

Executive Summary and Recommendations

Beyond the Dollar

Rethinking the International Monetary System

A Chatham House Report

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The international monetary system is a lightning rod for tensions in the world economy. Its shortcomings may fuel protectionist pressure. It is also a system in flux, no longer meeting the needs of a changing world economy. This is why Chatham House and the ESRC World Economy and Finance Programme have looked at the current system, assessed the goals and principles that underpin it and made some recommendations for the way forward.

Countries are responding in different ways, and the steps that some of them are taking signal tensions and changes ahead. In times of stress, when countries are trying to secure steady economic recovery, domestic policy goals may be in conflict with international obligations.

The United States, in particular, may find it difficult and burdensome to support the dollar as the primary reserve currency. Domestic policy goals – i.e. growth and employment – may lead the United States to ‘benignly’ neglect the greenback, but China and the Eurozone would undoubtedly not be happy.

This decade will certainly be one of transition. We do not expect a big bang, but a long, gradual process of incremental change and adjustment. However, whether this transition and the rebalancing of the world economy will be smooth remains to be seen.

In this context, dialogue and policy cooperation play an important role in helping the world’s main economies and

countries issuing the key currencies to coordinate their efforts and rebalance the world economy. Such dialogue should be informed by the recognition that the world economy is much more complex and integrated than in the 1970s when the Bretton Woods monetary arrangements were abandoned. As a result, the interests and requirements of the emerging economic powers should be taken into account.

Policy cooperation should aim to avoid any protectionist reaction to exchange rate movements. It should also help prepare the ground for a smooth transition to a more appropriate system by fostering the exchange of information and cooperation among the world’s main trading areas.

There is an argument for moving towards a multi-currency reserve system in line with the multipolar world, as well as expanding the use of a supranational currency such as the Special Drawing Right (SDR) (see Box 1). The policy recommendations below not only propose the measures that we regard as necessary but also take into account the political and economic costs involved in the transition from the current inadequately functioning system to a more sustainable and functional one.

Recommendations for managing change to the international monetary system¹

1. *A multicurrency reserve system for a multipolar world economy*

- 1.1 Develop a multicurrency reserve system that is appropriate for a world of regional trading blocs – Europe, Asia, the Americas – alongside a still pre-eminent dollar. The disadvantage of losing network externalities would be compensated by gaining stability. Historical experience has shown that two or more reserve currencies can operate simultaneously.
- 1.2 Encourage a more extensive use of Special Drawing Rights as a supranational currency alongside international reserve currencies that are issued by sovereign states or by sovereign states pooled together in a currency union, as is the case for the euro.

¹ This list of recommendations has been drawn up by the editors based on the chapters in the report, discussions at the various workshops and other meetings. Not all contributors agree with all of the recommendations.

1.3 Promote cross-border dialogue and policy cooperation in order to manage the transition from a system based on the dollar to a multicurrency one. Institutional arrangements should be strengthened, with a clear mandate to avoid major imbalances.

2. *Increase the use of the Special Drawing Rights*

2.1 Expand the supply of SDRs in a frequent, predictable and politically independent way, so as to increase the existing stock at least in line with world GDP, gradually reducing the accumulation of dollars.

2.2 Establish a new committee (the 'International Monetary Policy Committee') to produce regular recommendations to the IMF board for new SDR allocations. The constitution of such a committee should be designed to ensure that its decisions are independent and fair. It might be chaired by the IMF managing director and composed of the heads of the central banks whose currencies make up the SDR, along with independent experts to allow independent decision-making on changes to the composition of the basket of currencies in the SDRs.

2.3 Establish a substitution account under the IMF into which member countries can deposit dollars, euros, yen or sterling, and receive the equivalent amount in SDRs in their account based on the exchange rate then prevailing. The size of this account should be limited initially and increased gradually, as experience is gained of its use by member countries and of the pattern of deposits and redemptions. Initially the substitution account might allow only one-way transfers, but it should work towards allowing both purchases and redemptions.

2.4 Take steps to increase the use of and demand for SDRs, beyond official circles, in international trade and finance:

2.4.1 The IMF should permit SDR accounts to be opened by private-sector actors.

2.4.2 The IMF or another suitable provider should create a settlement system, so that transactions denominated in SDRs can take place directly between buyers and sellers on a secure and transparent platform.

2.4.3 The development of SDR-denominated financial instruments and markets in which to trade them should be encouraged. In particular there needs to be a market-maker willing to buy and sell SDR bonds at bid/offer spreads that are competitive *vis-à-vis* those in existing bond markets. These measures would greatly strengthen confidence in the liquidity of SDRs (i.e. their marketability, acceptability by all countries, convertibility to the dollar and other currencies, and use as a unit of account and settlement for oil and other commodities).

3. *Promote dialogue and policy coordination to provide stability, confidence and balanced adjustment*

3.1 Foster greater efforts in the peer monitoring and assessment of the full range of economic policies that impinge on countries' balance of payments and exchange rates.

3.2 Encourage international dialogue between countries issuing a reference currency and individual or *groups* of countries using the reference currency. Consultation would pre-specify credible actions that would be taken in the case of growing imbalances and required change in reference currencies.

4. *Strengthen the role and legitimacy of international institutions*

4.1 Rebalance subscriptions to and voting rights within the IMF more rapidly and more radically than is currently taking place. These changes are needed to improve governance of, and increase international confidence in, the IMF. They are important in paving the way to wider use of SDRs. Without them the IMF risks becoming marginalized as an agent of a group of countries

with a dwindling global presence. Following the reweighting of the voting rights, the composition of the Executive Board should also be rebalanced.

- 4.2 Strengthen the IMF's 'score-keeping' capacity by allowing it to issue its own quarterly reports on exchange rate and other relevant policies. These would help in the evaluation of the full range of economic policies that affect exchange rates and the balance of payments, and establish a set of benchmarks against which countries' actual policies and policy commitments could be assessed. The IMF would thereby become more vigorously engaged in 'naming and shaming'. Both the management and the board must adjust the incentives for the staff to raise sensitive issues. IMF management,

rather than the board, should have the authority to approve such surveillance reports, to further insulate the staff from political pressures.

- 4.3 Mandate the IMF to deal with currency misalignments and promote monetary coordination, or establish an institution for this purpose. Such an institution could start as a caucus of the countries issuing the reserve currencies – the United States, the Eurozone, the United Kingdom, Switzerland and Japan – and also include countries with the largest accumulation of reserves. This institution should eventually fulfil the function in terms of international monetary affairs that the World Trade Organization does for international trade.

Box 1: The Special Drawing Right

The Special Drawing Right (SDR) is an international reserve asset created by the International Monetary Fund in 1969. The SDR is largely used as a unit of account by the IMF, other international organizations (such as the Universal Postal Union), and agreements such as the Warsaw Convention and Montreal Convention. IMF member states can exchange the SDRs among themselves voluntarily. Private entities or individuals cannot hold SDRs.

The SDR is not a currency but a basket of currencies currently comprising the dollar, the Japanese yen, the euro and the pound sterling. The relative weights of these currencies are adjusted every five years. The next adjustment will take place in 2010.

The SDR was initially created to be a potential supplement to the dollar and gold under the fixed exchange rate regime of the Bretton Woods Agreement. However, the demand for SDRs declined after the suspension of convertibility of the dollar for gold in 1971 and the move by major economies towards a floating exchange rate system through the 1970s. More attention has been paid to the SDR recently after China, the largest holder of dollars as reserves, suggested that it might be an alternative international reserve currency.

There have been only four allocations of SDRs made thus far. The last two allocations of 161.2 billion and 21.5 billion were made in August 2009 and September 2009 respectively. The total amount of SDRs is currently 204.1 billion.

These SDRs are distributed to the IMF member states in accordance with quotas that are largely decided by the size of their economy and its openness. The quota determines each member's voting power in the IMF and its access to IMF funding as well as its financial obligations to the IMF. The Fourteenth General Review of Quotas is currently under way.