# The Current Crisis and the Reform of the International Monetary System

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**Abstract**

The global financial crisis of 2007-2009 has sparked some discussions on the need to reform the international monetary system (IMS). The current crisis in the world, intensified by the effects of the war in Ukraine, raises the issue of IMS reform again. An IMS based on the US dollar as a key world reserve currency is no longer able to provide global financial stability. The strong reliance of the global economy on the US dollar as a key currency in cross-border transactions and global foreign exchange reserves has provided the US with significant benefits and a central role in the global financial system. The current crisis shows the need to implement the IMS reform in the direction of creating an international reserve currency, which would have a stable value and would not depend on the monetary policy of one country. The issuance and management of such a currency should be based on rules aimed at maintaining global financial stability. This paper investigates whether the special drawing rights (SDR) can take on the role of a world reserve currency and meet the objectives of IMS stability and neutrality, or whether a more realistic option is an IMS that relies on multiple reserve currencies. The disturbances on the world market due to the war in Ukraine raise the question of whether it is possible to divide the IMS into several smaller currency blocks, with their financial infrastructure. The paper also points out the influence of digital currencies and digital payment systems on the existing international monetary order and capital flows.

**Keywords:** International monetary system, IMF, SDR, US dollar

## 1. Introduction

The International Monetary System (IMS) in the post-war period was created on the growing U.S. role in the world economy. The United States, as the world's leading economic power, has imposed its national currency as the world's reserve currency, which became the benchmark for a system of fixed exchange rates. The accepted convertibility of the US dollar to gold at the Fed was a key pillar of the Bretton Woods monetary system. All countries were obligated to intervene in the foreign exchange market in order to maintain a fixed exchange rate for their currency. The result of this monetary model is the growing demand for dollars in the post-war period. In order to meet this demand, the US had to accept the creation of a current account deficit. Over time, it grew to an unsustainable level, so the US was forced to devalue the dollar. Since the dollar enjoyed the status of the world's reserve currency, in the system of fixed exchange rates it represented an intervention currency in the foreign exchange market. This practically meant that the devaluation of the dollar could only be achieved if other currencies revalued their value against the dollar. Since such readiness did not exist, the US decided first to introduce a tax on all imports, and then the convertibility of dollars for gold was abolished. This effectively abolished the Bretton Woods system of fixed exchange rates, with the transition to the system of floating exchange rates.

Despite the change in the exchange rate system, the dollar has retained its role as the world's key reserve currency to this day. Thus, US monetary policy continued to influence the interest rates of other countries. The external shocks and the emergence of banking and financial crises in the world have affected other countries through the mechanism of interest rates and exchange rates. The growth of foreign exchange reserves in countries in transition and developing countries strengthened the demand for US securities, which are denominated in dollars. Accumulated foreign exchange reserves became sensitive to changes in the exchange rate of

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the dollar, which contributed to increased demands for reform of the IMS. The BRICS (Brazil, Russia, India, China, and South Africa) countries, which are also the leading holders of foreign exchange reserves in the world, took the lead in these requests.

The instability of the dollar and uncertainty about US monetary policy are serious challenges for the countries with the largest foreign exchange reserves in the world. In addition, the US's excessive privilege in the current IMS, due to the role of the dollar as the dominant world reserve currency, began to "bother" many countries, primarily BRICS members. First, the Asian Financial Crisis of 1997-98 and then the Global Financial Crisis (GFC) of 2008-09 heralded the process of reforming the IMS. The response to the GFC was to increase international liquidity through quantitative easing and the introduction of foreign exchange swaps between the Fed and the central banks of developed countries. The GFC, and then the Eurozone sovereign debt crisis, renewed calls for IMS reform.

It is often pointed out the need to create an IMS that is not based on a single national currency but on a basket of currencies. In this sense, it was often emphasised that a multi-currency IMS should be formed, where several currencies (foremost, the US dollar, the Euro, and the Chinese yuan) would share the status of the world's reserve currency. The other considerations went in the direction of replacing dollars with Special Drawing Rights (SDRs), which are artificial asset created within the framework of the International Monetary Fund (IMF). Since the value of the SDR is determined by a basket of currencies (the dollar, the Euro, the British pound, the Japanese yen, and the Chinese yuan), it is believed that this would bring stability to the movement of the SDR value, which is a desirable property of a reserve currency. In recent times, the world has been swept by cryptocurrencies, questioning the viability of the existing IMS. In addition, the war in Ukraine, accompanied by strong disturbances on the world market, opened the issue of choosing the currency of payment for raw materials on the world market. Russia requires that oil and gas imports from this country be paid for in Russian rubles. Something similar can be expected from other large exporters of raw materials, primarily oil and natural gas.

Demands for reform of the IMS have intensified due to geostrategic shifts in the world economy. The process of globalisation has supported the leading role of the dollar in the world economy, and deglobalisation, which is underway, demands this change. The technical improvement of the payment system has accelerated cross-border capital flows, which also necessitates the reform of the existing IMS. The risks for financial stability in the world are intensified by the current inflationary pressures, with hints that the development of stagflation is possible. Uncertainty in the energy market and rising food prices further threaten the living standards of a large part of the world's population. The growth of policy interest rates in the world, primarily in developed countries, hints at the growing difficulties of developing countries and countries in transition in servicing external debt. So there are several reasons for the reform of the existing IMS. In this paper, IMS reform issues are considered from the point of view of current events in the world economy.

## 2. The Instability and Risks of the Existing IMS

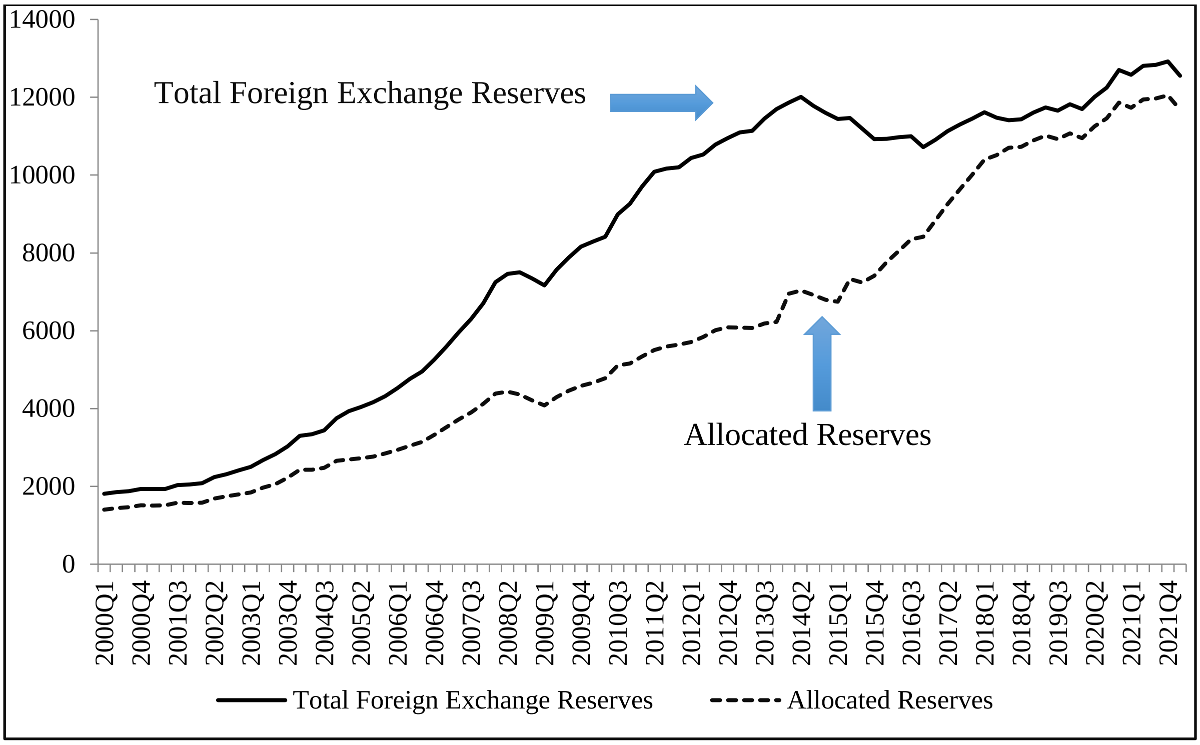
The frequency of financial crises and their unpredictability leads not only to short-term disruptions of the world economy but also affect long-term trends in employment and production growth (IMF, 2009). This was noticeable in the Eurozone countries after the GFC, when the public debt crisis occurred. Previously, significant current account deficits were formed in the peripheral members of the eurozone. The crisis of public debt, primarily in the Eurozone, imposed the need to adjust the current account in order to reduce the ratio of public debt and gross domestic product (GDP) to a more acceptable level (Reinhart, Reinhart, and Rogoff, 2012). The picture repeats itself during and after the COVID-19 pandemic crisis. An expansive monetary policy combined with an increase in public debt created the conditions for financial instability. The gross debt of the general government as a percentage of GDP of many countries has spun out of control, but now in an environment of rising inflation. The tightening of monetary policy in order to suppress inflation represents the closure of one channel of feeding demand, which would mean that another channel in the form of the growth of the public debt should be allowed. However, this is not possible now, at least not to the expected extent, as it would contribute to further current account imbalances, along with the spread of financial instability.

2008/09 GFC highlighted the weaknesses of the IMS and the need for reforms. The expansionary monetary policy of developed countries prevented a long-term recession on a wider scale. The swap arrangements between the Fed and the central banks of developed countries enabled a satisfactory level of dollar liquidity, which alleviated financial instability in the world. The weaknesses in financial supervision have surfaced. Many countries have requested financial assistance from the IMF, and developed countries have strengthened mutual coordination. However, the relaxation of fiscal restraints led to a rise in the public debt of the Eurozone, which required urgent intervention. Although currency swaps between central banks nourished financial liquidity, the expansion of public debt threatened domestic macroeconomic stability. The financial risks have increased, so the Bank for International Settlements (BIS) has strengthened control mechanisms through Basel 3, as a set of reform measures. The goal was to increase the resistance of the banking and financial system to potential new shocks. Due to growing systemic risks, it was necessary to strengthen the role of control mechanisms.

The outbreak of the COVID-19 pandemic has led to a sharp decline in economic growth in the world, with a decrease in world trade. Although initially there was a withdrawal of capital from less developed countries, sufficient liquidity had to be ensured to prevent the outbreak of a financial crisis. The swap arrangements between the Fed and the central banks of developed countries were put back into operation, along with a relaxing public debt policy. This is the same mechanism that was applied during the GFC 2008/09. However, since inflationary pressure has arisen in developed countries, the risks of a new financial crisis have increased today, although for other reasons. Such expectations are supported by a large increase in global energy and food prices. The translation of global value chains (GVCs) into regional chains is a step towards the regionalisation of the world economy. This can lead to a redirection of international capital flows, with inevitable consequences for poorer countries. The risks of sudden reversals of capital flow primarily concern these countries.

## 3. The Foreign Exchange Reserves as Shock Absorbers

In the period after the Asian financial crisis of 1997/98, many developing countries and emerging countries strongly increased foreign exchange reserves in order to protect against potential external shocks. Namely, this crisis showed that countries with larger foreign exchange reserves could use them to mitigate the volatility of the exchange rate and that their macroeconomic disturbances were smaller than in countries with a smaller amount of foreign exchange reserves. Apart from this reason, many countries wanted to avoid IMF conditionality when approving loans for economic stabilisation. They actually tried to avoid using IMF loans. The growth trend of global foreign exchange reserves is shown in Figure 1.

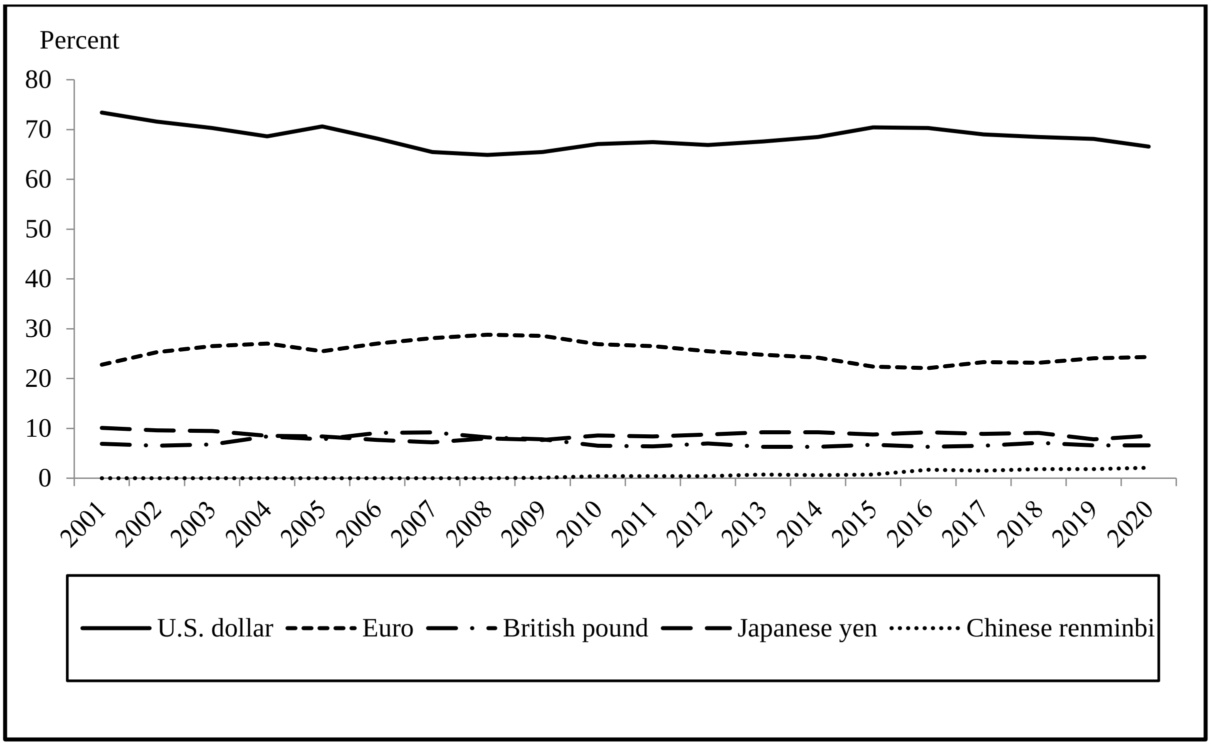



Source: https://data.imf.org/regular.aspx?key=41175 (Accessed 07/26/2022)

**Figure 1:** Officional foreign exchange reserves (US Dollars, Billions)

In the period up to 2014, the global foreign exchange reserves had a dynamic growth. This was followed by a milder growth trend in global foreign exchange reserves, which led to a drop in the ratio of foreign exchange reserves to GDP. Of course, there are differences between countries. Countries that tied their exchange rate to another currency or a basket of currencies tended to have a larger amount of foreign exchange reserves, due to more frequent interventions in the foreign exchange market in order to alleviate pressures on the exchange rate. China had the largest growth in foreign exchange reserves in the period up to 2014. Countries with a flexible exchange rate had the lowest growth. The foreign exchange reserves of commodity-exporting countries grew due to the increase in the prices of raw materials on the world market. In this way, these countries converted current account surpluses into foreign exchange reserves. Some countries' foreign exchange reserves grew even during the GFC, because they avoided using them to cover up that they were under pressure that could intensify if investors started to transfer capital to other countries (Chiţu, Gomes, and Pauli, 2019). Certain countries have been increasing their foreign exchange reserves due to uncertainty regarding the availability of international liquidity in the event of a major financial crisis. The motive for increasing foreign exchange reserves in some countries is volatile capital flows, which can put pressure on the exchange rate of the national currency, or the imbalance of their current account. In some countries, the reasons for the growth of foreign exchange reserves are related to the strengthening of export competitiveness.

The growth of global foreign exchange reserves is characterized by the relatively stable role of the US dollar in the currency structure of reserves. A good indicator of the international role of the dollar is the index constructed by Bertaut, Von Beschwitz, and Curcuru (2021). We give the calculation of these authors in graph 2.




Note: Index is a weighted average of each currency's share of globally disclosed FX reserves (25 percent weight), FX transaction volume (25 percent), foreign currency debt issuance (25 percent), foreign currency and international banking claims (12.5 percent), and foreign currency and international banking liabilities (12.5 percent).

Primary Source: Source: IMF COFER; BIS Triennial Central Bank Survey of FX and OTC Derivatives Market; Dealogic; Refinitiv; BIS locational banking statistics; Board staff calculations.

Secondary source: Bertaut, Von Beschwitz, and Curcuru (2021), The International Role of the U.S. Dollar, retreived 7/5/2022 from https://www.federalreserve.gov/econres/notes/feds-notes/the-international-role-of-the-u-s-dollar-20211006.html

**Figure 2:** Index of international currency usage

According to the findings of Bertaut, Von Beschwitz, and Curcuru (2021), the US dollar shows a dominant stable share of around an index value of 75 after the 2008/09 GFC, and the next highest index value is the euro at around 25. The index level of the Chinese renminbi is only around 3, although the growth tendency was revealed in the last ten years. The Japanese yen and British pound index are above the Chinese currency index.

The international use of currencies shows that the dollar is still the world's key currency. Its share in the foreign exchange reserves has decreased since 2000 (although it is still dominant), and its use in invoicing world trade, international payments, and cross-border capital flows is also still dominant. All this indicates that the mainstay of the existing international monetary system, in addition to the institutions that were created at the time of the Bretton Woods monetary system, is the US dollar. Thus, little has changed in the IMS compared to the situation that existed during the Bretton Woods IMS. The numerous reasons for the reform of the IMS arose in this context. In addition, the US as the largest economy in the world has built the role of the dollar as the key world currency based on its economic and military hegemony in the world. It can be expected that the US will vehemently defend the existing international status of the dollar, because the loss of the status of the world's key reserve currency may be a sign of the decline of US economic power. The dollar's current position allows the US government to more easily finance budget and trade deficits with government securities.

The erosion of the dollar as the world's dominant reserve currency could threaten US hegemony in the world (Farrell and Newman, 2019; McDowell, 2021). Countries that have intensive diplomatic relations with the US tend to have the most US dollars in their foreign exchange reserves (Norrlof, 2020). However, the introduction of sanctions ("weaponisation" of finance) against a country that has dollars in its foreign exchange reserves makes their use impossible (the case of US sanctions (freezing of foreign exchange reserves) against Russia due to the war in Ukraine). Therefore, it is likely that now other countries in the world, which estimate that for various reasons they could come under the influence of US sanctions, will try to reduce the share of the US dollar in their foreign exchange reserves, due to the risk that they will receive zero value. Of course, other reasons also affect the currency restructuring of foreign exchange reserves. The strengthening of financial and capital markets in other currencies opens the possibility of obtaining higher returns (Arslanalp et al., 2022).

Despite the open process of currency restructuring of global foreign exchange reserves, Weiss (2022) points out that today about three-quarters of foreign government holdings of US government bonds in the hands of foreigners are owned by countries that have some form of military connection with the US. Based on this data, the author concludes that it is unlikely that the dominance of the US dollar will be ended even if countries less geopolitically connected to the US would reduce the use of dollars for trade invoicing and debt denomination. Dooley et al. (2022), on the other hand, believe that sanctions on the use of Russian international reserves will not reduce the attractiveness of the dollar as a reserve currency. He explains his belief by the fact that countries have to convince foreign investors that their investments are safe, and they can do that if they have enough reliable foreign exchange reserves, such as dollar reserves.

## 4. The Special Drawing Rights (SDRs) Prospects as International Currency

The growing need for creating international liquidity revived the interest in strengthening the role of the SDR in the IMS. The SDR is created by the IMF, and its value is determined on the basket of currencies (US dollar, euro, Japanese yen, British pound, and Chinese yuan). This asset was created with the intention of helping IMF member countries in easing the balance of payments crisis. SDR funds are approved based on the quotas of member countries.

In response to the current crisis, the IMF allocated SDRs in the amount of 650 billion dollars in August 2021. Fund members can use these funds independently of the macroeconomic policy. However, the SDR is not a currency and there is no free market for its exchange with other currencies, but the exchange is done within the framework of the IMF. In addition, of the mentioned SDR allocation, about 60% was allocated to high-income countries, which have no difficulty in borrowing to finance budget deficits. More than 17% went to the US, which can normally print the desired amount of dollars through the issue of government securities. It is obvious that even in the distribution of SDR, the largest amounts are received by developed countries[2].

In order for the SDR to become widely represented as a means of payment in international trade and international finance, it is necessary to establish its exchangeability for other currencies. Today, the SDR is used in settlements between governments and international institutions, and it needs to be used in business transactions in order to qualify as a real currency. Its use in international trade would be useful in many ways in stabilizing the prices of goods and financial assets. If the IMF were to introduce securities denominated in the SDR, the process of affirming the SDR as a real, marketable currency could be opened. In that case, countries could keep part of their foreign exchange reserves in the form of SDR, which would reduce the risks of losing

[2] Data are provided according to https://www.imf.org/en/About/FAQ/special-drawing-right (accessed 10/30/2022). Also, see Chelshy (2011).

their value, which exist with the current currency structure of foreign exchange reserves. If the management of a significant part of the global foreign exchange reserves expressed in SDR were transferred to the IMF, the role of this asset would be strengthened, while stabilizing the financial markets. Over time, opportunities might be created for a greater allocation of SDRs, and the replacement of existing currencies for SDRs in the structure of foreign exchange reserves. Only in that case, SDRs could significantly increase the global liquidity of the IMS. Perhaps that would be the way to create a world central bank, something similar to what John Maynard Keynes suggested long ago[3].

The use of SDRs to finance IMF programs could contribute to the consolidation of the Flexible Credit Lines introduced during the GFC 2008/09 (IMF, 2017). However, it could strengthen the SDR's position as a reserve currency. As for the SDR, it could be concluded that this artificial asset does not have the potential to threaten the US dollar as the world's reserve currency for now.

## 5. The Current Crisis and IMS Reform

An effective IMS can stimulate economic growth in the world and can be a satisfactory framework for global financial stability. These are also prerequisites for the integration of the world economy, from which all countries would have visible benefits. Financial crises revealed the weaknesses of the existing IMS and indicated the need to improve the mechanisms of its functioning. Although it is unrealistic to expect fundamental changes in IMS in the short run, the number of countries in which the necessity of reforms is perceived is increasing. In current circumstances characterized by the increased risks of crisis, countries in transition and developing countries are particularly exposed to these risks. Building an open economy and including these countries in global value chains increases the impact of the economic policy of developed countries on their economy. The spillover effects of financial measures in developed countries on developing countries are intensified with the increase of their openness. Less developed financial markets of developing countries are more sensitive to reversals in capital flows. The accumulation of financial risks, especially among non-banking financial institutions, draws attention to the need to strengthen the supervision of the global financial system. The strengthening supervision over capital flows and the creation of a global network to preserve financial security, along with the coordination of economic policy between countries, are directions of engagement that can act to prevent a crisis. Gallagher and Kozul-Wright (2022) propose the creation of a so-called "global financial safety net", with the intention to create a financial fund that could mitigate financial instability in the event of a crisis.

Given that the world is facing increased uncertainty and low economic growth, the ideas of reforming the IMS are once again relevant. The increased global cooperation and the creation of institutions that will facilitate this cooperation is an important prerequisite for crisis prevention. Taylor (2019) shows that monetary policy in recent years has been conducted defensively or offensively towards the environment, with the aim of countering foreign influences on the exchange rate. Therefore, the feasibility of certain reform ideas should be taken into account, starting from the current constellation of international economic and political relations.

One of the responses to insufficient global liquidity is the expansion of the club of global reserve currencies, which would create a multipolar currency structure of reserve currencies. In this way, investment alternatives would increase, along with an increase in official international liquidity. In addition, Farhi et al. (2011) believe that a multipolar currency structure would contribute to the reduction of exchange rate fluctuations and reserve asset prices (interest rates).

[3] See Ghosh (2019) for an interesting presentation of Keynes's ideas from today's point of view.

Of course, the supply of international reserves to the market is related to the fiscal balance (Obstfeld, 2011). In fact, no country in the world could continuously create a fiscal deficit, and offer its currency to the rest of the world in an unlimited amount. A new institutional framework is needed for the new multipolar system of official reserves ((Smaghi, 2011). This scenario looks quite realistic because in the last 20 years China's economic power has grown rapidly, while the US economy has become more vulnerable. In the possible distribution of roles in the group of reserves currency, the renminbi could specialize in payments in the real economy and international trade, especially in raw materials trade, while the dollar would specialize in providing assets for the financial system. Certainly, it is necessary to assess how the evolution toward a multipolar currency system could affect global monetary and economic stability.

The introduction of sanctions, affecting access to financial instruments and resources, against Russia due to the war in Ukraine raises the question of coherence and trust in the international financial system. In fact, sanctions can lead to the segmentation of the international financial system (Harding, 2022). In the current global geopolitical landscape, it is difficult to safeguard global financial stability. Although the supply of dollars during the GFC 2008 and during the COVID-19 pandemic, via swap arrangements between the Fed and the central banks of developed countries, helped to avoid financial illiquidity, the question is whether that mechanism can be used today due to the political tension between Russia and the West countries.

The collective economic power of the BRICS countries cannot be ignored in discussions on IMS reform. Could their economic power lead to a diminishing role of the dollar in the international monetary system? Although dollar swap arrangements were used as a buffer against global financial illiquidity during the GFC 2008 and during the COVID-19 pandemic, it would certainly be more difficult to implement today. The US ensured that the world received an unlimited amount of dollars so that the dollar acquired the status of a "global public good" (Wolf, 2022). Such an intervention would hardly be feasible in today's geopolitical divisions in the world (Brunnermeier, James, and Landau, 2022).

The modern improvement of the digital payment system in the world imposes a digital version of the IMS reform. The Bank for International Settlements (BIS, 2022, p. 75) proposed a plan for a digital monetary system. This plan is based on a digital version of the national currency, with the expectation that in this way the stability of the system could be preserved while increasing the efficiency of operations. This proposal was created at a time of great volatility in the cryptocurrency market. The innovation in international payments provides the possibility to make them faster and cheaper. This increases the degree of adaptability of IMS. In the future, the digital yuan could compete with the US dollar in invoicing international trade. Although the digitization of payments imposes certain reforms, primarily in payment technology, it does not solve the issues related to the reserve currency.

The fragmentation of the international monetary system into several currency areas is also a possible option for the reform of the existing IMS. This possibility is increasingly certain after the introduction of financial sanctions by Western countries on Russia, and the freezing of Russian foreign exchange reserves. Russia's insistence on payment in rubles for oil and gas exports may be followed by similar actions in other countries. The BRICS block is considering various modalities of introducing a common digital currency, which would be used for invoicing their exports, including a BRICS stable digital currency, whose value would be derived from the value of a basket of stable digital currencies of the members of this group. China has already advanced in testing a stable digital yuan, with the prospect of using the currency for international payments. The ongoing process of internationalisation of the yuan can be strengthened by the introduction of a stable digital yuan. The aforementioned processes will significantly influence the shaping of the future international monetary system.

## 6. Conclusion

The existing IMS is in many components a legacy of the Bretton Woods IMS. The IMF and the World Bank are institutional pillars inherited from the post-war period. The US dollar built its status as a key world currency in the Bretton Woods IMS. However, the stability of the world economy was undermined during the 70s of the last century. From then until today, we have witnessed frequent occurrences of banking and financial crises in the world, as well as cyclical movements in the world economy. The 2008-09 GFC and the crisis caused by the COVID-19 pandemic highlighted certain weaknesses in the existing IMS and the need for its reform. Although the US dollar has lost its global importance in some international roles (the dollar's participation in the currency structure of global foreign exchange reserves has decreased, but it is still the dominant currency in this role), its role in other areas is still strong (invoicing international trade, foreign exchange market, securities market, capital market). Given its status as a key international currency, the dollar has enabled the US to finance its budget and current account deficits without difficulty. American government securities, although with low yields, represent a safe asset, which is why all central banks in the world keep a significant part of their foreign exchange reserves in this currency. In this way, they become largely dependent on the US monetary policy. When the value of the dollar against other currencies decreases, the value of foreign exchange reserves denominated in this currency also decreases. The risks of potential loss of value, as well as the desire of central banks to increase the yield from holding foreign exchange reserves, led to the gradual diversification of the foreign exchange portfolio of central banks. This is why the dollar's share of global foreign exchange reserves has declined over the past 20 years. Although this share has declined, dollar liquidity during the GFC and the COVID-19 crisis prevented the outbreak of a larger-scale crisis. Namely, the dollar swaps between the Fed and the central banks of other developed countries ensured the necessary liquidity of banking systems and contributed to the preservation of financial stability. Despite this, the weaknesses of the IMS related to the key reliance on the dollar as the US national currency have been revealed. Even before the GFC 2008/09, the BRICS countries indicated the need for IMS reform. Various modalities of that reform were considered, but there were almost no visible changes to the IMS.

In the meantime, there have been major disruptions in the world economy (GFC 2008-09, Eurozone public debt crisis 2010-12, Covid-19 crisis, as well as a current indication of global stagflation), which have highlighted the need for IMS reform. The emergence of numerous cryptocurrencies and the instability of this market led to the creation of stable digital currencies. Advances in technology have enabled the development of digital payment systems, which have increased the efficiency of money transfers and reduced costs, especially in cross-border payments. The war in Ukraine, apart from the direct impact on the strong increase in global energy and food prices, was also the reason for the US and other Western countries to impose financial sanctions on Russia, including the freezing of their foreign exchange reserves. Thus, the risk of holding foreign exchange reserves in dollars became obvious. Therefore, it can be expected that in the future each country will review its own exposure to this risk and that there will be a strengthening of the process of de-dollarisation of global foreign exchange reserves. Russia has already introduced the ruble as a payment currency for its oil and natural gas exports. China has been promoting the internationalisation of the yuan in international payments for a long time. These processes can also lead to the fragmentation of the IMS, with the emergence of several larger economic and currency blocs. This would lead to certain reforms of the IMS, as each group of countries would seek to protect their own interests. Although this would represent a deviation from the desired pattern of IMS reform, which should be implemented in the interest of all countries, the existing economic and political circumstances in the world could contribute to deglobalisation of the world economy and fragmentation of the current IMS.

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