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How should the crisis affect our views of the international monetary system?

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The early phase of the crisis was dominated by large capital outflows, induced foreign liquidity shortages, and, in some cases, large induced changes in exchange rates. The current phase is characterized by large capital inflows, strong appreciation pressure on many currencies, concern about currency manipulation, and talk of currency wars. So it is not surprising that the French have put reform of the international monetary system at the top of their agenda for the G20 Presidency.

What people mean by reform of the international monetary system varies widely, from increases in SDR allocations to the creation of a global currency. But it clearly includes at least the following issues (some of which overlap with issues of "capital account management", which is the focus of another session).

I. Global liquidity provision

When the crisis started, some investors looked for safe havens, others needed to repatriate funds, and many countries faced large capital outflows. Those led in turn to funding problems, and, in some cases, to sharp depreciations and adverse balance sheet effects. These effects were attenuated in some countries through the use of previously accumulated reserves (although on a surprisingly limited scale), and, in others, through the provision of swap lines from foreign central banks. Later on, these swap lines were supplemented by the provision of liquidity through new IMF windows, first the "flexible credit line" (FCL), and more recently the "precautionary credit line" (PCL).

The main question is whether the current arrangements can be improved upon. Precautionary saving in the form of reserve accumulation is socially inefficient. Bilateral swap lines only benefit some countries, not others. Various arrangements have been proposed:

Some have suggested increasing allocations of special drawing rights (SDRs)—although for these to go to the countries most likely to need them, allocation rules would have to be profoundly modified. The Fund has explored extensions of the FCL, and the creation of a contingent liquidity window, GSM, which would provide liquidity to a large number of

countries, but only under conditions of high systemic risk. Others have suggested that swap lines be run through the IMF rather than bilaterally.

In all these cases, the central issue is that of conditionality, and whether the degree of conditionality should be a function of the state of the world economy. In times of high systemic risk, conditions should probably be less stringent than in normal times. Another issue is the degree to which the development of such liquidity provision would affect the accumulation of reserves by emerging market countries.

II. Current account balances

The crisis and the post-crisis adjustments have led to a reexamination of current account imbalances. The issue is whether countries, right or wrong, should be free to run large current account imbalances, or whether there should be multilateral "rules of the game".

Some have argued that large current account deficits may not only be dangerous for the countries running them, but for others as well—an argument similar to the effects of actions by large financial institutions on systemic risk. Others have argued that, in the current context, large current account surpluses are impeding the world recovery: Given that many advanced countries cannot increase domestic demand, they need to increase net exports. For this to happen, the other countries, at least those that can increase their domestic demand, should correspondingly decrease their net exports.

Should there indeed be, as suggested for example by the U.S. treasury, rules governing current account balances? Are current account balances the right variable, or at least the least bad variable, to focus on? Can realistic rules be designed? Can they be enforced? (These questions are related to issues raised in the session on capital account management. Should there be rules on reserve accumulation, on capital controls? And, if so, how can they be enforced?)

III. Reserve currencies

Another old issue is that of the dominance of the dollar as a "reserve currency." The fact that both central banks and private investors see U.S. T-bills as a safe asset has allowed the U.S. to easily finance its current account deficit—what has been called, somewhat misleadingly, an "exorbitant privilege''. During the acute phases of the crisis, it has led to strong capital inflows into the U.S., and dollar appreciation.

Some have argued that this exorbitant privilege should end, and the world should have multiple reserve currencies. Is it desirable? Is it feasible? Currencies do not become

reserve currencies by fiat or privilege: Investors do not want to hold dollars, but U.S. T-bills, because the T-bill market is deep and liquid. Thus, the question is whether other markets, say the market for Euro bonds, can offer similar advantages.

Some have argued that the SDR could become a reserve currency. This would require the creation of a deep and liquid market in SDR-denominated bonds. The same questions as above arise. Would it be desirable? Is it feasible? Is there enough demand and supply for such bonds as to create a deep and liquid market? Could, for example, the IMF, which lends in SDR, create some of the supply by partly financing itself through the issuance of SDR bonds?

These questions do not exhaust the list of questions on the table. Old questions such as fixed versus floating rate arrangements, or the existence of optimal currency areas, must also be revisited. One interesting aspect of the crisis is that countries with fixed exchange rates do not appear to have done systematically worse than those with floating rates. The difficulties faced by a number of Euro members in adjusting to idiosyncratic shocks also forces one to reconsider the costs and benefits of common currency areas.