The future of the international monetary and financial system

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The Future of the International Monetary and Financial System

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Following the collapse of the Bretton Woods system, the international community sought new stability in the financial system and the assurance of sustained growth. The crisis that began in 2007-2008 has revealed weaknesses that affected advanced economies first and foremost. Efforts have since been made to consolidate the international financial architecture, to coordinate macroeconomic policy, and to improve foreign exchange relations, even if this latter objective has proven complex.

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The "International Monetary and Financial System" (IMFS or IMS, broadly-speaking) covers four major components with regard to the commitments of International Monetary Fund (IMF) member countries: rules governing international current account transfers and payments; capital flows; foreign exchange reserves; and, finally, exchange rate relations and the exchange rates that make up the IMS in the narrower sense. The key motivation behind the agreements and rules laid down in these different areas is to facilitate the exchange of goods and services, as well as capital flows between countries.

Let us focus on the evolution of the IMS following the dismantling of the Bretton Woods system. Established after the Second World War, it was a system of fixed but adjustable exchange rates, based on the US dollar, which was itself convertible into gold. Since the system was dismantled in 1973, relations between the convertible currencies of advanced economies have been based on the concept of the free floating of the currencies concerned, and, progressively, the free movement of capital.

The international community has endeavored, following the end of the Bretton Woods system, to seek the optimal monetary and financial relations to ensure the stability of the international system, while trying to create the conditions for significant and smooth growth.After a difficult period in the 1970s and the first half of the 1980s, advanced economies gradually entered a period of steady real growth and price stability, characterized by a marked mitigation of economic cycles and low volatility with regard to growth and inflation. Two interpretations may be associated with this "Great Moderation" of a little over twenty years – from the mid-1980s to 2007.

The prevailing view was that advanced economies, and to a large extent the world economy as a whole, were characterized by a close-to-optimal situation in terms of growth, price stability, and relative financial stability.

The contrary assessment pointed out that this period was marked by a succession of serious financial crises: sovereign risk crises in developing and emerging countries in Latin America, Africa, and the Middle East in the 1980s and early 1990s; financial crises in eastern and central Europe, culminating in the Soviet Union's collapse in 1991; the Mexican financial crisis of 1994; the sovereign risk crisis in Asia from 1997; the Russian financial crisis of 1998; and the bursting of the dot-com bubble in 2000. All of these crises together have formed a practically unbroken chain of catastrophic financial events from 1985 to 2007. This assessment also partially attributed these crises – as in the previous period of "stagflation" in the 1970s – to the lack of binding monetary and financial regulations in the new system of floating currencies since 1973.

These two assessments each reflected an aspect of the economic and financial reality. But after the subprime crisis of 2007, after the bankruptcy of Lehman Brothers in September 2008, and after the sovereign risk crisis of advanced economies (especially in Europe in 2010), we now know two important truths that had thus far unfortunately remained largely hidden. First, far from being moderate across the board, the "Great Moderation" was accompanied by the considerable accumulation of outstanding public and private debt, and hence of economic and financial risks, thereby creating not only the conditions for an abrupt reversal of the financial cycle, but also conditions of structural weakness for the entire financial sector. Second, this accumulation of risk was concentrated almost entirely in the financial sector of advanced economies. This concentration of risk, the weakness it entailed for advanced economies, and the outbreak of the crisis in these countries, came as a major surprise to many. Since the Second World War, the international community had grown accustomed to successive crises in developing economies, emerging economies, and centrally-planned economies, but not in advanced economies.

Without claiming to be exhaustive, three main reasons may be put forward to explain the extreme seriousness of the financial crisis that hit the advanced economies.

Crises in advanced economies

The first reason is the persistent increase, year after year, and the generalized excess, of private and public debt. This phenomenon had been almost entirely ignored by the international community prior to the outbreak of the crisis, as were the best economic analyses that accounted for such situations: particularly, Hyman Minsky's financial instability hypothesis and Irving Fisher's debt deflation analysis.

This excessive indebtedness revealed a serious flaw in the IMS in the broader sense, since it had no warning or prevention mechanism for situations involving abnormal debt accumulation levels. Nevertheless, it is difficult to attribute sole responsibility for the 2007–2008 global financial crisis to the laxity of the generalized floating exchange rate system. First, because the main criticism, *i.e.*, that of the "Triffin dilemma," which suggests that the dollar, as the sole anchor of the international monetary system, forces the US economy toward lax management, in order to supply liquidity to the world economy, applies both to the Bretton Woods system and to the post-Bretton Woods system, to the extent that the "exorbitant privilege" of the dollar remains in place *de facto*, if not *de jure*. It remains a fact that the spontaneous behavior of global economic and financial agents continues to grant the US dollar a privileged role, even though this role is far from exclusive, especially since the creation of the euro. Moreover, massive private and public over-indebtedness characterized almost all advanced economies, not just the United States, seeming to suggest that the practical functioning of the economy gave a *de facto* privilege to all advanced economies rather broadly, and not just the country or countries issuing the reserve currency or currencies.

A second reason lies in the widespread feeling of confidence and excessive calm, both in the public and private sectors, already mentioned as a component of the "Great Moderation." Low volatility with regard to real economic growth and inflation – in a context of significant growth and low inflation – was considered to be strong and sustainable. As such, pursuing prudent and wise policies did not appear, or no longer appeared, indispensable.

The governance of many private financial institutions had been exceptionally lax, and the financial risk management culture within these institutions was woefully flawed. This ignorance of the accrual of economic and financial risks was widely shared by the public sector and all public authorities, even though the Bank for International Settlements – the international sanctuary for central banks – had accurately assessed the dangers of the situation. This calmness of the public authorities was all the more paradoxical given that the accrual of private and public debt in advanced economies involved increasing risks not just for economic and financial stability, but also for price stability. The potential risks of deflation highlighted by Irving Fisher – in the case of private debt – could be added to the inverse risks of inflation – in the case of public debt and calls for the monetary funding of fiscal deficits.

This general feeling of calm and confidence was bolstered by a broad consensus among the international economic and financial community on the validity of "the assumption of the efficiency of financial markets." According to this assumption, the prices expressed by the markets incorporated to a very considerable extent the information available, and would therefore always be close to the "fair price." The belief in the market's efficiency was accompanied by the idea that the economic and financial system was always close to a Pareto equilibrium, while the possibility of multiple equilibria was to be disregarded. Before and during the crisis, Dynamic Stochastic General Equilibrium (DSGE) models, regardless of their qualities, appeared unable to account for the reality of the economic situation, its vulnerability, and the dynamics of the crisis. This led me to publicly state, in November 2010, that "in facing the crisis, we felt abandoned by our conventional economic tools." In the absence of a binding international monetary system, this general atmosphere of confidence, calm, and, in short, nonchalance, further reinforced the anomalies associated with the situation of excessive indebtedness.

Advances in information technology

As for the third reason, it relates to the impressive advances in science and technology, especially in information and communication technologies, which greatly amplify the multiple economic and financial dimensions of globalization.

In the field of financial instruments, technology has allowed for an unprecedented level of sophistication, thus enabling the emergence of multiple "derivatives" of traditional monetary and financial instruments that have contributed to the establishment of entirely new financial instruments and markets, which are obscure and hard to decipher due to their complexity.

At the same time, advances in information and communication have significantly increased the degree of interconnection between financial and non-financial institutions, and between markets and economies at the national, continental, and global levels. This unprecedented interconnection has given rise to new, untested features of the global financial system. The manifestation of a systemic risk of considerable magnitude came about abruptly following the bankruptcy of Lehman Brothers on September 15, 2008. The level of interconnection between the stakeholders of the global financial economy was now such that, in these exceptional circumstances, the correlation between the behaviors of private decision-makers across all markets in all advanced economies was extremely high – resulting in a worldwide panic with a near universal and almost immediate transmission of the initial shock.

In this respect, the financial crisis of 2008 differed radically from that of 1929–1930. In the case of the most serious financial crisis of the twentieth century, the transmission of the initial financial shock to other economic and financial entities, countries, and continents, was relatively slow. In the case of the twenty-first century financial crisis, this now universal transmission was instantaneous. What took a quarter in the 1930s now happened in half a day... In light of these technological advances, it is vital today for the international monetary and financial system to adapt to take into account these new “emerging features” of global finance. Any degree of complacency in this regard could be catastrophic.

In any event, the 2007–2008 financial crisis of advanced economies lies at the root of a multidimensional transformation of the international monetary and financial system. This transformation has only just begun. It must be pursued with resolve over the coming years, as the risks associated with the malfunctioning of the IMS in the broader sense are considerable.

Today, this structural change in the international monetary and financial system may be analyzed along two main lines. In the broader sense: a strengthening and deepening of the international financial architecture with a view to significantly enhancing its resilience. In the narrower sense: possible improvements in terms of exchange rate relations.

Strengthening and deepening of the international financial architecture

In the years leading up to the financial crisis, there was a broad consensus among reformers that the international financial architecture needed to be more inclusive, and around opening the doors of international financial consultation to emerging economies. The development of key guidelines for prudential regulations, standards and codes would include all economies with systemic influence. A further demand involved subjecting all entities involved in the functioning of the international financial system, and not just the banks, to a genuine international coordination of prudential regulations, so as to encompass the system as a whole.

Before the 2007–2008 crisis, the international community indeed continued to grant advanced economies a significant privilege. In the case of informal coordination in economic, financial, and monetary matters, the G7 held most of the authority and influence, at the levels of governors and finance ministers, and ultimately heads of state and government. Regarding the central banks, the group that had the leading role in terms of informally coordinating prudential regulations was the group of the ten largest central banks of industrialized countries, which meets in Basel.

Admittedly, the central banks had already decided to broaden the role of the Bank of International Settlements (BIS) "Global Economy Meeting," which brought together around thirty central banks, thus anticipating future developments in the architecture of international relations. But it was not until the crisis that this architecture underwent a shift. The G20 – which brings together all of the world's systemically important economies, and not just those of the advanced countries – came to replace the G7 as the main forum for informal consultation. This was a historic change. Naturally, this change in global informal governance needed to be accompanied by equivalent changes in the formal governance of international financial institutions, particularly the IMF and the World Bank. It is unfortunate that these changes have been slow, and on the whole remain arduous and inadequate.

The G20 has two fundamental global responsibilities: on the one hand, the coordination of macroeconomic policies at the level of systemically important economies; and on the other hand, the development of all prudential regulations, standards and codes, and regulations concerning the prevention of systemic economic and financial risk.

The first element is crucial. The lax macroeconomic policies of advanced economies were among the main causes of the disaster. Good coordination to prevent the emergence of excessive external deficits – which are merely a reflection of abnormal internal imbalances – such as the persistence of abnormally high external surpluses, is a prerequisite for global financial stability. Everyone knows how difficult it is, in normal times, for different nations, or groups of nations, to venture beyond the framework of mere national sovereignty in this area, in order to accept the idea of a greater common good, which is also in the national interest, namely the stability of the global economic and financial system itself. What appears to be obvious in the context of a serious global crisis remains very difficult to recognize in normal times. From this angle, the persistence and increase of abnormally high internal and external deficits and substantial surpluses more than ten years after the global financial crisis is extremely concerning.

The launch of the Mutual Assessment Process on the macroeconomic front, with the support of the IMF, is a theoretical first step toward a change that must be deepened and considerably strengthened if we are to avoid the repetition of similar crises. We can only raise the alarm in this regard, given the persistent increase in total public and private debt as a proportion of global Gross Domestic Product (GDP).

The second element of the G20's new responsibility has existed, virtually, since the Asian crisis – as a complement to the G7's responsibilities –, but the G20 has taken center stage with the recent financial crisis. The Financial Stability Board, created in April 2009, reports to the G20, while its predecessor, the Financial Stability Forum, reported to the G7. The Financial Stability Board now has seventy national member institutions, representing twenty-four countries and six regional and international financial institutions – in particular, the IMF, the World Bank, the Organization for Economic Co-operation and Development (OECD), the Bank for International Settlements, the European Central Bank, and the European Commission. It also includes six "international standard-setting bodies": the Basel Committee, the International Association of Insurance Supervisors, the Committee on the Global Financial System, the Committee on Payment and Market Infrastructures, the International Accounting Standards Board, and the International Organization of Securities Commissions. This list provides an idea of the complexity, but also the universal nature, of the interconnected global financial system created in recent years. It also goes to show that since the 2007–2008 global financial crisis, the two objectives of "inclusiveness" of all systemically important countries and "comprehensiveness" in considering all elements of the international financial system have been followed.

Lax macroeconomic policies have been among the main causes of disaster

Such inclusiveness and comprehensiveness are necessary for a better functioning of the IMS in the broader sense, but they are not enough. The progress to be made in this area is all the more significant as the new features of a system that is rapidly changing under the influence of globalization and technological developments are only gradually appearing, and are difficult to foresee. The key responsibility of the Financial Stability Board in this regard remains the correct identification and prevention of systemic risk.

Possible ways to improve exchange rate relations

Even if both elements of macroeconomic coordination and financial regulatory dialogue operated at their best – which is far from the case –, the international monetary system would still have serious imperfections in terms of exchange rate relations. Three important flaws may be highlighted, among others:

First, since certain currencies play the *de facto* role of reserve currency, the system remains potentially unbalanced. The dominant central currency must offer the additional liquidity required to support global economic and trade growth. The dominant economy is therefore forced to accept a structural current account deficit, mechanically funded through an increase in the foreign exchange reserves of other countries. There is a contradiction here between the aims of the dominant economy's internal monetary policy (which should in particular include the domestic stability of the global monetary anchor), and its external role as provider of global liquidity. This is the "Triffin critique," as previously highlighted, which in this case applies both to the dollar-centered gold standard exchange rate system and to the post-Bretton Woods system of floating exchange rates with a *de facto* dominant currency.

Second, in a system that lacks a neutral and objective monetary anchor (as is currently the case), the external financial constraint is massively asymmetrical. The constraint exerted on economies and countries with external deficits to balance their accounts is much stronger than the incentive for surplus countries to reduce their savings surplus. Of course, this is what we would expect the macroeconomic element of global regulation by the G20 (and the IMF) to do. But the asymmetry in the practical functioning of the monetary system (in the narrower sense) makes "mutual assessment process" efforts in particular partly ineffective.

Third and finally, in a system of free movement of capital, dangerous currency bubbles may arise on account of floating exchange rates. The tangible experience of post-1973 fluctuations shows that market investors, operators, and participants are capable of pushing exchange rate relations to unsuspected extremes *ex ante*. In the 1970s and 1980s, dollar fluctuations in relation to European currencies ranged from 1 to 3 ("Carter" dollar at its lowest, "Reagan" dollar at its highest). Since the creation of the euro, fluctuations on dollar-euro relations have been contained at about 1 to 2 (dollar at 0.83 at their lowest, dollar at 1.59 at their highest). Such wide fluctuations with regard to one of the most important prices, which expresses a key economic and financial relationship between the world's two major advanced economies and all the economies associated with the two major international currencies, are incompatible with global financial stability in the long term.

In short, while real, albeit still very modest, progress has been made in reforming the IMS in the broader sense, nothing has really been committed to in terms of exchange rate relations themselves, as part of the IMS in the narrower sense.

At best, one may notice that, during the 2007–2008 turmoil, exchange rate relations between major convertible currencies displayed a remarkable degree of stability. One may have reasonably feared that foreign exchange markets themselves would suffer a strong shock, and that a currency crisis would be added to the financial crises. This was not the case.

In the medium and long term, the reform of the IMS, in the narrower sense of exchange rate relations, remains crucial. Three dimensions are worth considering: the creation of a new global currency; the broadening and strengthening of Special Drawing Rights (SDR); and the improvement of current regulations regarding exchange rate relations between major convertible currencies – the legacy of the G7.

The creation of a global currency

As Keynes suggested in 1944, a truly international reserve currency issued by a global body with worldwide membership could theoretically provide real symmetry in external adjustments. It would also allow us – at least theoretically – to counter the Triffin critique, provided that the global currency's issuing body takes care to meet the increased demand for foreign exchange reserves by avoiding excessive growth and a liquidity deficit, while equitably redistributing the seigniorage associated with the currency issue.

Unfortunately, what may be desirable in theory is not necessarily so in practice. Implementing a genuinely global currency that acts as the anchor of the international monetary system is dependent on meeting certain economic, political, and politico-strategic conditions, which not only are currently non-existent, but will be difficult to meet in the future. One therefore wonders whether it is possible to imagine more realistic progress toward improved global monetary and financial stability.

Strengthening special drawing rights

SDRs are an international reserve asset created in 1969 by the IMF to complement the official foreign exchange reserves of member countries. The initial idea was to complement the fixed parity system by adding a third global reserve asset to gold – the ultimate reserve asset – and the gold-convertible dollar. The SDR is a potential claim that may be exchanged for the currencies of IMF member countries, based on voluntary agreements between member countries, or when the IMF selects member countries with strong external positions to acquire SDRs belonging to countries with poor external positions.

The SDR is not a currency. Nor does it strictly-speaking amount to a claim on the IMF. But it is, in theory, an instrument that allows for creating foreign exchange reserves in the event that domestic monetary policy constraints on the reserve currency – the dollar at the time – are incompatible with the creation of liquidity required for international economic and trade growth. In this respect, the SDR was created to mitigate the adverse effects of the Triffin dilemma.

The many advantages of Special Drawing Rights

At its inception, the SDR was worth 1 dollar or 0.888671 grams of fine gold. After the dismantling of the Bretton Woods system, the value of the SDR was pegged to a basket of five currencies (the G5 currencies: dollar, yen, deutsche mark, pound sterling, and French franc). Today, after the creation of the euro, the SDR basket still includes five currencies: the dollar, the euro, the yen, the pound sterling, and a newcomer, the Chinese renminbi. The weighting of this basket of currencies, set in 2015, points to the Chinese currency scaling up to third place: dollar 41.73%, euro 30.93%, renminbi 10.92%, yen 8.33%, sterling 8.09%.

Although it is not a currency but a basket of currencies, the SDR is, in many respects, a useful instrument for reforming the international monetary system. In particular, it includes three features that are worth highlighting:

- As a reserve asset, it is the only instrument that may be issued without being associated with a debt directly attributable to an economy;
- As a store of value, its aim is to represent a stable global monetary entity better than any floating national currency.

As a unit of account, the SDR has the potential benefits of lower volatility of its value, hence potentially lower costs of foreign exchange hedging. It may present compelling theoretical advantages as an international billing currency, and as a reporting currency, on commodity markets, for instance.

These features help explain why a large number of international institutions use SDRs as a unit of account. This is not only the case of the IMF, but also the Bank for International Settlements, the African and Asian Development Banks, the Universal Postal Union, etc.

Of course, these unit of account and store of value functions – which make the SDR a fairly "good" virtual currency in the Aristotelian sense (an instrument of exchange, a unit of account, and a store of value) – only become effective if the SDR is used substantially as part of official reserves, and is actively traded in liquid and deep private markets. However, the use of this instrument remains extremely modest: cumulative SDR allocations amount to just $204 billion, approximately.

For a reform of the IMS based on the promotion of the SDR, progress would need to be made in both "official" and "private" arenas. For the "official" SDR, the most promising routes are the following four: make greater use of the SDR; facilitate the diversification of foreign exchange reserves, particularly through the creation of a substitution account allowing for the conversion of the foreign exchange reserves of the various countries into SDRs; make holding SDRs more attractive, including through their remuneration; and finally, ensure at all times that the SDR basket composition accurately reflects the relative importance of the various economies in international trade and financial transactions.

In the case of "private" SDRs, a necessary, if not sufficient, condition for their development would be to design a genuine private market for the SDR, deep and liquid enough to have certain features of the instruments denominated in major international currencies. In view of the starting point – a non-existent private market –, such a goal calls for a huge effort. In particular, the international community would need to develop a multilateral clearing system – based, for instance, along the lines of the clearing model that the Bank for International Settlements managed in the past with respect to the privately-traded European Currency Unit (ECU). Another important aspect for the credibility of the private SDR is the negative impact of periodic revisions of the SDR basket. This pegging to a basket of currencies is the main drawback of the SDR. In order to mitigate this drawback, there would need to be full transparency with regard to the basket revision schedule.

In short, although the best theoretical solution for IMS reform remains the creation of a global currency, strengthening the use of the SDR presents itself as a second possible dimension of reform, albeit a similarly challenging one. The main issue is that even if the SDR comes close to being a "good" currency given two of its features (unit of account, store of value), it is still nonetheless a basket of currencies, whose nature changes over time. It was a change of this kind that made the key difference in Europe between the ECU as a "basket" in the 1990s and the euro as a "real currency" after 1999, which immediately climbed to second place among major convertible currencies, far ahead of the yen, in third place.

The SDR should not, for that matter, be dismissed as part of a long-term perspective, for two further reasons. The inclusion of the renminbi gives the SDR the status of a truly global instrument, and no longer one that represents advanced economies alone: the relative credibility of this reserve instrument will thus be enhanced in due course.

It is also worth considering an important phenomenon that I have described as "conceptual convergence," which characterized the central bank community during the crisis. This alignment between the positions of the various central banks expresses itself in many areas: for example, in the area of banking supervision – now almost unanimously considered as something that central banks can and must legitimately exercise –, or in the area of preventing systemic financial risks, in which most countries believe that central banks have an important role to play. But the most remarkable of alignments involves the convergence of large central banks with regard to the definition of price stability. All central banks issuing SDR basket currencies – except for the People's Bank of China – have followed the same definition of price stability – namely 2% in a medium-term perspective – since the Federal Reserve's decision in 2012, and the decision by the Bank of Japan in 2013, following earlier choices by the European Central Bank and the Bank of England. In my view, this is a phenomenon of great importance. For the SDR, the fact that four out of the five currencies in the basket now have the same nominal price stability target adds an additional element of credibility to this instrument, both as an instrument to retain value and as an instrument of account at the global level.

Improving the management of exchange rate relations between major convertible currencies

The most modest means to improve the functioning of the IMS would be to improve the management of floating exchange rate relations, as has been carried out since the dismantling of the Bretton Woods system within the G5 and then the G7 of governors and finance ministers of countries issuing major convertible currencies.

These regular informal meetings are often deemed by analysts to have no real bearing on exchange rates. This is not my feeling. When currency trends in foreign exchange markets have been deemed worthy of a clear and simple message sent by all G5 and G7 members to market participants and investors, this message has been received, understood, and has influenced foreign exchange relations. This was in particular observed after the 1985 Plaza Accord, where the message was that the dollar's decline in relation to other currencies was desirable; after the Louvre Accord in 1987, where the message was that the dollar's decline had been adequate, and that exchange rates were appropriate "around current levels"; after the April 1995 agreements, the message being that any further decline in the dollar would not be in line with the economic fundamentals of the countries concerned; and, finally, after the September 2000 agreements, where the symmetrical message was that any further drop in the euro would not be in line with the relative economic conditions in the euro area and the United States.

A glimpse of exchange rate relations between major currencies since 1973 may be summarized as follows: free floating is the rule, where exchange rates are determined by the decentralized decisions of all market investors and participants. However, this free floating may be tempered by the possibility of G7 members sending a signal to market operators when there is consensus among authorities (central banks and ministers) in assessing that the system's overall cohesion risks being seriously challenged by spontaneous behavior that goes far beyond what seems reasonable in light of the fundamentals and policies of the countries concerned.

Four conditions need to be met for markets to be significantly influenced by the messages sent out by authorities: the message must be simple and clear, ideally along the lines of "no further increase (or no further decrease) of a given currency in relation to others"; the economic and monetary fundamentals and the policies pursued by authorities must be in line with the recommendations of the message – market operators can only be persuaded if the message is not contradicted by the economic reality or by authorities' economic and monetary policy decisions; authorities themselves must take a financial risk, however modest, by intervening on foreign exchange markets, in order to give the signal credibility; and finally, it is key for G7 members to be clearly unanimous in conveying the message, so that no market participant may conclude that any one of the partners is simply paying lip service to the agreement. Since these conditions are only exceptionally met, the international community very rarely decides to suggest a relative containment of exchange rate relations to the market. Great freedom of action among market operators is therefore the rule at almost all times. The exchange rate system seems to be characterized by a principle of "asymptotic freedom."

By analogy with physics, we could say that there is a principle of relations between currencies at work not unlike the "strong interaction" that governs the relations between the three "quarks" within baryons – particles that make up the nuclei of atoms, protons, and neutrons, in particular. A simplified picture involves imagining the quarks connected by elastic bands. When the elastic bands are relaxed, the quarks have total freedom of movement. But if they move away from each other, the elastic bands stretch. It is in this context of "asymptotic freedom," tempered only by the tension of the elastic bands of strong interaction, when the quarks move too far away from each other, that the cohesion of the proton or the neutron is guaranteed.

Such a concept of very broad freedom, tempered by the need to contain the exercise of this freedom in order to ensure the cohesion of the whole, also seems to provide a rather good account of the nature of the new economic, financial, and monetary governance that must be practiced at the continental, regional, or global level. When sovereign countries are called upon to manage their economies in the context of strong interdependencies within a larger economic and financial entity – whether a continental integrated economy or a globalized world economy –, cohesion and prosperity may require the relative "containment" of everyone's freedom of management. I wish to offer four emerging examples of economic and financial governance that are, or should be, inspired by this concept of "tempered freedom."

A "tempered freedom"

First among them is the coordination of macroeconomic policies between systemically important economies (the G20 mutual assessment process). In the context of the freedom of management of sovereign countries, it is a question of containing possible excessive internal and external national imbalances, especially, but not exclusively, in the field of current account deficits and surpluses, when these challenge the stability of the global economy.

Second is the informal consultation prompting the definition of prudential regulations and financial standards and codes at the global level. In this area too, the principle of freedom of economic and financial decisions is applicable to each of the market economies that make up the global economy. But this principle of freedom – which is naturally applied in every nation, within the framework of the rule of law, without which there can be no market economy – is tempered at the global level by informal international consultation, conducted especially within the framework of the Basel Committee, the Financial Stability Board, and the G20. This consultation – referred to above as the second element of the G20's new responsibility – seeks to preserve global systemic financial stability, by containing certain key ratios within value "ranges" believed to preserve the cohesion of the whole, for instance in the case of banks (capital requirements and liquidity ratios).

Finally, in the third and fourth spots, the fiscal and economic governance of Europe and the euro area offer two further examples of "tempered freedom" in view of the need to ensure the cohesion of the whole.

As such, the members of the Economic and Monetary Union have agreed on a Stability and Growth Pact (SGP), which allows them a great deal of freedom to conduct their fiscal policy, provided that it does not cross certain limits considered to be detrimental to the stability and cohesion of the Union as a whole. The same goes for economic policy aspects that would be considered excessive in the context of the Macroeconomic Imbalance Procedure (MIP): European institutions, the Commission and the Eurogroup, reserve the right to make recommendations, of a binding nature if necessary, to temper the conduct of economic policy – but only if the stability of the entire Union appeared to be called into question.

Conversely, evidence has shown that inadequate compliance or non-compliance with "tempered freedom" regulations may indeed jeopardize the cohesion of the whole. Inadequate compliance: the financial crisis was partly the result of the lack of effective monitoring of the macroeconomic policies of systemically important economies, hence the creation of the G20 mutual assessment process. Inadequate compliance: the previous prudential regulations applicable to banks proved to be lax and ineffective during the crisis. Non-compliance with regulations: in Europe, the Stability and Growth Pact has not been adequately observed; Greece and Portugal have shown that a small number of countries with serious budgetary imbalances may jeopardize the cohesion of the whole. Absence of regulations: in the euro area, a lack of monitoring of competitiveness indicators and excessive current account deficits prior to the crisis explains a significant part of the difficulties faced by Ireland or Spain, which also challenged the cohesion of the whole. This should no longer normally apply, following the creation of the MIP.

Let us return to possible improvements in the practical functioning of the IMS, in the narrower sense, with regard to the practical management of exchange rate relations in the context of the G7 of governors and finance ministers. A simple albeit bold idea today would be for the main convertible currencies, and members of the SDR basket, to display the bilateral central rates considered to be reasonable equilibrium rates in a medium-term perspective. This would not involve returning to a fixed exchange rate system – free floating would remain the rule. Nor would there be bands of fluctuation fixed *a priori*, and the "containment" signals suggested to market participants would be based, as they currently are, on the consensus of the governments and the central banks issuing the participating currencies. But in the eyes of market participants, the public disclosure of the medium-to-long-term bilateral equilibrium rates calculated by the IMF and accepted by the authorities of the currencies concerned could play a significant role of systemic stabilization and would, in my view, offer a more convincing – and perhaps more effective – illustration of the concept of "tempered freedom." This would be the case even if the suggested containment could not be triggered mechanically or automatically, any more than it is today.

A further argument in favor of displaying the central rate relates to the recent "conceptual convergence" between central banks mentioned earlier. Since the central banks have very similar definitions of price stability in the medium term – and since they are mindful of the solid anchoring of their inflation expectations in a medium- and long-term perspective –, the possible display of their equilibrium bilateral central rates in the medium term would be significantly more credible.

The integration of the renminbi

Finally, the inclusion of the renminbi, which is now a full member of the SDR basket, in the informal consultation between the world's major currencies, introduces an additional factor in the improvement of the management of global exchange rates. It introduces greater inclusiveness and more credibility to the SDR, even if its status remains incomplete as long as the Chinese currency is not freely convertible.

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To summarize, the international community is in midstream with regard to the international monetary and financial system.

Drawing lessons from the crisis, it has made some progress, albeit very limited, in seeking coordination on the macroeconomic policy front, and has made real headway in developing financial prudential regulations, standards, codes, and principles at the global level. This progress is real. Countries with systemic influence – including emerging economies, and not just advanced economies, as was the case before the economic and financial crisis – are now present as part of this informal global governance. But progress remains very insufficient and there is no room for the slightest degree of complacency with regard to the global situation.

Similarly, the global community has made virtually no progress in terms of exchange rate relations, compared to the *de facto* management system that is the legacy of the G7, whose most striking illustrations have been the Plaza and Louvre accords, as well as the successive examples of consensus that led to the messages issued to market participants, particularly in April 1995 and September 2000.

While the creation of a global currency – which Keynes suggested in 1944 – is out of reach, I am not entirely pessimistic with regard to conceivable future progress in two other possible dimensions of reform: Special Drawing Rights and the pragmatic management of exchange rate relations between major convertible currencies. And there are four reasons for this.

First, a worldwide awareness that the lessons of the worst financial crisis of the twentieth century demand an inclusive and systemic approach to the economy and to global finance. It is a question of gradually building a new concept of international cooperation for a world that is both more multipolar and more decentralized in its decisions, as well as more interconnected.

Furthermore, the "conceptual convergence" between the central banks of advanced economies, as expressed in the area of inflation in particular, with a common definition of price stability at 2% in a medium- and long-term perspective, may facilitate possible progress.

Equally important is the emergence of the renminbi (and later other major currencies of emerging economies), whose integration into the SDR and into informal consultation between major currencies should allow for fresh progress at the global level.

Finally, the clear understanding, apparently shared by all central banks, that while cyclical exchange rate fluctuations are useful and legitimate within certain limits, the systematic pursuit of a competitive advantage based on the greatest possible depreciation of the world currency on foreign exchange markets would be contrary to everyone's interest, and to the cohesion of the global economic system as a whole. The rejection of the beggar-thy-neighbor policy is among the great lessons of the crisis of 1929–1930.

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