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GRAY/10/1905

May 27, 2010

**Statement by Mr. Pereira on Seminar--Reserve Accumulation and International
Monetary Stability
(Preliminary)
Executive Board Seminar 10/2
May 28, 2010**

At a time when the economic recovery is proven to be more fragile and uneven than expected, a powerful counter-cyclical tool is in our hands: large and regular SDRs allocations. Sovereign debt risks are mounting in advanced economies, with potential domino effects. Global fears are rocking markets, bringing to the fore the lack of room to maneuver in order to respond to new shocks. Confidence on the recovery in major economies is fading. Yet, as rightly stated by the staff, *a lot can be achieved by a way of collaboration*. We urge colleagues to grasp this window of opportunity to gauge the scope for action and timely support large and regular SDR allocations during time-crisis to curb the deflationary pressures that are looming major advanced economies. Failure to respond will drag the world economy into uncharted territory. This Chair has long called for collective actions in this area (Gray/10/594; Gray/10/1384). It can be done at the stroke of a pen. It will not require amending the Articles of Agreement, and the needed safeguard can be agreed upon. Above all, it is imperative to sustain global aggregate demand and to curb rising unemployment to contain a downward macro-financial spiral. This multi-speed world economy will not survive to protectionist responses. We have already thought the unthinkable; but we cannot avoid the unavoidable. This is the time to act and strengthen the global reserve system in a way conducive to a more balanced growth and stability.

This global financial crisis is rooted in the ‘tectonic plates’ of the international monetary system (IMS). The crisis, that is this time anchored in major advanced countries, has brought to the fore the need to strengthen the global reserve system. In a nutshell, we agree with the staff that the current IMS is conducive to destabilizing policy choices. In our view, a system based on a national currency is resilient, but inherently unstable and inequitable. It prompts strong pro-cyclical swings (both in capital flows and trade) with the burden of adjustment falling on deficit countries; it lacks an ‘automatic adjustment mechanism’ for the problem of global imbalances, only corrected by recurrent global recessions with asymmetric economic and social impact on developing countries; it promotes large deficits in the reserve issuing country (consumer of last resort – incurring debt to

purchase imports), prompting an inflationary bias in the booming years and a deflationary bias when the cycle blasts; it forces a net transfer of resources from developing to developed countries (reserve aid) as a result of self-protection against highly procyclical capital flows and the lack of ‘collective insurance’ mechanism to manage balance of payment crises; it leads to unsustainable asset bubbles fostering excessive risk taking and volatile capital flows, as financial intermediaries underprice risks and engage in carry trade investment and speculative positions exacerbating the procyclicality and speculative nature of short-term capital inflows¹.

However, despite its weaknesses, we underscore that the current IMS is flexible and resilient. At this juncture, it is unclear whether a multi-polar system will be better. Moving into a different system would be counter-productive, undermining confidence, and triggering a global depression. Yet, we agree that exploring complementary arrangements to underpin a more robust system is essential. The good news is that the Fund can play a key role in this process.

Diversifying the supply of reserve assets will be critical to bring about an orderly global rebalancing act. On the one hand, the U.S. needs a weaker dollar to find a way out of this crisis (increased net exports). The sovereign debt crisis looming the eurozone is pushing exchange rate adjustment in the opposite direction. Two key concerns arise. First, the U.S. could face deflationary pressures going forward, dragging the economy into an “L” shape recovery. Second, it could potentially create undue tensions with China, exacerbating the pressures for a faster appreciation of the renminbi. All these could easily undermine the global recovery and dent the concerted and collective actions needed to rebalance the world economy. On the other hand, developing countries need to sustain domestic demand in a world where access to international financial markets will be crowded out by the unprecedented financing needs (both private and public) of advanced economies. Uncertainties will trigger the need for higher demand of reserves for precautionary reasons, increasing the opportunity cost of owned resources in terms of foregone consumption and investment in a context of weaker external demand. In other words, without supplementing official reserves adding a global reserve asset (SDRs), developing countries will not be in a position to free up owned resources for development purposes. If that were the case, the lack of global aggregate demand will be unduly exacerbated.

Indeed, demand for reserves would reach levels insupportable by reserve issuers. We thank the staff for this crystal-clear message. Failure to diversify the supply of reserve assets will impose serious risks to all members. A new ‘fallacy of composition’ is building and it could only be curbed by cooperative actions. Otherwise, the system will be even more vulnerable to policy mistakes. For instance, fears about fiscal sustainability in advanced economies will result in higher interest rates everywhere. This could weaken the health of the banking system, triggering assets sell-offs, capital outflows and a credit-less recovery that hinders potential growth. We fully agree with the staff that by diversifying reserve assets, the exposure to outturns and policies in a single country will be reduced, providing more stable store of values.

¹ For a comprehensive analysis of the flaws of the IMS, we highly recommend “Special Drawing Rights and the Reform of the Global Reserve System”, by Jose Antonio Ocampo – G-24 Working Paper.

Yet, for some countries, a key question needs to be answered first: Will members be credibly held accountable ex post once a new system of large and regular SDRs allocations is implemented? In our view, the answer is YES and must be rooted in the Fund's cooperative nature. We do not see the need for a system where the Fund will 'determine' a country's reserve adequacy position for precautionary purposes or adopt a multilateral framework for managing capital flows that will give the Fund jurisdiction over capital controls (i.e., ensuring that capital controls are not used in place of needed policy reforms). We also disagree with the idea of imposing penalties to countries in order to internalize the negative externalities of excessive reserve accumulation. Tellingly, if these weaknesses and asymmetric impacts between groups of countries are rooted in the arrangements of the IMS in and by itself, none of these alternatives to hold countries accountable will be adequate. The only workable answer in time-crisis will come from the supply side, helping meet the demand for reserves in a way conducive to growth and stability.

Tellingly, strong safeguard mechanism are already in place. First, SDRs are allocated based on countries' quota shares, so around 60 percent of these rights goes to advanced economies. Second, there could be either cancellation or no allocation if an upside scenario were to materialize with a sufficiently high voting majority. Third, reconstitution requirements could be brought forward, easing the pressures over reserve issuing currencies, underpinning the voluntary exchange of SDRs and ensuring sound debt dynamics. Fourth, the allocation of SDRs does not generate money supply per se. Countries can hold on their allocation and if they decide to spend, the monetary impact would ultimately depend on the extent to which central banks decide to sterilize neutralizing their impact on inflation. Indeed, given that the stock of SDRs is negligible relative to total reserves, we agree with the staff that the impact of these SDR allocations on global money supply and inflation is unlikely to be sizeable as they will cover only half of the estimated annual increase in precautionary reserves. The fact that the institution of escrow accounts will require the amendment of the Articles of Agreement and will weaken the counter-cyclical nature of the SDR system prevents us to see this option as a feasible solution. Above all, some clear-cut lessons must be finally drawn from this crisis: 1) global cooperation is key for the recovery; 2) unlike past experiences, this crisis is not of the making of developing countries – policy slippages mounted in major advanced countries and financial centers.

A regular supply of SDRs in the order of \$ 200 billion a year –for some years, as suggested by the staff- will have a key counter-cyclical global effect. Is this only for the benefit of developing countries? We do not think so. Advanced countries could redistribute those resources to ease liquidity pressures in countries where markets are rushing to the exit, avoiding excessive pro-cyclical adjustment that is endangering social and political stability. Containing their deflationary bias is important (particularly for the eurozone given their tight trade linkages). Developing countries could strengthen their reserve position and free up domestic resources for development purposes. It is true that SDRs are an unconditional right to obtain foreign reserves from other members, and that is exactly the beauty of it. It is a multilateral agreed process to better redistribute existing liquidity and smooth the adjustment process in time of stress.

To conclude, the world economy is still at a critical juncture. Deflationary pressures will soon be palpable in advanced countries and fiscal sustainability concerns will not only limit the capacity to respond against new shocks but also force higher interest rates everywhere. If the U.S must pursue current account deficits to provide net supply of dollar to the rest of the world, it will be only partially capturing the benefits of expansionary fiscal and monetary policies. Stiglitz put it exactly right: *“Producing and exporting T-Bills to be held in foreign reserves creates no jobs, whereas exporting goods certainly would. With the new global reserve currency, countries wouldn’t need to buy U.S. T-bills to hold in their reserves. Of course, that would mean that the value of the dollar would decrease,...aggregate demand would be stronger, and there would be less need for the government to run a big deficit to maintain the economy at full employment.”*². “The Fund can play a key role in averting the feared adverse scenario, bringing about an agreement on large and regular SDRs allocation for some years with adequate safeguards. We close with a key message in these times of despair: **much can be achieved by way of collaboration.**

We truly commend the staff for an excellent paper and look forward for a constructive discussion.

² Joseph E. Stiglitz, chapter eight: “From Global Recovery to Global Prosperity” in 2010, *Free Fall*, 2010, W.W. Norton & Company.