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Improving the International Monetary and Financial System

Remarks by

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Nearly four decades have elapsed since the demise of Bretton Woods, and during that time, the international monetary and financial system has undergone a significant transformation. The changes that have occurred reflect deliberate policy choices by the official sector as well as the organic interactions of investors, institutions, and advancing technologies. Judging by the standards of global economic growth, stable prices, and financial stability, the international monetary and financial system, in its current incarnation, has a decidedly mixed record. Wrenching crises and economic distress, notably including the difficult experience of the past several years, have punctuated periods of solid growth, low inflation, and financial stability. Thus, the subject of today's discussion is vitally important, and I am pleased to contribute my thoughts on steps we can take to improve our international economic order.[1]

In evaluating our policy priorities, I find it helpful to distinguish between the international *monetary* system and the international *financial* system.[2] The international monetary system is the set of rules, conventions, and institutions associated with monetary policy, official capital flows, and exchange rates. It also includes mechanisms to provide official sector support to countries facing funding pressures. The international financial system is much broader, encompassing both private and official participants in global financial markets. I consider this distinction important in thinking about how to reduce the incidence and severity of future crises while preserving a prosperous global economy.

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[1] These remarks solely reflect my own views and not necessarily those of any other member of the Federal Open Market Committee. I appreciate the assistance of Trevor Reeve of the Board's staff in the preparation of these remarks.

[2] For a further discussion of this distinction, see Edwin M. Truman (2010), "The International Monetary System and Global Imbalances" (Washington: Peterson Institute for International Economics, January), www.iie.com/publications/papers/truman0110.pdf.

In the case of the recent global financial crisis and recession, I would apportion responsibility to inadequacies in both the monetary and financial systems. With respect to the international monetary system, the basic story is now quite familiar: Strong capital outflows from countries with chronic current account surpluses--in part reflecting heavily managed exchange rates, reserve accumulation, and other shortcomings in the operation of the international monetary system--put downward pressure on real interest rates, in turn boosting asset prices (particularly for housing) and enhancing the availability of credit. These developments contributed significantly to the buildup of financial imbalances, but they were not, on their own, sufficient to have engendered the massive financial crisis we experienced.

Had the additional domestic credit associated with these capital inflows been used effectively, the imbalances need not have led to financial ruin. In the United States and other countries with current account deficits, however, borrowing too often supported excessive spending on housing and consumption, rather than financing productive investment. Most important, declines in underwriting standards, breakdowns in lending oversight by investors and rating agencies, increased use of opaque financial products, and more-general inadequacies in risk management by private financial institutions helped foster a dangerous and unsustainable credit boom. With the financial system evolving rapidly, supervisors and regulators, both in the United States and in many other countries, failed to recognize and address the mounting vulnerabilities. In short, these failures rooted in the financial system interacted with weaknesses in the global monetary system to create stresses and instabilities that eventually triggered--and amplified--the recent financial crisis and subsequent recession.

Other economic crises can similarly be traced to the interaction of weaknesses in the global monetary and financial systems. For example, the Asian financial crisis of the late 1990s was rooted in failures to prudently allocate capital to productive investments--failures of financial intermediation. But these problems were made worse by characteristics of the international monetary system, as heavily managed exchange rates encouraged excessive foreign currency borrowing. The collapse of the Thai baht in mid-1997, which marked the beginning of the crisis, resulted in substantial balance sheet losses--particularly for that country's banks--and triggered a widespread reappraisal of risk in the entire region. As investors lost confidence, capital fled these economies, precipitating a severe downturn. As in the recent experience of the United States, better management of domestic financial systems in the emerging Asian economies would have greatly limited, if not prevented, the financial vulnerabilities that ultimately resulted in the crisis, but policies regarding exchange rate regimes and capital flows were also an important part of the story.

The conclusion I draw from these and other financial crises is that we must strengthen both the financial system and the monetary system to create a more stable and less crisis-prone global economy. Improving the international financial system requires better management of national financial sectors and also enhanced international cooperation and coordination, because in a globalized economy with strong, complex, cross-border linkages, even domestic financial stresses can have serious international repercussions.

Countries need to work together to ensure that weaknesses in the global financial system are recognized and addressed. I am encouraged by the progress we have made in strengthening the banking sector through the capital and liquidity requirements of Basel III. We have also made important strides in improving international cooperation and coordination in the supervision of systemically important financial institutions, whose operations and exposures span numerous jurisdictions. That said, we need to continue working toward viable resolution mechanisms for these institutions. Further work is also needed to improve our macroprudential approach to managing vulnerabilities. And we must collaborate to ensure that risky activities do not migrate to the shadows of the financial system in an attempt to circumvent regulatory authorities.

We must also strengthen the international monetary system. We need a system characterized by more open capital accounts, flexible exchange rates, and independent monetary policies. Open capital accounts, supported by appropriate financial supervision and regulation, channel savings to their most productive uses, thereby enhancing welfare. Exchange rate flexibility improves domestic macroeconomic management, allowing countries to pursue independent monetary policies tailored to their individual needs, and limits unwelcome spillovers to other economies. Such a system can also flexibly adapt to changing economic and financial realities as countries develop, technology progresses, and shocks buffet the global economy.

Our current international monetary system does not yet fulfill these objectives. We now have a hybrid arrangement in which some economies have flexible exchange rates, maintain open capital accounts, and pursue independent monetary policy--a sensible reconciliation of the so-called impossible trinity. But other countries heavily manage their exchange rates, with varying mixes of capital mobility and monetary policy independence.

Inflexible exchange rates in these countries have tended to inhibit adjustment of unsustainable global imbalances in trade and capital flows. Indeed, as I noted, such imbalances appear to have fostered the buildup of vulnerabilities in the run-up to the recent financial crisis. Countries with current account surpluses and restricted capital flows have been able to resist currency appreciation for prolonged periods, even when justified by underlying fundamentals. In principle, adjustment of imbalances could occur if countries permitting relatively limited movements in nominal exchange rates allow their national price levels to adjust over time. But sterilization operations and other policy tools can, and often have, restrained such adjustment. Meanwhile, countries with current account deficits should take steps to increase national saving, including by putting in place credible plans to reduce their fiscal deficits in the longer run.

The international monetary system, in effect, still suffers from the same asymmetry that bedeviled the Bretton Woods system--namely, a marked differential in the pressures facing surplus and deficit countries to permit automatic adjustments or to undertake policy to reduce persistent global imbalances. Surplus countries can resist adjustment by restricting capital flows and exchange rate movements, but deficit countries are forced to adjust when they run out of international reserves or lose access to external borrowing. This asymmetry has served to inhibit the global rebalancing process, and it could threaten the ongoing recovery: If deficit countries curtail spending without offsetting spending increases in the surplus countries, aggregate demand would decline, with adverse consequences for the global economy.

Thus, in my view, we need to continue working toward an international monetary system characterized by more-flexible exchange rates, open capital accounts, and independent monetary policies that will facilitate the adjustment of global imbalances. But we must recognize that countries face diverse challenges in such a transition. For countries with undervalued currencies, the adoption of more-flexible exchange rates requires an internal shift in resources across sectors--a transition that takes time. As noted earlier, the recent crisis has also uncovered numerous flaws in the functioning of regulation of our financial system, and these, too, will take time to correct. Finally, although I have not addressed this concern in my remarks today, the expansion of public-sector deficits and debts in many countries poses very serious medium- to long-run risks for both the international monetary and financial systems that will need to be addressed.

Against the background of these longer-term issues, we must also support countries' efforts to address their more immediate challenges. Some advanced economies struggle with weak demand, high unemployment, and disinflation. Many emerging market economies face increasing inflationary pressures and capital inflows amid strong growth. In light of these differing challenges, a cooperative spirit among policymakers is essential to ensure prosperity of the global economy.