

# REFORMING THE GLOBAL RESERVE SYSTEM

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# Global Imbalances and Instability

- Problems with global financial system highlighted by persistent global imbalances, high levels of instability
  - Feb 27 episode, where a rumor in China led to largest declines in stock markets since 9/11
- Standard discussion involves shared blame
  - U.S. fiscal and trade deficit
  - European slow growth
  - China's undervalued currency

# Putting imbalances in perspective

- U.S. deficit is more than \$850 billion
  - China's multilateral surplus is only about \$150 billion
  - So even if eliminating China's surplus fully translated into a reduction in U.S. deficit, U.S. deficit would still be more than \$700 billion
  - Likely would have no effect—U.S. just buys textiles from Cambodia and Bangladesh
  - But Cambodia and Bangladesh less likely to be willing to finance U.S. deficits
  - So global instability might actually be increased
    - U.S. may face problem financing deficit
      - Will be financed
      - But adjustments may be "painful"—large changes in asset prices

# Do the imbalances represent a problem?

- “Normal” economics has some countries borrowing from others. Why worry about U.S. borrowing?
  - Something peculiar about richest country in the world not being able to live within its means
    - \$500 billion last year flowed from poor countries to rich countries
  - Deficits OK when money is being spent on investment to make economy more productive
    - Problematic in the U.S.
  - Given demography, this is a period in which the U.S. should be saving, not borrowing
- Worry is that there will be a disorderly adjustment

# But is Bush to blame?

- Standard argument—twin deficits
  - Fiscal deficit leads to trade deficits
  - In partial equilibrium setting, relationship is clear
    - $TD = CF = \text{Investment} - \text{Domestic Savings}$
    - *Ceteris Paribus*, an increase in the government deficit reduces domestic savings, and exacerbates the trade deficit (TD)/Capital inflows (CF)
      - Of course, in Barro-Ricardo world, public borrowing is offset by increased private savings
      - But even if there is *some* effect, not large enough
    - More to the point: we are not in a *ceteris paribus* world

# The data

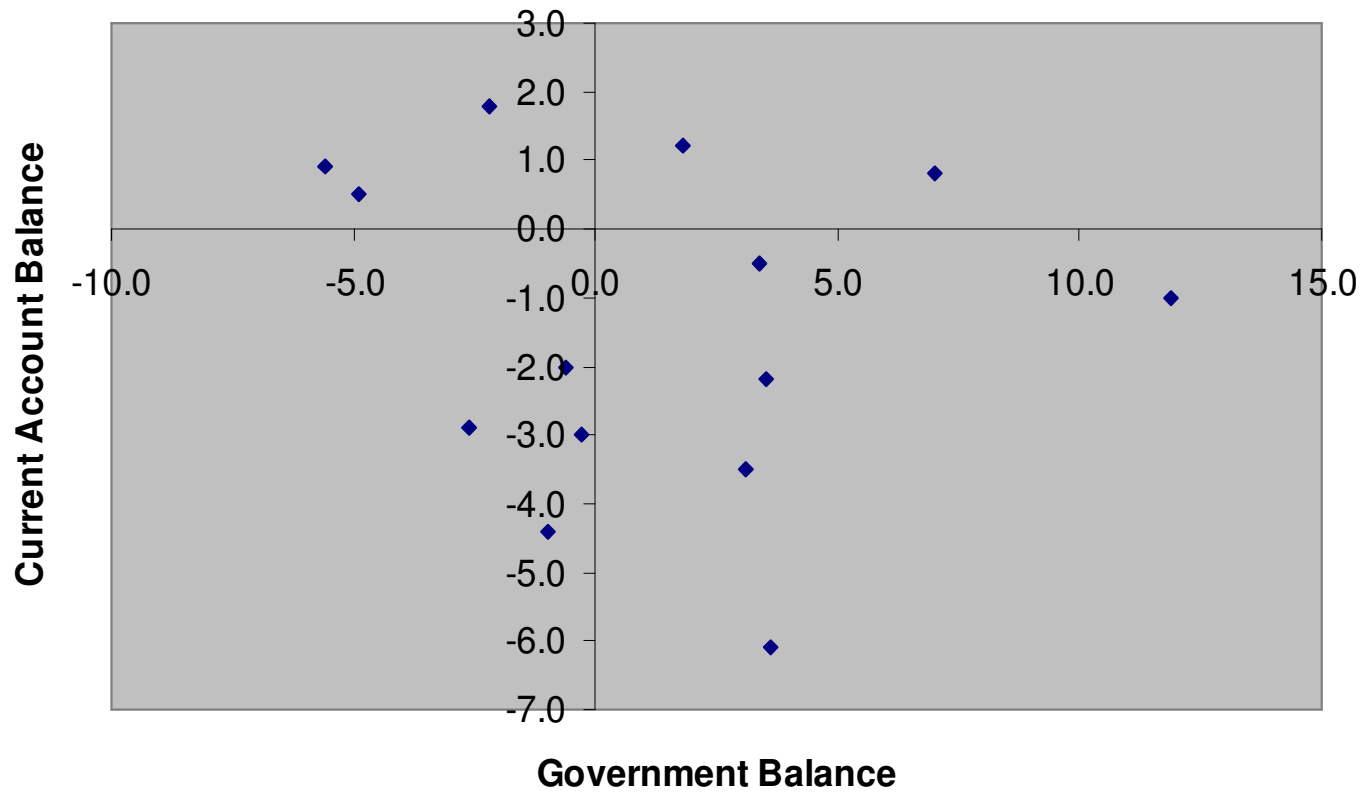
## ■ Time series

- U.S. has been steadily increasing its Trade Deficit, regardless of what happens to fiscal deficit
  - In 90s, investment increased
  - From a balance sheet perspective, it makes a big difference—borrowing to finance an asset rather than a consumption binge

## ■ Cross section

- No relationship across countries

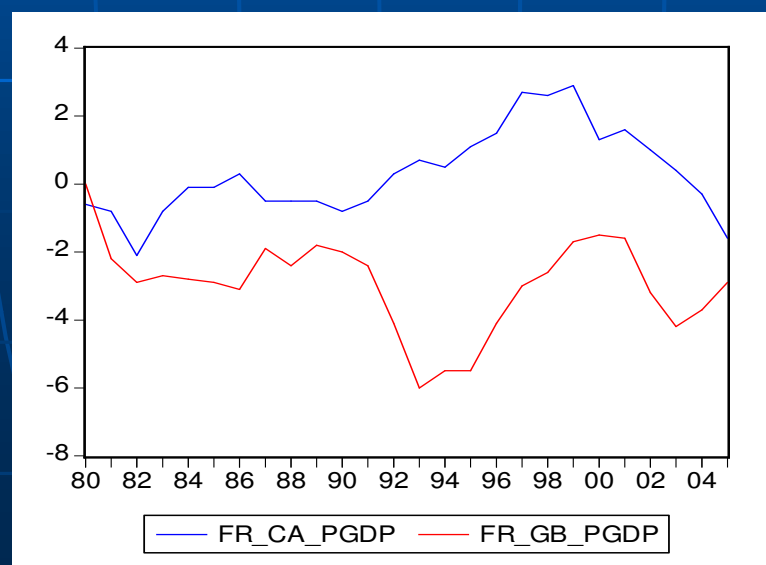
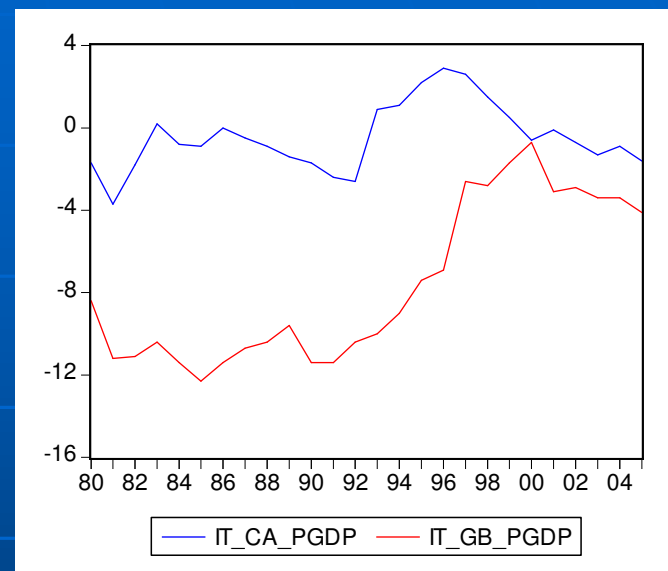
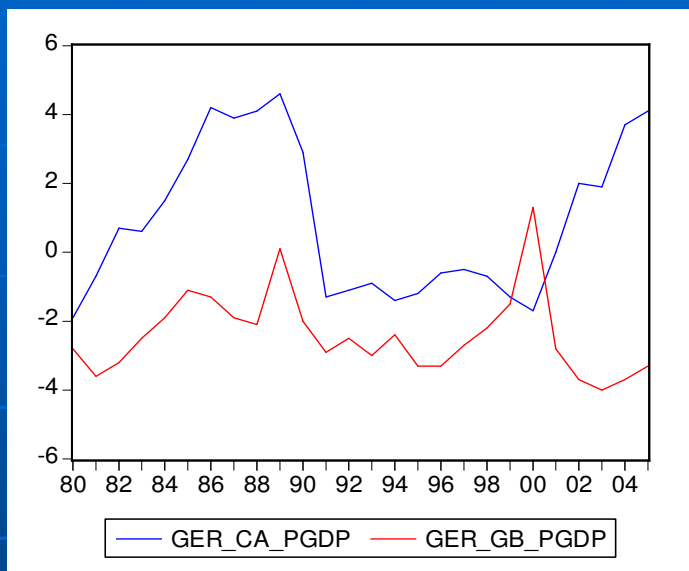
### Global Double Deficits 2004 (%GDP)



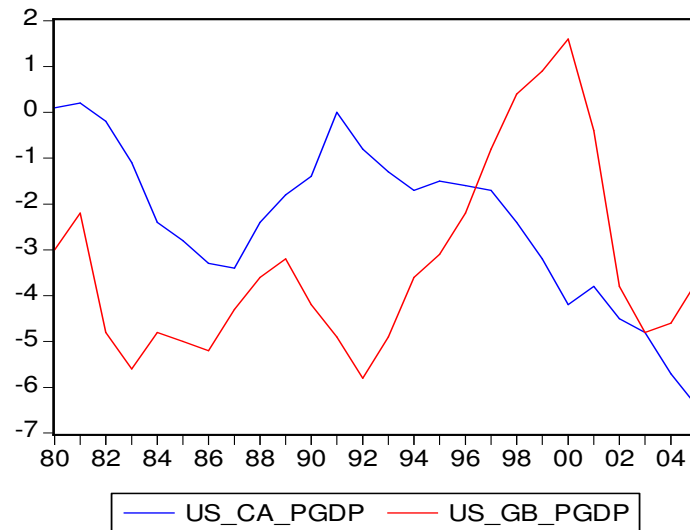
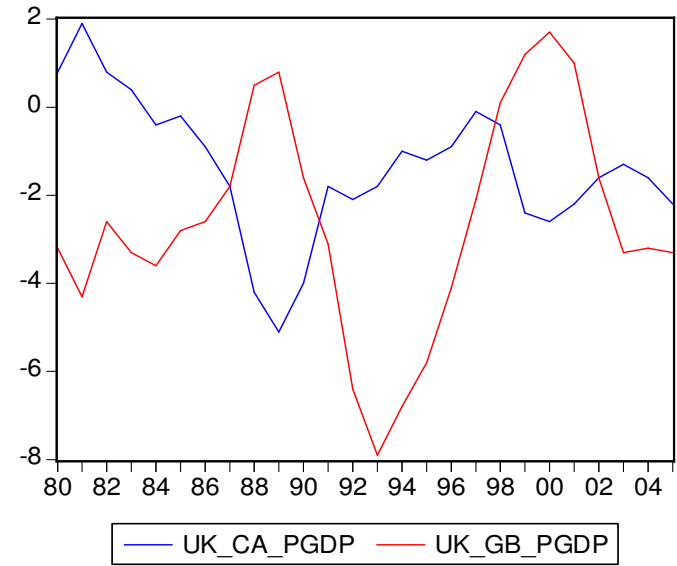
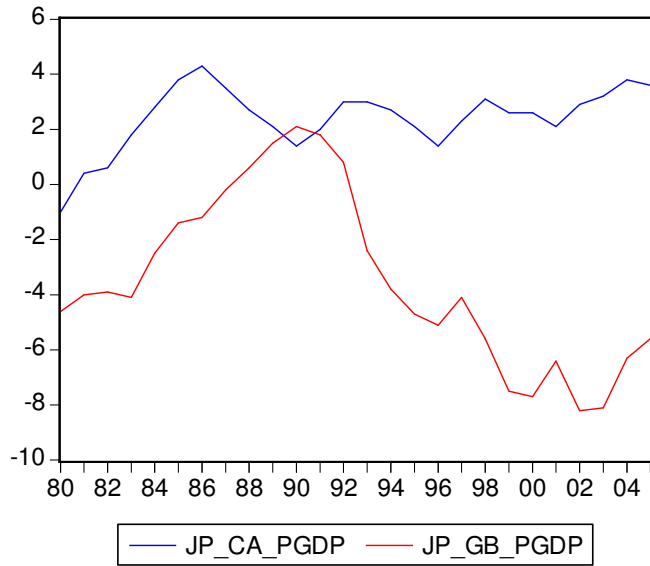
# No Systematic Relationship

- With the exception of Canada, the data shows no systematic relationship between the Current Account Balance and the Government Balance
- In the case of Canada, the Current Account Balance appears to cause the Government Balance, but not vice versa

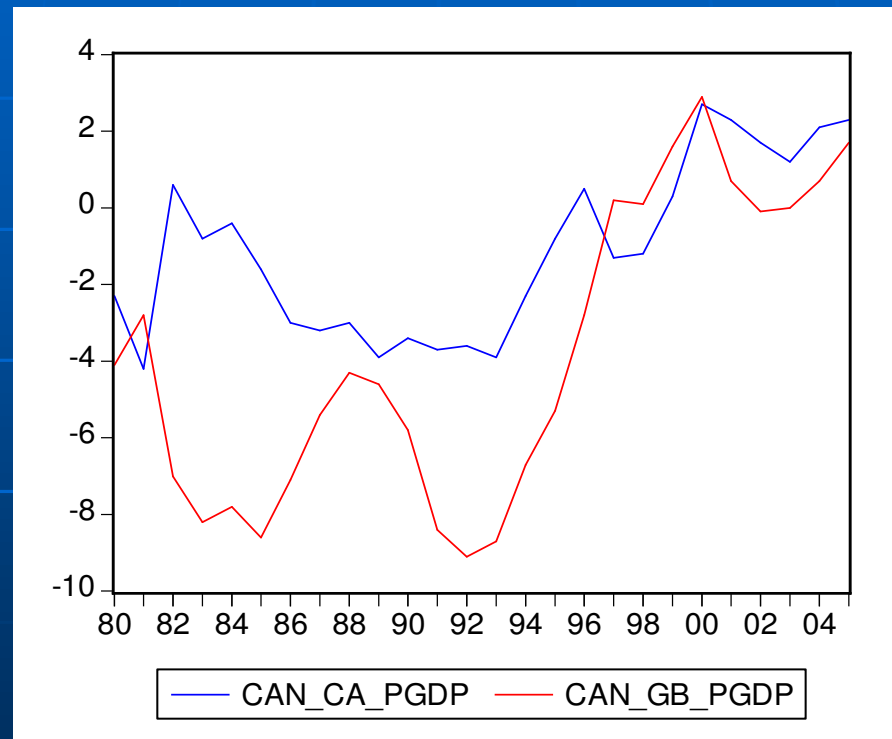
# Germany, France, Italy



# Japan, US, and UK



# Canada displays apparent causality



# An alternative View

- Fiscal deficits are endogenous
  - What is required to maintain the economy at full employment
  - Capital inflows are *exogenous*
    - Foreigners want to hold T-bills in reserves
    - Exchange rates and other asset prices adjust to make sure this is possible
  - But since Trade deficit = CF, that means trade deficit is effectively exogenous
    - Negative effect on aggregate demand
      - U.S. is exporting T-bills rather than automobiles
      - But T-bills do not generate employment
    - Government must offset this, either through monetary or fiscal policy
    - It is in this sense that trade deficit *causes* fiscal deficit
    - In the 90s, irrational investor boom meant government deficit was not needed—but that is an exception

# Implications

- It is the dollar reserve system that is at the root of the problem
  - UK had a similar problem when sterling was reserve currency
- The U.S.—and world—would be better off shifting to a global reserve currency
  - Current system is inherently unsustainable
  - As IOU's accumulate, confidence in dollar erodes
  - If confidence erodes, Central Banks may move out of dollar, dollar weakens, reinforcing problem
  - Is there a tipping point? Are we near there?
  - The dollar reserve system is fraying

# Current system is fraying

- Process may be unstable
- Growing lack of confidence in dollar
  - Feeding on itself
- Asia major source of global savings
  - Paying high price for re-circulating savings in West
  - Beginning to explore alternatives

# Problems getting worse

- Risk of crises and IMF intervention has led countries to accumulate huge amounts of reserves, mostly in dollars
- Increase in reserves one of major underlying factors in reserve increases

# Further problems: Insufficiency of global demand

- Purchasing power “buried” in ground
- In past, deficiency was made up by loose monetary and fiscal policies
  - But countries who provided this global service were punished
- U.S. has become consumer of last resort
  - Prides itself on providing this global service
  - But something is wrong with a global financial system which requires the richest country of the world to spend beyond its means to maintain global prosperity

# Further problems: Inequities

- Developing countries are lending U.S. trillions of dollars at low interest rate
  - Consequences most clear at micro-level, with standard prescription—keep dollar reserves equal to short term dollar denominated debt
    - Firm in poor country borrows \$100 million from U.S. bank at 20% interest
    - Country has to put \$100 million in reserves—\$100 million T-bills implies lending to US
    - Net flow zero *except* interest received 5%, interest paid 20%
    - Form of foreign aid by poor countries to U.S.
      - Magnitude greater than U.S. aid to developing country

# Instability

- Basic trade identity:  $\text{sum of surpluses} = \text{sum of deficits}$ 
  - If some countries insist on having a surplus, some others must have deficit
  - Hot potato of deficits: as one country eliminates its deficit, it appears somewhere else in the system
  - US has become deficit of last resort
    - Apparent in statistic
    - But is this sustainable?

# Implication

- Surplus countries are as much a part of systemic problem as deficit countries
  - Keynes emphasized negative effect on global aggregate demand
  - Should “tax” surplus countries to provide appropriate incentive

# PROPOSAL:

## Global reserve currency

- Issued in amount commensurate with reserve accumulation
  - Offsetting negative effect on aggregate demand
  - Would thus not be inflationary, would avoid deflationary bias of current system
- Would enhance global stability
  - Inherent in any single country being reserve currency
  - But provide an additional degree of flexibility
    - Countries could run a small trade deficit without having a problem
    - Net reserves would still be increasing

- Could provide incentives *not* to have surplus by reducing surplus country's allocations of global reserve currency
- New allocations could be used to finance global public goods and development
- Would not be inflationary as long as annual emissions were less than or equal to increases in reserves

- There are two actual precursors—IMF SDR's and Chang Mai Initiative
  - SDR's episodic, and U.S. has vetoed last expansion
  - Proposal can be thought of as globalization and refinement of Chang Mai initiative
  - A Europe/Asia joint endeavor would be a way of introducing it
  - U.S. will resist, since it thinks it gains from low interest loans
  - But it loses from high instability
  - And amounts of loans will in any case be decreasing

- Some in Europe aspire for the Euro to become global reserve currency
  - Europe would have same problem—high price to pay for getting cheap loans
  - Worse—because Europe's hands are tied
    - Growth and Stability Pact
    - Central Bank focusing only on inflation
  - Two-country reserve system may be even more unstable
- Can only hope that wish is not realized

- Ideas are developed at greater length in
  - J. E. Stiglitz, *Making Globalization Work*, especially Chapter 9
  - Bruce Greenwald and J. E. Stiglitz, "A Modest Proposal for the Reform of the Global Financial System," presented at AEA meetings, January, 2006.

# Summary

- Reform of global reserve system is essential if we are to deal effectively with global imbalances
- A global reserve system is required
- Many alternative institutional arrangements
- Likely to lead to a more stable—and more equitable—global financial system