Reforming the International Monetary and Financial System

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Problems with Global Financial Architecture

• High level of volatility
• With developing countries bearing burden of risk
• Rapid spread of crisis from the U.S. to the rest of the world
• Not the way efficient markets are supposed to work
  – Supposed to be stable, self-correcting
  – Rich countries, better able to bear risk, should bear the brunt
Interplay of Causes

• Deregulation, capital and financial market liberalization allowed banks/financial sector to engage in excessive risk taking (and in many cases predatory lending)
  – Facilitated rapid spread of crisis around the world
  – Only period without financial crisis was four decades after Great Depression when there was strong regulation
    • Not only was there greater stability, but also faster growth
    • Instability is bad for growth—raises risk premium
• Misalignment of incentives (private rewards differ from social returns) contributed not only to excessive risk taking and short sighted behavior, but also to distorted innovation
  – Didn’t innovate in ways which enhanced ability to manage risk
  – Aimed at regulatory, accounting, and tax arbitrage
  – Volcker: hard to find evidence of positive effect of most of innovations on growth
High volatility induced large increases in reserves
- Especially after IMF/Treasury mismanagement of ’97 East Asia crisis
- Large reserves weaken global aggregate demand
- Problem not savings glut, but investment dearth
  - Financial and economic system failed to recycle savings to meet global needs—addressing poverty, retrofitting world to address problems of global warming
  - Instead, money went into housing bubble in U.S.
Global Imbalances

• Part of world producing much more than it is consuming, part consuming much more than it is producing
  – Problem is opposite of direction that one would have expected
    • US should be saving for retirement of baby boomers
  – Surplus countries contribute to weak global aggregate demand
    • Key problem facing world today

• Disorderly unwinding of global imbalances did not cause this crisis
  – But could cause next
    • Crisis not caused by savings glut
    • Low cost money could have been used as basis of global boom if financial sector had allocated it well
  – Pressures to redress
Sources of Global Imbalances

• Need to be viewed as part of global general equilibrium
• Excess spending in U.S.—facilitated by its role as reserve currency
• Excess savings in rest of world
  – Savings for reserves—to protect against global volatility
    • Class of 1997: learned what happened if reserves were inadequate
    • Class of 2008: learned benefits of reserves
    • Could lead to problem being exacerbated
  – Export-led growth model
  – High volatility of natural resource (oil) prices
Prospects and Consequences

• U.S. will increase its savings, at least temporarily
  – Risk is that it will happen faster than the surplus countries increase their consumption/investment
  – Leading to further weaknesses in global aggregate demand

• Crisis has increased demand for “precautionary reserves”
  – Those countries with large reserves fared better
  – IMF proposals to take on greater role in “insurance” not likely to work
    • Lack of confidence that money will be there when they need it
  – Demand by natural resource countries for buffer against volatility likely to remain strong
    • Volatility remains high
An Alternative Model to Export-led Growth?

– High unemployment in Europe and America will put significant pressure on China and others running large surpluses
  • These countries are contributing to weak global aggregate demand
  • Exerting a negative externality on others
– Can have export-led growth without large surpluses
– But WTO removed some key instruments other than the exchange rate
– TRIPS has made it more imperative for countries to develop their own technological capacities
– China has resources and capabilities for an alternative model based on innovation
  • But many other countries don’t
Resolution of Global Imbalances

• G-20 proposal
  – U.S. save more
    • Already happening
  – China consume more

• Problems
  – In absence of coordination—risk of global slowdown
  – Planet cannot survive if everyone consumes in America’s profligate style
Alternative Resolution

• Deeper reforms
• Based on recommendations of UN Commission
• Global Regulatory System
• Reform of Global Reserve System
• Improvements in risk mitigation
  – Including new mechanisms for restructuring sovereign debt
• Recycling savings to meet global needs
A New Global Financial Regulatory System

• Obvious that the current international institutions did not prevent crisis
  – Promoted policies that led to crisis and its rapid spread around the world
• Change in name from Financial Stability Forum to Financial Stability Board not likely to be sufficient
• Has to be predicated on a changed understanding of the role of regulation
• Global coordination required to avoid regulatory arbitrage
• But will be difficult to achieve
• Alternative strategy: regulate first, harmonize later
  – Each country has obligation to its citizens to protect its economy
New Global Reserve System

• Weaknesses of current system long recognized
  – Contributes to instability
    • Especially as the dollar becomes a poor store of value
  – Contributes to weaknesses in global aggregate demand
    • As countries have hundreds of billions of dollars in “precautionary savings”
  – Inequitable
    • Poor countries lend reserve countries trillions of dollars at low interest rates
    • Value of “foreign aid” to rich greater than that they receive

• Dollar reserve system already fraying
• Makes little sense in 21st century multilateral world for so much of the world’s global financial system to depend on the currency of one country
Instability

• Basic trade identity:
  sum of surpluses = sum of deficits
  – If some countries insist on having a surplus, some others must have deficit
  – Hot potato of deficits: as one country eliminates its deficit, it appears somewhere else in the system
  – U.S. has become deficit of last resort
    • Apparent in statistics
    • But is this sustainable?
Surplus countries are as much a part of systemic problem as deficit countries

- Keynes emphasized negative effect on global aggregate demand
- Keynes argued that one should “tax” surplus countries to provide appropriate incentive
Proposed Global Reserve System

• Issued in amount commensurate with reserve accumulation
  – Offsetting negative effect on aggregate demand
  – Would thus not be inflationary and would avoid deflationary bias of current system

• Would enhance global stability
  – Inherent instability in any single country providing reserve currency
  – But provide an additional degree of flexibility
    • Countries could run a small trade deficit without having a problem
    • Net reserves would still be increasing
• Could provide incentives *not* to have surplus by reducing surplus country’s allocations of global reserve currency
• New allocations could be used to finance global public goods and development
• Would not be inflationary as long as annual issuances were less than or equal to increases in reserves
• There are two precursors—IMF’s SDRs and Chiang Mai Initiative
  – SDR issuances are episodic, and U.S. has vetoed last expansion
  – Proposal can be thought of as globalization and refinement of Chiang Mai initiative
• Since UN Commission Report, idea has had considerable support from around the world
• U.S. will resist, since it thinks it gains from low interest loans
  – But it loses from high instability
  – And amounts of loans will in any case be decreasing
  – And trade deficit—flip side of reserve accumulations—contributes to weak aggregate demand
Risk mitigation

• More extensive lending in borrowing country currencies
  – Already happening
  – IFIs could promote

• Sovereign debt restructuring
  – Reducing costs of restructuring
  – Giving a fresh start
  – If history is guide, likely to be many problems in years to come
Recycling Savings to Meet Global Needs

• Global problem: a world with excess capacity and a world with huge unmet needs
  – Global warming
  – Global poverty
• Solution: More investment
• Challenge: Recycling savings to more productive use
  – Global financial markets before the crisis failed
  – Money “recycled” to what in the end proved a highly unproductive use
Prospects

- Prospects of a globally coordinated resolution under the G-20 framework not good

- Alternative frameworks may have better prospects
  - Especially working towards creation of new global reserve system
    - Can be used to help address issues of global warming and global poverty and help stabilize global economy
    - An old idea (Keynes), but perhaps an idea whose time has come