Three fundamental problems of the international monetary system essay

The International monetary system shows three fundamental problems . The first one, which was highlighted by John M. Keynes during the debates that led up to the Bretton Woods agreements, Is that the present International monetary system has a bias against countries running balance of payments deficits (Keynes, 1942-43). The countries in external surplus have no strong incentive to adjust, and thus the burden of adjustment falls mainly on deficit countries. Adjustment generally takes place with a lag and rather abruptly when deficit financing suddenly dries out. The asymmetric djustment tends to generate a global recessionary effect if the corrections that deficit countries need to adopt to balance their external ac counts do not find financing in adequate quantities, and if those adjustments are not offset by expansionary policies in surplus countries.

This problem can be called the anti- Keynesian bias of the system. The second problem, which has become known as the Trifffln dilemma, after the pioneering work by Robert Triffin (1961, 1968), arises from the fact that an International reserve system based on a national currency (the U. S. dollar) has some Inherent Instabilities.

In particular, the only way that the rest of the world can accumulate net assets In dollars Is If the united States runs a balance of payments deficit. But that can lead to a loss of confidence in the dollar. By and large, this has led to strong cycles in the value of the main international currency and in the U. S. current account deficit, which strongly affects the rest of the world economy.

More generally, global monetary conditions are largely determined by the monetary policy of the U. S. which is designed with no regard to its global repercussions. According to the reformulation as a “ general dilemma” by the late Padoa-Schioppa (2011, pp. 63-64), “ the stability requirements of the system as a whole are inconsistent with the pursuit of economic and monetary policy forged solely on the basis of domestic rationales In all monetary regimes devoid of some form of supranationallty’. The third problem of the current International monetary system Is Its Inequitable character.

The need to accumulate International reserves forces eveloping countries to transfer resources to those countries that issue reserve currencies. This inequity bias has been magnified in recent decades by financial and capital market liberalization and by the strongly pro-cyclical behavior of the capital flows toward developing and emerging economies. This behavior has generated a massive accumulation of foreign exchange reserves as a form of self-insurance against abrupt interruptions in international financing. This accumulation can also be seen as a rational response by each country to a system that lacks a “ collective nsurance” in the form of adequate IMF emergency financing.

It also generates a “ fallacy of composition”, as the collective attempt by these countries to accumulate reserves may generate current account surpluses that act as a global recessionary bias, or Increase the demand for “ safe” assets which, If not matched by an Increased supply, may have global financial repercussions, particularly on the risk premla of those assets considered “ safe”.