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A Response to the Comments of Henk Brouwer

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As Director Brouwer points out, I have argued that the international monetary system itself is the main source of global imbalances. Of course there are other contributing factors, but a key currency system creates a framework for global interactions and responses in which, as Triffin pointed out decades ago, the key currency country must run deficits in either the current or capital account even though its deficit position will undermine confidence in the currency over time. As noted in the paper Stephany Griffith-Jones and I presented at the FONDAD Conference,[1] this problem would also occur if the euro, the yen or the yuan were to replace the dollar.

Our joint paper for the conference makes several other points about the problems of emerging economies in confronting the key currency system. Although some developing countries or regions are, as Director Brouwer notes, running current account deficits, IMF data underscore the charge that capital is flowing from the poor to the rich by repeatedly reporting that 70 percent of the annual global current account surplus is invested in the US. And while limited domestic absorption and limited financial markets compared to those in the US can contribute to imbalances, the real problem is the scale of private capital flows to emerging economies and their pro-cyclical nature – in particular, the

[1] See Jane D'Arista and Stephany Griffith-Jones (2006), "The Dilemmas and Dangers of the Build-Up of US Debt: Proposals for Policy Responses", In: Jan Joost Teunissen and Age Akkerman (eds.), *Global Imbalances and the US Debt Problem: Should Developing Countries Support the US Dollar?*, FONDAD, The Hague.

experience of either feast or famine and of abrupt shifts in exchange rates and competitiveness. During the recent, low-interest-rate environment in advanced economies, inflows of foreign portfolio investment reached historically high levels. For emerging economies, the result was a loss of control by monetary authorities over the growth of domestic credit that forced them to intervene in their own markets to mop up the excess liquidity created by foreign institutional investors and re-export this liquidity as investments in international reserves.

It seems to me that Henk Brouwer's observation that there is sufficient investment in emerging economies to achieve economic growth overlooks the growing concern that export-led growth – vigorously promoted over the last two decades – has not fostered a successful development agenda. Measures of the quality of life have failed to advance in many countries and have declined in others. In many emerging and developing countries, growth itself has been inadequate on a per capita basis and, even in countries with high growth rates, inequality appears to be widening as pressures for price competitiveness continue to act as a global constraint on wages.

As for the proposals offered in this short paper, Brouwer argues that they are not feasible – that similar proposals have been offered in the past, that they have been opposed by the major economies and that these reforms are not consistent with the economic and political incentives of those players. To answer these objections, I will paraphrase comments that Kenneth Rogoff, the former chief economist of the IMF and currently a professor of economics at Harvard University, recently published in the *Financial Times* that make points similar to those I would choose to make in reply.[2]

While Professor Rogoff agrees with Director Brouwer and others that the financial system does not need grand plans, he argues that it does need "fixing". He notes that grandiose plans have vanished but so has introspection in the policy community – replaced, he says, by the "smug belief" that there is no problem markets cannot solve. He doubts that markets and central banks could handle the fallout from several highly credible economic and geo-political scenarios he outlines. Thus he concludes that the disappearance of grand plans is a loss because they provided a reservoir of ideas to spur major improvements in an international framework growing increasingly irrelevant as private debt and equity markets dwarf official financing.

[2] "No grand plans, but the financial system needs fixing", In: *Financial Times*, February 7, 2007.

As I noted in my comments at the FONDAD Conference, I very much agree with Professor Rogoff's assessment of the value of proposals for architectural reforms. In writing about US financial reforms in the 1930s, I found that most were not based on new ideas and some were proposals that had been offered decades before and were pulled off the shelf and modified when the crisis hit. Designing reform proposals seems to me a particularly appropriate role for political economists – not only for the sake of anticipating a breakdown in the system but because any system can benefit from ideas for improvements.

The particular reforms offered in this paper are, as I noted, modifications of earlier plans proposed by Keynes, Triffin, Kaldor and others. Like previous plans, they propose a non-national reserve currency and a larger role for the public sector in managing cross-border payments. But the structure of the International Clearing Agency (ICA) differs from those in earlier proposals in that it would allow each nation to use its own currency in international transactions by creating a system in which an international agency would clear transactions among national central banks in the way that these national institutions clear for their commercial banking systems.

Moreover, unlike the Keynes proposal or the IMF, the ICA could conduct open market operations at an international level and thus undertake counter-cyclical and lender-of-last-resort operations. It has become obvious that the IMF's dependence on contributions from member countries constrains its ability to lend. Moreover, the IMF's framework for issuing a non-national reserve currency does not permit it to interact with private markets. These limitations have marginalised the SDR and the Fund's ability to stabilise imbalances in a world in which trillions of dollars move through global markets on an annual basis.

Many emerging market countries are aware that the IMF has become less relevant as a force either for stabilising the system or for addressing potential crises. They are also aware that their large holdings of dollar reserves augment their role in determining the sustainability of the international monetary system. They may or may not be ready to embark on the kinds of policy coordination so often and so unsuccessfully advocated for the G-7 but, if they do decide to create institutions friendlier to their own needs, a new architectural framework will evolve from that process without the guidance of the major economies. The failure of the major economies to engage in the process may result in reforms that are less consistent with their economic and political interests than those that might be achieved through participation.