAL MONETARY AND FINANCIAL SYSTEM

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### A. Introduction

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The debate about the policy implications of the current financial and economic crisis has focused on emergency measures to overcome the crisis, and on the need to improve supervision and regulation of national financial markets (issues discussed in chapters I and III of this *Report*).<sup>1</sup> However, the lessons to be drawn for reform of the international monetary and financial system have received relatively little attention in the debate so far.

A massive influx of international capital contributed to the financial bubble in the United States in the build-up to the current financial crisis. Unrestrained capital flows led to huge imbalances in many other countries, too, and the reversal of those flows during the crises caused very serious payments difficulties and problems with exchange-rate management. This was quite similar to what had happened in previous crises in emerging-market economies, such as the debt crisis of the early 1980s and the 1997–1998 crises.

This illustrates the strong links between international financial transactions, on the one hand, and trade and macroeconomic performance of interdependent economies on the other. This chapter discusses some elements in the reform of the international monetary and financial architecture which

could, in combination with strengthened financial regulation at the national level, reduce the likelihood of similar crises in the future and help create a stable macroeconomic environment conducive to growth and smooth structural change in developing countries.

The lopsided distribution of domestic demand among major economies, along with a pattern of exchange rates that did not reflect the diverging fundamentals, led to imbalances in the external accounts of many countries. These factors contributed to the rapid spread of the financial crisis from the United States to other deficit countries that had been the destination of speculative carry trade flows, typically in combination with speculative bubbles in their domestic financial and real estate markets. These countries were affected by a sudden halt in capital inflows and reversals of carry trade positions. But the financial crisis also affected, with particular vigour, some of the major surplus economies, which, after many years of current-account surpluses, had accumulated large external asset positions vis-à-vis the deficit countries. These were often high-risk assets, as foreign investors were attracted to the market for dollar assets not only because the dollar is a reserve currency, but also because financial regulation in the United States has been less stringent than in

their home countries, which allowed risk-taking that would not have been possible at home. Thus, losses from financial activities in the deficit countries had a strong contagion effect on the financial system in some of the surplus countries.

The absence of an appropriate system of governance in international monetary and financial relations is the main reason for the increasing prevalence of current-account imbalances in the global economy. It has allowed a dramatic increase in debtor-creditor relations between countries, and efforts by many developing countries, notably in Asia, to maintain stable, and slightly undervalued exchange rates vis-à-vis the dollar (*TDR 2006*, chap. IV).<sup>2</sup> This requires massive intervention in the foreign exchange market, leading to an accumulation of reserves and official capital outflows as a result of which asset claims on the reserve currency are built up. The reserves also serve as a cushion against the risk of attacks on the national currency from highly volatile international financial markets.

Another reason for the build-up of current-account disequilibria, and the resulting international asset-liability positions, is the large movements of relative prices of tradable goods across countries. These movements are often driven by speculation on currency markets that leads to distortions in the pattern of real exchange rates (RERs). The outbreak of the global financial crisis triggered the unwinding of these speculative positions, depreciated the former target currencies of carry trade, and forced companies and private households in the affected countries to deleverage their foreign currency positions or to default, which endangered the (mainly foreign) banks in these countries.

All these developments hint at major shortcomings in a global monetary and financial system, where financial markets can exercise enormous influence in determining the competitive position of entire economies in international trade. A large share of private capital flows is speculative in nature, and depends on the expectations of actors in international capital markets that are very often unrelated to macro-economic fundamentals or medium- to long-term considerations.

This chapter seeks to highlight some elements of reform of the international financial architecture, which is long overdue. Section B discusses the problems associated with the behaviour of financial markets, which is increasingly determining macro-economic performance and policies in the rapidly integrating world economy. Their behaviour is not based on a sound interpretation of data on income growth and employment at the macro level or on a proper assessment of the long-term performance potential of corporate firms in the real sector of the economy; instead it is motivated by financial returns and capital gains generated in the financial sector itself. In the resulting “confidence game” governments are tempted to cater to financial market participants, which, in the current financial crisis, have shown

more clearly than ever their ineptitude at assessing risk and the sustainability of asset and liability positions. Against this background, section C discusses the need for more pragmatism in the management of international capital flows, in light of experience that it is not the quantity but the quality of such flows that matters. Short-term flows typically do more harm than

good by distorting the pattern of exchange rates and destabilizing the financial systems of the destination countries.

Section D addresses the issue of the reform of the current international reserve system, which has received greater attention in the context of the crisis. The role of the dollar as the main reserve currency has been called into question, partly because it is believed to require a current-account deficit in the United States, and also because the dollar has significantly lost value. Reflections about an alternative reserve system are often linked to the question of how to provide more adequate international liquidity to developing and emerging-market economies. But equally if not more important for solving the problem of instability in international financial relations, is the need for appropriate reform of the multilateral system of exchange-rate determination. Section E discusses how a multilaterally organized system aimed at stabilizing RERs would not only provide a framework for greater financial stability, but would also foster stability and efficiency of the international trading system.

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Financial markets can exercise enormous influence in determining the competitive position of entire economies in international trade.

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## B. The problem of the predominance of financial markets over fundamentals

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As in earlier episodes of financial crisis in developing countries, the surge in private capital flows towards developing and transition economies in the years preceding the current crisis was viewed by many observers as a sign of the growing strength of the receiving economies and as beneficial for development. However, as the financial crisis evolved and financial investors began moving out of risk, boom soon turned into bust, like many previous episodes in emerging-market economies.

The events of recent months have revealed a huge misallocation of resources and the creation and subsequent destruction of enormous book values, which have been driven by financial markets. This experience has shattered the belief that unfettered financial liberalization will maximize welfare. It would therefore seem appropriate to reassess the principles that have determined the attitude of many governments to financial markets over the past 25 years or so. These principles were based on the assumption that free financial markets always lead to optimal social outcomes, or at least to outcomes that are preferable to those that can be achieved with State intervention, and that the effects of market failure, should it occur, are less serious than those resulting from government failure.

Accordingly, privatization, deregulation and liberalization of trade and finance were promoted. These aimed not only at achieving more efficient resource allocation, but also at reducing the scope for State discretion. Equally important for developing

and transition economies was the shift from a national perspective on development towards an outward orientation, including price determination by global markets and a greater reliance on foreign capital inflows. Efficiency enhancement in resource allocation was sought to be achieved through opening up to global competition, both for market shares in goods markets and for foreign capital. As a result, orthodox macroeconomic and structural policies came to be conducted in such a way that they were judged to be “sound” by financial market participants who were assumed to have the appropriate knowledge to make such judgements.

With their growing size, financial markets today have acquired an enormous power not only to influence macroeconomic outcomes, but also to impose the orthodox approach to economic policy-making in line with their aim to reduce government interference in their businesses. The perceptions of financial market participants, rating agencies and financial journalists have been influenced to a large extent by the IMF, which has also propagated this approach since the early 1980s.

Thus, when financially fragile positions built up in emerging markets, they were typically interpreted as the consequence of deviations from orthodox policies, such as the absence of an inflation targeting framework or of an austere government budget rule. Budget deficits beyond a certain point, or inflation rates higher than 2 per cent, have typically been blamed on wrong national policies without

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The crisis proves that free financial markets do not lead to optimal social and macroeconomic outcomes.

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any consideration given to, for example, the employment situation or the origin of price increases. Similarly, soft currency pegs, “too many” controls on the financial system, underdeveloped markets for securities, or the dominance of a relation-based banking system were also viewed as causes of financial vulnerability.

The traditional strategy of the IMF in providing assistance to countries in situations of external payments difficulties has been not only to help debtor countries keep up with their repayment obligations vis-à-vis foreign creditors, but also to restore the confidence of financial markets through the policy conditionality attached to its lending. In this approach, restoring investor confidence is considered to be a precondition for halting the flight of short-term capital and alleviating the pressure on the exchange rate to depreciate. Eventually, with the right policy reforms in place, the concerned economies would once again “deserve” new private capital inflows.

The financial crisis has shown that the basic assumption underlying this approach to economic policymaking is wrong: financial markets do not make correct judgments on economic performance and on the quality of economic policies. They are not concerned with the proper interpretation of macroeconomic fundamentals; otherwise a number of economies with excessive private debts – including those that were destinations of carry trade operations, but also the United States – would not have attracted excessive amounts of capital. Moreover, actors in financial markets are not concerned with properly assessing the performance of corporate firms or with the long-term valuation of real estate; otherwise large bubbles would not have occurred in stock and real estate markets. And they are not concerned with a correct interpretation of real demand-supply relations in primary commodity markets; otherwise there would not have been excessive commodity price fluctuations. Rather, they are concerned with guessing how certain “news” will influence the behaviour of other financial market participants, so as to derive maximum benefits from asset price movements

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Speculation based on uniform expectations cannot be sustained ...

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... because speculative investments do not generate increases in real income.

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triggered by “herd behaviour”, no matter whether this is justified by fundamental economic performance indicators.

As the present crisis evolved, the vulnerability of different economies to the shocks varied, as did their capacity to cope with them. In some developing and transition economies, past fundamentals suddenly appeared to be unsustainable even when the financial markets had shown their “confidence” by moving funds to those economies and sharply revaluating their currencies before the crisis broke out (box 4.1). The same is true for countries that, prior to the financial shock, had fixed exchange-rate regimes in the form of pegging or a currency board system, but which were overvalued due to relatively high inflation rates and rapid wage growth measured in international currency. This was the case, for example, for the three Baltic States, Pakistan and Ukraine. In most cases, the IMF urged them to abandon the peg and to return to floating combined with its usual restrictive conditionality to restore the “confidence of the markets”. Policies to restore “market confidence” have usually been sharply contractionary, at considerable economic and social costs. They have typically involved higher interest rates to prevent further currency devaluation in a floating regime, cuts in government spending to reduce budget deficits, and pressure on wages to counter inflationary effects of rising import prices as a result of depreciation and to boost the profitability of capital.

The deficiencies of the current system have never been better exposed than by the current crisis. Financial deregulation, driven by the belief in the efficiency of financial markets, has bred a spate of “innovative” financial instruments in the most sophisticated financial markets that are completely disconnected from productive activities in the real sector of the economy. Such instruments favour purely speculative activities based on apparently convincing information, which in reality is nothing but an extrapolation of existing price trends into the future. In this way, speculation on excessively high returns can support itself for a while, much like the

### PLAYING THE CONFIDENCE GAME: THE CASE OF HUNGARY

Hungary is among the countries that have been the hardest hit by the global financial crisis. It is also an outstanding example of boom-and-bust cycles generated by the belief that financial markets are always right.

Between 2000 and 2006 Hungary's economy performed fairly well, with annual GDP growth averaging 4.4 per cent and inflation falling from 10 per cent in 1999 to less than 4 per cent in 2005 and 2006. Exports expanded rapidly, but imports increased even faster, causing a deficit in the current account of 7.3 per cent of GDP, on average, from 2005 to 2008. In 2007, monetary and fiscal policies were tightened in an attempt to counter inflation that had re-accelerated to about 8 per cent, and to lower the budget deficit that was approaching 10 per cent of GDP (IMF, 2009).

In spite of the growing current-account deficit, the Hungarian currency, the forint, appreciated strongly from 2000 onwards. This was because the short-term interest rate was persistently higher than in many other European and Asian countries, and this differential attracted inflows of short-term capital. Even when domestic demand growth slowed down considerably in 2007 and 2008, the current account did not shrink due to a dramatic loss of international competitiveness of domestic producers. By 2005, the RER – the most comprehensive measure of overall competitiveness – had risen by more than 30 per cent, and by 2008 it had risen by almost 50 per cent compared to its 2000 level. During all these years, monetary policy aimed at checking inflation had been considered “sound”, and financial markets had maintained their confidence in the Hungarian economy, despite its growing current-account deficits and its worsening competitive position. When the crisis hit in 2008, and investors suddenly stopped speculating on further gains from interest arbitrage and currency appreciation, turning instead to less risky assets, the forint depreciated sharply. This led to a sharp downward adjustment of the RER; however, by March 2009 the RER was still about 25 per cent above the level of 2000 (IMF, 2009).

The sharp devaluation had been necessary to regain some of the competitiveness lost and to reduce the current-account deficit. With the negative demand shock from the global crisis already looming and a budget deficit that had been brought down to 3.4 per cent in 2008, it would have been appropriate to support the expansionary effect of currency depreciation by reducing interest rates to stabilize domestic demand, while at the same time discouraging a new wave of speculation of the carry-trade type.

In November 2008, Hungary had to resort to IMF assistance to cope with the currency crisis, which meant that it had to accept the Fund's traditional conditionality package, including quick budget consolidation and interest-rate hikes. However, with the return of “appetite for risk” in the financial markets in early 2009, the return of Swiss-franc-based carry trade and a revaluation of the forint the interest rate was cut back in July 2009. Overall, the strategy of restoring the confidence of financial markets in the Hungarian economy, instead of strengthening real demand and improving the expectations of entrepreneurs willing to invest in real productive capacity and job creation, has led to a dramatic deterioration of the economic situation. Moreover, it has reduced the possibility of returning to sustained growth and balanced external accounts in the medium term.

It is indispensable to stabilize exchange rates through direct and coordinated government intervention, instead of letting the market find the bottom line, and trying to “convince” financial markets about the credibility of the government of the depreciating currency through procyclical policies such as public expenditure cuts or interest rate hikes.

Ponzi schemes of the 1920s. As long as new agents with large amounts of (frequently borrowed) money bet on the same “plausible” outcome (such as steadily rising prices of real estate, oil, stocks or currencies), and the expectations of market participants are “confirmed” and repeated by the media, so-called analysts and policymakers every day, betting on ever-rising prices appears to be a rather risk-free and high-return business.

However, as independent and non-partisan information is missing, this type of speculation, contrary to the mainstream view in the theoretical literature in economics, destabilizes, instead of stabilizing, the prices of the targeted assets. Sooner or later speculation based on uniform expectations of this kind cannot be sustained by the real economy, because the funds have not been invested in the capacity to produce goods and services that could have generated increases in real income. When the enthusiasm of the financial markets eventually

fades, the adjustment of exaggerated expectations to real-life conditions becomes extremely painful: the more economic agents have been directly involved in speculative activities leveraged with borrowed funds, the greater becomes the pain of deleveraging (i.e. adjusting the level of borrowing to significantly diminished revenues).

As financial markets do not operate efficiently, the orthodox notion of “sound economic policies” and the rationale for restoring the “confidence” of the financial markets collapses. Giving financial markets the power to exercise the same strong influence on economic policy decisions and reforms, as in the past, would sow the seeds of a future crisis. It is therefore problematic that the current IMF policy response in developing and transition economies (see also chapter I, section D), instead of mitigating the results of misallocation driven by speculative financial markets, is again tending to aggravate the outcome, which will invite new rounds of speculation.

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## C. Stemming destabilizing capital flows

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Financial globalization implies a de facto loss of national policy autonomy for developing countries and emerging-market economies. External financial conditions largely determine the scope for development strategies and domestic macroeconomic policies. These conditions are influenced mainly by monetary policy decisions taken in the economies that carry the largest weight in the world economy. But increasingly they are also influenced by the behaviour of participants in international financial markets. These participants are motivated by risk-return considerations aimed at optimizing returns on their portfolios which contain

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Financial globalization implies a de facto loss of national policy autonomy.

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a large variety of assets in different currencies. Since these external factors themselves are unstable, and private capital flows can suddenly reverse direction entirely unrelated to domestic fundamentals, this pattern has led to boom-bust cycles in many developing and transition economies in the past, and again in connection with the present global financial crisis.

In the context of the present crisis, several authors (Rodrik and Subramanian, 2008; Reinhart and Rogoff, 2008; Wolf, 2008) have again suggested reconsidering the use of restrictions on international capital mobility, such as international



taxes or national capital controls, as a means of reducing the risk of recurrent international financial crises. This option may be all the more relevant as efforts to strengthen international prudential regulation may not keep up with financial innovation. Thus, in citing advice by Keynes, Rodrik and Subramanian (2008) state: “If the risk-taking behaviour of financial intermediaries cannot be regulated perfectly, we need to find ways of reducing the volume of transactions. ... What this means is that financial capital should be flowing across borders in smaller quantities, so that finance is ‘primarily national’”.

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The financial crisis challenges the conventional wisdom ...

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## 1. Taxing international financial transactions

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The introduction of a tax on financial transactions has recently received renewed attention (Helleiner, 2009; Rodrik, 2009; Schmidt, 2007). Such a tax was first suggested in Keynes’ *General Theory*, “to mitigate the dominance of speculation over enterprise”, and advocated again in the 1970s by Nobel laureate James Tobin (1978), “to throw some sand in the wheels” of international financial markets. It was further discussed in the 1990s (*TDR 1996*; Dornbusch, 1997). Such a tax would serve to raise the cost of cross-border financial movements. It could be levied each time a unit of capital crossed borders, so that the effective tax burden would be greater, the shorter the time horizon of a financial transaction. This could discourage, in particular, short-term speculative flows that are the most volatile element in international financial markets, and that distort trade patterns through their cumulative impact on exchange rates, thereby reducing the policy autonomy of governments. The tax would not interfere with desirable long-term financial transactions in support of productive investment, since the tax burden for such long-term transactions would be insignificant as a cost item.

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... that dismantling all obstacles to cross-border private capital flows is the best recipe for countries to advance their economic development.

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This kind of tax has often been dismissed in the past on the grounds of difficulties in implementing it in an effective manner, since it would require the co-operation of all countries. However, foreign exchange trading relies on dense networks of information, accounting and legal services that exist only in a relatively small number of financial centres where the vast bulk of such trading is concentrated. If the tax were to be imposed in those centres, it is highly unlikely that the foreign exchange trading business would flee en masse to lightly regulated offshore financial centres (Cooper, 1994; Schmidt, 2007).

A tax on international financial transactions would not prevent imbalances in the external accounts, but by reducing the possible gains that can be had from interest arbitrage and exchange-rate movements, it would help to reduce the amount of potentially destabilizing speculative capital flows among countries that apply the tax (and in the system as a whole if a sufficiently large number of countries applied it).

## 2. Capital-account management

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Another approach to crisis prevention is to put in place measures that hinder the free inflow and outflow of private capital in individual countries. For a long time, the idea of capital controls was taboo in mainstream discussions of appropriate financial policies, as market forces were considered the only reliable guide for the allocation of capital. This was despite the fact that the IMF Articles of Agreement provide for the possibility that “members may exercise such controls as are necessary to regulate international capital movements ...”<sup>3</sup> Some rethinking began in the aftermath of the Asian crisis, when the standard policy advice was for a “sequencing” of liberalization of international financial transactions, along with setting up domestic prudential regulatory and supervisory regimes. Experience with the current

financial crisis also challenges the conventional wisdom that dismantling all obstacles to cross-border private capital flows is the best recipe for countries to advance their economic development.

When introduced in a period of crisis, capital-account management mainly takes the form of restrictions on capital outflows. On the other hand, when it is conceived as an instrument to prevent the build-up of speculative bubbles and currency misalignment and to preserve domestic macroeconomic policy space, it primarily implies certain restrictions on capital inflows. A regulatory regime of comprehensive capital-account management can target both the level and the composition of capital flows. A rich menu of both price-based and quantity-based types of instruments can be combined and flexibly handled to match specific local requirements (Stiglitz et al., 2006; Ocampo et al., 2008). In principle, barring or limiting certain types of inflows can be achieved in more ways than one, ranging from outright bans or minimum-stay requirements, to tax-based instruments like mandatory reserve requirements or taxes on foreign loans designed to offset interest rate differentials.<sup>4</sup> In many cases, instruments directly targeting private capital flows may also be appropriately combined with, and complemented by, prudential domestic financial regulations. The experiences of numerous emerging-market economies such as Chile, China, Colombia, India, Malaysia, Singapore and Taiwan Province of China (Epstein, Gabel and Jomo, 2004) belie the assertion that capital controls are ineffective or harmful.

It has been suggested that capital-account management could be applied in a counter-cyclical manner by restricting excessive foreign borrowing in good times and controlling capital flight during crises (Rodrik, 2009), although capital flows unrelated to investment and trade are undesirable at all times. In any case, it would certainly be a step forward if surging capital inflows were no longer perceived as a sign of a strong receiving economy, but as a potential for disequilibria, with negative repercussions on monetary

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The experiences of numerous economies belie the assertion that capital controls are ineffective or harmful.

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The IMF should more actively encourage the use of capital controls and advise on their national implementation.

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management and trade. The IMF should therefore change its stance by more actively encouraging countries to use the possibility of introducing capital controls as provided for in its Articles of Agreement, and advising them on their national implementation (Rodrik, 2009; South Centre, 2008). Since introducing flexible management of capital inflows requires certain administrative capabilities, it would also be appropriate for the Bretton Woods institutions to provide advice to policymakers in developing and transition economies and help them create and strengthen their administrative capacities to run a capital-account management regime that suits their country-specific requirements.

### 3. Dealing with debt and payments crises

In view of the potential impact of the global financial and economic crisis on developing countries, a multilaterally agreed mechanism for a temporary standstill on debt repayments would greatly help orderly debt workouts (*TDR 2001*, chap. VI, section D). Since it would involve the private sector in the resolution of financial crises in emerging markets, it would influence investor and creditor behaviour and portfolio decisions. This could also help reduce potentially destabilizing capital flows.

Once crises have broken out, the resolution of sovereign debt has also often been a messy and time-consuming affair that has been damaging to the interests of both private creditors and sovereign debtors. Given these experiences a clear set of international rules and procedures could be of benefit to all: they could force holdout creditors to accept the terms of debt restructuring, impose stays on litigation during restructuring negotiations, and provide for the extension of new credits during restructuring exercises. Proposals for the introduction of an orderly international debt workout mechanism for sovereign debt, modelled on national insolvency procedures,

have been made by UNCTAD since the 1980s (*TDR 1986*, annex to chapter VI; *TDR 1998*, chapter IV; *TDR 2001*, chapter VI, section D). And after the experience with the Asian financial crisis, a “sovereign debt restructuring mechanism” was discussed in the IMF (Krueger, 2002). This proposal failed to gain sufficient support, but it helped generate momentum for the inclusion of collective action clauses (CACs) in new international bond issues. These clauses allow for such provisions as altering repayment terms by a super majority of bondholders and restrictions on

individual creditors from disrupting restructuring processes. However, the effectiveness of CACs is limited because most of them do not cover all categories of bonds, nor do they endorse standstill provisions. They are designed primarily to facilitate the restructuring of sovereign debts *after* a crisis has broken out. In addition, CACs leave many of the key decisions concerning debt restructuring to private creditors, rather than allocating them to an independent arbiter, or sharing decision-making more equally with sovereign debtors in a formal institutional setting (Helleiner, 2009).

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## D. International reserves and the role of SDRs

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### 1. Disadvantages of the current system

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Another issue that has received renewed attention in the discussion about necessary reforms of the international monetary and financial system is the role of the United States dollar as the main international reserve currency. The current international monetary system, with flexible exchange rates between the major currencies, the dollar as the main international reserve currency, and free international capital flows, has failed to achieve the smooth adjustment of payments imbalances. This is the conclusion reached by the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System (also known as the Stiglitz Commission) (UNPGA, 2009). The main reason for this failure is that the system has not provided for any disciplines on surplus countries and on deficit countries whose currencies are used as an international means of payment or store of value, such as the United States. As a result, the international

monetary system cannot influence the behaviour of the major players that have been responsible for the current global imbalances. Moreover, it allows other deficit countries to avoid adjustment as long as they can continue to borrow abroad. But when their ability to continue to borrow abroad is cut off, for whatever reason, their adjustment takes the form of a contractionary crisis, which may have knock-on effects on other economies with which they have trade and credit-debt relations.

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The current international reserve system does not provide for any disciplines on surplus countries and on deficit countries that issue reserve currencies.

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No country is obliged to hold reserves in dollars; indeed, central banks have been increasingly diversifying their reserve holdings in other currencies, in particular the euro, in order to reduce the exchange-rate risk in a world of financial and currency instability. Nevertheless, since the dollar serves as the main currency for settling international

transactions, it has continued to be the preferred choice. However, an international reserve system in which a national currency is used as a reserve asset and as an international means of payment has the disadvantage that monetary policy in other countries cannot

be designed independently from the monetary policy decisions of the issuing central bank. These decisions are not taken in consideration of the needs of the international payments system and the world economy, but in response to domestic policy needs and preferences in the country of the reserve currency. This problem also exists in a multiple reserve currency system. Moreover, an economy whose currency is used as a reserve currency is not under the same compulsion as others to undertake the necessary macroeconomic or exchange-rate adjustments to avoid continuing current-account deficits. Thus, the role of the dollar as the main means of international payments has also played an important role in the build-up of the global imbalances in the run-up to the financial crisis.

Another disadvantage of the current international reserve system is that it imposes the burden of adjustment exclusively on deficit countries (except if it is the country issuing the reserve currency). Yet, to the extent that one or several countries run surpluses, one or several others must run deficits. The asymmetry in the adjustment burden introduces a deflationary bias into the system, because deficit countries are compelled to reduce imports when their ability to obtain external financing reaches its limits, whereas surplus countries are under no systemic obligation to raise their imports in order to balance their payments. By the same token, central banks can easily counter pressure on their currency to appreciate by buying foreign currency against their own; but they only have limited possibilities to do so when there is pressure for currency depreciation, because their foreign exchange reserves are limited. IMF policies support this bias by imposing conditions of restrictive policies on deficit countries in connection with its lending activities, rather than pressing surplus countries for more expansionary policies in connection with its surveillance activities. Thus, as long as there is no multilaterally agreed rule for countries to support each others' economies through coordinated demand management and through symmetric interventions in the foreign exchange market, the system has a deflationary bias.

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In the absence of symmetric interventions in currency markets, the system has a deflationary bias.

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The economic costs and benefits of reserve holdings cannot be seen in isolation from a broader macroeconomic strategy.

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## 2. The cost of holding foreign exchange reserves

The experience with financial crises in the 1990s led developing and transition economies to believe they could not rely on adequate assistance from the international financial institutions in times of need. It also made them reluctant to abide by the procyclical conditionality typically attached to such support. As a result, many of them tried to avoid current-account deficits and, indeed, accumulated large amounts of international reserves as a form of self-insurance. This has led to discussions about the cost of holding foreign exchange reserves. However, defining these costs is not straightforward (box 4.2).

One way to look at the cost of reserve holdings is to compare the financial returns on the reserve holdings of a country – typically the interest on United States Treasury bills – with the generally higher interest which would have to be paid by that country on borrowing on international capital markets. In this case, the costs would imply an outward income transfer for the country holding the reserves. Such a calculation is valid when reserves are “borrowed”, in the sense of being associated with capital inflows (i.e. increased liabilities vis-à-vis foreign lenders or non-residents who purchase domestic financial assets (Akyüz, 2009)). This applies to about half of the total reserves of developing and emerging economies. However, the capital inflow is rarely initiated by the receiving countries for the purpose of creating a cushion of foreign exchange reserves. Rather, they are often the outcome of portfolio investment decisions of foreign agents. In this case, the purchase of the reserve currency by the central bank is likely to be motivated primarily by the desire to counter pressure on the domestic currency to appreciate. This has often been the case not only in situations where central banks have wanted to fend off the effects of rising capital inflows on their currency, but also in situations where large

current-account surpluses have exerted pressure for currency appreciation, such as in China and in fuel-exporting countries in recent years.

The link between exchange-rate management and changes in foreign exchange reserves suggests that the economic costs and benefits of reserve holdings cannot be seen in isolation from a broader macroeconomic strategy. In the absence of intervention in the foreign exchange market, and the associated reserve accumulation, currency appreciation would lead to a loss of international competitiveness of domestic producers, and lower exports, output and employment. At the same time, the unchecked net inflow of private capital could destabilize the domestic financial system, resulting in an increased risk of a banking crisis. The underlying problem is that in the current monetary system, effective multilateral agreements for exchange-rate management and the provision of adequate international liquidity in times of need are missing. Reform that aims at addressing the causes rather than the symptoms of the current crisis must therefore focus on these two latter aspects.

### 3. Reform of the reserve system and the role of SDRs

The question of the reserve currency in the current international monetary system has been reviewed at considerable length in the report of the Stiglitz Commission: it takes up the issue of reform involving Special Drawing Rights (SDRs) as the main form of international liquidity. One proposal discussed by the Commission, which has also been reiterated by other authors (see, for example, Bergsten, 2007), was first discussed in the late 1970s to facilitate reserve diversification away from dollars without creating the risk of a major dollar crisis. This proposal envisaged giving central banks the possibility to deposit dollar reserves in a special “substitution account” at the IMF, to be denominated in SDRs. The SDRs could also be used to settle international payments. Since the SDR is valued as the weighted average of the major currencies,<sup>5</sup> its value

is more stable than that of each of the constituent currencies. This does not mean that the exchange rate risk would disappear; it would simply be shifted to the IMF. The risk would have to be covered either through the generation of higher revenues by the IMF or by guarantees from member States. Moreover, the reserve currency country could still delay adjustment in case of external imbalances if the IMF invested the dollar reserves deposited by central banks in United States Treasury bonds. But then there would remain the problem of exchange-rate determination of the currencies of the member States.

A step that would go much further than the introduction of a substitution account would be to enable a new “Global Reserve Bank” or a reformed IMF to issue an “artificial” reserve currency, such as the “bancor” suggested by Keynes in his Bretton Woods proposals for an International Clearing Union.<sup>6</sup> The new global reserve system could be built on the existing system of SDRs (Akyüz, 2009). One possibility is for countries to agree to exchange their own currencies for the new currency, so that the global currency would be backed by a basket of currencies of all the members. But other variants are also discussed in the Commission’s report. The new system could contain penalties against countries that maintain deficits, and equally against countries that maintain surpluses. A variable charge would be levied depending on the size of the surpluses or deficits.

Recognizing the need for increasing international liquidity in the current financial and economic crisis, the G-20, at its London Summit in April 2009, announced its support for a new general SDR allocation, which would inject \$250 billion into the world economy and increase global liquidity. However, a major problem with the G-20 proposal is that the new SDRs are allocated among the IMF’s various members in line with the existing pattern of quotas, so that the G-7 countries, which do not need liquidity support from the IMF, would get over 45 per cent of the newly allocated SDRs, while less than 37 per cent would be allocated to developing and transition economies, and less than 8 per cent to low-income countries. Countries most in need of international liquidity would thus receive the smallest shares.

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Any reform of the international monetary and financial system has to address the issue of SDR allocation.

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**Box 4.2****ON THE COST OF INTERNATIONAL RESERVES**

The reasons for a central bank to build up foreign exchange reserves are manifold. One important reason appears to be disenchantment with international financial institutions in general, and a loss of faith in the IMF in particular. After the painful experiences of the financial crises of the 1990s, many developing and emerging-market economies were no longer willing to rely on the global monetary institutions as lenders of last resort. Consequently, they accumulated large reserves as an instrument of self-insurance.

While most observers agree that reserve accumulation can help reduce the probability of a financial crisis in developing and transition economies, it is often argued that this kind of self-insurance has high opportunity costs, because the money tied in reserves could be used for other purposes in support of economic development and poverty alleviation (see, for example, McKinley, 2006; and Stiglitz and Charlton, 2005). According to the Chairman of the United States Federal Reserve, Ben Bernanke (2005: 6), by accumulating reserves, “governments have acted as financial intermediaries, channelling domestic saving away from local uses and into international capital markets.” Reserves are seen as part of a country’s “savings”, and very high reserves are interpreted as a kind of “surplus savings”. However, the view that reserve holdings have opportunity costs in terms of foregone domestic consumption or investment is questionable.

A build-up of reserves in international currency implies an intervention of a country’s central bank in currency markets, through the purchase of foreign currency with its own currency. The largest proportion of these reserves is denominated in United States dollars, which are not held in cash but invested in dollar-denominated interest-bearing assets, mostly United States Treasury bonds. However, the domestic currency that the central bank uses for the purchase of dollar reserves is not withdrawn from domestic income. It is not financed from tax revenues or by additional government borrowing, but results from a process of money creation. The purchase of foreign currency increases the amount of domestic currency in circulation in the same way as the central bank’s purchase of domestic bonds in open market operations or that bank’s credit to domestic commercial banks. This is reflected in the central bank’s balance sheet as an addition both on the assets side (foreign bonds) and the liabilities side (currency in circulation). Whether the central bank increases the amount of currency in circulation by acquiring domestic government bonds or foreign government bonds has no impact on the amount of domestic consumption or investment. However, it has an impact on the exchange rate of the domestic currency vis-à-vis the dollar, which is what is intended by the intervention, namely to prevent an appreciation of the domestic currency.

Similarly, accumulated reserves cannot be turned into higher domestic consumption or investment by a decision of the central bank. Assume that in order to make reserves “available” for public infrastructure investment, the central bank decides to sell the United States Treasury bonds against its own currency. This will lead to an appreciation of the domestic currency against the dollar, while the domestic currency in circulation falls by an amount equal to that of the reduction in the stock of reserves. This implies the elimination of the money that was created at the time of the initial intervention in the currency market. In other words, whenever the central bank converts foreign currency reserves back into its own currency the money disappears.

This happens because a central bank does not function in the same way as a private firm or household. For them depositing money in a bank account has the opportunity cost of not being used for consumption or investment purposes. Those “reserves”, if reactivated, indeed represent an increase in purchasing power. If invested wisely, the household or firm gains from the activation of its saved “reserves”. Reserves of the central bank are of a completely different nature. As the central bank is able to create money out of nothing, the activation of reserves (through the bond or currency market) simply amounts to a destruction of currency in circulation: for the overall economy the money just disappears. This is so because the central bank is a unique institution with the monopoly of creating base money (if reserves are increased) and destroying base money (if reserves are reduced). On the other hand, if the central bank wants to

**Box 4.2 (concluded)**

stimulate investment in general, and is willing to finance public investment directly, it can do so at any time – independently of its level of international reserves.

However, reserve holdings may imply financial costs for the public accounts. When the increase in the amount of domestic currency in circulation resulting from the intervention is not desired for reasons of domestic monetary policy, the central bank sterilizes this effect by reducing its liquidity provision to the domestic banking system through other channels. In the case of full sterilization, the liabilities of the central bank remain unchanged, while on the assets side of its balance sheet the increase in the holdings of foreign bonds is compensated by a reduction of its holdings of domestic currency assets. In this case, the cost of the reserve holding for the central bank would be the difference between the interest earned on United States Treasury bonds and the foregone interest that would have been earned from domestic currency assets if – as is likely – the interest earned on the Treasuries had been lower. Similarly, if the sterilization is achieved through the central bank's issuing of domestic sterilization bonds, the cost will be the difference between the interest to be paid on these bonds and that earned on the Treasuries. These would represent financial costs for the central bank – or the public budget – but not for the economy as a whole, as no outward transfer of real income would take place.

The creation of reserves takes real resources away from the economy as a whole only if the intervention occurs in response to an inflow of foreign capital, rather than to an increase in demand for the domestic currency due to a rise in net exports. The additional reserves resulting from the intervention would then be accompanied by an increase of external liabilities on which interest has to be paid. If the interest to be paid to the foreign investor or creditor is higher than the interest rate on United States Treasury bonds, the reserve holding entails a net cost for the economy. This is generally, though not always, the case, because it is rare for low interest rates to be associated with an appreciation pressure for the domestic economy. The latter may occur in situations such as that of China, where a low valuation of its currency, stemming from a financial crisis in 1993, has led to a huge current-account surplus and where, additionally, a large inflow of foreign investment occurred. In this case, it is the current-account surplus that has caused the piling up of reserves, and not the other way around, as implicit in mainstream theory (see Bernanke, 2005).

In any case, an evaluation of the costs and benefits of reserve holdings needs to take into account the fact that the accumulation of foreign exchange reserves not only reduces the risk of a financial crisis, but also influences a country's exchange rate in a way that increases the international competitiveness of its domestic producers.

Thus any reform of the international monetary and financial system aimed at making the SDR the main form of international liquidity, with all the features of a global reserve medium, would have to address the issue of SDR allocation more generally. A fundamental question to be resolved at the outset would be what purpose the SDR as the main medium of international liquidity should fulfil. For example, would it be used for clearing among central banks or could it also be used by the private sector? Issuing SDRs then has a geographical and a time dimension.<sup>7</sup>

With regard to the geographical dimension, the Stiglitz Commission proposed that SDRs should be allocated to member States on the basis of some estimation of their demand for reserves, or, more generally, on some judgement of "need". Appropriate criteria for determining the need of countries would need to be worked out, but clearly an allocation according to the current structure of IMF quotas would be entirely out of line with needs. One approach would be to distribute new SDRs in relation to the size of the demand for reserves in recent years. Another approach would be to link the issuance of

SDRs with development financing by allowing the IMF to invest some of the funds made available through issuance of SDRs in the bonds of multilateral development banks. As highlighted by the Stiglitz Commission, such a proposal had been made by an UNCTAD panel of experts in the 1960s, before the international liberalization of financial markets began and when access to capital market financing by developing-country borrowers was very limited.

With regard to the time dimension, the question of frequency and cyclicity arises.

Over time, the need for international liquidity grows, in principle with the growth of the world economy and the expansion of international trade and financial transactions. Yet an annual increase of SDRs in line with global GDP would mean that additional SDRs would be issued in periods of high growth, while they are needed most in periods of slow growth or recession. The G-20 finance ministers meeting in April 2009 endorsed the proposal for a countercyclical issuance of SDRs. If the purpose of SDR allocation is to stabilize global output growth, it would indeed be appropriate to issue more SDRs when global growth is below potential or during crisis periods, and to issue smaller amounts or retire SDRs in periods of fast global output growth.

An international financial system that does not primarily aim at catering to financial market participants – whose decisions are more often than not guided by misconceived notions of “sound” macroeconomic fundamentals and policies – but at preventing crises and ensuring a favourable global economic environment for development, should provide emergency financing without the sort of conditions attached that exacerbate recessions and disequilibria.

The rationale for the unconditional provision of international liquidity in times of crisis is that, in order to balance the external payments, deficit countries need to restore the competitiveness of their domestic producers. Therefore countries in danger

of a downward “overshooting” of the exchange rate need international assistance, rather than belt-tightening and procyclical policies. Without such assistance, they would have to lower the overall cost level, which mainly involves cutting wages. However, contrary to predictions by orthodox economic theory, wage cuts have an immediate dampening effect on domestic demand and further destabilize the economy. Moreover, wage cuts of the size needed to restore competitiveness are deflationary and add to the general depression of production and investment. In such situations, even countries with

current-account deficits and weak currencies need expansionary fiscal and monetary policies to compensate for the fall in domestic demand, because the potential expansionary effects of currency devaluation are unlikely to materialize quickly in a sharply contracting global economy.

One of the advantages of using SDRs in such a countercyclical fashion is that it would, in principle, facilitate the task of preventing excessive currency depreciations in countries in crisis. This could best be achieved by allowing all countries unconditional access to IMF resources by an amount that is needed to stabilize their exchange rate at a multilaterally agreed level. However, the rules and conditions for access would need to be elaborated carefully, including determining the level at which exchange rates should be stabilized. Another important issue would be the extent to which SDRs should be made available in crisis situations, to cover not only current-account transactions but also capital-account liabilities. This is because, a priori, the purpose of giving countries unconditional access to international liquidity should be to ensure that the level of imports can be maintained, and not to bail out foreign investors.

Whatever form an enhanced scheme of SDR allocation takes, it will only be acceptable to all countries of the system if the terms at which SDRs can be used as international liquidity are absolutely clear-cut, particularly SDR parity vis-à-vis all national currencies.

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A proposal to link the issuance of SDRs with development financing was made by UNCTAD as early as the 1960s.

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Unconditional countercyclical access to IMF resources would help prevent excessive currency depreciations.

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## E. A global monetary system with stable real exchange rates and symmetric intervention obligations

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The most important lesson of the recent global crisis is that financial markets do not “get the prices right”; they systematically overshoot or undershoot due to centralized information handling, which is quite different from the information collection of normal goods markets. In financial markets, nearly all participants react in a more or less uniform manner to the same set of “information” or “news”, so that they wind or unwind their exposure to risk almost in unison.<sup>8</sup>

The currency market, in particular, causes results quite different from those envisaged by theory, such as an appreciation of the nominal exchange rate in countries that have high inflation rates over considerable periods of time. In fact, high-inflation countries are the main targets for short-term capital flows, because they usually offer high interest rates. In so doing, they attract “investors” that use interest rate arbitrage by carrying money from countries with low interest rates to those with high interest rates, thereby putting pressure on the currency of the latter to appreciate. This is just the opposite of what is required by macroeconomic fundamentals: countries with relatively high inflation need nominal devaluation to restore their competitiveness in goods markets, and those with low inflation need appreciation.

A viable solution to the exchange-rate problem, preferable to any “corner solution”, would be a system of managed flexible exchange rates which

aims for a rate that is consistent with a sustainable current-account position. But since the exchange rate is a variable that involves more than one currency, there is a much better chance of achieving a stable pattern of exchange rates in a multilaterally agreed framework for exchange-rate management.

The Bretton Woods system and the European Monetary System provide precedents for what could be an appropriate solution to determine exchange rates within a multilateral framework. In these systems, the implicit rule was that the exchange rate of the national currencies with the international currency would be determined by the purchasing power of the currency expressed in all other currencies. This rule may be difficult to introduce at the time the system starts, because of the problem of determining the initial purchasing power parities of each currency. However, it would be straightforward and simple once the system is on track. It may also be necessary to apply some additional criteria that reflect structural features related to the level of development of different countries.

Once a set of sustainable exchange rates is found and accepted by the countries, inflation differentials may be the main guide for managing nominal exchange rates in order to maintain the real exchange rates (RERs) at sustainable levels. However, for some countries, at certain times additional factors may need to be taken into account. For instance, countries’

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Achieving a stable pattern of exchange rates stands a better chance within a multilaterally agreed framework for exchange-rate management.

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falling export incomes resulting from factors that are beyond the control of an individual country may warrant an exchange-rate adjustment, even though it may have no impact on the general domestic price level. Sustainable levels of RERs can also change with countries' development, and the body in charge of exchange-rate management would need to take that evolution into account.

Management of the nominal exchange rate is therefore required to maintain stability in the RER, but the scope for an individual monetary authority to do so is limited. It can always check an unwanted appreciation of its exchange rate by purchasing foreign currencies against its own currency, thus accumulating foreign exchange reserves (with the need for sterilization of the domestic monetary effect); however, its capacity to counter a potentially overshooting devaluation is circumscribed by the amount of the foreign exchange reserves that it can sell in exchange for its own currency. The situation would be quite different if exchange-rate management became a multilateral task in which countries whose currencies were under pressure to devalue were joined in their fight against speculation by the monetary authorities of those countries whose currencies were under pressure to appreciate.<sup>9</sup>

An internationally agreed exchange-rate system based on the principle of constant and sustainable RERs of all countries would go a long way towards reducing the scope for speculative capital flows, which generate volatility in the international financial system and distort the pattern of exchange rates. Since the RER is defined as the nominal exchange rate adjusted by the inflation differentials between countries, a constant RER results from nominal exchange rates strictly following inflation differentials. A constant RER at a competitive level would achieve the following:

- Curb speculation, because the main trigger for currency speculation is the inflation and interest rate differential. Higher inflation and higher interest rates would be compensated by the devaluation of nominal exchange rates, thereby reducing the scope for gains from carry trade.

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An exchange-rate system based on the principle of constant real exchange rates would tackle the problem of destabilizing capital flows at its source.

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- Prevent currency crises, because the main incentive for speculating in currencies of high-inflation countries would disappear, and overvaluation, one of the main destabilizing factors for developing countries in the past 20 years, would not occur.
- Prevent fundamental and long-lasting global imbalances, because all countries with relatively diversified production structures would maintain their level of competitiveness in global trade relations.
- Avoid debt traps for developing countries, because unsustainable current-account deficits triggered by a loss in international competitiveness would not build up.
- Avoid procyclical conditionality in case of crisis, because, if the system were to have symmetric intervention obligations, the assistance needed for countries under pressure to depreciate their currencies would come automatically from the partners in the system whose currencies would appreciate correspondingly.
- Reduce the need to hold international reserves, because with symmetric intervention obligations under the “constant RER” rule, reserves would only be needed to compensate for volatility of export earnings but no longer to defend the exchange rate.

Such a multilateral system based on the “constant RER” rule would tackle the problem of destabilizing capital flows at its source. It would remove the major incentive for currency speculation and ensure that monetary factors do not stand in the way of achieving a level playing field for international trade. It would also get rid of debt traps and counterproductive conditionality. The last point is perhaps the most important: countries facing strong depreciation pressure would automatically receive the required assistance once a sustainable level of the exchange rate had been reached in the form of swap agreements or direct intervention by the counterparty.

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## F. The role of regional cooperation and international policy coordination

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Establishing an exchange-rate system such as outlined in the preceding section would take some time, not least because it requires international consensus and multilateral institution building. As long as an optimal multilateral exchange-rate system that minimizes the incentives for destabilizing capital flows is not in place, quantitative restrictions on capital mobility (as discussed in section C above) may be helpful in preventing speculative capital movements from exerting pressure on exchange rates and destabilizing the financial system in individual countries.

At the regional level, greater monetary and financial cooperation, including reserve pooling, regional payments clearance mechanisms that function without using the dollar, and regional exchange-rate systems could help countries in the region enlarge their macroeconomic policy space. They could also avert financial and currency crises, and reduce dependence on borrowing from the international financial institutions if such crises occurred.<sup>10</sup>

In this regard, considerable progress has been made among members of the Association of South-east Asian Nations (ASEAN), plus China, Japan and the Republic of Korea (ASEAN+3): their Chiang Mai Initiative is evolving from a network of bilateral swap agreements into a collectively managed fund that will pool the foreign exchange reserves of these countries (Henning, 2009).<sup>11</sup> These exchange and credit facilities are intended to facilitate bilateral trade

and investment, and to disconnect such exchanges from international trade credit shortages and possible disturbances in the international financial system. Other ongoing initiatives seek to create or revitalize regional payment mechanisms. In Latin America, for example, several countries have agreed to use their national currencies for payments in trading with

each other.<sup>12</sup> Such agreements would be especially attractive if they were linked with easy access to trade credit, especially at times when such credit is more expensive and scarce. Furthermore, they could evolve towards a regional monetary system with a new regional currency. Currency swap agreements are also

becoming more frequent among central banks of emerging-market economies in different regions.<sup>13</sup>

While a multilateral exchange-rate mechanism would minimize the risk of large current-account imbalances emerging, it may not necessarily be sufficient to correct large imbalances that are the result of diverging rates of domestic demand growth over several years, such as the United States deficit and the German, Japanese and Chinese surpluses that had built up since the early 1990s. Therefore, the global economic governance would gain greater coherence if multilateral trade rules and a multilateral exchange-rate mechanism were complemented by an effective system of surveillance and macroeconomic policy coordination. So far, policy surveillance by the IMF has been effective only for countries borrowing from the Fund, and macroeconomic policy coordination has

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Greater monetary and financial cooperation would reduce dependence on borrowing from the IMF.

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been provided only on an ad hoc basis during crises, but not for the purpose of preventing such crises.

The present global macroeconomic situation, in which the central economic policy concern in all countries is to overcome the recession, highlights the necessity of an internationally coordinated policy response that also takes into account the needs of developing countries. As discussed in chapter I, the United States Government was quick to introduce an impressive fiscal stabilization package as a complement to monetary easing with the aim of reviving the credit market. Governments of many other countries also acted with similar responses, in recognition of the need for countercyclical monetary and fiscal policies. But in many cases, especially in Europe, more expansionary fiscal action is required to support the global fight against recession. Unfortunately, this pattern of international demand stimulus is repeating the earlier pattern in the distribution of global demand growth that led to the build-up of the global current-account imbalances in the first place.

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A further accumulation of external debt obligations by the United States would make the world economy even more fragile.

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Indeed, in the absence of a deep reform of the international exchange-rate system and appropriate rules and mechanisms for multilateral intervention in currency markets, there is a danger that, in responding to the present crisis, an increasing number of countries will aim at an undervalued exchange rate, bigger current-account surpluses and higher foreign exchange reserves. The question then is which country will run the necessary deficits. The experience of the years preceding the crisis suggests that the EU and Japan are quite reluctant to employ more expansionary policies. Thus, as long as the dollar is the main reserve asset in an unstable monetary system, the main deficit economy might again be the United States. However, a further accumulation of external debt obligations by that economy would make the world economy even more fragile. Therefore, developing countries may be well advised to turn to a more balanced growth strategy which gives greater emphasis than in the past to domestic and regional demand for increasing production and employment. ■

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## Notes

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- 1 See also UNCTAD (2009) for an analysis of the crisis and proposals for reform of the governance of the international monetary and financial system.
- 2 This has come to be called “Bretton Woods II” (Dooley, Folkerts-Landau and Garber, 2003).
- 3 IMF Articles of Agreement, Article VI, Section 3: Controls of capital transfers.
- 4 Like monetary policy itself, the use of tax-based instruments to offset interest rate differentials becomes complicated if expectations of significant exchange-rate changes come into play.
- 5 In July 2009, the SDR basket contained 0.632 dollars, 0.410 euros, 0.0903 pounds and 0.0543 yen.
- 6 Keynes first mooted the idea of a world unit of currency, together with proposals for an International

- Clearing Union, more than 50 years ago, at the Bretton Woods negotiations on post-war monetary arrangements. This set of proposals has been called the Keynes Plan. The Stiglitz Commission notes that the IMF, due to its current governance structure, may not be considered neutral enough by all countries or have the capacity to serve as the issuer of such a currency. It therefore proposes that a new Global Reserve Bank be created for the purpose.
- 7 A change in the allocation of SDRs would require an amendment of the IMF’s Articles of Agreement. A precedent is the amendment that was made in 1997 in order to distribute SDRs to countries which had joined the IMF after 1981 and thus had never received any SDRs: mainly transition economies in

- Eastern Europe and Central Asia. Because it was an amendment to the Fund's charter, it had to be approved by the legislatures of many IMF members, and specifically by the United States Congress, where it has languished for 12 years. However, the G-20 proposal for an increase in SDRs (see chapter I, section D.5 of this *Report*) has prompted the United States Government to call on Congress to finally take action.
- 8 The first quarter of 2009 shows this result: the parallel increase in stock and commodity prices, as well as the appreciation of previously devaluating currencies at the same time, shows once again a strong correlation between the unwinding of speculation in different markets that should be uncorrelated. Moreover, increases cannot be explained by any other factor than speculation. This yields the paradoxical result of rising prices of crude oil during the biggest global recession in decades.
  - 9 This was practiced by the members of the European Monetary System before the introduction of the euro as a common currency
  - 10 Options for, and experience and progress with, regional financial and monetary cooperation among developing countries were discussed in greater detail in *TDR 2007*, chap. V.
  - 11 See also Shamin A and Seyoon K, Asia agrees on expanded \$120 billion currency pool, Bloomberg, 23 February 2009.
  - 12 The use of domestic currencies for regional payments is considered an option in the Latin American Integration Association (LAIA-ALADI), which has been managing a regional system of payments and clearing among 12 Latin American central banks since the 1960s (ALADI, 2009). In addition, countries that integrate the Bolivarian Alternative for the Americas (ALBA) are considering the establishment of a regional system for clearing and payments in local currencies. The Unified Regional System for Payments Clearing (Sistema Unitario de Compensación Regional de Pagos, SUCRE) would initially comprise Bolivia, the Bolivarian Republic of Venezuela, Cuba, Ecuador, Honduras and Nicaragua (Prensa Latina, "ALBA aprueba acuerdo macro de moneda virtual Sucre", 3 July 2009, at: <http://www.alternativabolivariana.org/modules.php?name=News&file=article&sid=4695>).
  - 13 For instance, between December 2008 and March 2009, China signed bilateral currency swap agreements with Indonesia, Hong Kong (China), Malaysia, the Republic of Korea, and, beyond the region, with Argentina and Belarus, for a total amount of 650 billion yuan (\$95 billion). The agreements allow central banks to access to the partner's currency for a three-year (extendable) period. Such agreements may also enhance the yuan's role as an international currency and eventually favour the emergence of a multipolar exchange system.

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