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

We welcome staff's work on options to strengthen the international monetary system (IMS), providing a comprehensive starting point for the Fund's work in this area.

The policy choices of reserve issuing countries, excessive reserves accumulation and the concentration of reserves holdings present risks to the IMS. There are practical steps that can and should be taken in the near term to manage these risks, recognizing that the stability of the IMS ultimately rests on the policies of the largest economies. In our view, the most pressing concerns in the IMS do not arise from the choice of reserve asset, but from the accumulation of unsustainable external imbalances. Hence, in promoting the sound operation of the IMS, the priority should be on realistic proposals to assist in the unwinding of global imbalances, including enhancing the traction of Fund surveillance over the underlying policies in systemically important deficit and surplus countries that give rise to imbalances.

Historical precedents show that the times when major structural changes to the IMS have been politically feasible are when there is compelling evidence that continuing with the existing system is no longer tenable. While tensions may be emerging, we have not reached that point. That said, as a starting point in the debate on reform of the IMS, we appreciate that staff have framed the current discussion with a wide range of policy options, including some that are clearly ambitious given the current state of international cooperation. While discussion of potentially longer-term options is important, the challenge in moving this debate forward is to be pragmatic and focus on those options where we are likely to make tangible progress with the broadest support. To our mind, this will require more work to reach a consensus on the most pressing weaknesses in the current system.

In this spirit, we are open to further exploring ideas to mitigate excessive demand for precautionary reserves as a complement to strengthened surveillance, where we consider addressing information gaps (e.g. on reserves adequacy and the costs of excessive reserves accumulation), reducing underlying volatility (e.g. through better capital flow monitoring and promoting financial sector development) and enhanced cooperation (e.g. multilateral

understandings on managing capital flows) as more promising than binding or punitive approaches (e.g. penalties for non-compliance). We are also open to discussing proposals for additional reserve assets with the objective of developing a shared perspective on viable complements to the existing system in the longer term. However, we see less merit in ideas that would compromise the operation of independent monetary policy and flexible exchange rates that has been beneficial for many countries.

Demand Side - Reserves Accumulation

Reserves play multiple roles. They are the first line of defence in guarding against external pressures on a countries' balance of payments position, are viewed by markets as a measure of an emerging market economies' relative external strength, promote inter-generational equity and in some cases are the counterpart of trade or currency intervention policies. However, at some point, the benefits of reserves accumulation are offset by the costs. Some of these costs are domestic and should therefore be internalized (such as the opportunity cost of investing in low yielding international reserves assets), but some are systemic and therefore have the feature of a negative externality. The challenge is to achieve a shift in behavior towards the global optimum, which will require a change in the perceived cost-benefit tradeoff and hence a realignment of incentives.

Reserves adequacy. While a framework of binding targets for reserves is not realistic, we do see value in the Fund providing guidance on the appropriate level of precautionary reserves, provided it is well attuned to country circumstances and recognizes the complexity in establishing appropriate benchmarks for reserve adequacy. For this guidance to gain traction, however, more work is required to quantify the costs of excessive reserves accumulation. This means moving beyond the theoretical debate on the domestic costs of reserves accumulation to informing members of the true costs of their reserves accumulation policies and demonstrating that excessive reserves accumulation is not in their self interest. With the global recovery taking hold and emerging market economies taking advantage of strong growth in capital flows to rebuild reserves, we see this work as a priority.

Reducing capital flow volatility. Reduced capital flow volatility would address a key motive for reserve accumulation but should not come at the expense of the efficient allocation of global capital. As noted in the paper, empirical analysis suggests that countries with low financial sector development and intermediation capacity experience greater volatility and are least equipped to manage it. It follows that one area of focus should be promoting the development of deeper and more liquid financial markets in these countries and their related hedging capacity. This would allow both the public and private sectors to better manage financial risks and volatility associated with capital flows, likely reducing the demand for reserves and potentially encouraging further diversification and the emergence of alternative reserve currencies.

Closer monitoring of speculative capital flows. Closer monitoring of capital flows, particularly speculative transactions, could help identify potential instabilities and assist countries in managing capital flow volatility. We therefore see value in improving the mapping of global linkages and risk concentrations through the collection of better data on capital flows; though we should also bear in mind the potentially large resource costs. To be

effective, this should be accompanied by further efforts to improve the understanding of the nature of risks and contagion. Any proposals to address data gaps should be coordinated with the FSB as part of the joint work on information gaps for the G-20.

A multilateral framework for managing capital flows. We see the management of capital flows as an integral part of the Fund's surveillance remit and believe the Fund has a role in advising members on related policies through Article IV and multilateral surveillance processes. This includes looking at the reasons behind capital flow volatility and whether the amplitude is increased by the policies of source and/or destination countries, consistent with an increasing emphasis on cross-border risks. We are also open to discussing more explicit cooperation between members on responding to excessive volatility in capital flows, along the lines of the proposed multilateral framework, provided there is broad support for such an approach.

Bargains and penalties. We agree that excessive accumulation of non-precautionary reserves imposes a negative externality on the IMS that should be brought to bear on policy choices. However, our sense is that a 'grand bargain' along the lines of the proposed global adjustment mechanism would be difficult to achieve in the current environment as it will be hard to persuade all systemically important countries to put external considerations ahead of domestic ones. Achieving consensus on an internationally-administered system of penalties and sanctions seems even more unrealistic. As noted by the former BIS General Manager, Andrew Crockett, in a recent speech, 'to be successful, an international financial architecture has to harness, not run counter to, perceived national interests.'¹ Hence, we believe that cooperative approaches, along the lines of the G-20 MAP, are more promising than mandated approaches, where the focus should be on finding solutions that are perceived to be in each participant's national interest.

Supply Side - Diversifying Reserve Assets

A more diversified allocation of international reserves would reduce the system's (and individual countries') exposure to risks stemming from economic developments and policies in a single country, and may provide more stable stores of value by increasing reserve issuers' incentives to pursue sound policies. However, given the presence of a natural monopoly in the use of money and the absence of compelling evidence to suggest that continuing with the current system is untenable, we are less convinced by the arguments to drastically expand the role of the SDR and even less so about introducing a global reserve currency. Instead, we would place greater emphasis on enhancing the desirability of alternative reserve currencies so as to promote a gradual shift towards a multi-polar reserve system.

Actively encouraging diversification. Since market participants can already construct a more diversified portfolio of reserves, but choose not to, it's not clear that active coordination is what is needed to achieve more diversification. Better ways to increase diversification are to enhance the quality of the alternatives and reduce information gaps. As noted above, more work could be done on promoting deeper and more liquid financial markets and other

¹ Crockett, A. (2010): "What have we learned in the past fifty years about the international financial architecture?", luncheon address at the 50th Anniversary Symposium, Reserve Bank of Australia.

measures to enhance the desirability of alternative reserve currencies. If the barrier to diversification is a misunderstanding of the true costs of concentrated reserves accumulation, the Fund could undertake more work to highlight these costs. We would also be open to the Fund providing guidance on reserve diversification strategies, though this would obviously depend on members being willing to cooperate with the Fund on their reserve compositions.

Special Drawing Rights. Since the SDR basket can already be replicated in a reserves portfolio, several advantages of an SDR-based system are already possible but are not utilised. We are therefore sceptical that an SDR-based system would be adding much extra value in comparison with doing more to highlight the costs of concentrated reserves accumulation (as noted above). Moreover, to the extent reserve currency issuers don't necessarily have to run current account deficits to meet a growing demand for their currency, we don't see a strong case for significantly higher SDR issuance under normal circumstances. Nonetheless, subject to broad consensus, we would be open to exploring ways to gradually increase the role of SDRs as a complement to a multi-polar system, recognizing there are benefits from having reserve assets less tied to individual countries and that it will take time to develop viable alternatives. In moving the debate forward on this issue, we think there should be a greater focus on how to make the allocation of SDRs more flexible and relevant to a modern global financial system and have them play a stronger counter-cyclical role. In this context, we are open to exploring options for allocating SDRs other than on the basis of quota share and/or for facilitating their post-allocation redistribution. Discussions on the size of any future allocations, reconstitution requirements, voting thresholds for allocations, etc., would all need to be considered in the context of such an approach.

Substitution account. The idea of a substitution account was first floated in the 1970s but did not gain sufficiently broad support for adoption. The disagreements then – from broad questions about the fundamental purpose of the account to technical issues about how the account would work, including how financial obligations would be distributed – are just as unlikely to be resolved today. Countries that wished to diversify their reserve holdings could instead look to make use of the existing flexibility in the voluntary SDR trading arrangements to increase their exposure to SDRs, albeit only in a limited way given the amount of SDRs on issue.

A global currency. In essence, a global currency would re-establish a system of fixed exchange rates. In the foreseeable future, we see the IMS moving in the opposite direction, towards greater exchange rate flexibility amongst systemically important countries. Structuring a common currency would require giving up monetary policy independence and the associated macroeconomic benefits. While a parallel currency could allow domestic and international monetary policy to work independently, it would be almost impossible for the global central bank to have any meaningful control over its targets. Hence, we do not see these ideas as near-term priorities.

Actions Needed on Other Fronts

As flagged above, we are open to discussing many of the practical options put forward in the staff report for strengthening the IMS. At the same time, we think it is important to make swift progress on other fronts that would help ease pressures on the IMS that weren't the

focus of this report. First, we must continue to strengthen the quality and traction of Fund surveillance over policies that contribute to unsustainable global imbalances. Strengthened surveillance and improvements in the Fund's early warning capabilities would assist countries in managing some of the risks that motivate reserve accumulation. Second, it is important that we progress our discussions on options to strengthen the global financial safety net, including proposals to improve the availability of insurance-like IMF lending instruments, such as an enhanced FCL and PCL, that would mitigate countries' incentives for self insurance, though recognizing these will not replace reserves altogether. And finally, quota and governance reform of the IMF remains a critical ingredient for the IMF to play a more effective role and provide members with greater assurance that they can rely on Fund membership for country insurance.