It is a pleasure for me to participate in this symposium and to share a few thoughts regarding the debate on the challenges and the search for a new compass for the international monetary system (IMS).

When Mohamed El Erian coined the phrase « New Normal » for the first time, in early 2009, he meant to signify a downward shift of potential growth of advanced economies because of capital destruction and impairment in the financial sectors. Later on, the phrase became associated with anything post-crisis, linked with deleveraging, a slowdown in globalization and a strengthening of financial sector regulation.

When one considers the International Monetary System the expression “New Normal” is somewhat paradoxical because it seems that nothing, neither the Great Moderation nor the crisis, has fundamentally changed the IMS. It is in fact a remarkable feature of the current system (which some refer to as a “non system”) that it has survived the worst crisis since World War II. This doesn’t mean of course that the IMS is flawless. One could easily make a list of causes for concern. Off the cuff, this list would probably include possible contagion effects between assets and markets, spillovers associated with the exiting from accommodative policies, difficulties to adjust desynchronized business and financial cycles, global imbalances and so on.

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1 Former CEO of PIMCO (the Pacific Investment Management Company)
Hence, today, I would like to organize my thoughts in three parts: first, to acknowledge the resilience of the IMS, second, to review some of the current system’s weaknesses, and third to outline some possible improvements.

I. To begin with, it is fair to acknowledge that the International Monetary System has proved to be fairly resilient to the Great Financial Crisis. Before turning to the IMS under the “New Normal” let’s try to recall what the “Old Normal” was like. In the years preceding the great financial crisis, the world economy was growing strongly, - somewhere around 5% a year -, against a background of extremely muted volatility in the real economy, world trade was growing even faster (it nearly quadrupled between 1990 and 2007 while world output only doubled), and financial globalization proceeded at a similarly rapid pace (total cross-border financial assets and liabilities tripled from 125% of global GDP in 1990 to 360% in 2007). In addition, exchange rates of key global currencies were perceived to be misaligned with their fundamentals (a statement that is admittedly always difficult to substantiate as equilibrium exchange rates are not traded, but at least one can note that the euro/dollar or the dollar/yen, for example fluctuated very sharply in the space of only a few years, and several studies were pointing to substantial misalignments).²

This environment was fostered by a highly flexible international monetary system, - or “non-system” as we may call it - characterized by widespread financial liberalization, the generalization of central bank independence, monetary policy regimes aimed at focusing on domestic price stability and the coexistence of various exchange rate regimes (from fixed to totally flexible, with still a large share of managed exchange rates). In spite of the severity of the crisis that burst out in 2008, it is striking to see how many features of the IMS remain unchanged.

² For example, Olivier Blanchard, Francesco Giavazzi and Filipa Sa, 2005. "The U.S. Current Account and the Dollar," NBER Working Papers 11137, estimated that the dollar needed to depreciate very significantly by more than 50% (the need of dollar depreciation being especially strong against the renminbi and the yen).
In particular, few countries have changed their exchange rate regime. The crisis has only interrupted the slow evolution of the world economies towards more flexible exchange rate arrangements, more open capital accounts and towards more independent monetary authorities and inflation targeting.

Remarkably, although the Great Financial Crisis started in the US, the US dollar remains by far the dominating currency in the global financial system, accounting for more than 80% of global trade transactions and 60% of total accumulated reserves. Paradoxically even, the dollar has appreciated during the worst phase of the financial crisis in the US due to a “flight to quality” effect. The US dollar still benefits from a “safe haven” status as US sovereign debt remains the riskless benchmark asset despite significant fiscal external and fiscal imbalances, and the USD remains the anchor of the international monetary system.

Further, while global imbalances have abated somehow, this seems to be mostly due to transitory effects and does not reflect a fundamental change in the underlying growth models (the fall in the size of global current account imbalances reflects to a large extent the moderation of oil and other commodity prices, as well as the weakness in global trade). In addition, adjustment so far has been asymmetric: it is mostly deficit countries that had to adjust (a common feature in the current system, but not a desirable one as no country is here to compensate the fall in global demand).

Likewise, the “original sin”, which constrains emerging market economies to borrow in foreign currency (thereby giving rise to currency mismatches in their balance sheets) does not seem to have been overcome. As a consequence, the level of foreign exchange reserves in the EMEs still remains high when assessed against the usual benchmarks.

One also should note that global trade has remained fairly resilient during and after the crisis: while it fell significantly in the immediate aftermath of the crisis, driven by the fall in the import intensive categories of expenditures such as investment and inventories, it quickly rebounded afterwards. However, in recent years, trade has been relatively sluggish compared to the
pre-crisis period, but the downward spiral that was recorded in the 1930s, fuelled by protectionist measures, has been avoided. At the same time, the crisis did not interrupt the increasing complexity and fragmentation of the global value chains. This transformation may dampen the impact of exchange rate changes on trade flows for globalized industrial exporters, who import a large share of their inputs from other countries and therefore there are exposed to more diversified exchange rate risks.

- Similarly, despite new macro prudential and capital flows management measures, capital is still flowing across borders even if its composition, e.g. bank flows versus portfolio flows, may have changed over time. This change may actually impact the volatility of capital flows as non-FDI portfolio flows tend to be more volatile and surely increase the effect of capital flows on domestic asset prices and interest rates.

I could continue the list but let me stop here in the interest of time.

II. One of the side effects of the IMS resilience is that some of its vulnerabilities are still in place and risks may even have increased given the current desynchronization of credit and business cycles. One of these key vulnerabilities is that exchange rate systems still do not always allow for optimal adjustment. Disorderly currency movements and misalignments, either because of market behavior or policy interventions remain a source of risk.

Global foreign exchange trading volume now exceeds USD 1,200 trillion annually, a large multiple of all fundamental anchors such as global GDP, trade or capital flows. While the depth of foreign exchange markets could be seen as dampening the volatility, it is also a consequence of operations such as carry-trade, which could generate unwelcome bouts of volatility and misalignment.

In addition, while the Great Financial crisis seemed to have slowed the financial globalization process down, notably cross borders banks interlinkages, financial
market interlinkages remain very strong. The high correlation of asset prices is not only coming from cross borders capital flows, but also from contagion due to global factors, as risk aversion or global liquidity. This is highlighting the fact that capital flows management measures are far from being waterproof tools when it comes to seeking protection from global financial turmoil.

This explains, to some extent, that the level of reserve has continued to increase in recent years, as countries are permanently seeking additional protection.

Finally, global imbalances persist. The relative importance of excess imbalances from the largest economies has narrowed, but most of the adjustment has been borne by deficit countries. Furthermore, the global pattern of current account balances has shifted, with the emergence of new cases of excessive deficits and surplus, as mentioned in the last IMF External Sustainability Report.

All in all, the global financial environment is likely to remain potentially unstable for some time, while two aggravating factors are going to make the overall balance of risks tilt on the downside, hence challenging the IMS resilience. First, policy space will remain scarce as long as fiscal room for maneuver remains limited. Second, economies will need to digest the effect the asynchronous monetary exit and gradually tightening financial conditions in the context of desynchronized business and credit cycles and strongly correlated asset prices.

**III. How to reduce these vulnerabilities or sources of instability?**

Despite decisive regulatory steps taken and a clear improvement in terms of financial regulation and supervision both at the global and the national levels, the environment remains hazardous. And if there are reasons to believe that certain IMS-related risks remain unaddressed, it comes naturally to wonder what market development and policy initiatives could be needed to strengthen the system and prevent other crises. Thinking about possible solutions, I voluntarily refrain from touching upon financial sector regulatory reforms, leaving this particular aspect to the expertise of Andreas [Dombret].
In theory, two approaches can be followed to promote global stability in the IMS: cooperative policy actions or market-driven developments.

Should international cooperation as it stands today turn into close coordination on monetary policies, - say, with the G20 as the leading forum for policy impulses and the IMF the main institution promoting implementation, for example ? Such development seems hardly feasible as central bank mandates are purely domestic and in fact may not even be necessarily desirable as there is no reason to think that coordination could lead to optimal adjustments.

Let me take the example of the Eurozone. The crisis demonstrated that a monetary union, i.e. the most extreme form of monetary policy coordination, requires a very high level of economic and institutional integration. We had to complete the EMU and have began to do so by setting up a banking union and a regional safety net and by strengthening fiscal and macroeconomic discipline. Hence, monetary and exchange rate policy coordination requires a high level of policy commitment, which is not in place yet at the global level and is just emerging at the regional level in some places of the world.

Regarding cooperation on exchange rates, one should recall that in the past the global financial community has been successful at implementing coordinated actions, when the global exchange rate configuration appeared out of line. This was for instance the case of the Plaza (1985) and Louvre (1987) agreements. This raises the question do we need and could we still implement such agreements today? If not is it a question of political will? Or is it that financial flows have become too large for Governments and central banks actions to be effective ? Or do we believe that exchange rate and monetary policy are too intertwined and that such exchange rate cooperation will entail monetary policy coordination? Do we think that macroprudential tools are the answer to all of our problems?

In the meantime, does this mean we should rely exclusively on markets to address the vulnerabilities of the IMS, through pursuing the liberalization of capital flows and the flexibilization of exchange rates? I do not believe so.
We have at least two avenues to explore to improve the functioning of the system. The first one is to strengthen the global safety nets with its three layers, the bilateral one (central banks swaps), the regional one (regional financial arrangements, as in the Euro area and in Asia with the Chiang Mai multilateral initiative and the global one (the IMF) and improve coordination between these layers. In doing so, we must ensure a fair trade off between efficiency and moral hazard. The second avenue is a more efficient and cooperative use, both at the regional and the global level, of macro prudential tools to address vulnerabilities on specific assets markets to prevent bubbles and bubbles contagion.

**To conclude, is there a case for a complete overhaul of the IMS?**

Let me give you two possible answers to this question.

- The first one is “probably not”. The IMS as it is, being market driven, flexible and adaptable to all needs, held steady during the crisis. Paying due attention to the macroprudential oversight will be filling a crucial gap to prevent further crises. And the current design of international cooperation fora is paving the way towards a better internalization of global stability.
- The second one is “probably yes”. The current IMS flaws are as resilient as the IMS itself and may contribute to global financial crisis, imbalances and unsustainable growth models. Against this background, a return to a rule based system may be warranted.

I have no definitive answer and I would like to end this speech quoting Keynes, in 1933 after the Great Depression, “The decadent international but individualistic capitalism in the hands of which we found ourselves after the war is not a success. It is not intelligent. It is not beautiful. It is not just. It is not virtuous. And it does not deliver the goods. In short, we do dislike it, and we are beginning to despise it. But when we wonder what to put in its place, we are extremely perplexed.”