TOWARDS A REFORM OF THE GLOBAL RESERVE SYSTEM[1]

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It is a pleasure to be here and to have an opportunity to discuss what I consider to be one of the most important matters facing the world economy today. One of the difficulties in the global financial system is that in some sense almost everything is endogenous, yet we are always observing each of the pieces separately. I will be focusing on an important aspect that has not yet been sufficiently emphasized, at least in more recent discussions, although several of the themes I will talk about have strong historical antecedents.

The problems with the global financial system are highlighted by persistent global imbalances and high levels of instability. This is a topic of discussion at almost every meeting of global leaders. When these leaders get together they all have to share blame. The United States gets blamed for its fiscal and trade deficits, Europe gets blamed for slow growth, as if it had deliberately decided to grow slowly in order to punish the rest of the world, and China gets blamed for its undervalued currency. Whatever merits there may be in the sense of shared blame, I want to put this into perspective.

The United States' trade deficit is more than US$850 billion, whereas China's multilateral trade surplus is only about US$150 billion; when the US started talking about China's trade imbalances, it was actually close to zero. China has been growing very rapidly, but even if China were to eliminate its current US$150 billion trade surplus, and if all it would translate into is a reduction in the US trade deficit, the US deficit would still stand at some US$700 billion, or just under US$2 billion per day. Thus, the likely outcome of China eliminating its trade surplus would be very little change in the US multilateral trade deficit. The United States would quite simply start buying textiles and apparel from Cambodia, Bangladesh, or some other country rather

[1] Remarks prepared for the Money and Banking Conference of the Banco Central de la República Argentina, Buenos Aires, June 4, 2007. Many of these ideas are elaborated in my book *Making Globalization Work* (New York: WW Norton, 2006) and in a paper I wrote with Bruce Greenwald presented at the American Economic Association meetings in Boston, January, 2006, entitled "A Modest Proposal for International Monetary Reform."

than from China. There is a real risk that global instability might actually be increased, because while China may be willing to finance the US deficit, it is not clear whether Cambodia or Bangladesh would. It is plausible that these countries will think it better to invest their money into their own country; and if they do lend their money abroad, they are more likely to put it into euros or yen, rather than just financing the US deficits by holding dollars, which are a depreciating asset.

Thus, while it is true that even if China did not buy US bonds another country would, to induce those purchases may require large changes in asset prices. There is a high likelihood of what has come to be called a disorderly adjustment, and such adjustments are likely to be painful.

Some people say, “Well, some countries are going to have a surplus, and some countries are going to have a deficit. Why do we think that a US trade deficit of US$850 billion is a problem? We are just observing the outcome of an ordinary, competitive, global general equilibrium.”

I think there is something peculiar about the richest country in the world not being able to live within its means. The rich countries are borrowing while the poor ones are lending: US$500 billion last year flowed from the poor countries to the rich ones. Deficits might be acceptable if the money was to be spent on investments to make the economy more productive, but a lot of this money is going to finance consumption, particularly in the United States. Given its demographics, this is a period when people in the United States should be saving and not borrowing. There *is* fundamentally a problem. We should be worried.

But who is to blame for the current global imbalances? I argued above that attention should be focused not on China’s undervalued currency but on America’s trade imbalances. But who is to blame for the trade deficit? President Bush has been rightly criticized for many of the world’s current problems. He has undermined multilateralism. The Iraq war set off soaring oil prices. He has mismanaged the government finances—cutting taxes for the rich, the very people who have done so well in the last quarter century, creating a structural fiscal deficit that will take years to get rid of. The United States is spending not just on tax cuts for the rich and on the Iraq war, which it is estimated will cost in excess of US$2 trillion in the long run, but on a host of other things, including corporate welfare. The national debt will have increased by close to 50% under his watch—America will be paying for his mistakes for years to come.

But is Bush to blame for the trade deficit? The standard analysis is based on the theory of the twin deficits, which holds that when a country has a fiscal deficit, it is likely to have a current account deficit as well.

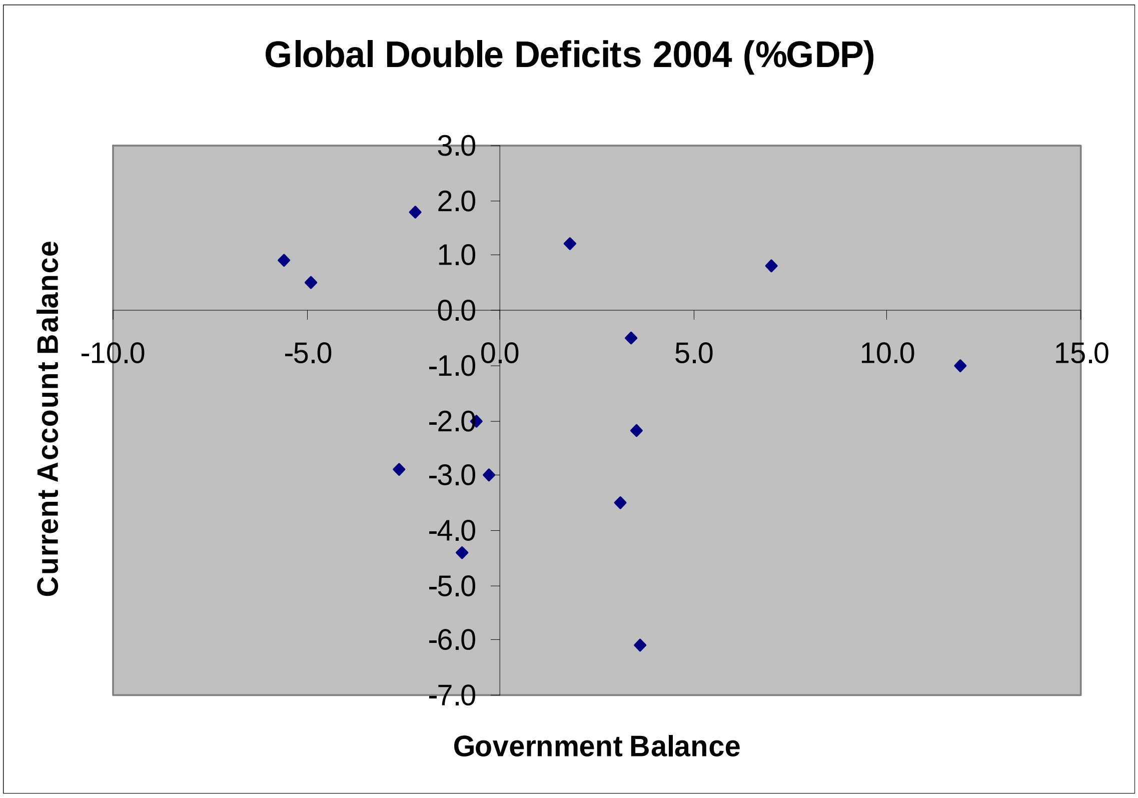
In a partial equilibrium setting the relationship is clear: ceteris paribus, any increase in the government deficit reduces domestic national saving. In equilibrium, capital inflows have to equal the difference between domestic investment and domestic savings; but capital inflows also have to equal the difference between imports and exports. Hence, if domestic savings falls *and nothing else changes,* then capital inflows and the trade deficit *must* increase.

Of course, in the real world, other things can and do change. Some economists have argued that when fiscal deficits increase, taxpayers, realizing that there are future bills to be paid, increase their savings *in a fully offsetting way*. (This is called the Barro-Ricardo model). If that were true, increased fiscal deficits would be accompanied by increased private savings, and national savings would be unaffected. Fiscal deficits would not be accompanied by trade deficits.

This is an example of a "theory" that, although widely taught in graduate schools, makes little sense and has little empirical support. What has been happening in the U.S. recently provides a dramatic illustration. Under President Bush, fiscal deficits have risen, but household saving has actually declined (to zero, or even negative in some quarters). When you hear somebody say, "Economic theory says…" one has to be cautious. Often such statements refer to a theory that assumes perfect markets, perfect information, and perfect risk markets, in an economy with identical individuals living infinitely long; the assumptions are suspect in the most advanced industrialized countries but are certainly not true in the developing world.

The Barro-Ricardo model, though, does make one important point: we are not living in a *ceteris paribus* world; there are lots of other things going on simultaneously. You can see this if you look either at cross section or time series data. Figure 1 provides data on trade deficits (current account balances). If you believe in the twin deficit argument, the data would be aligned along a 45 degree line through the origin; the two would increase in tandem. In fact, no real pattern is discernible in the data.

FIGURE 1



More interesting is the time series data, shown for seven countries in the following figures. Again, "twin deficit theory" has an obvious prediction: an increase in the fiscal deficit should be quickly reflected in an increase in the current account deficit. Figure 2 shows data for the U.S. What is striking is that the trade deficit has been steadily increasing *regardless* of what happened with the fiscal deficit and regardless of who was in the White House. In the 1990s the trade deficit increased, even as the fiscal deficit decreased. (The good thing about the 1990s was that it was linked to an increase in investment. In the 1980s and in this decade under President Bush, money is to a large extent going into a consumption binge, with household savings approaching zero. From a balance sheet perspective it does make a big difference; borrowing to finance an asset rather than consumption leaves the balance sheet obviously much worse off.)

FIGURE 2: United States

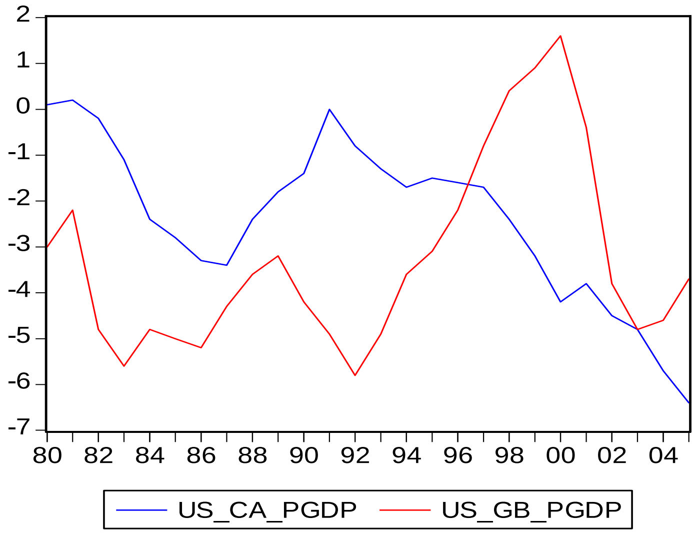


FIGURE 3: Japan

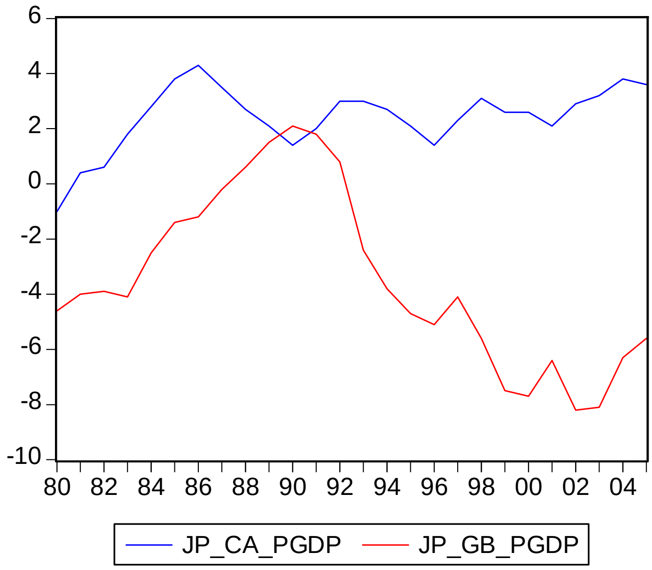


FIGURE 4: United Kingdom

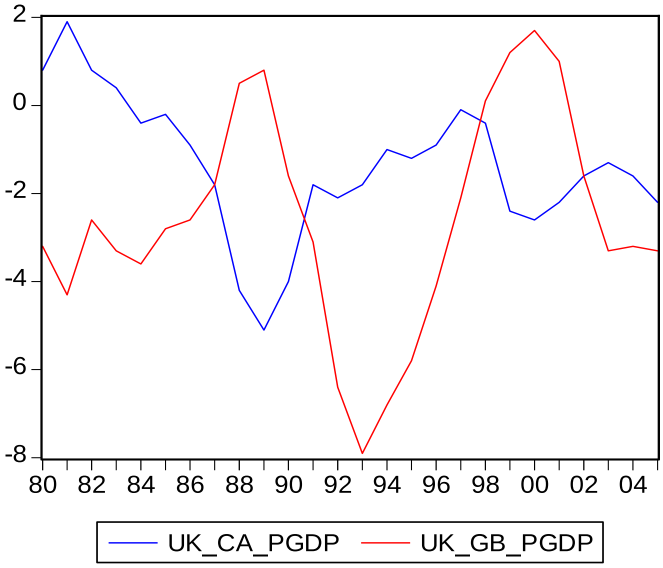


FIGURE 5: Germany

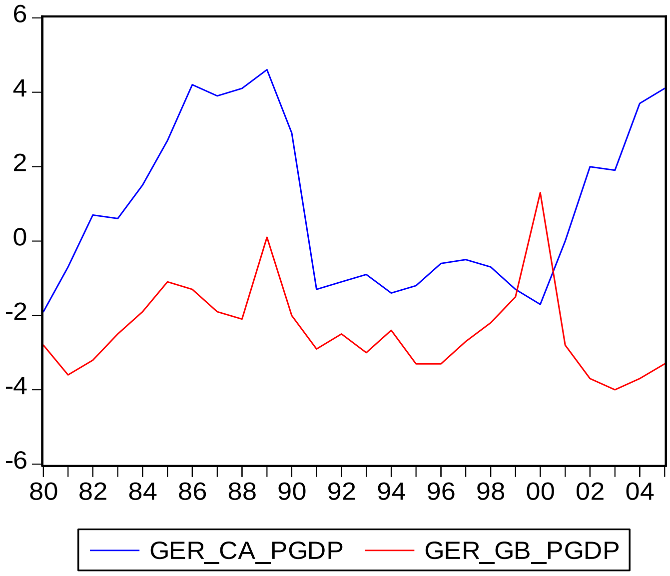


FIGURE 6: Italy

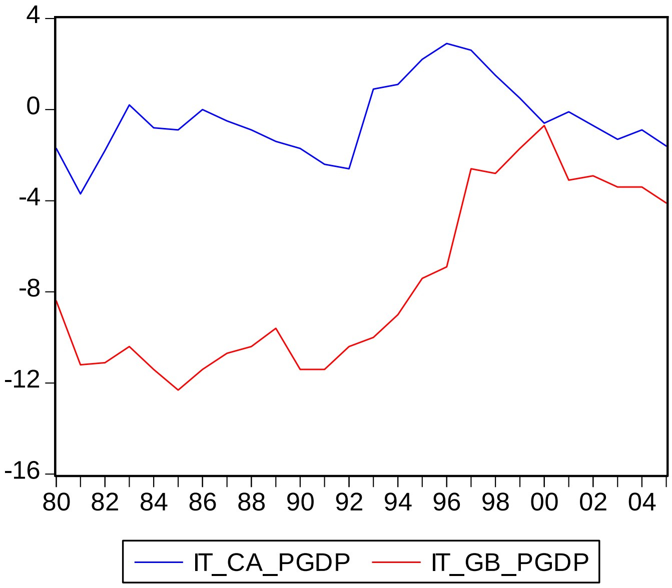
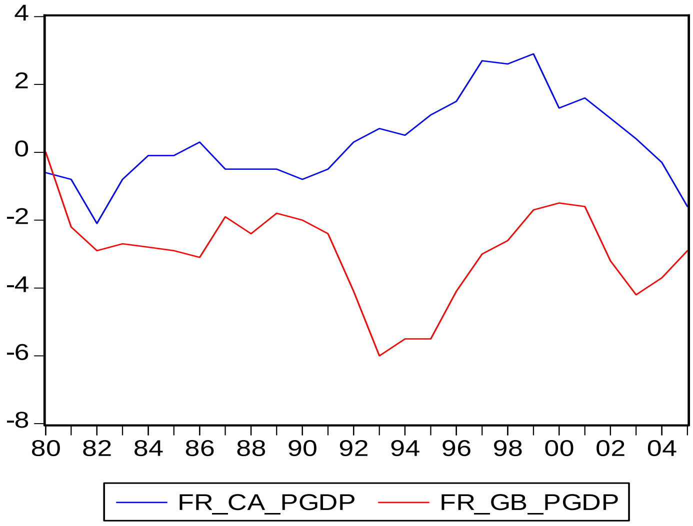
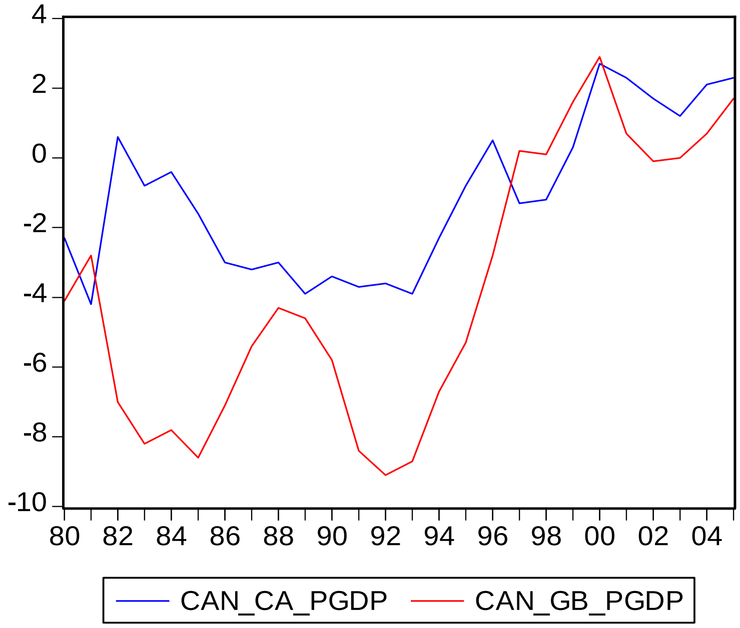


FIGURE 7: France



It is clear from the data that there is no systematic relationship between the trade deficit and the fiscal deficit; in other words, there is no such thing as the "twin deficits." Actually, if one looks at the other G-8 countries, it is also apparent that there is no systemic relationship, except for in one country, Canada (see Figure 8). I want to highlight Canada's story, because there is an interesting theory behind it. In the case of Canada there is a systematic relationship, but it is not the fiscal deficits that are giving rise to the trade deficits. Rather, if we do a Granger causality test, it appears that the fiscal deficit is endogenous and is being driven by the trade deficit. It is actually easy to understand what is going on, on the basis of standard Keynesian economics.

FIGURE 8: Canada



Fiscal deficits are what they are in order to maintain the economy at full employment. For a country like Canada, at least in the very short run, the trade deficit (capital inflows) is exogenous. A downturn in the U.S. economy reduces, for instance, Canada's exports to the U.S. and increases the trade deficits. But as external circumstances affect the economy (e.g. exports going down), the government has to respond. It typically uses fiscal policy to stimulate the economy to offset a potential threat of recession. Thus, it is the fiscal deficit that follows the trade deficit.

While the notion that trade deficits drive fiscal deficits seems plausible for a small country like Canada, I want to examine the view that at least in part capital flows should be treated as exogenous for the United States, and increasingly so for Europe.

Foreigners want to hold T-bills in their reserves, and exchange rates and other asset prices have to adjust to ensure that this is possible. In other words, countries around the world have a demand for reserves to protect themselves from the enormous volatility of world financial markets. They saw what happened in the global financial crisis of 1997-

1998 to countries that did not have sufficient reserves—a loss of economic sovereignty as the IMF dictated economic policies that plunged them into recession and depression. When I visited one East Asian country, the Prime Minister said to me, “You and I were in the class of 1997. We learned the hard way what happens when you don’t have enough reserves and you invite the IMF in. Never again; we will accumulate enough reserves to protect ourselves against the likelihood of the IMF dictating our economic policies in future.”

There has, in fact, been a massive increase in reserves in developing countries, in the trillions of dollars. This increased holding of reserves is largely responsible for the increase in capital flows from the developing to the developed countries.

From this perspective, the dollar reserve system is the root of the problem. In fact, as Keynes pointed out, the UK had a similar problem when sterling was the reserve currency. As I sometimes put it: countries that export more T-bills export fewer automobiles. The demand for sterling for reserves contributed to a strong pound, and with a strong pound it was difficult to export products and to compete with imports. The problem is that exporting T-bills (in contrast to automobiles) does not generate jobs. One of Keynes’s arguments for the founding of the IMF was to solve this problem, which contributed to Britain’s half century of slow growth. He wanted to create a new global currency, bancor, that would be held in reserves rather than sterling. While in a fundamental sense he failed, Britain’s problem was solved, as the US dollar became the reserve currency. The problem was shifted from the United Kingdom to the United States. Now, Europe wants the distinction of sharing this responsibility with the United States for reasons that are not totally clear. The problem is that as Robert Triffin pointed out many years ago, the current system is unsustainable. As the IOUs of the reserve currency country (now the dollar) accumulate, there may come a point where confidence in the reserve currency erodes, and as confidence erodes, central banks move out of the dollar, which weakens the dollar and reinforces the problem.

Is there a tipping point, and if so, are we near there? Around the world many central banks believe that the dollar reserve system is at the very least strained. The dollar reserve currency system is fraying. There is a growing lack of confidence in the dollar, which feeds on itself. As I said, the process may be unstable.

One feels the fraying of the dollar reserve system most strongly in Asia, which is the major source of global savings. Asia recognizes that it is paying a high price for re-circulating their savings in the West. The transactions costs are large, but even larger are the costs of putting their reserves in dollars (dollar denominated assets). Asia has been paying a high price for going along with the dollar reserve system, and, not surprisingly, they have begun to explore alternatives which I will talk about later.

One of the consequences of this enormous increase in reserves is the problem of insufficient global demand. In a sense, when a country holds reserves, it is burying purchasing power in the ground. In the past, the insufficiency in global demand that resulted from the reduced purchasing power as money was buried in the ground was made up for by loose monetary and fiscal policy. Governments all over the world were willing to spend beyond their income. However, in recent years most countries have been persuaded of the virtues of fiscal and monetary rectitude, and the countries that provided this service of maintaining global demand through loose monetary and fiscal policies were punished.

We have come to a new stage in the global economy in which the US has become the consumer of last resort. In fact, the US Treasury Secretary, often talks about the service the American economy is providing to the global economy by consuming beyond its means and how without this service (reflected in the US$850 billion that America is borrowing from abroad) the global economy would be much weaker. His stance has been that rather than criticizing America for its trade deficits, everyone should be thanking us for our consumption. But there is fundamentally something strange about this service coming from the richest country in the world when others are obviously so much more in need. There is something wrong with the global financial system which requires that the richest country in the world should spend beyond its means to maintain global prosperity.

There are further problems of global inequity. In effect, developing countries are lending the US trillions of dollars at low rates at the same time as they are borrowing money back at much higher rates. Consider the standard prescription that countries are told specifically after they have faced a crisis: “Keep reserves at least equal to your short-term dollar denominated or hard currency denominated short-term liabilities." Think about what that means if a company in a poor African country borrows US$100 million from a US bank and pays say 20 or 25% interest; that means the government has to hold US$100 million more in reserves. It borrows from the United States, but it lends to the United States exactly the same amount, making it a wash, except for one thing. When it borrows from the United States, it pays 20 to 25% interest; when it lends to the United States, it is getting, say, 5% interest (for a while it was getting only 1% interest). This amounts to a massive foreign aid program from underdeveloped countries to the United States, far more than all the foreign aid that the United States gives. Certainly, with the economic policy of the current administration, the United States is in need of foreign aid, but there is again something very peculiar about poor countries giving foreign aid to the United States.

The system also contributes to instability in a second way besides the one that I have described. There is a basic trade identity, which is that the sum of the surpluses equals the sum of the deficits. One of the nice things about trade identities is that they are always true. What that means is that if some countries insist on having a surplus, some others must have a deficit. If the deficit of one country goes down, and the surpluses of other countries stay the same, the deficit of some other country has to go up. In other words, one can think of deficits as like hot potatoes: if one country eliminates its deficit, it has to appear somewhere else in the system, unless the surpluses disappear. Japan, for example, has in one way or another insisted on having a surplus. In the past, the deficits moved around the developing world. As one country's deficit became too big, it would face a crisis, which would force a change in policy that would eliminate its deficit, but then the deficit would appear in some other developing country. This pattern was so evident throughout the crises of the 1990s and early years of this decade. But just as developing country governments have worked hard to reduce fiscal deficits, so too have they for their current account deficits. They have learned the dangers of excessively large trade deficits. The US has again come in to fill the breach; it has become the deficit holder of last resort as well as the consumer of last resort. The question is, is this sustainable?

One of the important implications of this analysis—one that Keynes emphasized—is that the surplus countries are as much a part of the systemic problem as the deficit countries. They have a negative effect on global aggregate demand, and they “force” some other country or countries to go into deficit. He suggested there should be a tax on the countries with a surplus to provide the appropriate incentive to contribute to global aggregate demand.

Finally, I want to suggest basically an extended and revised version of a proposal that Keynes talked about 75 years ago. The system was not adopted then, but I think the time for adopting such a system may now be right. The problems of the current reserve system have become much more evident, the world is much more integrated now that it was then, and accordingly, the effects are much more pervasive. With the decline of the dollar and the fraying of the current system, it is clear that there will have to be changes. The question is whether we shape the changes to create a new global reserve system which is more stable and more equitable.

The basic idea is simple: create a global reserve currency in amounts commensurate with reserve accumulation, offsetting the negative effect on aggregate demand. Obviously, the new reserve money would not be inflationary; it would actually avoid the deflationary bias of the current system that I referred to earlier. This new system would enhance global stability because, as I said before, when any single country’s currency is the reserve, there is an inherent problem with instability as its IOU’s mount. In addition, the new system would provide an additional degree of flexibility because countries could run a small trade deficit at the same time that their reserves would still be increasing. One could design the system to provide incentives not to have a surplus by reducing the surplus country’s allocation of the global reserve currency. The new allocations could also be used to finance global public goods and development and thus would contribute to solving some of the many global problems the world faces today.

There are two precursors to this idea: one of them is the IMF Special Drawing Rights (SDRs), and the other is the Chiang Mai Initiative. SDRs are basically a reserve currency created by the IMF; the problem is that the increases in SDR’s have been episodic, and political: the US has vetoed the last expansion. (It thinks it gains from the low interest loans that it gets currently. The US loses from the high instability, and as the dollar reserve system begins to fray it is not clear that it would, in any case, be able to sustain the dollar’s current reserve currency role.)

The proposal can be thought of as a globalization and a refinement of the Chiang Mai Initiative, in which the countries of East Asia agreed to exchange foreign reserves when necessary to fight against speculative attacks on their currencies and to prevent a reoccurrence of the East Asia crisis of the late 1990s. A Europe/Asia/Latin America joint endeavor would be a way of expanding this initiative.

Some in Europe aspire for the euro to become the global reserve currency, but Europe would pay a high price for getting cheap loans and would face the same problems that we noted have confronted the U.S. and Britain as reserve currency countries. The demand for euros in reserves would drive up the exchange rate, making it more difficult to export and to compete with imports. This would have a negative effect on Europe's aggregate demand. However, the demand problem for Europe might be worse than it has been for the US, because Europe's hands are tied because of the Growth and Stability pact that restricts its ability to use fiscal policy to stimulate demand and because it has a Central Bank that focuses only on inflation.

Finally, there is a worry that the two-currency reserve system may be even more unstable than the single reserve currency system. As they see the euro strengthening and the dollar weakening, they may start moving more into euros which would exacerbate the decline in the dollar.

Europe can only hope that its wish to have the euro become a reserve currency will not be realized, and the only way this can happen is through the creation of a global reserve system.

To summarize, reform of the global reserve system is essential if we are to deal effectively with global imbalances. The only way to approach this problem in a globalized world is *multilaterally*, with a global reserve currency. There are many alternative institutional arrangements by which a global reserve currency system might be managed, and many alternative ways by which one could introduce this new system, but the idea itself is more important than the particular way in which it would be managed or created. I believe that a new global reserve system is absolutely essential if we are to create a more stable and a more equitable global financial system.