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Why we need an International Monetary System

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« Markets actually do not work the way the new orthodoxy supposes. »

The present global currency system does not really work. There are many problems that may become dangerous to financial stability, writes William White.

The AuthorWilliam R. White was Chief Economist of the Bank for International Settlements until 2008. He currently serves as chairman of the Economic and Development Review Committee at the OECD in Paris.Over many centuries, the Holy Grail sought by statesmen and economists alike was an International Monetary System. Such a system was expected to provide a shared international currency to facilitate trade and capital flows. Further, that currency would also preserve its absolute value over time (what it could purchase in terms of goods and services) as well as its relative value against currencies issued by national authorities.

Of course, it was recognized and accepted that these longer term «stability» benefits came with a price. Shorter term national objectives would have to be subordinated to international rules required to ensure the sustainability of the system as a whole. The gold standard, which was at its peak between 1870 and 1914, evolved to provide these benefits. The Bretton Woods system, which dominated the post World War ll order until its collapse in 1971, was designed to do the same.

The gold standard collapsed in the face of the inflationary requirements of World War I. Yet, its benefits were thought so substantial that great efforts were made to reintroduce it in the period between the Wars.

In contrast, after the collapse of the Bretton Woods system, a new orthodoxy emerged. It was based on twin beliefs in the efficiency of market processes and the effectiveness of

discretionary policy making. If individual countries were to follow sensible macroeconomic policies at home, and exchange rates were allowed to float freely, then price stability more globally would be sure to follow. Regulatory oversight of an increasingly liberalized but efficient financial system was, similarly, thought capable of delivering financial stability.

As is now obvious, things have not worked out as was intended. What went wrong?

I believe that constantly rising price levels and the recurrence of ever more serious economic crises ought to lead us to a simple question. Is it possible that the underlying problem has been the absence of an International Monetary System? Or, to put it another way, is it possible that we can identify fundamental shortcoming in the current «Non-System» that are so great they justify searching for an alternative way to manage the global economy?

At least four shortcomings of the current «Non-System» can be easily identified. Fundamentally, they reflect a repudiation of the twin beliefs that underpin the new orthodoxy. Markets actually do not work the way the new orthodoxy supposes. Moreover, discretionary, national, policymaking is not effective. It focuses almost exclusively on the very short term objectives demanded by domestic politicians and their electorates. This ignores the fact that such policies might also have undesirable consequences over the longer term, both at home and also abroad.

What are the shortcomings?

First, there is no automatic adjustment mechanism to stop current account imbalances from becoming so large that they trigger a serious foreign exchange rate crisis. According to orthodox theory, countries with current account deficits should face steady downward pressure on their currencies. This should in turn raise the domestic price of both imports and exports, discouraging the former and encouraging the latter. To prevent prices from rising overall, governments should then «make room» by following restrictive fiscal policies in particular. Countries with external surpluses should adjust symmetrically preventing imbalances from accumulating to dangerous levels.

In practice, one or all of the links in this chain are broken. Exchange rates generally fail to adjust smoothly to accumulating external debt, while internal productive resources often take ages to adjust to altered price signals. This problem has become ever more serious with the growth of value added chains in international trade.

Finally, there is nothing to stop countries, when faced with recession, from relying on policies that actually exacerbate external imbalances. Think of the massive fiscal expansion

in the United States in 2009 and Germany's significant fiscal tightening since the euro crisis began.

Looking forward, what is to prevent China from relying on ever more exports to absorb its excess production capacity, built up over many years? In sum, neither markets nor policymakers behave as orthodox theory says they should, and recurrent crises are the outcome.

Important spillovers

Second, «spillovers» from the monetary policies of the large advanced countries can be highly disruptive for others. This reality might seem self evident to a Swiss reader, but is often denied by the perpetrators.

Spillovers arise from the growing correlation of bond yields worldwide, particularly with the yields on US Treasuries. As well, capital flows not only respond to interest differentials but also to changing perceptions of risk. In particular, low policy rates in the US (risk on) have encouraged more leverage on the part of banks with global reach and more aggressive international lending on the part of asset management companies. Further, capital inflows can create domestic problems on the way in and particularly on the way back out.

Those prepared to accept the reality of «spillovers» suggest that countries protect themselves through capital controls and macroprudential policies to minimize the domestic implications. However, such measures can be evaded, lose their effectiveness with time and involve significant distortions in free markets.

A further suggestion for self protection is that countries should allow their exchange rates to move more freely. There is some truth to this. However, left unimpeded, the exchange rates of smaller countries can deviate markedly from levels consistent with «fundamentals», particularly under the influence of short term «momentum» trading.

Efforts to resist this, as in Switzerland, can then be easily justified but also imply great risks. Central banks that accumulate foreign exchange reserves can suffer large losses if the domestic currency continues to strengthen regardless.

Dangerously unanchored

Third, the global monetary system is dangerously unanchored. Price levels have been drifting up for decades.

More recently, central banks almost everywhere have sought to resist the upward pressure on their currencies exerted by easy monetary policies in the large advanced economies. They too have both eased interest rates and dramatically expanded the size of central bank balance sheets. This has already increased inflationary pressures in many emerging market countries, and upward pressure on house prices in both emerging markets and many small advanced countries like Switzerland.

Moreover, what is happening in smaller economies could eventually feed back on the large advanced market economies in unexpected ways. We simply have no historical global precedents for what is going on today.

It might be suggested that the dollar remains the key reserve currency and that the Federal Reserve should set its policies with a view to stabilizing the global monetary system. However, this is not possible. The Federal Reserve's legislated objectives are strictly domestic. Moreover, attempts to incorporate foreign feedback effects onto the US economy, and then to US policy decisions, would surely fail.

Our knowledge of all the possible linkages, real as well as financial, is simply far too limited.

An extremely dangerous place

Finally, were there to be a significant future crisis, there is currently no international «lender of last resort» to meet demands for liquidity support in foreign currency. Taken together with the exhausted state of macroeconomic instruments in many countries, this implies that the current «Non System» has allowed the global economy to wander into an extremely dangerous place.

We need to renew the search for the Holy Grail of an efficient and stable International Monetary System.

The fundamental assumptions of the new orthodoxy are just wrong. Given this, attempts to patch up the current «Non System» based on these assumptions seem doomed to failure. Getting agreement on a solution to today's problems will be a long and arduous journey. On that journey, getting agreement on the character of the problems we face would seem the necessary first step.