

## **Some Simple Observations on the UN Commission Report on the Reforms of the International Monetary System and Recent Proposals for a New International Reserve Currency**

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Draft of remarks prepared for the North South Institute Conference: Policy Responses to Unfettered Finance, Geneva, 8th June 2009.

Recently there has been a good deal of discussion about the appropriate international reserve currency to preserve the purchasing power of international currency reserves. These discussions seem to ignore two basic criticisms, made by Keynes and Triffin, of functioning of the international monetary system. They suggest that the basic problem is not the asset that serves as the international currency, but rather the operation of the adjustment mechanism for international imbalances. They also suggest that the recommendations contained in the Report of the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System.

The 20th<sup>th</sup> century gold exchange standard was based on a system of free international exchange of goods, services and capital. In such conditions it was presumed that international competition would support the law of one price for all goods traded in international markets. When this was not the case international arbitrage would take place. Thus, if the gold price of goods was below that prevailing in other countries there would be an incentive to exchange gold for goods and export them to foreign markets where the gold price was higher. This should result in an equivalent gold price of similar goods in all countries. A corollary of this international competition was an elimination of trade imbalances as surplus countries would be accumulating gold and this was presumed to bring about a rise in domestic prices, raising the cost of exports and reducing the surplus. Another corollary was that the purchasing power of private savings would be stable over time. Note that the stability of the value of savings was inherent in the international adjustment mechanism.

Keynes criticized the gold standard system because he pointed out that the adjustment mechanism for imbalances was normally not through an arbitrage mechanism of prices adjustment, but rather through adjustments in the level of activity. He further noted that the quantity adjustment process tended to be asymmetric. While deficit countries that experienced a gold outflow could run out of gold before any price adjustment process this would mean that they would have to cut their imports by reducing activity. Surplus countries, however, could simply allow their surpluses to accumulate without changing their policies. The implication would be that there would be a tendency toward reducing the level of activity to bring about adjustment and thus a tendency of such a system to constrain global demand at less than full employment. This would constrain the ability of countries that chose to implement full employment policies if other countries chose not to adopt such policies. There was a second asymmetry involved, since the costs of adjustment in the system of quantity adjustment were born by the loss of labour income, while the purchasing power of private savings was preserved.

To resolve the problem of asymmetric adjustment Keynes recommended the creation of a clearing union, with settlement of temporary payments imbalances settled by means of unit of account that could not be traded in private markets. But, it was not the unit of account replacing gold that was of

importance in his proposal, it was that the government members of the Union would agree to implement coordinated symmetric adjustment policies, either by rule or consultation, with actions taken by both deficit and surplus countries. Costs of adjustment would then be equally born by all countries, and by capital and labour, and would allow the possibility of full employment global demand. Keynes's proposed system did not envisage private currency trading or the presence of international capital flows intermediated by private financial institutions to finance external imbalances. Note again, that under this system the preservation of purchasing power depended on an adjustment mechanism that eliminated imbalances, but it differs in that there is no automatic mechanism that ensures this result because it requires full employment. It must be imposed by coordinated policy action.

In the event, Keynes's proposal was not adopted and instead the dollar was inserted into the system in place of gold via fixing the dollar price of gold and the parity of all other currencies relative to the dollar. This dollar exchange standard possessed an additional difficulty identified by Triffin. He noted that irrespective of whether the dollar or any national currency playing the role of international reserve currency was fixed in terms of gold, it would eventually undergo a decline in the global confidence in its value. This was because the asymmetric adjustment that Keynes had noted of the gold standard would still exist for all countries, except the national currency serving as the international means of payment and store of value. Thus surplus countries, with no necessity of introducing adjustment policy, would increase their holdings of the national currency and all countries seeking increased international liquidity would also do so. This would lead to ever increasing deficits for the country issuing the national currency. If the currency was linked to gold, its outstanding issue would soon exceed its gold supply, leading to an inability to meet the commitment to fix the exchange value of the currency in gold. This was the dilemma in the dollar exchange system that Triffin noted.

Note that in this system there may be a tendency to support global aggregate demand if the country that issues the national currency is willing to accept increasing deficits, but that the opposite would be the case if the country pursues a policy of external balance. This was more or less the case of the US in the period of dollar shortage after the war and Germany in the European Monetary System before the creation of the Euro. Here the problem was the lack of global liquidity – the problem that the SDR was originally meant to resolve.

However, a version of the Triffin Dilemma is also present in a system in which the national currency serving as the international means of payment is not fixed in terms of gold. In this case its value in terms of other currencies is dependent on the willingness of surplus countries to hold the currency. In simple terms, once the link to gold is broken the system becomes a Ponzi scheme in which the external value of the international currency is determined by the willingness of other countries to lend to the country issuing the currency. Thus, the ultimate value of the international currency is only given by its purchasing power over its domestic output. If foreign holders are not willing to take output then the value of the currency will decline until they become sufficiently attractive. Note that in contrast to the gold standard, the price adjustment mechanism is reestablished through changes in the international value of the currency – the exchange rate on the relative prices of goods and on the capital value of international reserve holdings.

Finally, note that in all of these different organisations of the international financial system the stability of the purchasing power of the international currency is inherently linked to the existence of an adjustment mechanism that eliminates international imbalances, either automatically or through a coordinated policy mechanism. The question of the stability of the purchasing power of the international currency has little to do with what asset actually serves as the international currency.

The current demand for reform of the international system has not concerned the inability of the current system to support global full employment. Rather it has focused on the loss of international purchasing power of the dollar, and its substitution by an international reserve currency that is not an international currency. Some have suggested the use of the SDR as an international reserve currency. However, as long as the SDR remains a basket of national currencies it cannot resolve the problem, although it may, through diversification, reduce the volatility of the purchasing power of the international reserve currency. It should be noted that this diversification could always be achieved without the use of SDRs through a policy of reserve diversification by surplus countries.

Changing the international currency does not provide a solution to the problem of the declining value of accumulated surpluses because that problem is caused by the absence of an automatic international adjustment mechanism that is compatible with full utilization of global resources. One attempt to resolve this problem was the proposal of a commodity reserve currency which was widely discussed in the post war period but was never experimented.

From this point of view the question of preserving the value of accumulated surplus should rather be seen from the point of view of the excessive value of those surpluses or from the inappropriate distribution of that value between labour and capital. In the case of China, the value that they fear losing through a depreciation of the dollar would have already been eliminated if an automatic adjustment process been effective, and this would have been through a reduction in domestic income and employment. The introduction of the SDR or other alternative will not protect the value of their dollar holdings when the dollar was overvalued.

It is in this framework that the Commission recommendation is to be interpreted. The basic point of the analysis is that the international system suffers from a lack of aggregate demand, and this has only been offset by the anomalous developments in the US financial system that allowed US household's balance sheets to offset deficient demand in the rest of the world. This was exacerbated by the lack of official international liquidity as the IMF attempted to impose quantity adjustment on many developing countries who responded by undertaking policies to ensure external surpluses.

Thus the first order of business is to offset the balance sheet losses caused by the collapse of asset values and to provide an alternative source of demand to replace the US household. This comes in terms of government countercyclical deficit expenditure policies. For these to be truly effective they must be global, that is, both developed and developing countries must introduce them. For most developing countries this is difficult because they will require additional liquidity to finance their deficit expenditures. This leads to the necessity of an alternative or additional financial facility since the IMF has already gone on record as discouraging countries with weak fiscal or external positions from

participating in such policies. One method of financing such a facility is through an additional SDR allocation. At the same time, for those countries that have adopted policies to strengthen their external positions have found the resulting increase in their reserves has attracted additional external capital flows which will certainly be reversed as the international financial system deleverages. , Thus, the recommendation of the introduction of SDRs is to provide liquidity for developing countries, in a way similar to the link proposal first broached by UNCTAD I, and to emerging market countries that may be adversely affected by the rapid contraction in international flows. This is very much in line with the original objective of SDRs in providing additional liquidity in the absence of dollar liquidity and liquidity provided by the IMF.

It is also clear in the Report that the introduction of SDRs or another global currency cannot resolve the problem of the operation of the adjustment mechanism. Even a clearing union cannot do this without some commitment to coordinated symmetric adjustment by both surplus and deficit countries. This role is to be taken on by the Global Coordinating Committee that is proposed to be formed at a political level that would guarantee commitments to coordinated solutions. This Committee is thus an integral part of the reform of the international financial system.

This leaves two associated questions. The first is that some developing countries may choose to adopt a development policy based on net exports, which is in direct contradiction to the operation of an automatic or coordinated adjustment policy. These countries can be views as lending to the rest of the world or as borrowing effective demand from the rest of the world. The successful pursuit of these policies will thus require either a distortion of prices, exchange rates or global demand. The resulting surpluses thus also have values that are distorted, and cannot be guaranteed. They require a coordinated policy to distributed surpluses and deficits, but also an appropriate distribution of the costs of this distribution as well as the required liquidity provision. Here again, the SDR plays a role, but as a provider of liquidity, rather than as a stable store of international value. Again, there is no automatic market mechanism to bring this about.

The second problem concerns international capital flows. As already mentioned, the original Bretton Woods proposal did not envisage such flows would play a substantial role either in meeting payments imbalances or in the allocation of international capital. The system has turned out to be rather different and private flows have been shown to be capable of creating substantial distortions to the international adjustment mechanism. Thus, if international adjustment is to be coordinated, either to ensure the elimination of imbalances, or to permit imbalances to further the purposes of development of particular countries, capital flows will have to be part of that coordination process. Thus, the Commission also recommends that capital inflows be managed or controlled. This would also have a major impact on the question of the stability of the purchasing power of whatever is used as the international currency.

Thus, to sum up, the problem of the instability of the purchasing power of the international reserve currency is less a question of the asset hat serves as the international currency, but much more a question of the international adjustment mechanism and whether that mechanism is automatic or coordinated, and whether it is compatible with global aggregate demand sufficient to provide full employment.