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Palais-Royal Initiative*

Reform of the International Monetary System: A cooperative approach for the Twenty First Century

* A group convened by
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and also comprising
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« I would suggest that all those eager to envisage the post-crisis era in constructive terms need to promote the reconstruction of a fully fledged international monetary order.»

TOMMASO PADOA-SCHIOPPA (†)
"The Ghost of Bancor: the Economic Crisis and Global Economic Disorder"
Louvain-la-Neuve, 25 February, 2010

Tommaso Padoa-Schioppa who was one of the conveners of the Palais-Royal Initiative, passed away on December 18, 2010, a few days after the penultimate meeting of the Group.

With him, the world has lost an outstanding architect and advocate of the global common good.

PREFACE

The global crisis, which swept through almost all the economically well-developed nations and curtailed world growth in the first decade of the new century, is being contained. However, the cost has been enormous in human and financial terms: unacceptably high unemployment, shattered financial institutions and markets, and budget deficits that threaten to become unmanageable.

The purpose of this report is not to judge all the factors contributing to the crisis: the relative importance of misguided economic policies, structural weaknesses in financial institutions, failures in regulation and supervision, and weaknesses in international monetary arrangements. While we agree that, in spite of recent progress, there remains much to be done in the financial sector, the focus of this report is on international monetary reform. We share a conviction that too little attention has been paid to the importance of the international monetary system (IMS). The G20 Leaders, on the occasion of their Toronto meeting, agreed on the common goal "to build a more stable and resilient international monetary system". Indeed, the risks inherent in the current system (or "non-system" as many describe it) are too large to ignore. Those risks include retreating into a fragmented economic system vulnerable to protectionist pressure, and resorting to mutually inconsistent national or regional policies. In sum, the progress toward open, competitive markets on a global scale that has brought so many gains to so much of the world population is at risk.

As former Ministers, Central Bank Governors and officials in national or international institutions[1], we are all too familiar with the weaknesses and inadequacies of the existing system. This note outlines our diagnosis and some avenues of reform toward a more cooperative governance of the global monetary system that can produce the discipline and stability needed to underpin sustainable growth and employment creation[2].

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1 Only one of us is still in official service. All opinions expressed here are members' personal views.

2 An abridged version of this note was issued on January 18th, 2011. The present version adds analysis and details without raising substantively new issues.

I. THE NEED FOR REFORM

1. **The global crisis.** The crisis that engulfed the global economy in 2008 caught most experts and policy makers by surprise, bringing to light a number of hitherto unnoticed vulnerabilities. While these were chiefly found in the financial sectors of major advanced countries, troubles there quickly spread to the entire international monetary and financial system, in the form of a sudden stop or reversal of capital flows and in liquidity shortages, as investors scrambled to reduce risk exposures and deleveraged. The crisis made even more obvious how tightly the economies and financial markets of the world are tied together, with a shock in one major country rapidly propagating to the entire system.

2. **The response.** The crisis response highlighted the benefit of policy coordination as global fiscal and monetary stimulus, and the injection of massive amounts of liquidity averted an even more dramatic worldwide collapse in economic activity. For the first time since the end of World War II, the emerging market countries played a critical role in these efforts, not least through their ambitious fiscal stimulus policies. These developments also resulted in some narrowing of global imbalances. In the financial sphere, a series of reforms have been adopted and are now in the process of being implemented, and others are under consideration[1]. These developments justify a measure of optimism.

3. **Persistent dangers.** However, significant vulnerabilities remain in the financial sector, related inter alia to the role of the shadow banking system. It should also be cause for concern if, in parts of the finance industry, the lessons of the crisis were to be forgotten. In addition, the long-standing structural weaknesses of our international monetary arrangements have yet to be addressed. These weaknesses put in doubt the ability of the international monetary system to durably fulfill its fundamental purpose, namely "… to provide a framework that facilitates the exchange of goods, services, and capital among countries, and that sustains sound economic growth (Article IV of the International Monetary Fund). These weaknesses include the following:

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[1] Some of these initiatives aim at repairing a long list of well identified dysfunctions in the working of financial intermediaries – mostly banks and quasi-banks – and markets. Others aim at addressing the failure of regulatory and supervisory structures. One such initiative, which became operational during the month of January of this year, deserves a special mention, because it has managed to overcome strong nationalistic objections and can therefore be regarded as an encouraging example of accepting well justified sovereignty transfers. It concerns the European Union, which is establishing a new institution – the European Systemic Risk Board – and the European System of Financial Supervision, which is composed of three cross-border supervisory authorities.

- ***Ineffective global adjustment process***

- The system lacks effective discipline and countries can accumulate large current account imbalances – whether surpluses or deficits – for extended periods without facing effective pressures for adjustment.
- The peer review over the policies of member countries to be exercised by the IMF ("surveillance") has often been ineffective in bringing about policy adjustment on the part of countries with internal and external imbalances, especially when they have no need to borrow from the Fund. This reflects, among other issues, the lack of teeth of IMF procedures.
- This situation is fraught with three major risks: (i) the resurgence of prolonged and ultimately unsustainable current account imbalances, susceptible to unwinding in a very disorderly way; (ii) global inflationary pressure if too many countries run excessively expansionary fiscal and monetary policies; (iii) or, conversely, undue restraint on the global economy if too many countries try simultaneously to run current account surpluses.

- ***Financial excesses and destabilizing capital flows***

- In the run up to the crisis, an unsustainable global expansion was facilitated by rapid growth in global credit. Exceptionally low interest rates (accompanied by massive official reserve accumulation over the same period) triggered an intense search for yield. Combined with inadequate supervision over the financial system, including a blossoming shadow banking system, unrealistically compressed risk spreads and asset bubbles developed. These mounting vulnerabilities went unchecked in part because there are no commonly agreed definitions and measures of global liquidity.
- Large swings in capital flows as have occurred recently, in part as a symptom of an unchecked expansion of global liquidity, can overwhelm countries' ability to preserve macroeconomic and financial stability. This is all too evident in the recent tensions over potential currency or trade "wars" and in the increasing resort to capital controls.
- The capacity of individual countries or international institutions to cope with a future systemic liquidity crisis is not assured. In dealing with sudden shifts in international liquidity, unlike at the national level, there is no global lender of last resort. In the recent crisis, effective cooperative measures were taken at the peak of the crisis. These included swaps and liquidity lines extended by a number of central banks to counterparts, including in some emerging markets; tripling of the IMF's resources and revamping its lending facilities to allow for large scale precautionary and liquidity support; and a $250 billion SDR allocation. But these measures were ad hoc.

- ***Excessive exchange rate fluctuations and deviations from fundamentals***

- Since the advent of generalized floating in 1973, exchange rates among the major currencies in the system have fluctuated widely, reflecting, in part, strong and capricious speculative forces often disconnected from fundamentals. Exchange rates have failed to move consistently in a direction promoting the adjustment of imbalances. Such deviations from fundamentals can be the result of either inadequate fiscal, monetary and exchange rate policies or market behavior. This has posed particular problems for small open economies.

Large, lasting swings in currency values can cause serious distortions in the system and in the allocation of resources.

➢ ***Excessive expansion of international reserves***

Neither the supply of nor the demand for reserves are subject to collective decision-making. Several consequences of this can be identified:

- A number of emerging market countries and, to a lesser extent, advanced economies have accumulated an unprecedented volume of international reserves, either as a goal in itself (e.g. as a cushion against future uncertainties) or as a result of other policies domestic or external (e.g. to limit exchange rate appreciation). Partly as a result, emerging markets have become net exporters of capital to advanced economies, which appears contrary to longer-term priorities for economic development.
- Easy availability of financing has contributed to financial imbalances by postponing needed adjustment, including domestic policies to deal with mounting fiscal imbalances.
- Reserve balances have remained concentrated in a small number of currencies, predominantly the US dollar. Some diversification of reserves is taking place, but the question is being raised of the need for a multilateral way of facilitating such diversification to avoid the risk that expectations of moves by official reserve holders may trigger destabilizing shifts in private portfolios. It is important that such issues be properly dealt with.

4. Lack of effective global governance. There is no unified global governance structure to help ensure that major economic and financial policy decisions made nationally, including exchange rate policies, are mutually consistent and contribute to global stability. In a world so deeply inter-connected, economic outcomes in each country depend significantly on developments and policy decisions made in others. In such a world, there is a strong case for rules and processes to be developed to help ensure global stability. The IMF was intended to provide this structure, but has been insufficiently effective, for three reasons:

- For too long, it was presumed by many that if each country kept its own house in order, and did not manipulate its exchange rate, that would be enough to guarantee global stability. This view has proven too optimistic with respect to the self-equilibrating function of markets and economies.
- There is no shared analytic framework for assessing the spillover effects of policies in large countries on other economies and the system at large.
- The IMF, as the central institution of the system, has suffered from a "legitimacy deficit", reflecting both the underrepresentation of some emerging market and developing countries, and the failure of the Fund's peer review process to have much influence over the policies of its largest members.

The failure to adjust its governance structure in a timely manner has hindered the Fund's ability to act as the intended institutional "machinery" to promote international monetary cooperation (Article I). The emergence of the G20 as the de facto primary forum for economic and financial cooperation contributed to filling that void. Notwithstanding the success of the G20 in reacting to the onset of the recent crisis, its effectiveness and legitimacy could be improved if somehow it could speak for all countries in the global economy.

5. **Urgency**. Most of the problems described above are not new, but the consequences of not addressing them are increasing and inhibiting the realization of the full benefits of globalization. Much effort has been made in the last year or so to make the international financial system sounder and more robust. But as long as problems in the international monetary system are not addressed, an increasingly integrated world economy becomes more and more vulnerable. A muddling through approach therefore is an increasingly inadequate response. Any meaningful comprehensive reform will require taking near-term steps within a longer-term vision constantly compatible with an underlying concern about the maintenance of prices stability.

6. The remainder of this report provides specific suggestions for reform that could meet these aims. While all group members agree with the general thrust and approach of the report there are, as one could expect, different degrees of enthusiasm for some of the suggestions. Sections II to VI below address the key long-standing issues that governments have to resolve:

- The absence of effective discipline towards global adjustment in the system, which calls for profound reforms in the field of multilateral peer review of national policies ("surveillance");
- The volatility of exchange rates and their behavior that often appears to be inconsistent with orderly adjustment and allocative efficiency;
- The difficulties in managing global liquidity to avoid both droughts and floods;
- The questions surrounding the role of the SDR; and
- The governance issues tied up in the decision-making and operations of the system.

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II. ECONOMIC AND FINANCIAL POLICIES

7. Policy spillovers. Surveillance over countries' economic and financial policies is inadequate. Not only must surveillance be improved, but it needs to be broadened to problems of global dimension, including developments in global liquidity and macro-prudential issues. In broadening the scope of its surveillance in these areas, the IMF should cooperate, as appropriate, with other relevant multilateral institutions (e.g. the FSB, the BIS and the OECD). The experience of the past decades has shown that problems emerging in national economies have often not been addressed in a timely manner, reflecting both differences in analytic understanding and the inability of IMF surveillance over its members' economic and financial policies to yield needed policy adjustments. In addition, keeping national economies in order, even if a necessary condition, is not sufficient to ensure global stability. Member countries' policies, both domestic and external, interact and affect regional and global stability in ways that go beyond each country's domestic policies and stability. Even when policies are appropriate for a country's own stability, they may have adverse spillovers on others.

8. Stronger surveillance. Strengthened IMF surveillance over its member's policies is therefore required. Effective surveillance needs to address the fiscal, monetary and financial policies of national governments, with particular attention to exchange rates, and must give due attention to global liquidity developments, as elaborated below in Sections III and IV. Stronger surveillance also requires a review of the governance of key international institutions and their relations with all countries, as proposed in Section VI. It should contain, in particular, the following key elements: (a) stronger multilateral obligations, backed by clear, objective norms or quantitative benchmarks on economic and financial policies and performance to function as alarm signals with appropriate thresholds; (b) assessment procedures that permit judgment about the causes and implications of any deviation from those policy norms; and (c) consequences, including the possibility of both incentives and sanctions. While all countries should be subject to the same obligations and assessment procedures, particular attention should be directed to countries whose policies have a larger potential impact on the stability of the international monetary system. This new surveillance process should also aim at eliciting a supportive response from financial markets, helping to orient market sentiment towards stability objectives that have been agreed at a multilateral level.

- **Suggestion 1. IMF member countries should undertake to ensure that their policies are conducive to the stability of the global economic, monetary and financial system.** We suggest that Article IV of the IMF Articles of Agreement be amended to reflect this strengthened commitment and to ensure that firm surveillance applies not only to exchange rate policies but to all economic and financial policies relevant for both domestic and global macro-financial stability. In the same spirit, Article VI should be amended to provide the IMF with the mandate and responsibilities it needs to effectively monitor and assess capital movements and restrictions on such movements imposed by member countries (*see suggestion 11.*). Its role in this area should be similar to the prerogatives it has regarding current account restrictions.

- **Suggestion 2**. **In support of surveillance over each country's or group of countries' compliance with the obligations under the Articles, the IMF should adopt norms for members' policies.** The development of such norms should draw on the advice and experience of all IMF members and other available expertise. The norms might cover, for example: current account deficit or surplus; real effective exchange rates; measures to deal with capital inflows and outflows; changes in relative size and composition of reserve assets; inflation rates; fiscal deficits; and government debt ratios. Norms might also be established with respect to financial sector soundness and the effectiveness of banking supervision. Norms should be established in such a way that they function as alarm signals, with appropriate thresholds defined for each of them whenever possible.

- **Suggestion 3**. **Persistent breach of a norm would trigger a consultation procedure and, if needed, remedial action.** The purpose of the consultation would be to ascertain the underlying causes and potential consequences of the deviation from the norm, both for the country itself and for the good functioning of the international monetary system. The assessment would have to look at all relevant factors, including economic policies in the country concerned and in other countries. The country's specific structural features and its present economic circumstances would also be taken into account. If the assessment concludes that a persistent deviation from the "norm" is not justified by any relevant specific circumstances and is a source of serious disturbance for the good functioning of the international monetary system, it should be followed by policy recommendations.

- **Suggestion 4**. **For systemically relevant countries whose policies do not appear to meet the norms, compliance with obligations should be explicitly ruled upon by the relevant organ of the IMF**. All countries would be subject to the same obligations; and compliance with these obligations would generally be assessed in the context of IMF bilateral surveillance. However, a more stringent process would apply to countries whose policies are seen by the IMF as having a potential impact on the stability of the international monetary system[1]. In doing so, no double standard should be applied. Oversight of compliance with IMF obligations should be more transparent than is currently IMF practice in order to increase the accountability of those engaged in the surveillance process. For example, relevant documents, other than those dealing with highly sensitive issues, and records of IMF Board discussions should promptly be released to the public and in full.

- **Suggestion 5**. **The IMF should develop positive incentives for countries to remain in full compliance with the requirements of the strengthened surveillance system.** Such incentives could include automatic qualification for liquidity facilities (such as the flexible credit line -FCL- and precautionary credit line -PCL-) and access to the voluntary SDR market (allowing a member to sell SDRs against freely usable currencies without having to demonstrate a BOP need and without recourse to the mandatory procedure called *designation*).

[1] This would apply in particular, for instance, to places where shadow banking institutions are located.

- **Suggestion 6. Strong consideration should be given to including in the surveillance framework the possibility for the IMF to impose appropriate graduated remedial actions if a country has persistently violated one or more obligations.** The process might entail more in depth analysis of what the breach of the norm might imply, initial informal meetings with the country concerned, possibly a special consultation, a review by the ministerial body overseeing the IMF, and, ultimately, if no action is taken by the concerned country, moving to the next phase of consequences. The latter might include, e.g., intensive follow-up reviews and public reports on the country's policies and its global spillovers; financial penalties; freezing part or all of the country's voting rights; restrictions on capital flows to countries in current account deficit or with an unsound financial sector. The activation of WTO procedures and trade sanctions, based upon IMF's assessment, should also be considered. The process for adopting such consequences would be the same as for assessing compliance, with the exception that special majorities would be appropriate for some measures.

III. EXCHANGE RATES

9. Importance. Exchange rate regimes are at the heart of any international monetary system. An essential objective of a well functioning international monetary system should be delivering exchange rates that are reasonably stable and in line with fundamentals. In this regard, tensions are all too obvious in the current environment. Exchange rates are driven by a combination of present and anticipated policies, and by market forces. Thus, instability may arise from several sources: inconsistent or unsustainable policies (or policy mixes) that can give rise to large and persistent exchange rate misalignments; false perceptions by market agents regarding long-term fundamentals or future policies; and more purely speculative activities.

10. Policies and benchmarks. For the system to operate effectively, countries need to conduct their economic and financial policies with an eye to fostering exchange rates broadly in line with fundamentals and with global balance. Under the Articles of Agreement, members of the IMF have the right to choose their own exchange rate arrangements, and a stated obligation to avoid manipulating their exchange rate or the international monetary system in order to secure an unfair competitive advantage. The IMF is expected to exercise "firm surveillance" over all members' exchange rate policies. However, forceful pronouncements from the IMF on this front have been rare, and generally with insufficient or no effect on the policies of the largest members. There is, then, a need to make countries' obligations on exchange rate policies more specific, including possibly through the use of benchmarks based on macroeconomic fundamentals to identify instability and misalignment. Such benchmarks could also inform strengthened efforts to mitigate market-driven deviations from fundamentals. In particular, major countries have a special responsibility to mitigate the large and persistent swings of their currencies and their negative impacts on the rest of the world. Further consideration of the best ways of achieving this in a new international context is necessary.

- **Suggestion 7**: **The IMF should develop globally consistent exchange rate "norms".** These norms would be broadly consistent both with globally sustainable external positions and with each country's internal and external macroeconomic balance. Taking into account the respective underlying fundamentals (stage of development, demographic makeup, resource endowment, productivity trends and other structural features), these "norms", to be updated regularly, would be used to help identify significant exchange rate instability and misalignments, at least for the most systemically relevant economies.

- **Suggestion 8**: **Under this approach, each country would be expected to refrain from exchange rate policies that push or keep their exchange rate away from its norm**. This obligation would effectively be a more specific expression of the general obligation that members should seek to pursue policies consistent with the stability of the international monetary system. Compliance with this obligation would be assessed in the context of surveillance, with the procedures and consequences as described in suggestions 2 and 3, and with references to norms. Of course, only persistent and significant deviations from the norm would be examined.

IV. GLOBAL LIQUIDITY

11. Floods and droughts. In the run up to the crisis, an unsustainable global expansion was facilitated by rapid growth in global credit. The result was a commodity price boom and what was subsequently recognized as a global asset price boom. Then the crisis struck, and liquidity in financial markets all but evaporated, leaving financial intermediaries and central banks around the globe scrambling for hard currency financing. From peak to trough, gross capital inflows worldwide fell from nearly 20 percent of global GDP to less than two percent. Now they appear to be heading back to, or exceeding, their pre-crisis level, and the risk remains of a return to "business as usual". Such extreme fluctuations have critical effects on the functioning of the global economic and financial system and macro-financial stability at the country level. Yet the phenomenon is poorly understood.

12. An evolving concept. While diverse methodologies and statistics are available at the national level, there are no commonly agreed definitions and measures of global liquidity. In the international context, liquidity has historically been associated with official reserves. This association was pertinent in the Bretton Woods era of low capital mobility; it is no longer appropriate. In the current global environment, liquidity cannot be solely or even predominantly associated with official reserves and a much broader definition needs to be adopted. In addition, the financial system plays a significant role in the determination of financial conditions, including the volume of credit supplied by financial institutions and the risks they take. In some countries, the so called "shadow banking system", which grew largely out of the view of monetary and financial surveillance, amplifies this role. While the crisis has spurred awareness of the need for an integrated approach between monetary policy and macro-prudential regulation at the domestic level, how this process plays out internationally has yet to be fully determined.

13. Policies and markets. Global liquidity conditions are influenced by the monetary policy stances in major financial centers, exchange rate arrangements, and the innovation and risk-taking behavior of the financial system. A key consideration is that liquidity creation and credit extension in major economies are transmitted to other economies through capital flows and exchange rate pressures. Thus, seemingly appropriate liquidity conditions in individual economies may add up to excesses or shortfalls internationally. Furthermore, liquidity has many dimensions and can change quickly as, to some degree, perceptions are a state of mind dominated by confidence or fear. As conditions that are either too loose or too tight can have undesirable consequences, the search for the appropriate approach to the management of liquidity conducive to balanced monetary and financial conditions at the global level is particularly challenging.

14. Monitoring and surveillance. A shared approach to the understanding and measurement of global liquidity is needed, as is better surveillance of developments that can dramatically change liquidity conditions when there is a significant change in market confidence (as reflected, for example, in risk spreads). This approach will require reinforced cooperation among the central banks and authorities in charge of macro-prudential policies of the largest economies and financial centers, with a view to ensuring global liquidity conditions consistent with sustained systemic stability.

15. Dealing with capital flows. One potential consequence of excessive global liquidity is large and volatile capital flows, which can pose acute challenges to macroeconomic and financial stability. Thus, further consideration should be given to measures, such as capital controls and broader macro-prudential measures that might effectively allow countries to protect their economies from the negative effects of such flows. However, such interventions should be limited and a key challenge in this regard is to ensure that the measures do not create distortions more harmful in the longer run than the inflows themselves, and do not affect other countries negatively (e.g., by deflecting capital flows to them). The development of internationally agreed guidelines in this area, covering both issues of disruptive inflows and outflows would be useful. It should be clear that using capital controls to maintain an undervalued exchange rate is not compatible with a well-functioning international monetary system.

16. Liquidity provision in crisis times. In light of the experience of the recent crisis, further steps should be taken to make the IMF more akin to a global lender of last resort ready to act in a reliable, rules-based fashion, and with appropriate protections to limit moral hazard. This would provide the membership with a stronger financial safety net - at a lower cost for the countries and for the system itself - than through reserve accumulation.

- **Suggestion 9**: **The IMF and the BIS should work together towards a shared analytical approach for a better measurement and surveillance of global liquidity**. These are necessary in order to make possible international surveillance of this important determinant of the stability of the international monetary system. Given the many dimensions of liquidity, a set of indicators will probably need to be developed, underpinned by adequate statistical tools. The adequacy of these indicators will need to be reviewed on a regular basis to take into account the effects of financial innovation.

- **Suggestion 10: The central banks and the authorities in charge of macro-prudential policies of systemically relevant economies should conduct their policies taking into account the need for broadly appropriate global liquidity conditions.** The IMF, the BIS and the FSB should regularly monitor developments in global liquidity with a view toward formulating recommendations for all systemically relevant countries regarding the conduct of their policies (including monetary and exchange rate policies, as well as financial regulatory and supervisory policies) with a potential impact on global liquidity.

- **Suggestion 11**: **Use of capital controls, subject to IMF surveillance under an amended Article VI, may be warranted as an option to prevent disorderly exchange rate movements or financial instability.** The IMF should establish a more complete analytic framework on capital flows, both in capital exporting and importing countries, in light of the experience gained over the last two decades that have been characterised by large and volatile capital flows. In this context, if a country was experiencing substantial market pressure on its currency to appreciate or depreciate as a result of existing or expected large capital flows, and considered imposing, tightening, or extending capital controls, such measures would be subject to close surveillance by the IMF to ensure that they are designed so as to limit their distortionary effects; that an effort is made in a reasonable timeframe to create the conditions for their removal or their alleviation; and that they are not being misused to prevent necessary exchange rate or other economic or financial adjustments.

- **Suggestion 12: The IMF should work with relevant governments, central banks, and regional pools to put in place, with appropriate safeguards, permanent crisis financing mechanisms akin to a global lender of last resort.** To constitute an effective alternative to further precautionary reserve accumulation, the mechanisms for activation of such arrangements should be rules-based. The Fund should be enabled to proceed expeditiously on the basis of its technical assessment of the severity of the situation. Safeguards to reduce moral hazard would be essential (e.g., graduated lending charges, provisions regarding private sector involvement in resolving the crisis, etc.). To increase the Fund's capacity to mobilize resources, the following ideas merit consideration: large-scale borrowing from markets; emergency SDR allocations (with a streamlined decision-making process); and contingent loan/swap arrangements with key central banks and reserve pools.

V. THE ROLE OF THE SDR

17. An evolving international monetary system. The International Monetary System will continue to evolve, in part reflecting continued shifts in the relative weights of different economies in the world. There is a question whether, looking forward, the new needs that arise in a multi-polar world can be adequately addressed by one or more national currencies, or if a non-national currency instrument may have a role to play, e.g. as a complementary reserve asset and/or as an international numeraire not directly affected by the domestic policies of one economy.

18. Background. The SDR – a basket currently made up of the four freely usable currencies issued by economies accounting for a large share of world trade – was first created at the end of the sixties with the view of contributing to an adequate long-term creation of primary reserve assets in the context of the Bretton-Woods system. The objective, as stated in the IMF's Articles of Agreement, was to make the SDR "...the principal reserve asset..." in the international monetary system. Its use was considerably reduced after the system of fixed exchange rates and the peg of the U.S. dollar to gold were dismantled. It has nevertheless demonstrated its usefulness during the recent crisis with a rapidly decided exceptional allocation.

19. Re-examining the SDR's role. It might be useful to re-explore the potential role of the SDR (e.g. as a reserve asset, as a unit of account, etc.) in serving the public common good of monetary and financial stability in the new context of today's globalized and increasingly multi-polar world. It is recognized that the SDR's role as a store of value will remain limited so long as it depends on the value of the component currencies. However the use of the SDR as a unit of account could reduce the volatility of valuation in comparison with the use of a single currency. Furthermore, having an internationally created reserve asset has proved useful on occasion in the past and may prove useful again in the future. Making this reserve asset more generally acceptable and usable would be in the common interest of all countries. Furthermore, the issue of the SDR's potential role in a long term perspective in addressing potential demands that may arise should remain under consideration, not only to stay in compliance with the undertaking of the Articles of Agreement[1], but also in view of the role it could play in addressing potential demands that may arise[2].

- **Suggestion 13: The scope for the SDR to play a greater role in the international monetary system should be examined.** The following ideas with regard to SDR as a reserve asset and as an international unit of account might be explored:

[1] Art. VIII, Section 7: *"Each member undertakes to collaborate with the Fund and with other members in order to ensure that the policies of the member with respect to reserve assets shall be consistent with the objectives of promoting better international surveillance of international liquidity and making the special drawing right the principal reserve asset in the international monetary system".*

[2] Suggestions 13 to 15 have not been fully developed but there was a near consensus amongst the group on proposing that the subject merits serious discussions.

- *Reserve asset: regular allocations of SDR under appropriate safeguards might be considered and, in addition, procedures for allocating SDR's in exceptional circumstances might be put in place*. Furthermore, in view of making the SDR the principal reserve asset in the international monetary system, as stated in the Articles of Agreement, its attractiveness could be improved.
- *The scope for supporting the orderly diversification of reserves via a mechanism allowing their conversion into SDR-denominated claims could be re-examined.* This objective underlay work on a substitution account in the 1970s. While efforts at the time faltered, alternative designs for a substitution account could be explored.
- *Unit of account: the IMF could work with the private sector to explore ways in which the SDR could be more widely used in private transactions*, as was beginning to happen in the early 1980s, and for invoicing commodity prices and international trade in SDR. Moreover, international statistics established by the IMF, and by other international institutions (on balance of payments and international reserves in particular) could be reported in SDR as far as possible. Finally, the IMF could consider formulating vis-à-vis the SDR the exchange rates "norms" described in suggestion 7.

➢ **Suggestion 14: The composition of the SDR basket should reflect the relative importance of economies in international trade and financial transactions.** Changes in the composition of the SDR basket should be rare and rules-based to maximize predictability (e.g., periodic adjustments of the weights in the basket should follow predictable rules, and currencies would be included or excluded once they meet certain objectively defined criteria). The requirement that only currencies widely used in international payments and financial transactions can be part of the SDR basket should be maintained.

➢ **Suggestion 15: The scope for the use of the SDR in incentives to improve the workings of the adjustment process could be explored.** Consideration might be given to conditioning allocations of SDR to countries on their observance of norms (or agreed targets). Access to the voluntary SDR market might be conditioned on a country's meeting the full requirements of a strengthened multilateral surveillance system.

VI. GOVERNANCE

20. **Issues**. Three essential issues have surfaced over recent years in the governance of the international monetary system, hindering its proper functioning:

- The need for a decision-making structure combining legitimacy and effectiveness by giving a formal framework to the relationship between the pertinent group of Heads of State or Government, the group of Ministers and Governors, and the key International Financial Institutions;
- The tendency for the present peer review processes to operate as peer protection, suggesting the need for a mechanism to break the de facto "pact of non-aggression" among countries that leaves the global interest without an effective advocate;
- The legitimacy deficit of the IMF, partly addressed by the Seoul G20 meeting of November 2010.

Additional meaningful measures should be undertaken to address current fundamental governance problems, especially to respond to the increased responsibilities we envisage for the IMF, and allow the membership to work in a framework even more conducive to mutual trust and partnership.

- **Suggestion 16**: **To ensure both effectiveness and legitimacy, we favor considering a governance of the international monetary system based on a single three-level architecture, ensuring universal representation through a system of constituencies**, which has served well the IMF and the World Bank. This would ensure both a universal representation which would enhance the legitimacy of the G20, while preserving a limited number of key participants in the decision making bodies, to contribute to the effectiveness of the overall governance structure.

  Three levels. The system of governance would be based on a three-level integrated architecture, comprised of:

  - The Heads of Government or State, meeting sparingly (e.g., once a year) except in times of crisis;
  - The Finance Ministers and Central Bank Governors, taking strategic decisions related to the functioning of the international monetary system in the framework of a "Council" as envisaged in the Fund's Articles of Agreement. This Council could be activated to take over and merge the functions of the IMFC and the G20 ministers and governors, as far as the latter's role in the global economic, monetary and financial domains is concerned. This would require an amendment to ensure a representation of Central Banks in the Council, as it is the case in the current G20 structure; and
  - Executive Directors overseeing the work of the IMF, and its managing director.

These organizational changes would require an adjustment of the existing constituencies and of the number of chairs at the three levels.

- ***Voting***. We favor lowering of the voting threshold on most important decisions from 85 percent to 70-75 percent as well as the extension of the double majorities to a few other decisions, thus ensuring that decisions affecting key aspects of the institution command the support of the majority of members.

- ***Global institutional coordination***. To facilitate the institutional coordination, we suggest that the BIS, the FSB, the WTO, the World Bank and possibly other organizations be invited to meetings of the Council.

➢ **Suggestion 17. In order to give a stronger voice to the global interest of the system, consideration should be given to establishing a Global Advisory Committee (GAC) made up of eminent independent personalities**.

- Such a body could provide independent advice to the key organs of the IMF (e.g., the IMF Council, Executive Board, Managing Director) in the fields of surveillance, management of international liquidity and reserves, whether at its own initiative or at their request. While that advice would not be binding, it would in principle be made public. Consideration would need to be given to protecting confidentiality in a limited number of cases.

- Its membership, limited in size, should allow a diversity of perspectives and be selected on the basis of highly recognized technical competence, operational experience and independence. Fully transparent nomination rules would have to ensure that these conditions are met, along with some regional balance. Terms of membership would not be renewable.

- This reform could be introduced by the IMFC without requiring an amendment of the IMF Articles of Agreement.

➢ **Suggestion 18. Regional organizations**. Recognizing that in some parts of the world regional organizations have increasing authority over economic, monetary and financial policies, as well as provision of financing, it would be worth undertaking a study about the modalities of their representation and relations with the IMF.

Concluding Remarks

The crisis heralded, indeed accelerated, a transition to a new world where emerging market economies play a role on a par with advanced ones in driving global growth; a world that will be fundamentally multi-polar, and in which global monetary problems must be dealt with cooperatively. The international monetary system to which we aspire is one that preserves the gains of the past sixty-five years, without succumbing to its own instability. It is a system that maintains freedom of trade and current payments and that allows sharing more widely the benefits of financial globalization, appropriately regulated. It is a system where all countries recognize their stake in global stability and accept that near-term national objectives may, if needed, be constrained by the global interest. International cooperation is, in the long run, a necessary ingredient in the search for national prosperity. This should lead every country to look with a renewed sense of responsibility and discipline to the system as a whole. The G20 or a "G" of similar limited size, under the proposed renovated architecture, would be in a powerful position to promote the global common good, and to make it prevail, including, at times, against a narrow, short-term interpretation of national interests. The opportunity for the emergence of a fully fledged international monetary order is here at stake.

POSTSCRIPT

Tommaso Padoa-Schioppa who joined us in inviting this group of our common friends and colleagues, sharing our concerns and hopes, passed away a few days after the penultimate meeting of our group, on December 18, 2010. We have lost an admired friend and the world an outstanding proponent and actor of the global common good. As we are concluding our work, we would like to reproduce herewith the concluding paragraph of the note we sent with him, last summer, to call for our inaugural meeting:

"It may seem surprising that, as persons very familiar with the difficulties of any reform initiative, we now propose to address the root problems of the international monetary order going well beyond piecemeal measures and trying an overall reconstruction of the system. We propose this approach because we see no alternative. And we think that it would be unforgivable not to seize the opportunity offered by the aftermath of the crisis. Ours will appear a utopian task to those who still dream for a simple marginal adaptation of the status quo. It is, however, a much less audacious task than the one undertaken by those who deemed it possible, in 1945, to build a multilateral international monetary system on the ruins left by World War II. The undertaking we propose deserves that everyone brings a contribution which will be made more useful by the very experience and wisdom of persons who are so familiar with both the difficulty and the challenges involved."

As Tommaso would have certainly done it, we want to express wholeheartedly our gratitude to all those who have contributed so generously to the preparation of this document.

Alexandre Lamfalussy, Michel Camdessus

Paris, February 8th, 2011

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