A MONETARY VIEW ON THE ACTIVITY OF INTERNATIONAL FINANCIAL INSTITUTIONS AND SUSTAINABLE DEVELOPMENT IN A GLOBALIZING ECONOMY

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In order to generate enough funding for sustainable development it can be used money creation, but money creation implies a very serious risk: runaway inflation, which can be avoided if money creation should be tied to strict conditions. Money creation must be an international, global effort in which all international financial institutions, the major central banks and the leaders of all nations with internationally accepted currencies should participate. It would be impossible for money creation to take place in only a limited number of countries, as national and international holders of the currencies involved would rapidly exchange their holdings to other currencies. That would drive down the value of the currencies that would be created, resulting in massive inflation due to loss of faith. To maintain faith in the value of money, money creation should be done by the most reputable international financial institution: the IMF. Moreover, it should get the full support of the majority of the international financial and economic community - including the directors of the main central banks and the leaders of all nations with internationally accepted currencies. The supply of newly created money to a particular country should be tied to the execution of a comprehensive, multi-year sustainable development program. All national programs should fit into a global program that should be matched with global productive capacity. Fitting the national programs into the global program would be the task of a global development organization: something comparable to current international development organizations such as the World Bank and the United Nations Development Program (UNDP).The worst case scenario would be a total loss of confidence in money and a consequent economic and financial collapse. If the problem of chronic and growing imbalances between productivity and demand is not solved, almost certainly it leads to a major financial crisis.

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The recent turmoil in financial markets has now led to a much more uncertain situation**.** Although market liquidity problems should recede in the coming months, wider credit spreads would persist, reflecting a welcome reappraisal of risk following a period of unusual compression. Overall, we believe that a combination of solid fundamentals and appropriate action by central banks and other authorities should help to calm rough financial waters and provide resilience to the global economic expansion. In advanced economies, economic fundamentals remain solid. The balance sheets of core financial institutions were strong at the onset of the current market turbulence, while the financial positions of corporations remain robust. These economies also entered into the period of turmoil with positive levels of business confidence, and generally healthy situations in labor markets and household net wealth. As for emerging market countries (EMCs), recent growth momentum has been very strong and improved balance sheets and policy frameworks have provided resilience in the face of the current turmoil. Many EMCs now have current account surpluses, and have built up substantial international reserves. Fiscal and monetary policy frameworks have also improved in many of these countries. Price stability has become the cornerstone of monetary policy, and a number of countries have adopted, or are moving to adopt, inflation targeting.

Many also have flexible exchange rate regimes, which can act as a shock absorber to rapid changes in external circumstances. And their direct exposure to the U.S. subprime market remains quite small. As a result of these positive factors, EMCs have been relatively less affected by the recent turbulence. That said, there are "pockets of vulnerability"-particularly in countries that have depended heavily on external flows to finance large current account deficits and rapid credit growth. Looking back, the past decade or so has been a period of rapid and far-reaching change for the global economy, as the process of globalization has accelerated**.** But this impressive progress has been interspersed with episodes that were difficult, and even threatening, at times. National policymakers, regulators, and international financial institutions-including the IMF-have had to adapt to keep pace with these changes. And the latest financial market volatility has brought new challenges. The recent developments in financial markets came at a time when spreads and volatility were at historic lows. The "search for yield" led to a relaxation of credit standards, most notably in the U.S. subprime housing market. Securitization and financial innovation made it easier to transfer credit risk. But they also appear to have encouraged lenders to focus more on the volume of business and less on credit quality. This, coupled with the creation of very complex credit structures that were viewed as diffusing risks, led to a general sense of complacency. In this environment of complacency and yield-seeking, creditors did not adequately assess risks in many cases-they may not have had sufficient tools with which to conduct due diligence, or they may have been overly reliant on third party assessments, such as those of ratings agencies. Seen in this light, if financial market developments represent a return to greater market discipline compared with the recent past, this should be good for the global economy in the longer-term. More realistic asset valuations-a "rebalancing" of the assessment and pricing of risk-should provide the foundation for medium-term global strength. The rapid reprising of risk and the lack of transparency regarding exposures of financial institutions to distressed assets has raised a host of uncertainties. With markets drying up, it has become difficult, if not impossible, to value some structured credits. This has been particularly problematic for investors who funded purchases of these credits with short-term loans. The reliability of credit ratings has been called into question. Reputational risks may have forced banks to internalize losses of otherwise independent entities, and relatively new and opaque structures may have masked off-balance sheet exposures and contingent liabilities. We have seen this particularly in the case of some German banks, where there was considerable surprise at the extent of their exposure to the U.S. subprime market. This has raised the question about whether the relevant perimeter for risk consolidation is larger in this complex financial world than the usual accounting or legal perimeter. As a result of the dramatic drying up of liquidity in some funding markets, several central banks-including the ECB, the Fed, and the Bank of England-have taken steps to facilitate access to their discount windows in order to restore the smooth functioning of markets. The key risk is that of a sustained deterioration in financial conditions. A broad pull-back from risky assets is also possible. And credit conditions could become substantially tighter for households and corporate. The macroeconomic consequences of such a deterioration in financial conditions are hard to calibrate, however. This is partly because financial linkages have been underdeveloped in macroeconomic modeling. But, beyond this, markets themselves have changed rapidly in recent years. Until now, many of the new instruments-particularly complex derivatives-have been untested at times of stress. However, we can identify key areas of risk that would have a macroeconomic impact if they were to materialize. I will briefly discuss these now.

The risks to EMCs are likely to depend on country-specific circumstances. The main downside risks come from the deterioration in the external environment, and the possibility that investors will shy away from the EM asset class. However, increasing trade and financial linkages also make them susceptible to a more insidious slowdown in global growth. Even so, the reasons for concern are much greater in some countries than in others. A number of countries have relied on large external inflows-particularly bank flows-to finance current account deficits, credit growth, and rapid asset price increases. These inflows could be affected by a general retrenchment of risk, especially if market liquidity remains limited. But even in some surplus countries, reliance on bank flows to fund credit growth has increased countries' vulnerability to reductions or reversals of these flows.

We have mainly spoken about risks to the short-term global outlook, but there are also key medium-term vulnerabilities that are important to bear in mind. The most pressing of these is the issue of global imbalances, which are projected to be large and persistent for the foreseeable future. An orderly rebalancing of the pattern of current account balances and of currencies-as highlighted by the title of this seminar series-is needed to resolve global imbalances.

Financial globalization has allowed the smooth financing of persistent imbalances between savings and investment.

What can the IMF do to help resolve global imbalances? The IMF initiated the first Multilateral Consultation to focus on reducing global imbalances while sustaining strong global growth. During the 2007 Spring Meetings, the five participants-China, the Euro area, Japan, Saudi Arabia, and the United States-jointly set out their policies aimed at reducing the risk of a disorderly resolution of these imbalances. These policy plans were concrete and mutually consistent. They are also in each participant's own interests, and some progress has been made on several fronts. The key now is sustained implementation.

We have seen the benefits most pointedly in the strong global growth of recent years-particularly in EMCs. But we have also witnessed new challenges, especially over the past few months where new channels for the propagation of shocks have become evident. This has made it even more important that the IMF's tools for monitoring and assessing risks be continuously upgraded.

The IMF is making every effort to strengthen surveillance of our members' economies and of the global economy. Why the emphasis on surveillance? We know that many observers believe that the IMF is mainly a "firefighter" which provides emergency financial assistance to countries during financial crises. This is one of IMF's roles. But, thanks to improved policies and a benign external environment, many countries have not needed to borrow from the IMF. In fact, several members have repaid the IMF. All of this has occurred at a time of vast changes in the global financial system. To better respond to the challenges of an increasingly globalized economy, the IMF is in the process of reforming the surveillance framework.

In order to generate enough funding for sustainable development it can be used money creation, but money creation implies a very serious risk: runaway inflation, which can be avoided if money creation should be tied to strict conditions. Money creation must be an international, global effort in which all international financial institutions, the major central banks and the leaders of all nations with internationally accepted currencies should participate. It would be impossible for money creation to take place in only a limited number of countries, as national and international holders of the currencies involved would rapidly exchange their holdings to other currencies. That would drive down the value of the currencies that would be created, resulting in massive inflation due to loss of faith. To maintain faith in the value of money, money creation should be done by the most reputable international financial institution: the IMF. Moreover, it should get the full support of the majority of the international financial and economic community - including the directors of the main central banks and the leaders of all nations with internationally accepted currencies. The supply of newly created money to a particular country should be tied to the execution of a comprehensive, multi-year sustainable development program. All national programs should fit into a global program that should be matched with global productive capacity. Fitting the national programs into the global program would be the task of a global development organization: something comparable to current international development organizations such as the World Bank and the United Nations Development Program (UNDP).The worst case scenario would be a total loss of confidence in money and a consequent economic and financial collapse. If the problem of chronic and growing imbalances between productivity and demand is not solved, almost certainly it leads to a major financial crisis.

The international financial system is unstable and subject to serious crises. The crises are a recurrent feature of the international economy and they represent market failures that not only imply some resource misallocations, much more, shocking setbacks in the growth prospects for the emerging economies, with serious implications for income distribution and living standards for their citizens. The Asian crisis was, in fact, the outcome of an interaction between the failings of markets, the failings of governments, and the failings of the international monetary system. The international capital market has an unquestionable responsibility in the Asian crisis. The markets are intrinsically imperfect, as is their information. Governments, too, bear a major responsibility in the Asian crisis. Multilateral institutions also must shoulder some of the blame for this crisis. Their interventions have not always been appropriate for preventing the recent crises or indeed for solving them. They may have encouraged governments and local banks as well as international investors to take excessive risks in the emerging countries. The application of predetermined solutions may also have helped aggravate the crises under way. Most important is the fact that the international community has tended to intervene belatedly because of the decline of the G-7 and the problems this created for international monetary cooperation. The efficiency of the multilateral financial institutions was severely undermined as a result.

At the most general level, policymakers in open economies faces a macroeconomic „trilemma”. Typically, they are confronted with three desirable, yet contradictory objectives: to stabilize the exchange rate, to enjoy international capital mobility, to engage in a monetary policy oriented toward domestic goals. Because only two out of the three objectives can be mutually consistent, policymakers must decide which one to give up: this is the „trilemma”.

The decline of the G-7 and of monetary cooperation bears a special responsibility in this development. The decline has substantially weakened the scope of preventive action by the multilateral financial institutions in response to governments' economic policies and to unstable investor behavior. Countries whose financial systems had not been adjusted were allowed to lift all controls on capital movements with the rest of the world, and in some cases they were actually encouraged to do so.

The argument would be that the world's rising monetary and financial instability is due to fixed exchange rates and the support they have received from the international community, notably the International Monetary Fund (IMF). The corollary of this position is that strict curbs should be placed on IMF interventions. In a universe in which all agents were perfectly informed, we might assume that this recipe would ensure international monetary and financial stability-provided that economic policies converged. But we know that this is not the case. In practice, policy convergence-whether in the monetary or the fiscal sphere-has not proved to be a sufficient guarantee of monetary stability.

The alternative solution would be to strengthen international monetary cooperation, and the focus should be on exchange rates. Not that exchange rates should be manipulated-quite the contrary. However, they do exhibit three characteristics that make them irreplaceable as tools of international monetary cooperation. First, they are, by nature, variables of common interest. Second, as relative prices of currencies, they provide reliable confidence indicators for the economic policies carried out in the different currency zones. Third, exchange rates are valuable signals of economic imbalances.

This leads us to recommend a reform of the system aimed at providing greater stability-but without introducing a "fixed factor" that could compromise the growth of unsynchronized economic regions. Several approaches are possible here. They all hinge on the notion of a cooperative effort focused on the dollar-euro link, which forms the basis of the international monetary system. This implies an intensive dialogue between US and European authorities.

It must be emphasized that the quality of the cooperation depends on the quality of the currencies. Unfortunately, studies on the monetary policy of governments and central banks seldom address this quality issue. The monetarist arguments for regulation through quantitative management of the money supply have exerted such intellectual dominance that the quality of the currency is almost never discussed any more. In the past, it was inherently demonstrated by the functioning of the gold standard. While the issue may seem less urgent in the leading industrialized nations, the same is not true of the emerging economies.