

"International Monetary System Reform: A Practical Agenda"

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It is a pleasure to be here to discuss such an important issue, and with such a distinguished group. Reform of the international monetary system is always an intellectually juicy topic, but sometimes it gets lost in abstruse debates that lead nowhere. Now is a moment when we should focus our collective attention on a pragmatic policy agenda with real practical consequences.

I will direct my remarks this morning to three immediately relevant issues: first, the challenge of ensuring effective international economic cooperation to achieve a sustained well balanced global recovery; second, the importance of moving to more consistently flexible exchange rate management across all the major economies to support rebalancing and reduce the long-prevailing asymmetric bias in the international monetary system; and third, the benefits of developing a consensus around a coherent framework for emerging economies to manage capital flow volatility. I will conclude by emphasizing the crucial role the IMF can play to advance this reform agenda by delivering more forceful surveillance.

International economic cooperation proved highly effective in dealing with the aftermath of the global financial crisis, when all G20 economies faced similar problems of grappling with a collapse in demand and confidence. The task now is harder, but no less relevant. Recent global growth has been fragile and uneven. Much of the emerging world is growing fast, but is now facing risks of overheating. By contrast, in advanced economies, the recovery has been more gradual, output gaps remain a serious concern, and sustained fiscal consolidation will be needed. This uneven recovery raises the specter that external imbalances could again widen, which could be both destabilizing to financial markets and threaten to undercut global economic momentum.

At the Pittsburgh Summit in September 2009, the G20 created the Framework for Strong, Sustainable and Balanced Growth as a central foundation for effective cooperation across the world's largest economies. We need to build on this Framework to achieve consensus on joint efforts to identify the root causes of imbalances and agree on policies to address them. Success is imperative for the health of the global recovery and for the G20's credibility.

Last month in Paris, the G-20 finance ministers agreed on a set of indicators to focus on large imbalances requiring policy action. Next month in Washington, we aim to agree on a set of indicative guidelines, against which the indicators will be assessed, a key step in the path to reaching concrete conclusions on policy deliverables before the end of the year.

Successful rebalancing will require complementary actions being taken across countries. Advanced countries, including the United States, will need to deliver credible multi-year reforms to restore fiscal sustainability. Other nations must play their part by undertaking the difficult reforms required to develop new sources of growth. Most importantly, major emerging economies with persistent current account surpluses need to reduce their reliance on export-led growth and shift their economies towards domestic consumption and investment. This will require policy reforms to encourage robust growth of domestic demand and to encourage a corresponding shift in the pattern of supply towards domestic markets.

This leads me directly to my second theme, the importance of greater willingness across all major economies to allow exchange rates to move flexibly. The current international monetary system is an uneasy hybrid of flexible and heavily managed exchange rates, which is increasingly ill suited to facilitating global adjustment as a number of rapidly growing emerging economies with heavily managed exchange rates are taking on rising importance in the global economy. This is a new form of a long-standing asymmetry in the system, which surplus countries do not face adequate pressure to let their currencies adjust.

The limited degree of currency flexibility in the world's largest exporter and second largest economy, China, is of particular concern. China's currency remains substantially undervalued, notwithstanding some increased flexibility vis-à-vis the dollar since last June. In turn, in order to avoid losing competitiveness relative to China, many of China's neighbors also intervene heavily and also have undervalued currencies. Such policies undermine the key role of the exchange rate in shifting the pattern of global supply and demand, imposing an undue burden on others and threatening to impede strong and sustainable global growth. All major economies, whether emerging or advanced, should be prepared to allow exchange rates to move to facilitate external adjustment in response to market forces.

Now let me turn to my third topic, the need for developing consensus around a coherent policy framework for emerging economies to manage volatile capital flows. To some degree, the increased attention being paid to this issue is a consequence of the previous two issues—a world with

a multispeed recovery combining flexible and heavily managed currencies is one in which capital flows will tend to be volatile, putting pressure on macroeconomic frameworks and threatening to exacerbate financial vulnerabilities.

It is relevant to stress that capital flows to emerging markets typically reflect strong growth and attractive rates of return, and have the potential to help fill substantial investment needs. Particularly in countries with undervalued currencies, capital flows are a natural economic response to perceptions of higher financial returns. A real appreciation is called for in these cases. This is most easily and effectively achieved through a nominal appreciation. Efforts to block nominal appreciation in these cases would eventually result in a real appreciation through inflation, but this adjustment is likely to be delayed and costly. Countries can also use the classic remedy of fiscal tightening and monetary easing to reduce pressures on domestic interest rates and lower incentives for capital inflows, while maintaining domestic demand on a steady course.

The difficulty arises when capital is flowing to a country with an already overvalued exchange rate, with more than adequate levels of reserves, and where there are concerns that excess growth in credit or asset prices could leave the domestic financial system vulnerable. The challenge here is to carefully develop an approach to contain the short-term risks without undermining the real long-term benefits that capital flows offer, and without distorting the market signals (and needed adjustments) that capital flows reflect.

But even in such extreme instances, measures to deter capital inflows should be seen only as a temporary fix, and should be carefully structured to minimize distortionary or discriminatory effects. Experience has taught us that such measures are unlikely to have much lasting impact on aggregate flows, particularly as market participants find ways to evade their impact. There are also significant administrative costs for governments and compliance costs for firms.

At a systemic level, I am concerned that imposition of capital controls and heavy foreign exchange intervention in certain emerging market economies has diverted capital flows to other economies that do not impose such measures, complicating policy management in these countries. High growth countries that have moved to more flexible exchange rate regimes and more open capital accounts seem particularly vulnerable to such spillovers. We need to guard against negative externalities imposed by the proliferation of defensive measures against the free flow of capital. This is why a joint effort to develop a sensible consensus on approaches to be used in responding to surges is particularly important.

Finally, let me emphasize the crucial role that the IMF can play in advancing this reform agenda. Through its surveillance role, the Fund can and should do more to promote more flexible exchange rates, a better balanced global economy, and more coherent management of volatile capital flows.

The IMF has long been an acknowledged center of expertise on international monetary issues. Accordingly, the Fund is being relied on to play a key technical part in the G20 Growth Framework. Moreover, it has embarked on very promising work on reserve adequacy and exchange rate assessment, which provide essential underpinnings for rigorous policy assessments. And the Fund can contribute to the task of developing sensible guidelines for managing capital flows, by applying a careful analytical framework and drawing lessons from cross-country experience.

But the Fund must do more than provide high-quality technical analysis. It must also provide a stronger voice for globally coherent policies. The U.S. has long called for the IMF to strengthen its surveillance of exchange rates, and it remains critical for the Fund to follow through and speak more forcefully on exchange rate issues. For a start, the IMF could increase transparency of surveillance by more widely publishing bilateral and multilateral surveillance products, including by making publication of Article IV reports mandatory and publishing its exchange rate assessments.

But more than this, the Fund needs to make sure that its voice is forceful and candid. The recent report by the Independent Evaluation Office of the IMF's performance in the run-up to the financial crisis makes quite clear that there is room for the Fund to do a better job at identifying and communicating risks to the global economy. This is not just about sharpening the tools in the toolkit, but also applying them more effectively to gain greater influence over policy decisions. This may require broader reforms of the Fund's governance structure to, in the words of the IEO report, "clarify roles and responsibilities ... and establish a clear accountability framework."

I will end here by reiterating my central point: reform of the international monetary system is a key issue for today's global economic policy agenda, but to be most useful it should be squarely directed at delivering practical results to underpin a sustained and well balanced global expansion.