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Remarks for the conference
"Building an International Monetary and Financial System for the 21st Century: Agenda for Reform"[1]

I would like to present some (rather speculative) thoughts on whether and how the current global financial crisis may change our views about the long-run future of the international monetary and financial system. I will organize my remarks under two headings: first, money and exchange rates (the international monetary system), and second, financial regulation (the international financial system).

International Monetary System. If one tried to define an underlying paradigm for the modern international monetary system, it would probably be a set of inflation targeting areas linked by floating exchange rates. This is of course not a realistic description of the system as it stands now, but it may be a good model for the end point toward which the system is thought to be converging. By contrast with the Bretton Woods system, nominal anchors are provided by independent central banks that (implicitly or explicitly) target the inflation rate, rather than nominal exchange rates.[2]

Will the current crisis change the paradigm? I don't see any reason to think so---in particular, I do not think that the current crisis will put fixed exchange rates back in fashion.[3] But I think that the current paradigm leaves scope for conflict between different conceptions about how monetary policy should respond to a credit crunch. And these conflicts have an international dimension that is problematic and might lead to protectionism. So while we do not need a new paradigm for the international monetary system, we may need to think of a system to mitigate those conflicts.

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[1] Conference organized by the Reinventing Bretton Woods Committee, New York City, November 24-25 2008.
[2] See Rose (2007), "A Stable International Monetary System Emerges: Inflation Targeting is Bretton Woods Reversed," *Journal of International Money and Finance* 26, 663-681.
[3] It may be too early to tell but recent developments do not seem to revive the case for managing the exchange rates between the three main currencies. As for the exchange rate regimes of emerging market countries, it is interesting that two of the first three countries to apply to an IMF package had inflation targeting regimes, not fixed peg (Iceland and Hungary, the third country being Ukraine). This being said, I would be very surprised if the crisis put fixed pegs or target zones back in fashion. Most likely, when the dust settles we will have observed again that countries with fixed pegs tend to have more severe problems of currency mismatches in their balance sheets, so their crises are likely to be deeper and more difficult to manage. The crisis may reinforce the view that emerging market countries should resist appreciation and accumulate reserves in an international credit boom, but even a country like China presents exchange rate flexibility as its long-run objective.

Let me explain. There is a good economic case for increasing the rate of inflation to say, 5 or 6 percent, in a credit crunch with a large overhang of debt. First, this is a relatively efficient way of deleveraging the liabilities of debtors, by reducing the real burden of their debt or equivalently inflating their nominal equity. Second, as the literature on the Japanese liquidity trap has shown, the best way to avoid a liquidity/deflationary trap is to credibly commit to a positive level of inflation (what Paul Krugman, called "committing to being irresponsible")[4]. And third, the alternative policy mix of fiscal stimulus with low or negative inflation has not worked well in Japan.

However, I do not expect a consensus on the view that inflation is an acceptable way of getting out a credit crunch. Actually, I would expect many people in this room and outside to strongly disagree with this prescription. First, many people will point to the risk of losing credibility, i.e., the risk that nominal expectations lose their anchor and long-term interest rates increase to levels that hurt the very borrowers that we want to help. I personally think that the credibility problem can be managed in the context of a credible flexible inflation targeting framework,[5] but there is room for reasonable disagreement on this. Furthermore, actively pushing up the inflation rate might be inconsistent with the strict inflation targeting mandate of many central banks.

But my point is precisely that there is room for disagreement over what inflation targeting means in a severe credit crunch. This might lead to conflicts will not stay below the surface for long if the credit crunch is protracted. The conflicts may occur between the monetary authorities and various domestic constituencies, but also between countries. For example, imagine what the protectionist pressure would be in Europe if the U.S. adopted a strategy of higher inflation which would depreciate the dollar (even though dollar depreciation would not be the primary purpose of U.S. monetary policy).

One may draw a parallel with the interwar monetary problems. The old view was that the interwar monetary instability was due to beggar-thy-neighbor competitive devaluations. A new view holds that the problem was more fundamentally with the deflationary effects of the interwar Gold Standard system.[6] The depreciations were simply the reflection of the fact that countries unshackled themselves from the constraints of the Gold Standard, and should not have led to protectionism. Shall we reenact a modern version of this drama, with the role of the Gold Standard played by strict inflation targeting?

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[4] Krugman, 1998, "It's Baaack! Japan's Slump and the Return of the Liquidity Trap," *Brookings Papers on Economic Activity* 2, 137-87.

[5] The central bank would have to explain that inflation increases temporarily and will go back to the target as the credit crunch is resolved. See Jeanne, 2008, "What Inflation Targeting Means in a Credit Crunch", available at http://econ.jhu.edu/people/Jeanne.

[6] See Barry Eichengreen's *Golden Fetters: The Gold Standard and the Great Depression, 1919-1939*, Oxford University Press, 1992.

What can we do to mitigate such a risk? I do not think it would be realistic to expect international agreement on the optimal rate of inflation (lack of agreement is precisely the issue), but it would be good to limit the risks of protectionism by having at least an "agreement to disagree" allowing for some measure of experimentation with the rate of inflation. The new process of multilateral consultations under the auspices of the IMF could be a good vehicle for discussions about such an agreement. Why not have a new round of multilateral consultations between key members of the IMF on how monetary policies should respond to a credit crunch and the risk of a deflationary/liquidity trap?

International financial system. The question here is how we can reform the "international financial architecture" to avoid the repetition of a global credit and asset price boom-bust episode of the scale that we are observing now. The crisis generates short-term political demands for far-reaching reforms. However, those reforms are not urgent, since clearly the priority now is to deal with the crisis, not avoid the next one. Reforming financial regulation also involves very technical and complicated issues, so why not take our time and rely on orderly discussions between experts? Well, one reason is that the Basel 2 process is not very encouraging for the view that international discussions between experts lead to a relevant and timely outcome. But are there basic principles that political decision-makers could agree on soon in a forum like the G-20 to put the technical discussions on the right tracks?

Rather than addressing this question, I will instead use my privilege, as an academic, to put forward a proposal whose main merit is logic rather than practicality or political feasibility. I will make the case for an international agreement for the countercyclical prudential taxation on systemically risky financial instruments. Or to put it more shortly, some form of "international prudential taxation" (IPT). I present the general case for prudential taxation elsewhere[7] and will simply summarize the logic here.

First, let us take a step back and look at the anatomy of credit booms and busts. Clearly, some financial instruments contribute more to systemic risk than others. Some complex instruments may come to mind, but there is no need to go further than debt versus equity. The vicious circles in which fire sale of assets and deleveraging feed each other rely on debt---they would not work with equity. So plain vanilla debt is an example of what I have called "systemically risky financial instrument".

Systemically risky instruments have negative externalities in a crisis. Public economics 101 tells us that sources of negative externalities should be taxed. But systemically risky financial instruments should not be taxed in the crisis, when they have been already issued. They should be taxed preventively in the boom, to avoid an excessive build-up of systemic risk. And the tax

[7] See Jeanne, 2008, "Dealing with Credit Booms and Busts: the Case for Prudential Taxation," available at http://econ.jhu.edu/people/Jeanne.

rate should be higher if the boom is more likely to turn into a bust, i.e., the tax should have countercyclical component. I think it should be possible to base this countercyclical component on a probabilistic assessment of the systemic risk, without going into speculations about the boom is a “bubble” or not.

I am calling this approach “prudential taxation” because it borrows elements from both prudential regulation and tax policy. It is prudential because it aims at reducing the risk of financial disruption ex ante, in the same way as the prudential regulation of banks. But it pertains to tax policy rather than regulation to the extent that it would cover all financial instruments of a given type (such as debt) even when those instruments are not issued by banks or regulated financial institutions. The perimeter of the tax, in other words, would be much wider that the perimeter of financial regulation and supervision.

Finally, why an international agreement? The first, standard, reason is to mitigate the risk of international tax competition that would lead to an inefficiently low level of the tax. The second reason, which is less standard but I think not less relevant, would be to mitigate the risk of regulatory capture by domestic special interests.