“Towards a Multi-polar Currency System”

Remarks delivered at the high-level conference on the International Monetary System organized by the Swiss National Bank and the International Monetary Fund

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I would first like to thank the Fund and Swiss National Bank for inviting me to this panel. Let me organize my remarks around three simple questions:

- Will tomorrow’s International Monetary System (IMS) be multi-polar, as suggested by the title of this panel?
- Will a multi-polar system be more stable or less stable?
- What are the policy consequences?

1) The transition to a multi-polar reserve system has already started

It is traditionally understood that international reserve currencies are backed by underlying economic and financial trends, to be assessed against several, non mutually-exclusive criteria such as: economic weight, share of international trade in goods and services, share of cross-border financial assets, depth of domestic financial markets, role as a peg for other currencies, and last but not least, internal and external stability.

Emerging market currencies have already made substantial progress against these criteria and this will be amplified in the future:

<u>Economic weight</u>: by 2030, China is expected to become the world’s top player, representing around 28% of the

total {US + Eurozone + UK + Japan + BRICs}. The US economy will retain a major role, with the US GDP representing around 25% of the previous set of economies. Note that as a consequence, the US dollar is likely to remain the world's top reserve currency. The 16-country Eurozone would represent 17%, and Japan around 7%.

Share in international reserves: according to the COFER database, the share of the US dollar in international reserves has declined from 70% in 1999 to 56% in 2010. Meanwhile, the share of the euro has risen from 21% to around 30%. The share of non-SDR basket currencies has risen rapidly, albeit more recently: from 2% in early 2009 to 5% in late 2010.

Share in cross-border capital flows: the growing international role of the RMB is a case in point. Actions taken by the People's Bank of China to promote the RMB internationally are important steps to foster the role of the RMB as a reserve currency: capital-account opening, swap agreements with foreign central banks, fast development of the offshore-RMB market in Hong Kong and soon in Singapore – the so-called 'CNH' market-, etc. The use of the RMB in commercial transactions is speeding up: during the first quarter of 2011, 7% of China's trade was settled in RMB against only 0.5% in the first quarter of 2010.

Share in official liquidity provision: this may be less well understood, but it is nevertheless crucially important. As large, advanced economies are struggling with debt overhang, emerging market economies have become a necessary source of outside liquidity. In today's world, neither the US nor Europe can play alone the role of the international lender of last resort. In cases of systemic liquidity crises, such as the one we experienced in 2009, loans extended by emerging market economies will have to be mobilized.

2) **A multi-polar system may or may not be more stable**.

It is unclear whether such a system will provide more or less stability that today's dollar-led IMS:

In a world with multiple reserve assets, **there could be abrupt swings in the currency composition of private and public portfolios, as a result of economic and confidence shocks**. This may stabilize, rather than destabilize exchange-rates; the stability of the system would largely depend on monetary policies implemented by central banks as well as on investors' behaviors.

As Charles Kindleberger argued long ago, a hegemonic monetary system will be stable if the hegemon values the stability of the system as a whole. However, **the hegemon is always tempted to focus on its own economy at the expense of global stability**. Specifically, it is well known that the "exorbitant privilege" of the dominant currency may foster current-account imbalances and lead to crises. It is again the case today. The accumulation of foreign-exchange reserves denominated in US dollar has been accompanied by a US current account deficit. A loss of confidence in the US dollar would lead to large exchange rate fluctuations.

And here comes a paradox. On the one hand, it may well be the case that **an independent central bank geared towards domestic-price stability and benign neglect of the exchange rate are necessary conditions to become a reserve currency**. This is because investors will not trust a currency which can be strategically manipulated. This may be why Secretary Geithner has insisted recently that the PBoC should become independent for the RMB to join the SDR basket. On the other hand, **reserve-currency countries have a responsibility to internalize the consequences of their policies**, which precludes pure benign neglect.

A middle way is cooperation among reserve-currency countries to manage spillovers both within the group and on non-reserve currency countries, but only on an infrequent basis.

3) Policy consequences

Let me first state that **in any discussion on the future of the IMS, it is necessary to be very clear on what the end-game should be**. That is, on the desired features of a system with several major reserve currencies. My answer will be: floating exchange-rate regimes and open capital accounts, possibly with provisions to allow temporary restrictions to capital movements for macro-prudential reasons.

Let me now focus on the policy actions:

- **There is a need to manage the transition towards the multi-polar world**, which will be long and will entail many risks. This includes cooperating on exchange rates and on reserve diversification; deepening local currency markets and the availability of hedging instruments; and enhancing the supply of safe assets.

- **The Special Drawing Rights can be the focal point of international efforts to manage the transition.** Today, the SDR basket includes only the US dollar, the euro, the pound sterling and the yen. It does not play a material role in the IMS even though it could develop as a safe investment asset and as a way to raise new resources for the IMF. But discussing the broadening of the SDR basket to emerging-market currencies is a convenient way to organize discussions on issues such as capital-account convertibility, depth of local financial markets, exchange-rate flexibility, etc., all of which are key to the orderly transition towards a multi-polar system. The SDR could also provide an anchor during the transition period, fixing the expectations of economic agents regarding the weights of major currencies in the future monetary system. This is why G-20 discussions on a 'criteria-based path' to enlarge the SDR will be so important.

- **International cooperation is key.** Adjustment in the IMS will always be led by sovereign countries with independent economic policies. It is their responsibility and they should not shy away from it. But appropriate surveillance can help countries device, explain and implement such policies. Surveillance can happen at a regional or at a global level; it should be candid and even-handed; it should take account of spillovers across countries. The International Monetary and Financial Committee will be working on this agenda under the helm of its new Chair, Minister Tharman Shanmugaratnam. Cooperation between the Fund and regional financial arrangements, such as the EU forthcoming European Stability Mechanism or the Chiang Mai Initiative-Multilateralized (CMI-M) should also be clarified. Finally, candid and even-handed surveillance may require changes in IMF governance: this has been rightly pointed out, among others, by the 'Palais-Royal' report.