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Reforms to the International Monetary System[1]

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The issues currently engaging attention were laid out with admirable clarity by Edwin Truman in a lengthy background paper for an Institute for International Economics conference on The Future of the IMF in September 2005. He divided the topic up into four areas: The IMF's systemic role, its governance, lending facilities, and financial resources. I propose in this paper to focus on the first of those four areas.

This should not be taken to imply that the other three areas are all unimportant. Perhaps one can for the moment dismiss the last of them, since the Fund is currently very liquid and is likely to remain so unless and until lending picks up in a major way. The third issue, of lending facilities, has two aspects. One is whether the Fund should create a replacement for the never-used Conditional Credit Line (CCL) that has now been abolished or whether it should otherwise change its methods of supporting emerging-market countries in crisis. I do not see a strong case for reviving something like the CCL. Nor am I among those who see advantage in cutting back on support for middle-income countries in crisis: it is true that lending as a percentage of quota has increased over time, but this was a natural reaction to the fall in IMF quotas relative to all other relevant magnitudes combined with the end of borrowing from the Fund by the industrial countries. The other issue is whether the Fund should shift its Poverty Reduction and Growth Facility intended to support low-income members to the World Bank. Personally I am in favor of the latter rationalization, but it is a proposal that enjoys little support outside the United States and is therefore unlikely to be implemented any time soon.

But even if one can thus ignore the latter two of Truman's four areas, one can certainly not similarly dismiss reforms to IMF governance. The inadequacies here are obvious and widely resented, being reflected not just in Truman's paper and the pronouncements of the G-24, but also in the Managing Director's Strategic Review and in the speech to the IIE conference of Timothy Adams (the US Under Secretary for International Economic Affairs). There is little doubt about the nature that the reforms here will ultimately take: loss of the West European right to name the Fund's Managing Director in favor of a meritocratic process open to all, and a significant shift in voting power in the IMF from Europe to Asia. The critical question is whether these reforms

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occur with European leadership or not. If, for example, Europe were to propose a single ED for either the EU or the Euro-area with a vote equal to that of the United States, it might exercise increased rather than diminished influence. One fears, however, that it is more likely to occur in the teeth of European resistance and therefore mark a loss of European influence over the Fund, which will be further increased when the inevitable loss of the European monopoly in naming the Managing Director finally occurs.

Management of the World Economy

The other big issue is the one that I propose to spend the rest of this note writing about. It is the systemic issue of how the world economy is managed. At the moment it basically isn't managed at all; the philosophy is that one relies on each country to manage its own economy in what it perceives to be its own best interest without giving much attention to global consistency. It is hoped that this will lead to a satisfactory outcome for the world, just as the actions of individuals who think only of their own self-interest lead to a socially efficient outcome in an ideal market. And so far the world has indeed muddled through in this way, without any disaster remotely comparable to the global depression of the 1930s.

The question is obviously whether this can be expected to continue. The fact is that global imbalances have been expanding in recent years, and have now reached a point that most commentators regard as unsustainable. Yet there is no sign that the imbalances are in the process of being corrected. The dollar has fallen from its clearly overvalued level against the floating currencies of Europe and the Anglo-Saxon world, but this has at best leveled off the US current account deficit. Mention the need for a reduction in the US cyclically-adjusted fiscal deficit (which means a big tax increase), and the US administration recoils with the same horror that China does when one talks of the need for a 25 percent revaluation of the RMB. Or, for that matter, that many Europeans do when one mentions the need for structural reforms to liberalize sclerotic European labour markets. In other words, there is not the slightest sign that any of the major players are preparing themselves to take the measures that might correct the current imbalances, despite the fact that there is very wide agreement on what set of measures is required. Yet if such measures are not implemented, and if the judgment that the present situation is unsustainable proves correct, the result is bound to be a crisis.

What form might one expect such a crisis to take? The most likely form is a world recession. If there is at some stage a sudden collapse of confidence in the dollar, the values of the floating currencies of Europe and the Anglo-Saxon countries will surge against the dollar. The same will happen to the Asian currencies if and when their central banks finally tire of accumulating dollars, though one cannot rule out the possibility that they will decide to accumulate more dollars for a long time yet so as to maintain their exports. The shock to confidence would be expected to have a negative effect on demand in both the US and the other industrial countries. Offsetting that (though perhaps only partially, at least in the short run) in the United States will be the switch of demand toward US producers caused by the dollar depreciation. But in other industrial countries the recession would be fed by both the income decline caused by the loss of confidence and the switch of demand away from their producers as a result of the appreciation of their currencies. Even if Asian countries avoid appreciations, their output will still suffer from the loss of demand from the industrial countries. Given that both the industrial countries and the Asians have relied on export-led growth because they have had difficulty in expanding domestic demand in recent years, when there was no crisis, it is difficult to believe that they could suddenly replace foreign by domestic demand in the presence of a crisis. It is all too easy to imagine that in these circumstances a major world recession might develop.

The main purpose of an international monetary system should be to head off this type of disaster. Ideally the international monetary system should embrace a set of rules and practices that induce countries to adopt macroeconomic and exchange rate policies that sum up to a satisfactory global solution, and the International Monetary Fund, as the instrument that the international community created at the time of Bretton Woods, should then ensure countries' adherence to those policies. Could one conceive of a set of rules and practices that would have these virtues and which the Fund would then be expected to police?

A Reference Rate System for Exchange Rates

I believe that any such system needs to start from recognition that exchange rates are a key part of the solution and that they are inherently matters of international concern. No country has a sovereign right to decide "its" exchange rate, because an exchange rate is a relationship between the value of at least two currencies.[2] If one is to have any sort of governmental policy on exchange rates (rather than leaving them entirely to the market), then more than one government has a right to involvement in what is decided. In practice it is far preferable to have each country deal with the IMF representing the international community of nations than to have bilateral disputes between pairs of countries. Even if countries could reach bilateral deals, problems of potential inconsistency would arise. This makes it natural to ask whether one could devise an exchange rate system that would at the same time be compatible with such basic characteristics of current economic policymaking in most countries as floating exchange rates and inflation targeting and would also encourage countries to adopt globally consistent macroeconomic policies.

In my view this is indeed conceivable. I see the key as being IMF development of a system of reference rates for exchange rates. A reference rate is an estimate of the equilibrium effective exchange rate; each country agrees *not* to follow policies (notably intervention policy) that would have the effect of pushing the exchange rate *away* from that rate. Since there is no corresponding obligation to hold the exchange rate close to the reference rate, this is indeed a system that is compatible with floating exchange rates and inflation targeting (the two major features of macroeconomic policy in most industrial

[2] In technical terms there are n countries but only n-1 exchange rates, so that equal rights to decision-making implies a need to reach multilateral agreement.

countries and many emerging markets today). There is no question of forcing countries to adopt policies that might precipitate a crisis.

Why would such a system help to secure global policy consistency? First, because it would outlaw national policies like those of China (and some other Asian countries) today, which are focused on the preservation of disequilibrium exchange rates. Second, because it would require an internationally-agreed vision of a set of current account imbalances that would be mutually consistent, since one could not calculate a set of reference rates in the absence of such a vision. Third, it would permit IMF surveillance to become far more effective, not only because the Fund would be charged with ensuring that its members did not violate their obligations by inappropriate intervention but also because it would close a loophole that permits countries to defend inappropriate demand-management policies.[3] Fourth, provided the reference rates were public knowledge (and it is difficult to believe that in this day and age they could be kept secret even if an attempt were made to preserve confidentiality), they might provide the market with information that would make speculation more stabilizing. Public reference rates might also make public discussion of exchange rate movements more rational; newspapers might be more inclined to comment on whether an exchange rate movement was towards equilibrium instead of equating strengthening with virtue.

Why should member countries take note of Fund advice structured along these lines when it is well known that they largely ignore such advice as the Fund gives in its current surveillance operations? First, because the Fund would be drawing on a body of analysis that is not available to individual member countries. Without the reference rates and the background of an analysis that draws up a consistent global picture, the IMF offers nothing more than the countries can figure out for themselves. Since each of the major member countries have far more trained economists available to it than the IMF can deploy on any one country, it is rational to take little note of what the Fund says. This changes fundamentally if the Fund is drawing on a body of analysis of what is needed to produce a globally desirable outcome that is not available to individual member countries. Second, because the outlines of the desirable outcomes will already have been agreed in setting the reference rates; to refuse to comply with surveillance that is guided by those outcomes would be to refuse to will the means to effect an end that has already been mutually agreed.

[3] At the moment there is no clear criterion as to whether a country is pursuing excessively contractionary or expansionary policies; as long as these are not resulting in recession or inflation in that particular country the IMF has no basis to complain, even if the set of policies being pursued by all its member countries is collectively inconsistent with a satisfactory global outcome. Adoption of the reference rate proposal would replace this situation by a criterion that is in principle well defined and is consistent with an acceptable global outcome. A country would be judged guilty of excessively expansionary policies if its level of domestic demand exceeded the sum of potential output plus its equilibrium current account deficit, even if an appreciation of its exchange rate above the reference rate were masking the inflationary potential inherent in this situation. Conversely, a country would be judged to have deficient demand if its domestic demand was less than its productive potential by more than its equilibrium current account surplus, even if this shortfall were being masked by a depreciation of its exchange rate below its reference rate and an enlarged current account surplus

Would the Fund obtain sufficient additional leverage by agreement on the ends, so that members would start changing their policies to conform with Fund advice, or would it also be desirable to change Fund surveillance procedures? My own view is that the main problem has been the lack of a vision of where we want the system to go. I am skeptical that any changes in procedures are likely to have much impact on the major countries like the United States and China. If countries have leaders who understand that national interests are advanced by undertaking actions that are consistent with satisfactory global outcomes, and the world has a Fund that can advance a convincing picture of what actions those are, there is some chance that (say) the US Congress can be persuaded to modify its actions. I cannot see it changing its actions because it is bullied by the Fund, no matter what procedural innovations are introduced.

Determining the Reference Rates

Operating a system of reference exchange rates is obviously dependent on an ability to reach international agreement on what the set of reference rates would be. What would be involved in reaching such an agreement? Is it even conceivable that countries could ever reach agreement?

The IMF now uses two different approaches to calculating estimates of equilibrium exchange rates. One involves an adjusted PPP approach, adjustment being made for factors that are known to influence the equilibrium exchange rate (like net foreign assets, relative productivity growth, the relative output of manufacturing, and commodity prices). Naturally this also involves the selection of a base period when the exchange rate appeared to be in rough equilibrium. The other involves a series of partial equilibrium models in which calculations are made of how much impact the restoration of ubiquitous internal balance would have on the balance of payments, and then an elasticities calculation is performed to find how much exchange rate change is needed to secure external balance as well. An attempt is made to ensure multilateral consistency.[4]

Neither of these approaches, nor any of the other methods that can be found in the literature, claim to be able to identify an equilibrium exchange rate with any precision. In my early work I suggested that this is one reason for preferring wide target zones, of the order of +/-10 percent. Some subsequent writers have suggested that even this is over-ambitious and that a range of +/-15 percent (as used by the EMS in its final years) is more realistic. One implication is that it is unreasonable to expect that countries will accept obligations to hold exchange rates at levels that can only be calculated subject to such a wide margin of error, but of course a reference rate does not impose such an obligation. Many countries would presumably not object to the much weaker restraint imposed by a reference rate: of not intervening to push the rate away from what is believed to be the equilibrium rate. This does not, of course, mean that one should not anticipate initial resistance from countries (like China and several other East Asian countries) that are currently maintaining their rates at levels that now fall outside reasonable estimates of

[4] This is inspired by the same philosophy as that from which my own estimations of fundamental equilibrium exchange rates were made, though these involved the simulation of macroeconometric models.

equilibrium. But the question to ask is whether it would have appeared unreasonably onerous to them to join a system that contained such a rulebook, and whether if they had joined they would not have played by the rules. Some have argued that they have already violated the IMF's rules (by "manipulating" their currency), but in my view the current IMF guidelines on this subject are so ambiguous as to be unenforceable. A well-defined rule might have been expected to elicit the same respect that China has paid to its other international commitments.

The process of determining a set of reference exchange rates might be something as follows. The IMF staff would use their favored approach, or perhaps a variety of approaches, in order to generate a suggested set of reference rates for all IMF member countries. They would present these to the IMF Executive Board at regular intervals (quarterly or half-yearly). Some countries would doubtless object that their proposed reference rate was too strong (and occasionally there might also be a complaint that a proposed rate was too weak). Their Executive Director would make this case to the Board, using a mix of technical arguments (challenging some aspect of the IMF's model or claiming that the current account target that the IMF had assigned was inappropriate or arguing that the Fund staff had overlooked certain special factors) and political pleading, as is customary in such contexts. The Board might find itself impressed or unimpressed by the case it heard made. Where it declared itself impressed, the staff would amend their recommendations appropriately, using a procedure that guaranteed that the set of reference rates remained globally consistent. It would then present its revised recommendations to the Board. If some countries remained dissatisfied, the process might be repeated, in principle more than once. But it would be necessary for the Board to reach agreement by a defined date, and it would therefore be necessary to agree ex ante a process for resolving any differences of opinion that could not be argued out in this way. I do not see that there is an alternative to allowing the (weighted) majority of the Board the ultimate right to impose its views on a minority.

Once agreement had been reached, the set of reference rates would apply for the next 3 or 6 months. They would be expressed as effective exchange rates rather than bilateral dollar rates, so that movements of third currencies would not distort policy. Rapidly inflating countries (those with an inflation of more than, say, 10 percent a year) could also have their reference rates adjusted periodically—perhaps monthly, on publication of a pre-specified relevant price index—so as to keep their real reference rates more or less constant.

Is Reform Conceivable?

Most countries would not see their interests adversely threatened by a reference exchange rate system, since it does not impose any obligation to undertake acts of which they might disapprove (like defending exchange rates). But that clearly does not apply to all countries. Specifically, since it would prevent the defense of a disequilibrium exchange rate; any country that presently manages its exchange rate and is not confident that its current rate would pass muster with the IMF would have a clear incentive to oppose reform. In practice this means that China and a number of other Asian countries that have managed exchange rate systems would have an incentive to oppose reform.

I nevertheless see three situations in which reform might occur. One involves the passage of time. Exchange rates do not remain disequilibrium rates forever. Sooner or later the countries that are currently attempting to defend undervalued currencies will experience adjustment, if not by nominal revaluation then by inflation (as first discussed by David Hume in the eighteenth century) . When that occurs they will lose their incentive to oppose adoption of a reference rate system. The disadvantage of this strategy is of course that a world crisis of the sort previously outlined may occur before the classic Hume adjustment mechanism has a chance to work.

The second situation in which reform is conceivable is in the midst of a crisis. It can be argued that every significant international monetary change in history has resulted from crisis, not from carefully-laid plans. (That assumes that introduction of the SDR was not a significant change, but at this point in history one has to acknowledge that this was probably true, even if one might have wished otherwise.) If the world does indeed experience the sort of crisis described above, then it is entirely possible that world leaders will search for an alternative system. It behooves us to think now about what they should adopt under such circumstances.

The snag is that once again reform would not head off the danger of crisis that is now looming. The third possibility is that world leaders will come to see the need to head off such a crisis ex ante, and will therefore adopt such a reform without the spur of a crisis. I would like to believe that such a scenario is likely, but I will believe this when I see it.