

Can Financial Reform Lead to Monetary Reform?

Peter B. Kenen
Princeton University

The participants in the London Summit made a number of significant promises to strengthen global financial governance. The early and forthright fulfillment of those promises could contribute substantially to the future stability of national financial systems and thus to the stability of the global financial system. It would also contribute to confidence in the perceived integrity of national financial systems, the institutions that inhabit those systems, and the individuals responsible for managing those institutions – confidence that has been gravely impaired in a number of countries, including my own.

Unfortunately, it may never be possible to achieve some of the objectives set out in the Communiqué of the London Summit. I am glad to know that the newly renamed Financial Stability Board has been instructed to “collaborate with the IMF to provide early warnings of macroeconomic and financial risks and the actions needed to correct them,” but I do not know, nor does anyone else, how those bodies will identify the risks at issue early enough to ward off costly crises. I would like to believe that the FSB and IMF will be able to draw lines in the sand and instruct national governments to keep their banks and other financial institutions from crossing those lines. We all know, however, that sands shift. We also know that practices which seem safe today, because they have been adopted by small institutions, may not seem safe tomorrow, after they have been adopted by large institutions.

I nevertheless welcome the commitment in the London communiqué “to extend regulation and oversight to all systemically important financial institutions, instruments, and

markets,” including systemically important hedge funds. Yet there may no way to know whether an institution is “systemically important” until it is subject to oversight, which means that it may be necessary to require a periodic census of *all* financial institutions over a certain size, measured comprehensively. I am even less satisfied by the commitment made in respect of rating agencies. I do not believe that those entities can avoid “unacceptable conflicts of interest” for as long as the issuer pays for the rating. (I should add in fairness that a G20 Working Group on regulation and transparency has published a report containing no fewer than 25 recommendations that flesh out the briefer treatment of these issues in the Summit Communiqué. Those recommendations, however, leave much to future clarification and quantification. The word ‘appropriate’ appears with distressing frequency.

I am much happier with the financial commitments made to and through the IMF. As I understand those commitments, the G20 are collectively committed to raise immediately an additional \$50 billion for the Fund, which, together with commitments already made by Japan and the European Union, will provide the Fund with the \$250 billion mentioned in the communiqué. These individual commitments will then be transformed into borrowings under the Fund’s existing network of credit facilities, the New Arrangements to Borrow, which will themselves be expanded hugely to 500 billion SDR. (They presently total only 34 billion SDR.)

What may be more important in the long run, the G20 are now committed to support a general SDR allocation amounting to \$250 billion. This echoes a proposal made by Ted Truman in an op ed column published by the *Financial Times* on March 6 2009, in which he noted that an SDR allocation is a way in which the United States can contribute to the

financial resources of IMF members without obtaining explicit approval from Congress – a matter to which I will turn shortly. The Secretary of the Treasury has merely to consult with key members of Congress at least 90 days before voting in favor of an SDR allocation; no action by Congress is required.

This brings me to the question posed in the title of my remarks. Moving beyond financial regulation, what if anything did the G20 summit contribute to the strengthening and long-run viability of the international monetary system? My answer is ‘not much’ because there is not a great deal that can be done. A sensible reform of the international monetary system would presumably reduce the relative importance of the US dollar as a reserve asset and as the main medium of exchange in foreign-exchange markets and other international financial markets. If that is to be done in an orderly way, it must be done with the tacit consent of the United States, and that may not be easy to obtain. Let me explain.

As most of you probably know, the United States did not adhere to the Articles of Agreement of the IMF in the usual way – by a two-thirds vote the U.S. Senate, which is the way it ratifies a treaty. Instead, it adopted legislation, the Bretton Woods Agreement Act, which governs the participation of the United States in the IMF. The good news is that the White House does not have to obtain a two-thirds vote of the U.S. Senate to approve an amendment to the Articles of Agreement of the Fund, which is what must be obtained to adopt or amend a treaty. The bad news is that the White House has to obtain approval by the House of Representatives as well as the Senate, which means that the White House must convince majorities in both the Senate and House that a proposed amendment to the Articles of Agreement of the IMF is consonant with the national interest of the United States.

I dwell on these peculiar arrangements because of the problems they pose whenever the United States is called upon to endorse a change in the Articles of Agreement of the Fund (such as the Fourth Amendment, which the United States has not yet endorsed). To start the process, the Secretary of the Treasury must persuade the President's advisors in the White House that the change under consideration is sufficiently important to warrant an expenditure of political capital, a precious commodity in this country even when, as now, the President enjoys widespread support in the country and the Congress. Next, the Treasury must persuade the relevant committees of the Congress to approve the requisite legislation without tacking on extraneous or damaging amendments, and then to obtain the approval of majorities in the House and in the Senate.

Accordingly, I feel sadly safe in saying that it may be nearly impossible to make a major discontinuous change in the governance of the IMF – to eliminate or even reduce substantially the number of cases in which 85 percent of the votes in the Fund must be cast in favor of a decision or, for that matter, to adopt any significant change in the Fund's Articles of Agreement that was not strongly favored by the United States.

Let me be clear. I am not defending the hegemonic influence of the United States in the IMF, nor am I defending the leading role of the US dollar in the international monetary system. I am merely trying to explain why it would be hard to make a major change in the governance of the IMF by amending its Articles of Agreement. As for the role of the dollar in the international monetary and financial system, that too may be hard to change, although significant change has already taken place with the advent of the euro, and a further change may well take place after the renminbi has become fully convertible for capital as well as current transactions.

In a recent speech, Governor Zhou of the People's Bank of China called for a fundamental reform of the international monetary system, one that would introduce "an international reserve currency that is disconnected from individual nations and is able to remain stable in the long run, thus removing the inherent deficiencies caused by using credit-based national currencies."¹

In principle, the SDR comes close to meeting Governor Zhou's objective, as he acknowledged in his speech. Its value is defined by a basket of four major currencies (the dollar, euro, pound, and yen) which are, of course, widely used in the invoicing of world trade and the issuance of international securities, and the quantity of SDRs is governed by the IMF, in which, as I have said, the United States has disproportionate influence, even though it cannot always command sufficient support to impose its own policy preferences.

In his recent speech, however, Governor Zhou skirted an issue that others are bound to raise – one that has proved fatal to earlier proposals aimed at enhancing the role of the SDR as a reserve asset. He proposed the creation of an open-ended fund which, he said, would allow subscriptions and redemptions of existing reserve currencies in exchange for SDR-denominated claims. This proposal resembles one made several years ago – the proposal for a so-called substitution account managed by the IMF, in which official holders could deposit dollars exchange for SDR-denominated claims. That proposal foundered when official holders of dollars insisted understandably that the United States should undertake to maintain the SDR value of the dollars held in the account by topping up the dollar holdings of the account whenever the dollar depreciated vis-à-vis the SDR. If the SDR-denominated fund proposed by Governor Zhou imposed the same maintenance-of-

¹ Zhou Ziaochuan, "Reform the International Monetary System," The People's Bank of China, Beijing, March 26, 2009.

value obligation on the United States, the proposal would be unacceptable not only the US Congress but also to the US Treasury, because it would impose an open-ended financial obligation on the United States.

We've been here before, and we'll be here again. I say that wearily, not flippantly. On a very serious note, however, the time may soon come to consider very carefully proposals like those made by Governor Zhou and the obstacles to their adoption. At the moment, however, governments have much work to do in order to stabilize the world economy. Once that has been done, they can and should turn their attention to longer-term issues rather than do what they have done before – lose all interest in reform of the international monetary system after the immediate crisis has passed.

There is, perhaps, reason to hope that this will not happen again, partly because the G20 summit has set in train some processes that will continue for some time to command the attention of finance ministries and central banks, partly because the US government has shown an interest in reforms that some earlier administrations would have dismissed or viewed as constraining unduly the freedom of the United States to disregard the concerns and aspirations of other countries' governments.

Let me conclude by proposing one reform that was attempted recently but was widely regarded as being unproductive. I refer to the multilateral consultations that the Fund conducted in an effort to achieve agreement on a package of policy changes that would to reduce global imbalances. The first round of consultations was disappointing because two key participants, the United States and the People's Republic of China, did little more than reiterate unilateral promises they had made before. In the wake of that rather fruitless meeting, I proposed another way to seek a more constructive outcome – that the Managing

Director of the Fund should take the lead by proposing confidentially a balanced set of policy changes specific to each participating government, not merely presiding over an all-too-familiar exchange of statements reaffirming the participants' existing policies.