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International monetary system – between crisis and reform

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Abstract. *The 2008 global crisis that hit in the heart of the system highlighted main deficiencies and vulnerabilities of the current international monetary system and revived the old concerns about its functioning. The reform of the international monetary system is under discussion again after a long period, during the '90 crises, especially in Southeast Asia, Russia and Brazil. To explain the relation between crisis and reform, this paper identifies some variables and hypotheses. It also analyses the matters that have sparked interest in reforming the international monetary system, in the context of the causes of the crisis and its vulnerabilities, admitting that the current system is not a perfect one. The paper concludes that it is time for a deep reform of the international monetary system.*

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1. Some interpretations of the relation between crisis and reform

Rodrik (1996, p. 26) believes that is a tautology to associate reform with crisis, the reform naturally becomes a problem when policies do not work, that a crisis is actually an extreme case of failure of the policy and therefore *"reform should follow the crisis"*. The author suggests that one reason why the hypothesis has not been tested empirically is that it cannot be rejected; in its opinion the hypothesis is being nonfalsifiable.

On the other hand, Drazen and Easterly (2001) argue that if one can distinguish between different versions of the argument "reform follows crisis", then the most sensible version is both non-tautological and testable.

To explain the *relation between crisis and reform*, economic literature identifies a number of *variables*:

- Crisis, which induce reform (Alesina, Drazen, 1991);
- Time, which shows not only the severity of the crisis but also its duration, political actors and interactions between factors (Drazen, 2009);
- Legal framework: Abiad and Mody (2003) find that a financial crisis slows or reverses deregulation, with the reform meaning; Helleiner and Pagliari (2010) emphasize the relation between crisis and international financial regulation reform; Franklin and Carletti (2010) consider the need for reform in the governance and regulation of central banks to minimize the risk of future crises; Dabrowski (2010) stresses the architectural elements missing from EU financial supervision and those that can help strengthen global coordination of policy and regulation;
- National, regional and international institutions: Fischer (2003) examines the role of IMF reforms in crisis prevention and management; Pop-Eleches (2009) explains the IMF's response to economic crises in Latin America and Eastern Europe and demonstrates that an economic crisis triggered economic neoliberal reforms only when the government and the IMF agree on the roots and the severity of the crisis; Petri and Plummer (2009) stress the need for new institutions in policies cooperation; Moshirian (2011) argues that in fact the crisis lead to new national and international institutions (for example, the Federal Reserve System in 1914, in the aftermath of the banking crisis of 1907; the IMF and IBRD in 1944, after de Second World War; the Financial Stability Forum and the G20 Forum of Finance Ministers, after the Asian crisis; G20 and the Financial Stability Board during the current crisis).

Drazen (2009) notes that there are four approaches to the question of whether a crisis triggers reform, which he calls the "crisis hypotheses":

- Crisis modifies the perception of the need for a change;
- Crisis makes each interest group to be more open to reform;
- Crisis weakens powerful interest groups that block reform;
- An extremely deterioration of the status quo do various groups willing to accept the uncertainty associated with important structural changes.

In response to the question why the financial crisis in 2008 has not led to more structural reforms of the financial sector, Drazen (2009) makes the following arguments:

- The complexity of the crisis;
- Crisis hypothesis must be refined to understand that adoption of structural reforms take time. Once the crisis has passed, financial market reform is an old problem. On the example of the global crisis, if the crisis hypothesis is true, the questions are why there were no major policy changes when it was perceived as a crisis and why if the crisis passed, financial reform legislation is still being discussed;
- Special interests inside and outside government are often responsible for the lack of significant reforms in response to the crisis.

Mircea Malița (2009, p. 49) believes that in fact "the crisis is above all a mental breakdown" and "to say that the system is recovering, but it keeps the ideas, prejudgements and bad practices, means that it take a break waiting for the next crisis".

When reform does not occur, the explanation given most often is that actually *the crisis has not yet become sufficiently severe* – for instance the '90s crises – and *probably is expecting the next crisis* – the crisis of 2008 – *to reform the international monetary system.*

On the other hand, for a crisis to justify reform, the reform must be regarded as closely related to solving the crisis. In other words, between the cause of crisis and structural reform adopted must be a strong connection (e.g., adoption of the Securities Act and Glass-Steagall Act in 1933, during the Great Depression, after the Wall Street crash of 1929 and the banking panic of 1933).

In his Nobel Prize speech, Robert Mundell (2000) highlights the role of monetary factors as a determinant of political events, arguing that many of the political changes of the twentieth century were caused by misunderstanding of the international monetary system disturbances, which were consequences of US growth and Federal Reserve System mistakes.

Napoleon Pop (2008, p. 19) states that in the fight to purify the global crisis "- the crisis is the signal of the need for global body recovery – no need to find any winners or losers, but success. Why? Because in the first case may be either the ones or the others, while the success is necessary for all".

Based on Ivy Baker Priest quote, former Minister of Finance in USA – "The world is round and the place which may seem like the end may also be only the beginning"; Mugur Isărescu (2009, p.11) interprets this idea as "the main lesson arising from today's crisis, unless was the lesson that, probably, humanity had the sensation that it learned every time there was a crisis".

According to Marin Dinu (2010) actual crisis has become a crisis of choice solutions, the consequence of option for inconsistent approaches, of extreme nature, ideological. The author (Dinu, 2010, p. 9) presents two hypotheses of delayed exit from the current crisis: "the crisis is very persistent turbulence in the bifurcation of the path-specific system for creating wealth; it signals the end of the long cycle of the economy and the emergence of another long cycle of inclusive economy, global; crisis is both of the principles, means and purpose (a crisis of the system), and by appealing to classical solutions is extended the critical unchanged functioning of the system entering into a vicious loop". In the first case we can talk about "the global opportunity for change that it implies (world is changing in the whole and the efforts to catch the wave are becoming fundamental)". In the second case, "the change takes the aspect of amplification effort for reinforcement the vicious loop resistance, the crisis worsened cyclical and thus the crisis is not approached as an opportunity for radical change, but as a correction for renewing the paradigmatically continuity".

There are some authors that deny the need for reform considering that crises are nothing but an inevitable adjustment in response to periodic excesses (Little, Olivei, 1999). They assess that if the crises are the result of national policy mistakes, systemic reform could not be justified.

Sceptic authors emphasize that the agreements regarding major repairs of the international monetary system occurred only in exceptional circumstances, usually as a result of wars, such as the agreement that led to the creation in 1944 of the Bretton Woods system.

The hypotheses that we can outline are:

- *That a crisis is necessary but not sufficient to induce reform*. It was in the '90s crises and is to be seen if it verifies in the context of the current global crisis.

But it happened a reform of the international monetary system without a crisis, talking here about an important moment in the evolution of the international monetary system – the creation of the European Monetary Union in 1999. The Euro adoption led to one of the largest and most powerful trading blocs in the world, although only 17 of the 27 European Union members are now part of the eurozone. Although the Euro has not changed the structure of the Euro area with heterogeneous and independent countries, it undoubtedly strengthened the economic and political ties in the region and its weight in the world economy. From this perspective, the Euro has somewhat modified the global balance of power, redrawing the international monetary landscape. The Euro has become the first real competitor to the US dollar since the American currency exceed the British pound as dominant international currency in the interwar period, while the Japanese yen continued to play a minor role as an international currency. As the British pound has maintained its role as an international currency beyond the power of the British economy for half a century, the US dollar remains the main currency, the Euro bringing only a slight reduction while maintaining the gap between the US and Europe regarding the international monetary role.

- *That a crisis induces policy change and the reforms taking place in times of crisis*.

The crisis episodes generally determine the question about how the international monetary system is built.

2. Financial crises and the reform of the international monetary system

The relation between crisis and reform of the international monetary system can be understood in the context of the causes of the crisis and its vulnerabilities, admitting the need for reform in this area.

Current international monetary system is not a perfect one, its weaknesses are highlighted and analysed in Romanian and foreign literature in recent years. According to these some directions are emerging today discussing about *the reform of the international monetary system and its organizational versions*, which are very different, giving rise to a fervent debate and generating reference studies and articles.

Analysing the functioning of the international monetary system in different periods it can be seen that each system had an operating period of no more than 40 years: gold standard system – 40 years; gold exchange standard system – 30 years; Bretton Woods system – 29 years; post-Bretton Woods system – 40 years.

Monetary and financial chronology of events shows that the international monetary system is not static, but is continuously evolving.

Over time, the world economy has been subject of periodic financial crises: before World War I, due to globalization; in the gold standard system – Baring crisis in 1890 and the US banking panic in 1907; in the interwar period – crisis in 1920-1925 and the Great Depression in 1929-1933; in the Bretton Woods system, more rarely, as currency crises; in the post-Bretton Woods system, in the time of liberalization and financial globalization.

Gradually, after the collapse of the Bretton Woods system, a variety of exchange rates, predominantly the flexible one, the free movement of capital, the freedom in the choice of exchange rate regimes, an excessive fluctuation of exchange rates and the dominance of the dollar as a reserve currency were attained, in other words an international monetary system like the current one.

The literature offers a number of typologies, chronologies and analyses of financial crises: Bordo, Eichengreen, Klingebiel and Martinez-Peria (2001), Eichengreen and Bordo (2002), Reinhart and Rogoff (2008), Eichengreen (2008), Bordo and Landon-Lane (2010).

The Great Depression of 1929-1933 was the result of an international monetary system with financial instability, severe imbalances and fixed exchange rates.

By its turbulence and contagion, the financial crises of the ’90 in emerging markets – Mexico (1994-1995), South-East Asia (1997-1998), Russia (1998), Brazil (1998-1999) and Argentina (1999-2002) – caused a strong interest in the reform of the international monetary system not seen since the collapse of the Bretton Woods system. These crises have revealed a number of weaknesses in the international monetary system which could justify a fundamental change. They have shown that the integration of emerging economies in the global system poses transformations that were not anticipated. Capital flows generated by capital account liberalization, capital market imperfections, fragility and insufficiently regulated financial systems caused financial, currency and banking crises.

Bordo, Eichengreen, Klingebiel and Martinez-Peria (2001) have shown that since 1973 the frequency of crises has doubled compared with Bretton Woods system or gold standard system and rival with crisis of 1929-1933. In other words, the crises became more frequent, but no more severe.

Eichengreen and Bordo (2002) identified 38 financial crises during 1945-1971 (21 in developed countries and 17 in emerging countries) and 139 in the period 1973-1997 (44 in developed countries and 95 in emerging countries).

The international monetary system has become a global one with new features and questions, its deviations at beginning in a form of functional crises turning into systemic crises.

If the '70s were marked by calling for a "new international monetary order", the '90 – especially after South-East Asia, Russia and Brazil crises – have brought into question the need for a "new international monetary architecture".

The '90s emerging market crises were managed by the IMF and the World Bank, in order to avoid global contagion and, in particular, expansion to developed countries. Even if they have not led to a reform of the international monetary system, these highlighted a number of important lessons: caution on liberalization of capital movements in developing countries; increased transparency that contributes to improved surveillance.

After the crisis in South-East Asia the debate has taken another dimension. The phrase "reform the international financial architecture" was many years on the meeting agenda of international bodies, while remaining at the promise of reform.

The global crisis of 2008 revealed the most serious global macroeconomic imbalances that have raised *concerns in the functioning of the international monetary system* and represent *challenges for its reform*. Major deficiencies of the current international monetary system – volatile capital flows, large and persistent imbalances in the balance of payments, volatility and misalignment of the exchange rate, excessive demand for reserve assets in emerging countries, inadequate global adjustment mechanisms – became its vulnerabilities, causing continued volatility in financial markets. The crisis that hit in the heart of the system highlighted the current international monetary system weaknesses that should be addressed through reform, and old fears resurfaced. These deficiencies are likely to be magnified by the rapid transformation of the global economy and growth in emerging economies, while the international monetary system failed to adjust itself.

Economists have various views when considering the relationship between the global crisis and the current international monetary system. The literature on the international monetary system and the financial crisis is reviewed by Lin, Fardoust and Rosenblatt (2012). This relation can be understood in the context of the global crisis causes, where the debate is still on going.

Some believe that global macroeconomic imbalances are the main cause of the crisis (Bernanke, 2009, Dunaway, 2009, Eichengreen, 2009, Krugman, 2009,

Portes, 2009), while others argue that they only facilitate the development of the crisis (Obstfeld, Rogoff, 2009, Roubini, Mihm, 2010, Borio, Disyatat, 2011).

On the other side, there are authors who believe that the current monetary system – through its weaknesses – was a trigger of the financial imbalances that led to the global crisis.

Whelan (2010) explains how European banks have played a major role in external financing of credit expansion in the United States, many of them facing serious financial problems when the toxic nature of the assets was brought out, this representing an important mechanism for widespread transmission of the US problems.

Eichengreen (2011) notes the role of the international monetary system and the US dollar in crisis, identifying causal chains.

Farhi, Gourinchas and Rey (2011) consider the absence of a systematic mechanism for sufficient and coordinated supply of liquidity a major weakness of the current system.

Lin and Treichel (2012) argue that the cause of the crisis was financial deregulation combined with the loose monetary policy, facilitated by the role of the US dollar as the dominant reserve currency.

The US dollar was a world "safe haven" but also benefited from a lack of viable alternatives. The US dollar still retains *a dominant position*, which was *partially influenced by the Euro* and, today and especially in the future, it *could be influenced by the growing importance of China and other emerging countries*. In such a world there is room for more than one currency, as Eichengreen (2007) said.

3. Conclusions

We believe that the current international monetary system, through its shortcomings, fragility and the dominance of the US dollar as reserve currency, contributed to global crisis and threaten the global economic outlook. Basically, the transmission mechanism of global crisis was the global monetary and financial system. On the other hand, the major global economic imbalances reveal also a failure of the functioning of the international monetary system institutions.

The interest in international monetary system reform has intensified since the frequency and size of the financial crises have increased, becoming more severe, more costly and less predictable. Policymakers, financial analysts and academic

economists should focus their efforts on designing an international monetary system compatible with the current power configuration of the world economy, that through the features, principles, operations and institutions to be resilient to shocks in the long term and minimize the risk of another global crisis.

Taking as reference Reinhart and Rogoff's statement (2008) – which believes that most crisis episodes created the illusion among policy makers and investors that "this time is different" – we can only hope that *"this time will be different" and there will be a profound reform of the international monetary system.*

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