

# International Monetary Fund

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## Whats wrong with the international monetary system

Warren Coats



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# What's wrong with the International Monetary System and how to fix it?

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Presented at the *Kemp Forum on Exchange Rates and the Dollar*

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April 20, 2017

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## Table of Contents

Table of Contents .....	2
Introduction .....	3
Background .....	3
The SDR.....	6
The Reformed SDR .....	7
Issued rather than allocated.....	8
SDR's valuation basket .....	9
Indirect redeemability .....	9
Political factors .....	10
US exorbitant privilege.....	10
Substitution account.....	11
Trust in IMF control of international reserves.....	12
Conclusion.....	12
Bibliography.....	13

## Introduction

The replacement of fixed exchange rates under the gold standard with floating rates and inflation targets has not worked out well. We need to return to money with fixed exchange rates, tightly tied to a hard anchor.

To avoid the weaknesses of the gold standard that ultimately led to its abandonment in the mid 1970s, we need to replace discretionary monetary policy with currency board rules for maintaining the value of national currencies to that of a hard anchor. The currency anchor should have a more stable value than gold.

The U.S. dollar and any other national currency should be replaced in international monetary reserves by an internationally issued currency following the same currency board rules and fixed to the same hard anchor as used by national currencies.

These steps would establish a market driven, international currency with a much better prospect of surviving than would a return to the gold standard. Economic efficiency and growth would benefit from the establishment of such a fixed exchange rate system.

## Background

The value of the United States' currency since its birth was tied to silver or gold or both, except during the period of the civil war, until President Richard Nixon closed the "gold window" in 1971 and formally floated the dollar's exchange rate in 1973. As recommended by Treasury Secretary Alexander Hamilton, the Coin Act of April 1792 established a mint and defined the dollar as 371.25 grains of pure silver minted with alloy into a coin of 416 grains. Gold coins were also authorized and the ratio of silver to gold in the value of a dollar was 15 to 1.

This bimetallic standard was suspended during the American civil war and was replaced by a pure gold standard from 1879 – 1933. With most other trading nations on gold standards as well, trade flourished during what has become known as the first era of globalization. In 1933 President Franklin Roosevelt undertook a series of measures, retroactively endorsed by Congress, that are hard to believe could have been legal. Roosevelt devalued the dollar 40% by raising the price of gold from \$20.67 per troy ounce to \$35.00, nationalized private holdings of gold and abrogated gold clauses in public and private contracts thus repudiating 40% of the value of government bonds outstanding. Surprisingly the Supreme Court upheld these measures. The gold standard was thus terminated domestically but retained for international settlements by the Gold Reserve Act of 1934.

The establishment of the International Monetary Fund after World War II formalized the so-called gold exchange standard by which the US dollar became the default international reserve currency. Member countries of the IMF fixed the exchange rates of their currencies to the U.S. dollar, which remained fixed to gold at \$35.00 an ounce. The U.S. pledged to convert dollars held by foreign central banks into gold at that fixed price.

The new, so-called Bretton Woods, system weakened the monetary discipline of the full-fledged gold standard. Foreign central banks built up reserves of U.S. dollars in order to soften or temporarily thwart the monetary consequences of balance of payments (BOP) imbalances at their fixed exchange rates. Under a pure gold or silver standard monetary and price adjustments occurred automatically via Hume's specie-flow mechanism when BOP disequilibria needed correction. Robert Triffin pointed out that the use of the dollar in international payments and reserves required the United States to have a BOP deficit sufficient to supply its currency abroad. The build up of dollar reserves by foreign central banks could eventually raise concerns about the capacity of the U.S. government to honor its growing debt obligations as well as its obligation to redeem its currency for gold when demanded by foreign central banks. Its international currency obligations could and often did conflict with its domestic monetary policy objectives (the Triffin dilemma).

In response to this dilemma, the United States and other members of the International Monetary Fund, created Special Drawing Rights (SDRs) in 1969 to supplement the dollar and other national currencies in international reserves. The SDR's value was defined as the same amount of gold as the U.S. dollar and was thus fixed to the dollar one for one. However, by that time the loss of monetary and fiscal discipline afforded by the rules of the gold exchange standard and President Lyndon Johnson's Guns and Butter financing of the Viet Nam war and the War on Poverty had undermined the credibility of America's commitment to redeem official holding of the dollar for gold.

In August 1971 President Richard Nixon "closed the gold window" in what was expected to be a temporary suspension of gold convertibility followed by a devaluation of the dollar to \$38 per ounce in March 1972, and again to \$42.22 in February 1973. However, no official transactions were made at these rates. The gold window never reopened and the exchange rate of the dollar for other currencies floated freely after March 1973, a state of affairs officially acknowledged by the Second Amendments to the IMF's Articles of Agreement in 1976.

The system of floating exchange rates (though many smaller countries continued to fix their exchange rates to the dollar or other major country currencies) did not end central banks' demands for dollars nor the Triffin dilemma. The Second Amendment to the IMF's Articles of Agreement obligated Fund members to make the SDRs "the principal reserve asset in the international monetary system" (IMF Article XXII). This article was totally ignored by everyone for a number of reasons including flaws in the basic design of the SDR, to which I will return later.

Floating exchange rates freed up central banks to focus on domestic price stability but introduced volatility and unpredictability to exchange rates, which was harmful for trade.<sup>2</sup> Having accepted the fact that monetary policy could only influence employment temporarily, most central banks around the world were made independent to pursue domestic price stability. Policy tools were refined during the 1980s and a variety of policy approaches were tested. A detailed inside review by David Lindsey of Federal Reserve policy formulation from 1975 to 2002 notes that: “The Federal Reserve discovered that pragmatic money targeting could not be done on a computer, as Milton Friedman had advocated. Communicating the ins and outs of monetary targeting in practice similarly was not easy....”

An increasing number of central banks began to target inflation directly, generally by targeting a short-term money market interest rate relative to estimates of its equilibrium real rate. The Fed (FOMC) made its inflation target explicit in January 2012. Monetary stability, defined as price stability, improved, but exchange rate volatility increased significantly. The Great Moderation that resulted from more stable domestic prices was followed by the Great Recession. The Great Recession of December 2007 to June 2009 highlighted the failure of inflation targeting to take account of asset price bubbles and for “inappropriate responses to supply shocks and terms-of-trade shocks”.<sup>3</sup> What followed can only be described as a nightmare (largely because of weaknesses in the U.S. financial system). After properly and successfully performing its function of a lender of last resort and thus preventing a liquidity-induced collapse of the banking system, the Fed went on to undertake ever more desperate measures to reflate the economy. These Quantitative Easings (QEs)—quasi-fiscal activities—have been widely discussed and have contributed little to economic recovery.<sup>4</sup>

The conclusion from the above history is that monetary policy is being asked to deliver more than it is capable of delivering. Central banks are generally staffed by very capable people, but they can never know all that they need to know to keep the economy at full employment as employers and jobs keep changing. The quality of forecasting models has greatly improved in recent years, but they remain unreliable. The policy strategy and intentions of the Fed and other inflation targeting central banks have become admirably, if not painfully, transparent, but given the uncertainty of its next policy actions, markets remain spooked by every new data release and speech by Fed officials. The idea that central banks can micro-manage monetary conditions to smooth business cycles is a conceit. In my opinion, central banks have given their price stability mandates their best shot and failed. The

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<sup>2</sup> Steve Hanke, “In Emerging Markets, It's Time To Dump Most Central Banks, And Their Currencies Too.” *Forbes*, March 22, 2017.

<sup>3</sup> Jeffrey Frankel. [\*"The Death of Inflation Targeting"\*](#). *Project Syndicate*, May 16, 2012.

<sup>4</sup> See for example, Warren Coats, “US Monetary Policy: QE3”, *Cayman Financial Review* January 2013.

successful, countercyclical management of the money supply with floating exchange rates is simply beyond the capacity of mortals.

We need to restore a more rule based, market drive, international monetary system, as we almost had with the gold standard. But the new system must avoid the deficiencies of the gold standard. We also need to understand why the SDR failed to provide the basis for such a new system in order to know how to fix its deficiencies.

## The SDR

The abandonment of the gold standard with its fixed exchange rate system for floating exchange rates did not end countries' demands for international reserves nor the need for an internationally issued reserve currency. For one thing almost no country's currency floated freely, giving raise to the term "dirty floating." With floating exchange rates it was difficult to refute or support claims that central banks intervened in currency markets to give their exports a competitive advantage.

With the adoption of the Second Amendments to the IMF's Article, the value of the SDR was changed from gold to a basket of currencies. Effective October 1, 2016 the Chinese renminbi (RMB) was added to the valuation basket joining the US dollar, Euro, Japanese Yen and British pound. The valuation basket is reviewed every five years according to very well defined criteria and adjusted as needed to reflect the importance of each currency in international payments and reserves. Based on currency weights established at each five yearly review, specific amounts of each currency define the valuation basket over each five-year period such that as exchange rates change, the currency weights of the fixed amounts change every day. The valuation basket has been adjusted every five years in a well-defined process that preserves its continuity of value on the day the new valuation basket replaces the old one. On March 30, 2017 one SDR was valued at 1.359920 USD.

To compete with the U.S. dollar in international reserves, the SDR would need the financial infrastructure of instruments and facilities enjoyed by the dollar. Developing such an infrastructure would require some prodding by the IMF, which has been totally lacking.

The attractiveness and importance of the existing SDR could be greatly enhanced without changes in the Fund's Articles of Agreement by continuing the relatively large allocations started in 2009, encouraging the adoption of the SDR unit for pricing and invoicing of all International Financial Institutions operations, and of globally traded commodities (e.g., oil). The demand for and thus the development and use of SDR denominated financial instruments ("private SDRs") would follow naturally from its wider use for pricing and invoicing. Clearing and settlement facilities for such SDR instruments and for the SDR currency counterparts would

also provide a major boost to the expanded use of SDRs as an international reserve asset in all respects.<sup>5</sup>

An all SDR IMF as advocated by J. J. Polak would further expand the use of SDRs.<sup>6</sup> Pegging domestic currencies to the SDR rather than the dollar or euro would generally provide increased real effective exchange rate stability and would further increase the demand for and use of SDRs of all types (official and private).

## The Reformed SDR

While valuing an SDR on the basis of five major currencies makes its value more stable than any one of them, the failure of most countries to fix the exchange rates of their currencies to it reflects, in addition to the lack of the private SDR infrastructure discussed above, a number of political and economic factors including some flaws in its design.

SDRs are allocated in proportion to IMF members' quotas, which reflect their economic size and importance in world trade, when its members conclude that there is "a long-term global need to supplement existing reserve assets." SDR allocations, while cleverly designed, suffer from two serious problems. SDRs created and allocated and recorded on the accounts of the IMF's member countries do not generally match the demand for them to hold as reserves by each recipient. Thus detailed administrative rules are necessary to regulate their use and to insure their acceptance by other member countries. This seriously diminishes their usefulness for international payments (but not as a unit of account) compared with, say, the U.S. dollar. Suggestions in the 1970s that SDRs might be allocated to help finance economic development in poorer countries, also raised the same concerns that would be raised if domestic central banks were to issue money for similar purposes. The idea that an international body would be given discretionary authority to issue SDRs as needed and to whom they were deemed to be "needed" was and remains a political non starter.

Two further enhancements could transform the SDR's attractiveness and potentially precipitate a virtuous cycle of its wider adoption as an exchange rate peg, invoicing unit, means of payment, and reserve asset to such an extent that dollar holdings in reserves might actually fall. First, allocations could be augmented or replaced by issuing (rather than allocating) SDRs with open market sales (and repurchases) of SDRs according to currency board rules. Second, the SDR's valuation basket, though

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<sup>5</sup> Coats, Warren, "The SDR as a Means of Payment," *IMF Staff Papers*, Vol. 29, No. 3 September, 1982

<sup>6</sup> Polak, Jacques J. *Thoughts on an International Monetary Fund based fully on SDR*. Pamphlet Series No. 28, International Monetary Fund, Washington, DC. 1979.



marginally attractive relative to the behavior of a single currency, could be significantly improved by giving it a constant real value (to be defined below). The first of these would require an amendment to the IMF's Articles of Agreement.

### Issued rather than allocated

If the IMF were to **issue** SDRs under currency board rules rather than **allocate** them, only those wanting them would acquire them. Thus they could be used freely like the monetary liabilities of any "other" central bank. The rules required to ensure the usability of allocated SDRs would not be needed. Under currency board rules the IMF would not and should not be given discretion to determine the global market's need for liquidity. Currency board rules oblige a central bank to passively buy and sell its currency at its fixed price in response to public demand. Under the Gold Standard, the price of the currency was set as an amount of gold (a gold anchor). For existing currency boards, the price is an amount of another currency (its exchange rate). The IMF would provide the amount of SDRs demanded by the market by passively buying and selling them for dollars or other key currencies at the SDR's officially fixed price for its anchor (the SDR valuation basket).

Now that Estonia and Lithuania have joined the Eurozone there are currently twelve central banks operating under currency board rules. The market supply of their currencies is regulated by the market via the central bank's commitment to buy and sell its currency for the foreign anchor currency at its official exchange rate. The SDR's market value could be kept equal to its official value (i.e., the value of its valuation basket) in the same way. The IMF would stand ready to passively buy or sell its SDR currency (balances in member central banks' SDR currency accounts with the IMF) for a select list of eligible assets (e.g., U.S. Japanese, UK and EU government debt securities) at the market value of one real SDR (see the discussion below of indirect redeemability).

A further reform might allow international commercial banks to hold official SDRs (i.e. open accounts in the SDR Department of the IMF) thus allowing foreign exchange market dealing in SDRs directly. The ability to settle market transactions with "SDRs" directly without first exchanging them for USD or EURO would further enhance the attractiveness of official (IMF issued) SDRs as reserve assets. Such SDR holding would take the form of deposit balances with the IMF or a third-party clearing bank such as the BIS. Account holders might be limited to IMF members as now or could be opened to all qualifying international banks. A two or three-tiered structure could be used to tie all banks into the system for the clearing and settlement of SDR payments.<sup>7</sup>

Countries pegging their own currencies to the SDR under currency board rule or using the IMF's SDR directly would have no monetary discretion that might be

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<sup>7</sup> International Monetary Fund, "[Reserve Accumulation and International Monetary Stability](#)", April 13, 2010.

abused. Unlike the gold exchange standard of the Bretton Woods system, such governments could not borrow from their central bank, and they could not actively interfere in the market's adjustment of monetary conditions required for external balance. There would be no Triffin dilemma.

### **SDR's valuation basket**

While pricing in SDRs, pegging an exchange rate to SDRs, or holding assets denominated in SDRs provide the stabilizing advantages of a portfolio of major currencies and the transactional efficiencies of a universally fixed and recognized portfolio, these advantages are modest relative to dealing in any one of the five basket currencies. If the SDR's value were determined by a basket of commonly consumed goods and commodities (e.g., a CPI or PPI basket), it would more closely achieve the goal of being a unit with constant real value. Its value would be anchored to the real economy. This would set it apart from any existing currency and could attract considerable interest for invoicing and denominating assets, and as a currency peg. If all currencies (or at least the major ones) were fixed to the SDR there would be no independent currencies to include in the valuation basket anyway requiring real alternatives.

### **Indirect redeemability**

Rather than buying and selling SDRs for the items in its valuation basket (ala the gold or other traditional commodity standards), the IMF would sell and redeem these "real SDR" for the basket indirectly (against government or other AAA financial assets of equivalent value).

Greenfield and Yeager explained why transactions in and storage of the items in the valuation basket are not necessary to tie the market value of a currency to that of its valuation basket.<sup>8</sup> If a currency is indirectly redeemable for its valuation basket, it can be redeemed for something of comparable market value to the basket rather than for all of the items in the basket. Any discrepancy between the market value of the currency and its official value defined by its valuation basket would create an arbitrage incentive to either buy or redeem the currency with the issuer at the basket price paying or receiving the equivalent value of the designated redemption asset (rather than everything in the basket).<sup>9</sup> This market mechanism for keeping

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<sup>8</sup> Greenfield and Yeager, 1983 and those cited there.

<sup>9</sup> To illustrate with the simplified case of a basket consisting of one ounce of gold defining one SDR and the market price of one t-bill initially equal to one SDR: if all market prices double so that one ounce of gold and one t-bill cost 2 SDRs in the market, it will be profitable to redeem SDRs for the one ounce of gold equivalent in t-bills per SDR. The one ounce of gold value of an SDR when redeemed will buy one t-bill in the market, thus one SDR may be redeemed for one t-bill, but that t-bill will buy 2 SDRs in the market giving rise to arbitrage profits from redemptions. The

the quantity of currency equal to the market's demand for it at its official value is well known and has functioned well with existing currency boards.

## Political factors

### US exorbitant privilege

Interest in enhancing the role of the SDR has waxed and waned over the years, but on every occasion was ultimately opposed by the United States. Two reasons for the lack of U.S. support seemed to have dominated. The U.S. enjoys the profits of seigniorage from dollars held abroad. However, the trade deficits by which it supplied its currency to international holders have contributed to the offshoring of its manufacturing industries. Secondly, the termination of the U.S.'s obligation to redeem its currency for gold and its ability to borrow abroad in its own currency (its so called "exorbitant privilege") removed an important restraint on deficit financing for the U.S. and many other countries. While this was politically desirable in the short-run, it contributed to growing deficits in the long-run, thus promoting the excessive leverage that was a major contributor to the recent global financial crisis. In addition, floating exchange rates and their accompanying exchange rate uncertainty were a detriment to trade.

Attitudes may be changing. Former Federal Reserve Board Chairman Ben Bernanke stated at the 2015 annual meetings of the IMF and World Bank that: "Earlier the international use of the U.S. dollar benefited the United States. Now the costs and benefits of the dollar's reserve currency role are more balanced."<sup>10</sup>

Jared Bernstein argued in a New York Times op-ed article that, "what was once a privilege is now a burden, undermining job growth, pumping up budget and trade deficits and inflating financial bubbles."<sup>11</sup>

In 2009, in the wake of the international financial crisis originating in the United States, Zhou Xiaochuan, the Governor of the People's Bank of China, called for the ultimate replacement of the U.S. dollar as the world's reserve currency with one issued by the IMF (the Special Drawing Right—SDR). "The acceptance of credit-based national currencies as major international reserve currencies, as is the case in the current system, is a rare special case in history. The crisis again calls for creative reform of the existing international monetary system towards an

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resulting contraction of the market supply of SDRs will reduce market prices in SDRs.

<sup>10</sup> Ben Bernanke at the 16<sup>th</sup> Jacques Polak Annual Research Conference at the International Monetary Fund, November 5, 2015

<sup>11</sup> Bernstein, Jared, "Dethrone 'King Dollar'". *The New York Times*, August 27, 2014.

international reserve currency with a stable value, rule-based issuance and manageable supply, so as to achieve the objective of safeguarding global economic and financial stability.”<sup>12</sup>

The weaknesses of the floating exchange rates that replaced the gold standard have also become clearer with time. These increase the cost of trade from volatile exchange rates (e.g. over a 40% swing in the Euro/USD rate since introduction of the Euro), political tensions from currency manipulations/wars, and prolonged and distorting balance of payments imbalances from lack of clear and enforced rules.

### Substitution account

Over time the value of the assets held by the IMF against the SDR currency it would issue, consisting of the eligible government debt it had purchased when selling its SDRs, would not necessarily match the market value of its liabilities (the SDR). These assets would earn interest from which the IMF's operations could be financed and any valuation gains or losses relative to the valuation basket defined value of its SDR liabilities could be covered. In an all SDR world, one in which all countries have pegged their currencies to the SDR or used it directly, the only valuation risks to the eligible SDR denominated debt held by the IMF would arise from changes in interest rates (and default). Thus the IMF's holdings of such assets should have short maturities.<sup>13</sup>

The possibility of net gains or losses on the assets held by the IMF against its Real SDR liabilities relative to the value of those liabilities raises the same issue faced by any central bank. Who would cover any losses should they arise? When this issue was discussed in the 1970s in connection with a proposal to substitute US dollars held in central bank reserves with SDRs (the so-called Substitution Account), many IMF members argued that the U.S. should cover any losses because the Account directly benefited the U.S. The U.S. saw it differently, as do I. The proposal was dropped when no agreement could be reached on how to share this risk.

Revival of the old substitution account idea lacks “only” political will and would allow large-scale substitution of existing U.S. dollar reserves with SDRs without exerting exchange rate pressure on the dollar. Substituting issued SDRs would be dramatically more attractive than the earlier proposal to substitute allocated ones with all of their regulations for their use. Agreement would still be needed on how

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<sup>12</sup> Zhou Xiaochuan, "Reform the International Monetary System", Website of the People's Bank of China, March 23, 2009.

<sup>13</sup> A change in world demand for Real SDR's would produce redemptions (for a fall in demand) or additional purchases of SDR currency. These would reduce or increase the amount of SDRs outstanding (and hence the size of the IMF's balance sheet), but would not (if these operations were timely) significantly change the market value of SDR currency nor of the IMF's assets (abstracting from the IMF's other financial activities).

the IMF's collective membership would stand behind the integrity of its Real SDR liabilities issued under this proposal. To the extent that the eligible assets purchased by the IMF when issuing SDRs were denominated in SDRs, there would be no exchange rate risk. In a recent study, Peter Kenen found that had it been adopted in the 1970s when proposed, the Account would not have resulted in any maintenance of value cost (to the U.S. or the IMF's members collectively).<sup>14</sup> The IMF and the United States would be wise to have a Substitution Account ready in the wings in case there is a sudden drop in the demand for dollars in reserve holdings.

### Trust in IMF control of international reserves

While the world benefitted greatly from the single world currency created by the gold standard, few countries would be willing to give discretion to the IMF or any other world central bank to determine the supply of issued SDRs. The proposals by some developing countries in the 1970s to allocate SDRs for development finance were greeted with alarm. Issuing SDRs under currency board rules would give the issuer no monetary discretion at all. Following the Bosnian war, which ended in 1995, I was impressed that the three warring factions (Bosniak, Serbian, and Croatian), who had great difficulty agreeing on most issues concerning the establishment of a new central bank, agreed immediately without discussion that it should be a currency board. Currency board rules were the only thing all three groups were prepared to trust to the new central bank.<sup>15</sup> The same is likely to be the case for issuing SDRs.

## Conclusion

The United Nations Commission on International Trade Law, in its search for "a universal unit of constant value which would serve as a point of reference in international conventions for expressing amounts in monetary terms," concluded that the most desired approach was to combine the use of the SDR with an index that would preserve over time the purchasing power of the resulting unit.<sup>16</sup> The real SDR proposed here would establish such a unit without the two-step process of indexing the SDR's valuation currency basket.

If the IMF's SDR replaced its currency valuation basket with a basket of globally traded goods, its use for establishing values in contracts and for pricing globally traded goods and services is very likely to spread widely. If the IMF issued such real SDRs according to currency board rules, central banks are likely to increasingly

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<sup>14</sup> Kenen, 2010.

<sup>15</sup> The author led the IMF missions that established the new Central Bank of Bosnia and Herzegovina. See his account in *One Currency for Bosnia: Creating of the Central Bank of Bosnia and Herzegovina*, Jameson Books (Ottawa, Ill.) 2007.

<sup>16</sup> General Assembly document A/CN9/200, May 11, 1981.

replace the US dollar and other national currencies in their foreign exchange reserves with real SDRs.

If all or most countries pegged their currencies to the real SDR or used the real SDR directly ("dollarized"), the world would have returned to a gold standard like system of, in effect, a one world currency. The reduction in exchange rate risk and the cost of hedging such risks would make a material contribution to world trade and economic well-being.

The tighter monetary and fiscal discipline of such a global monetary system would significantly enhance the likelihood that the international monetary system and domestic monetary systems fixed to it would adhere to the rules of the game.

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