Strengthening and deepening the international financial architecture

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In the years leading up to the 2007-08 financial crisis, there was a broad consensus among reformers that the international financial architecture needed to be more inclusive and the doors of international financial consultation should be opened to emerging economies. The development of key guidelines for prudential regulations, standards, and codes should include all economies with systemic influence. Further, all entities involved in the functioning of the international financial system, not just the banks, should be subject to a genuine international coordination of prudential regulations, so as to encompass the system as a whole.

Before the 2007/08 crisis, the international community indeed continued to grant advanced economies a significant privilege. In the case of informal coordination in economic, financial, and monetary matters, the G7 held most of the authority and influence, at the levels of governors and finance ministers, and ultimately heads of state and government. Regarding the central banks, the group that had the leading role in terms of informally coordinating prudential regulations was the group of the 10 largest central banks of industrialized countries, which meets in Basel, Switzerland.

Admittedly, the central banks had already decided to broaden the role of the Global Economy Meeting of the Bank for International Settlements (BIS), which brought together around 30 central banks, thus anticipating future developments in the architecture of international relations. But it was not until the crisis that this architecture underwent a shift. The G20—which brings together all of the world’s systemically important economies, not just those of the advanced countries—came to replace the G7 as the main forum for informal consultation. This was a historic change. Naturally, this change in global informal governance needed to be accompanied by equivalent changes in the formal governance of international financial institutions, particularly the International Monetary Fund (IMF) and the World Bank. It is unfortunate that these changes have been slow and, on the whole, remain arduous and inadequate.

The G20 has two fundamental global responsibilities: on the one hand, the coordination of macroeconomic policies at the level of systemically important economies, and on the other hand, the development of all prudential regulations, standards, and codes concerning the prevention of systemic economic and financial risk. The first element is crucial. The lax macroeconomic policies of advanced economies were among the main causes of the 2007/08 disaster. Good coordination to prevent the emergence of excessive external deficits—which are merely a reflection of abnormal internal imbalances—such as the persistence of abnormally high external surpluses, is a prerequisite for global financial stability.
The launch of the G20 Mutual Assessment Process on the macro economic front, with the support of the IMF, is a theoretical first step toward a change that must be deepened and considerably strengthened if we are to avoid future crises of a similar nature. We can only raise the alarm in this regard, given the persistent increase in total public and private debt as a proportion of global GDP.

The second element of the G20’s new responsibility has existed, virtually, since the 1997 Asian crisis—as a complement to the G7’s responsibilities—but the G20 has taken center stage with the more recent financial crisis. The Financial Stability Board (FSB), created in April 2009, reports to the G20, while its predecessor, the Financial Stability Forum, reported to the G7. The FSB now has 70 national member institutions, representing 24 countries, several international standard setting bodies, and six regional and international financial institutions—in particular, the IMF, the World Bank, the Organisation for Economic Cooperation and Development, the BIS, the European Central Bank, and the European Commission. This list goes to show that since the 2007/08 global financial crisis, the two objectives of “inclusiveness” of all systemically important countries and “comprehensiveness” in considering all elements of the international financial system have been followed.

Such inclusiveness and comprehensiveness are necessary for a better functioning of the international monetary system (IMS) in the broader sense; however, they are not enough. The progress to be made in this area is all the more significant as the new features of a system that is rapidly changing under the influence of globalization and technological developments are only gradually appearing and are difficult to foresee. The key responsibility of the FSB in this regard remains the correct identification and prevention of systemic risk.

To sum up, even if much progress has been made over recent years, a lot remains to be done as regards global financial governance, and there is ample room for further reforms.

The best diagnosis and the best set of necessary reforms are to be found in the report of the Eminent Persons Group on Global Financial Governance (EPG) published in October 2018: “We need a credible and well-coordinated global financial architecture to meet the needs of a world that is more decentralized in decisions, yet more interconnected and more challenged in its future” (emphasis in original).¹

A “new multilateralism” should substitute now for the old multilateralism. This new concept must reinforce the resilience and the strength of the global financial system as a whole. It is the aim of the reforms proposed in the EPG report: significantly improve sustainable and inclusive development, preserve financial stability, and govern the global system as a system rather than a set of individual agencies.

¹ G20 Eminent Persons Group on Global Financial Governance, Making the Global Financial System Work for All (n.p.: G20 EPG, 2018), 11
POSSIBLE WAYS TO IMPROVE EXCHANGE RATE RELATIONS

Still, in my view, even if, thanks to the reforms proposed by the EPG report, the international community were to achieve a significantly greater development impact, secure more effectively the benefits of interconnected financial markets, and make the international system work much more significantly as a whole, there would still be cause to reflect on serious imperfections of the IMS in terms of exchange rate relations.

First, since certain currencies play the de facto role of reserve currency, the system remains potentially unbalanced. The dominant central currency must offer the additional liquidity required to support global economic and trade growth. The dominant economy is therefore forced to accept a structural current account deficit, mechanically funded through an increase in the foreign exchange reserves of other countries. There is a contradiction here between the aims of the dominant economy’s internal monetary policy (which should, in particular, include the domestic stability of the global monetary anchor) and its external role as provider of global liquidity.

Second, in a system that lacks a neutral and objective monetary anchor (as is currently the case), the external financial constraint is massively asymmetrical. The constraint exerted on economies and countries with external deficits to balance their accounts is much stronger than the incentive for surplus countries to reduce their savings surpluses. Of course, an appropriate symmetry of incentives is what we would expect the macroeconomic element of global regulation by the G20 (and the IMF) to do. But the asymmetry in the practical functioning of the monetary system (in the narrower sense) makes Mutual Assessment Process efforts partly ineffective.

Third, in a system of free movement of capital, dangerous currency bubbles may arise on account of floating exchange rates. The tangible experience of post-1973 fluctuations shows that market investors, operators, and participants are capable of pushing exchange rate relations to unsuspected extremes ex ante. In the 1970s and 1980s, dollar fluctuations in relation to European currencies ranged from 1 to 3 (the “Carter” dollar at the lowest point, the “Reagan” dollar at the highest). Since the creation of the euro, fluctuations in dollar-euro relations have been contained at about 1 to 2 (with the dollar at 0.83 at the lowest point, 1.59 at the highest). Such wide fluctuations with regard to one of the most important prices, which expresses a key economic and financial relationship between the world’s two major advanced economies and all the economies associated with the two major international currencies, are incompatible with global financial stability in the long term.

In short, only very modest progress has been made in reforming the IMS. At best, one may notice that, during the 2007/08 turmoil, exchange rate relations between major convertible currencies displayed a remarkable degree of stability. One may have reasonably feared that foreign exchange markets themselves would suffer a strong shock, and that a currency crisis would be added to the financial crises. This was not the case.
In the medium and long term, the reform of the IMS, in the narrower sense of exchange rate relations, remains crucial. Three dimensions are worth considering: the creation of a new global currency; the broadening and strengthening of Special Drawing Rights (SDRs); and the improvement of the current handling of exchange rate relations between major convertible currencies—namely, improvement of the legacy of the G7.

**CREATION OF A GLOBAL CURRENCY**

As Keynes suggested in 1944, a truly international reserve currency issued by a global body with worldwide membership could theoretically provide real symmetry in external adjustments. It would also allow us—at least theoretically—to counter the Triffin critique, provided that the global currency’s issuing body takes care to meet the increased demand for foreign exchange reserves by avoiding excessive growth and a liquidity deficit, while equitably redistributing the seigniorage associated with the currency issue.

Unfortunately, what may be desirable in theory is not necessarily applicable in practice. Implementing a genuinely global currency that acts as the anchor of the IMS is dependent on meeting certain economic, political, and politico-strategic conditions, which not only are currently nonexistent but will be difficult to meet in the future. One therefore wonders whether it is possible to imagine more realistic progress toward improved global monetary and financial stability.

**STRENGTHENING SPECIAL DRAWING RIGHTS**

SDRs are an international reserve asset created in 1969 by the IMF to complement the official foreign exchange reserves of member countries. The SDR is not a currency. Nor does it, strictly speaking, amount to a claim on the IMF. But it is, in theory, an instrument that allows for creating foreign exchange reserves in the event that domestic monetary policy constraints on the reserve currency—the dollar at the time—are incompatible with the creation of liquidity required for international economic and trade growth. In this respect, the SDR was created to mitigate the adverse effects of the Triffin dilemma.

Although it is not a currency but a basket of currencies, the SDR is, in many respects, a useful instrument for reforming the IMS. In particular, it includes three features that are worth highlighting: as a reserve asset, it is the only instrument that may be issued without being associated with a debt directly attributable to an economy; as a store of value, its aim is to represent a stable global monetary entity better than any floating national currency; and as a unit of account, the SDR has the potential benefits of lower volatility of its value and hence potentially lower costs of foreign exchange hedging. It may present compelling theoretical advantages as an international billing currency and as a reporting currency, on commodity markets for instance.
For a reform of the IMS based on the promotion of the SDR, progress would need to be made in both “official” and “private” arenas. For the “official” SDR, the most promising routes are the following four: make greater use of the SDR; facilitate the diversification of foreign exchange reserves, particularly through the creation of a substitution account allowing for the conversion of the foreign exchange reserves of the various countries into SDRs; make holding SDRs more attractive, including through their remuneration; and finally, ensure at all times that the SDR basket composition accurately reflects the relative importance of the various economies in international trade and financial transactions.

In the case of “private” SDRs, a necessary, if not sufficient, condition for their development would be to design a genuine private market for the SDR, deep and liquid enough to have certain features of the instruments denominated in major international currencies. In view of the starting point—a non-existent private market—such a goal calls for a huge effort. In particular, the international community would need to develop a multilateral clearing system—designed, for instance, along the lines of the clearing model that the BIS managed in the past with respect to the privately traded European currency unit (ECU). Another important aspect for the credibility of the private SDR is the negative impact of periodic revisions of the SDR basket. This pegging to a basket of currencies is the main drawback of the SDR. In order to mitigate this drawback, there would need to be full transparency with regard to the basket revision schedule.

In short, although the best theoretical solution for IMS reform remains the creation of a global currency, strengthening the use of the SDR presents itself as a second possible dimension of reform, albeit a similarly challenging one. The main issue is that even if the SDR comes close to being a “good” currency given two of its features (unit of account, store of value), it is still nonetheless a basket of currencies, whose nature changes over time. It was a change of this kind that made the key difference in Europe between the ECU as a “basket” in the 1990s and the euro as a “real currency” after 1999, with the latter immediately climbing to second place among major convertible currencies, far ahead of the third-place yen.

The SDR should not, for that matter, be dismissed as part of a long-term perspective, for two further reasons. The inclusion of the renminbi gives the SDR the status of a truly global instrument, no longer one that represents advanced economies alone: the relative credibility of this reserve instrument will thus be enhanced in due course.
It is also worth considering an important phenomenon that I have described as “conceptual convergence,” which characterized the central bank community during the crisis. This alignment between the positions of the various central banks expresses itself in many areas: for example, in the area of banking supervision—now almost unanimously considered to be something that central banks can and must legitimately exercise—or in the area of preventing systemic financial risks, in which most countries believe that central banks have an important role to play, in particular through the design of macroprudentials. But the most remarkable of alignments involves the convergence of large central banks with regard to the definition of price stability. All central banks issuing SDR basket currencies—except for the People’s Bank of China—have followed the same definition of price stability—namely 2 percent in a medium-term perspective—since the Federal Reserve’s decision in 2012 and that of the Bank of Japan in 2013, following earlier choices by the European Central Bank and the Bank of England. In my view, this is a phenomenon of great importance. For the SDR, the fact that four out of the five currencies in the basket now have the same nominal price stability target adds an additional element of credibility to this instrument, both as an instrument to retain value and as an instrument of account at the global level.

**IMPROVING THE MANAGEMENT OF EXCHANGE RATE RELATIONS BETWEEN MAJOR CONVERTIBLE CURRENCIES**

The most modest means to improve the functioning of the IMS would be to improve the management of floating exchange rate relations, as has been carried out among the G5 and then the G7 governors and finance ministers of countries issuing major convertible currencies—including more recently informal discussions with China—since the dismantling of the Bretton Woods fixed exchange rate system after 1973.

These regular informal meetings are often deemed by analysts to have no real bearing on exchange rates. This is not my understanding. When currency trends in foreign exchange markets have been deemed worthy of a clear and simple message sent by all G5 and G7 members to market participants and investors, this message has been received and understood, and has influenced foreign exchange relations. This pattern was observed in particular after the 1985 Plaza Accord, whose message was that the dollar’s decline in relation to other currencies was desirable; after the Louvre Accord in 1987, whose message was that the dollar’s decline had been adequate and that exchange rates were appropriate “around current levels”; after the April 1995 agreements, the message being that any further decline in the dollar would not be in line with the economic fundamentals of the countries concerned; and finally, after the September 2000 agreements, whose symmetrical message was that any further drop in the euro would not be in line with the relative economic conditions in the euro area and the United States.
A glimpse of exchange rate relations between major currencies since 1973 may be summarized as follows: free floating is the rule, whereby exchange rates are determined by the decentralized decisions of all market investors and participants. However, this free floating may be tempered by the possibility of G7 members’ sending a signal to market participants when there is consensus among authorities (central banks and ministers) in assessing that the system’s cohesion is at risk of being seriously challenged by spontaneous behavior that goes far beyond what seems reasonable in light of the fundamentals and policies of the countries concerned.

Four conditions need to be met for markets to be significantly influenced by the messages sent out by authorities:

- The message must be simple and clear, ideally along the lines of “no further increase (or no further decrease) of a given currency in relation to others.”
- The economic and monetary fundamentals, and the policies pursued by authorities must be in line with the recommendations of the message—market operators can be persuaded only if the message is not contradicted by economic reality or by authorities’ economic and monetary policy decisions.
- Authorities themselves must take a financial risk, even if modest, by intervening on foreign exchange markets, in order to give the signal credibility.
- And finally, it is key for G7 members to be clearly unanimous in conveying the message, so that no market participant may conclude that any one of the partners is simply paying lip service to the agreement without effectively backing it.

Since these conditions are only exceptionally met, the international community very rarely decides to suggest a relative containment of exchange rate relations to the market. Great freedom of action among market operators is therefore the rule at almost all times. The exchange rate system seems to be characterized by “tempered freedom”: very large freedom most of the time, tempered only by the need to ensure the cohesion of the whole. This is one very important example of a larger principle. When sovereign countries are called upon to manage their economies in the context of strong interdependencies within a larger economic and financial entity—whether an integrated continental economy or a globalized world economy—cohesion and prosperity may require the relative “containment” of everyone’s freedom of management. I wish to offer three emerging examples of economic and financial governance that are or should be inspired by this concept of “tempered freedom.”

First among them is the coordination of macroeconomic policies between systemically important economies (the G20 Mutual Assessment Process). In the context of the freedom of management of sovereign countries, it is a question of containing possible excessive internal and external national imbalances, especially, but not exclusively, in the field of current account deficits and surpluses, when these challenge the stability of the global economy.
Second is the informal consultation prompting the definition of prudential regulations and financial standards and codes, tempered at the global level especially within the framework of the Basel Committee, the Financial Stability Board, and the G20. This consultation—referred to above as an important element of the G20’s new responsibility—seeks to preserve global systemic financial stability by containing certain key ratios within value “ranges” believed to preserve the cohesion of the whole, for instance capital requirements and liquidity ratios in the case of banks.

Finally, the fiscal and economic governance of Europe and the euro area offers two further examples of “tempered freedom” in view of the need to ensure the cohesion of the whole. In this way, the members of the Economic and Monetary Union have agreed on a Stability and Growth Pact that allows them a great deal of freedom to conduct their fiscal policies, provided they do not cross certain limits considered to be detrimental to the stability and cohesion of the union as a whole. The same goes for economic policy aspects that would be considered excessive in the context of the recent new European Macroeconomic Imbalance Procedure: the European Commission and the Eurogroup reserve the right to make recommendations, of a binding nature if necessary, to temper the conduct of economic policy—but only if the stability of the entire union appears to be called into question.

Let us return to possible improvements in the practical functioning of the IMS, with regard to the practical management of exchange rate relations in the context of the G7 (or new, de facto, G5—dollar, euro, pound sterling, renminbi, yen). A simple albeit bold idea today would be for the main convertible currencies and members of the SDR basket to disclose the bilateral central rates considered to be reasonable equilibrium rates in a medium-term perspective. Such a disclosure would not involve returning to a fixed exchange rate system—free floating would remain the rule. Nor would there be bands of fluctuation fixed a priori, and the “containment” signals suggested to market participants would be based, as they currently are, on the consensus of the governments and the central banks issuing the participating currencies. But in the eyes of market participants, the public disclosure of the medium-term bilateral equilibrium rates calculated by the IMF and accepted by the authorities of the currencies concerned could play a significant role in systemic stabilization and would, in my view, offer a convincing—and perhaps effective—illustration of the concept of “tempered freedom.” This would be the case even if the suggested containment could be triggered not mechanically or automatically, but on the basis of a shared convergence of views.

A further argument in favor of disclosing the central rate relates to the recent “conceptual convergence” between central banks mentioned earlier. Since the central banks have very similar definitions of price stability in the medium term—and since they are mindful of the necessity of solidly anchoring their inflation expectations in a medium and long-term perspective—the display of their equilibrium bilateral central rates in the medium term would be significantly more credible than the current practice.
Finally, the inclusion of the renminbi, which is now a member of the SDR basket, in the informal consultation between the world’s major currencies introduces an additional factor in the improvement of the management of global exchange rates. It introduces greater inclusiveness, even if the status of the renminbi remains incomplete as long as the Chinese currency is not freely convertible.

CONCLUSION

To summarize, the international community is in midstream with regard to the international monetary and financial system. Drawing lessons from the 2007/08 crisis, it has made some progress, albeit limited, in seeking coordination on the macroeconomic policy front, and it has made real headway in developing financial prudential regulations, standards, codes, and principles at the global level. Countries with systemic influence—including emerging economies, not just advanced economies, as was the case before the economic and financial crisis—are now fully exerting their role as part of this global governance. But progress remains insufficient and there is no room for complacency.

We have worldwide awareness that the lessons of the worst financial crisis since World War II demand an inclusive and systemic approach to the economy and to global finance. It is a question of gradually building a new concept of international cooperation for a world that is more multipolar and more decentralized in its decisions, as well as more interconnected. Many reforms should be resolutely implemented, as recommended by the report of the EPG.

As regards, more specifically, the management of exchange rate relations between major convertible—or soon to be convertible—currencies, the international community should also concentrate its reflection more on “tempered freedom” in view of ensuring the cohesion of the whole system.

I see three additional reasons to call for such reflection:

First, the recent “conceptual convergence” observed between the central banks of advanced economies, as expressed in the area of inflation in particular, with a common definition of price stability at around 2 percent in a medium and long-term perspective, may facilitate possible progress.

Second, equally important is the emergence of the renminbi (and later other major currencies of emerging economies), whose integration into the SDR and into informal consultation between major currencies should allow for fresh progress at the global level.

Finally, there is a clear understanding, shared by all central banks, that while cyclical exchange rate fluctuations are useful and legitimate within certain limits, the systematic pursuit of a competitive advantage based on the greatest possible depreciation of one’s currency on foreign exchange markets would be contrary to everyone’s interest, and to the cohesion of the global economic system as a whole. Rejection of the beggar-thy-neighbor policy is among the great lessons of the crisis of 1929–30.