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TOWARDS AN EMERGING MARKET FUND

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The Bretton Woods arrangement (BWA) was motivated by attempting to speed up the reconstruction process after WWII, and to prevent a replay of competitive devaluations. BWA boiled down to a system of fixed but adjustable exchange rate parities, subject to IMF agreement and surveillance. At the start of the BWA private capital market flows had come down to a trickle. As a result, the system induced countries to accumulate international reserves to smooth out trade flows. When reserves ran out, i.e., a balance-of-payment crises occurred, the IMF supplied international reserves through Stand By Arrangements and other facilities. For the sake of brevity, I will constraint the focus of the following discussion on the role of the IMF with special reference to Emerging Market economies (EMs).

BWA broke down in the early 1970s as the US, which already was the kingpin of the international payment system, followed a monetary policy incompatible with the USD/Gold parity – which led to jettisoning the system of IMF-determined exchange rate pegs altogether. This decision would have signaled the end of the Fund if, in line with initial expectations, the world economy switched to a system of freely floating exchange rates. But this was not to be. The USD replaced gold as the dominant international reserve currency, as a unit of account and a means of exchange. EMs, in particular, pegged their currencies to the USD (and more recently also to the euro), a phenomenon labeled Fear of Floating.[2] Thus, looking at the big picture, the world moved to an exchange rate system which is not vastly different from the one that prevailed under the BWA. Fear of Floating reinstated exchange rate pegging. The mechanism is different from that of the BWA, but economies that exhibit Fear of Floating will occasionally need balance-of-payment support, unless they always have a fluid access to the international capital market which, as experience shows, is not the case. This is an important reason why the Fund survived what on paper looked like its death sentence.[3]

The new system, which still holds and I will label BWA2, gives a commanding role to the Fed. The Fed is completely free to manage the supply of the dominant reserve currency without being constrained to maintaining a USD/gold parity as under the BWA. This is not a minor detail, because the USD is managed taking only US interests into account, as Fed authorities never tire to remind us. This situation elicits bitter political reactions from the rest of the world but, until recently and especially in developed market economies (DMs), the US hegemonic monetary position was tolerated because it was associated with a long stability period known as the "Great

[1] This paper was written for a book celebrating the 70th anniversary of the Bretton Woods conference, published by The Reinventing Bretton Woods Committee. I am thankful to Sara Calvo and Pablo Ottonello for valuable comments.
[2] See Guillermo Calvo and Carmen M. Reinhart "Fear of Floating," *Quarterly Journal of Economics*, vol. 68, May 2002, pp. 379-408.
[3] Sovereign debt problems are other important issues in which the IMF got involved, but will not be discussed here.

Moderation." However, the large recession and instability brought about by the subprime crisis is raising serious doubts about BWA2. Actually, these phenomena raised suspicion that the Great Moderation was the result of some kind of a mirage because it made it obvious facts that were somewhat hidden under the surface. For example, that

- The Fed is far from being the sole manager of the USD printing machine. Shadow banks have found ways to print sizable quantities of quasi-USD by increasing the liquidity of some financial assets.
- The new liquid assets are vulnerable to attacks, as illustrated by the meltdown of Asset-Backed securities during the Lehman 2008 episode; and, finally,
- The Fed's instruments for controlling effective USD liquidity are blunt and give rise to externalities. For example, low US interest rates may send "hot capital" to EMs in search for yield – and cause major disruption in EMs when those rates go back to normal. This, of course, exacerbates the worldwide antipathy caused by the Fed's US-centered policymaking.

These conditions send a clarion call for reinventing Bretton Woods, a key issue that this Committee has been campaigning for. The problems are very complex because they involve geopolitical as well as financial topics that economists do not understand that well. Thus, the new system will have to rely on the limited experience we have as a result of recent financial crises.

In the first place, I would like to note that there are many things that individual economies can tackle by themselves, without the help of Bretton Woods institutions. For example, policies aimed at lowering domestic financial vulnerability, like setting limits to banks' non-core bank liabilities (e.g., bank borrowing from external sources other than retail deposits), an example of what is now called *macro-prudential regulation*. But there are other policies that have become popular in EMs and that could benefit from some coordination or external assistance. A prominent example in this respect is accumulation of *international reserves*, an effective but costly policy. These costs could be reduced by "pooling" international reserves. The Fund has already gone in that direction by setting up new facilities, e.g., Flexible Credit Line. Unfortunately, however, few countries have applied because many EMs fear being stigmatized for the simple act of applying, since investors may infer that it signals that the government thinks the economy is weak and subject to speculative attacks.

I have discussed this issue before and suggested the creation of an Emerging Market Fund (EMF).[4] The EMF would be in charge of preventing large volatility in an EM index like the EMBI+. During the Russian 1998 crisis, for instance, the EMBI+ increased by more than 1000 basis points in a short period of time and it took about five years before it returned to its pre-crisis level. This global shock cannot be attributed only to EM domestic mismanagement. It is well known that the capital market was a major source behind the shock. The episode is not that

[4] See Guillermo Calvo, "Globalization Hazard and Delayed Reform in Emerging Markets," *Economia*, 2002. Reprinted in G. Calvo (editor) *Emerging Capital Markets in Turmoil: Bad Luck or Bad Policy?* Chapter 18, Cambridge, MA: MIT Press, 2005.

different from the subprime. However, in the latter case, reserve-currency central banks pumped in enough liquidity to push down DM financial risk indexes (e.g., TED spread) to pre-crisis levels in a short span of time. Without this type of policy there is wide consensus that the Great Recession would have become another Great Deflation.

EMs learned the lesson but, not being able to print reserve currencies, started an active policy of international reserve accumulation accompanied, in regions like Latin America, by current account surpluses. This probably helped EM quick recovery after the Lehman episode. But the role of DM monetary expansion cannot be discounted either. Unfortunately, these two positive factors are less widespread now. On the whole, EM current account deficits have deteriorated and it could be claimed that international reserves are lagging behind their optimal levels.[5] On the other hand, it is less likely that the Fed will activate currency swaps as in the Lehman crisis, especially if the next crisis is triggered by a hike in the Federal Funds rate in response to US overheating or inflationary pressures. Hence, this is the right time to reconsider setting up an EMF.

An EMF could initially be funded by a stock of SDRs sufficiently large to prevent sharp falls in an index of targeted bond prices. The objective is not to go against the trend but to prevent excessive volatility that might otherwise generate a "bad" self-fulfilling equilibrium. An EMF has the following advantages over the present IMF facilities:

- It does not cater to individual economies. Therefore, "stigma" should be less of a concern.
- It is aimed at alleviating *systemic* financial problems, which makes the EMF a natural addendum to the IMF foundational objectives.

Of course, the devil is in the details, and funds like this are subject to at least two types of risks:

1. They can run a substantial loss.
2. They can be subject to *moral hazard*.

Risk 2 is always present in these kinds of arrangements but it should be relatively minor in the present case because the EMF's central aim is to stabilize a price index involving bonds from many countries, not individual countries. Risk 1 is, of course, very hard to rule out. However, losses can be checked by (a) selecting the set of EM bonds protected by the EMF, and (b) setting the bands within which bonds prices will be kept by the EMF. These points involve technical issues which, however, could be somewhat sorted out on the basis of the available evidence about EM bond prices in the last ten-odd years. Moreover, both points require a deep understanding of the channels through which a meltdown of EM bond prices impinge on the real economy. The knowledge here is quite limited, and there is a wide array of possibilities to choose from. However, it is already clear to me that it will be unlikely that the EMF proposal will go anywhere if the US is not firmly on board. For example, if, say, one-third of all the

[5] See Guillermo Calvo, Alejandro Izquierdo and Rudy Loo-Kung "Optimal Holdings of International Reserves: Self-insurance against Sudden Stop," *Monetaria*, Centro de Estudios Monetarios Latinoamericanos, CEMLA, January-June 2013, pp. 1-35. Online here.

external debt from developing economies are covered, the fund would have to be around 1.44 trillion USD. On the other hand, if only one-third of external short-term debt from the same set of economies are covered, the fund would have to be around 400 billion USD.[6] The numbers are large relative to the IMF credit outstanding in July 2014, which amounts to around 130 billion USD.[7] But, fortunately, the EM sums quoted above are low relative to, for instance, the US Federal Debt, which exceeds 17 trillion USD. Thus, setting up the EMF is, in principle, possible but unthinkable without the active support of the US government.

In my opinion, we are at the verge of new crisis triggered by higher US interest rates and deep financial crisis in China due to a mishandling of shadow-bank fragility there. I am not saying that this scenario is unavoidable but I believe it would be a serious mistake to ignore it. If any of that happens and the US stays on the wayside, this will probably force EMs to take extreme measures that may move the world economy away from trade globalization. This retrenchment may have severe consequences, especially given that the industrial system is highly dependent on value chains.

[6] Data comes from the World Bank 2014 International Debt Statistics; click here.

[7] Click here. The sum reported there is 88 billion SDR, which amounts to 133 billion USD if the SDR/USD = 0.66, i.e., the exchange rate quoted for September 2, 2014.