Tiff Macklem: Renewing the IMF - some lessons from modern central banking

Remarks by Mr Tiff Macklem**,** Deputy Governor of the Bank of Canada, to the Global Interdependence Center, Philadelphia, 9 March 2006.

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I'm very pleased to be here in Philadelphia, and I'm grateful for the opportunity to speak to the Global Interdependence Center. Your group aims to foster dialogue "on the challenges and opportunities arising from our increasingly interdependent global civilization." The globalized economy has indeed generated tremendous opportunities to create wealth and to raise living standards. But as opportunities have arisen, so too have challenges. As economies have become more interconnected through trade and financial flows in a truly global marketplace, economic developments in one location can quickly have repercussions on the other side of the globe. In 1997, what began as a currency devaluation in Thailand became a crisis with repercussions not just in Asia, but in countries as far away as Russia, Brazil, and Canada. So, the challenge we face is to find the best ways to reap the economic benefits of globalization while minimizing the risks of disruption.

Today, I'd like to discuss how the International Monetary Fund (IMF) can do its part to meet this challenge. The IMF was created some 60 years ago to oversee the global monetary system in an era of fixed exchange rates. But the world has changed dramatically in 60 years. Most major currencies have been allowed to float. Financial markets are much larger, much more sophisticated, and vastly more integrated than they were 20 years ago, let alone in the 1940s. Trade has expanded enormously, and major new players have entered the global trading network.

The IMF has responded to new challenges with professionalism. It's taken on new responsibilities and developed new expertise. Yet concerns have arisen that the Fund has not kept pace with the changes in the global economy. After 60 years, it's time to take a fundamental look at the role of the Fund in the global economy. Under Managing Director Rodrigo de Rato, the IMF has launched a strategic review of its role and activities. This is the opportunity to consider what kind of a Fund we need to meet the challenges of the global economy in the 21st century. But to do this right, we must be ambitious.

I'm also pleased to be part of your "Central Banking Series" of speakers, because central banks can bring a valuable perspective to the discussion. Central banks have a large stake in a sound international monetary order, and thus have a profound interest in the IMF. And central banks have had to adapt to the same forces in the global economy that have affected the IMF: the collapse of fixed exchange rates, the expansion of private capital flows, the evolution of financial markets, and so on.

What I propose to do today is discuss how the Bank of Canada and other central banks have evolved in response to these changing circumstances. Then I'll outline how the lessons central banks have learned can be distilled into four key principles. I'll conclude by offering some thoughts on how these same principles could prove useful as we consider the IMF of the future.

The principles of modern central banking

For good reasons, Canada returned to a floating exchange rate in 1970.[1] With the collapse of the Bretton Woods system of fixed exchange rates shortly thereafter, other major industrialized countries followed Canada's lead. Unfortunately, the Bank of Canada, like many other central banks, did not take full advantage of the monetary independence that comes with having a flexible exchange rate. Without the anchor of a fixed exchange rate, and with no other monetary anchor in its place, Canada, like many other countries, suffered the effects of high inflation in the 1970s. Inflation reduced the ability of the price system to allocate economic resources efficiently; savings and investment decisions were distorted; and the economy went through boom and bust cycles.

Central banks, including the Bank of Canada, struggled with this problem, and from this bitter experience came a search for the right anchor. We, and others, experimented with monetary aggregates as intermediate targets. But deregulation and financial innovation weakened the reliability

[1] The floating exchange rate has served Canada's open economy well. Canada first adopted a floating exchange rate in 1950. In 1962, it returned to a fixed regime, but since 1970, it has allowed the dollar to float.

of money measures, and the relationship between money growth and inflation proved to be unstable. By the end of the 1980s, it became clear that price stability should be the Bank of Canada's pre-eminent objective, and that we should aim more directly at achieving it.

In 1991, Canada took the bold step of formalizing this objective with an explicit inflation target. Our inflation-target objective, which is established jointly with the Government of Canada, aims to keep inflation at the 2 per cent midpoint of a 1 to 3 per cent target range. The target has proven to be a very effective anchor. Inflation has been low and stable, and we've experienced solid growth in output and employment.

Canada was the second major country to adopt an inflation target. Today more than 20 countries have such targets. In other words, there's a good deal of international experience with inflation targeting. As in Canada, this experience has been very positive: inflation targeting, working in tandem with a floating exchange rate, has generally resulted in low inflation and sustained economic growth.

Stepping back, and looking beyond these positive results, we can distinguish four key characteristics of a credible and effective monetary policy framework: clear objectives and effective tools; legitimacy; the effective use of markets; and transparency and accountability.

Let me say a few words about each of these in turn.

First, *clear objectives and effective tools*. The Bank of Canada's monetary policy has one clear objective-to keep inflation at 2 per cent. And it has one instrument with which to get the job done-the target for the overnight interest rate.

Second, *legitimacy*. The inflation target is not just the Bank of Canada's target, but also the government's. This adds legitimacy to the monetary policy objective, thereby strengthening it. But legitimacy also comes from our experience of low inflation and good economic outcomes, with the result that there is now broad support among Canadians for anchoring monetary policy to a low inflation target.

Third, monetary policy works best when it is *market based*. We learned some valuable lessons in the 1970s. We learned that direct controls on wages and prices do not work beyond the short run, and that they introduce a myriad of distortions, which reduce market efficiency. We also learned that direct controls on credit expansion are difficult to calibrate and enforce. They also reduce the efficiency of the financial system as it allocates resources in the economy. Today, monetary policy is implemented entirely through financial markets. By controlling the overnight interest rate, monetary policy influences interest rates along the yield curve, as well as other asset prices. These, in turn, influence spending, and, ultimately, inflation. We have found that the transmission of monetary policy works most effectively when the central bank implements policy through markets, when it maintains a credible policy goal, and when it communicates its objectives and actions clearly.

This leads me naturally to the fourth characteristic - *transparency and accountability*. One of the most important things we have learned with inflation targeting is that monetary policy works best when it is well understood. The explicit inflation target is the centrepiece of our communications on monetary policy - it helps to anchor inflation expectations, and it makes it easier for us to explain our actions, and for people to judge our performance. It provides a strong incentive for us to meet the objective and to be accountable.

Taken together, these are the characteristics of effective, modern central banking. But I think that one can go further and say that these characteristics are useful *principles* that apply to the broader realm of public policy making. Let me now turn to the topic of IMF renewal, and talk about how these same principles can be applied to the task at hand.

Principle-based renewal at the IMF

The place to start is *clear objectives and effective tools* for achieving those objectives. The IMF's first Article of Agreement states that it should "promote international monetary co-operation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems." In the globalized, market economy of the 21st century, what this really means is the *promotion of global financial stability by supporting a market-based international monetary order*. I hope that there's a broad consensus that this should be the objective of the IMF. I view the challenge facing the Fund as being how best to fulfill this objective.

The main tool is surveillance. But surveillance needs to be more effective. This means two things. First, surveillance should be more multilateral, putting greater emphasis on the linkages between members, the spillover of one country's policy choices on other countries, and the joint risks that this implies. The reality is that in an increasingly globalized economy, our understanding of these linkages and spillovers is not as good as it should be. The Fund staff is an enormously talented group of men and women. We have to ensure that they undertake the research and analysis needed to understand the changing nature of global linkages. But understanding these linkages is not enough. We need a forum where risks are debated openly, frankly, and comprehensively by national policy-makers. In turn, this implies less emphasis on bilateral communication between the IMF and a given country and more multilateral discussions among countries, supported by the IMF.

Making surveillance more effective also means strengthening the analysis of the linkages between the financial sector and the real economy. In recent years, the Fund has devoted considerable energy to developing sound standards and codes for assessing the financial infrastructure of its member countries. This financial sector surveillance needs to be better integrated into IMF country reviews. This will allow potential risks to be identified earlier so that authorities can address any problems, rather than calling on the Fund for financial assistance in the midst of a crisis. Achieving this integration may require re-thinking the Fund's internal structure to ensure that all facets of its work feed effectively into its surveillance and provide sound analysis of the interaction of economic and financial developments and risks, both within and between countries.

Let me now turn to the second key principle - *legitimacy*. The Fund's effectiveness, and hence its ability to promote global financial stability, is what ultimately gives it legitimacy and credibility. At the same time, its effectiveness depends on its legitimacy as a truly global institution, and on a shared sense of trust and responsibility among its members. Global issues can't be effectively addressed if key players feel that they don't have an adequate voice as IMF members. In this respect, it is clear that important aspects of the Fund's governance arrangements have not kept pace with changes in the global economy. In particular, quotas and voting power at the Fund need to better reflect the growing power of Asian and other emerging-market economies.

The issue of quota and voting power is complex and will persist for years to come, since Asia is likely to continue to grow faster than other major regions. This suggests the need for a comprehensive solution, and we should work towards this end. But we also need to be pragmatic. We need to make concrete progress on the quota issue in the short term to show that members are serious about aligning the representation of Asian members with their economic weight. Of course, with a larger voice comes greater responsibility. So let's be clear: a larger stake for Asian members implies that they should be prepared to shoulder their fair share of the responsibility for promoting global financial stability as part of the international monetary order.

This brings me to the third principle - *effective use of markets*. As I have already highlighted, the role of the Fund in the 21st century should be to promote financial stability by supporting a market-based international monetary order. This means that the IMF must work to ensure that the international financial infrastructure is sound, that countries pursue sustainable policies, and that incentives encourage the appropriate pricing of risk and the efficient allocation of resources. It also means that the IMF should play a more active role in establishing the "rules of the game," clear rules that support a market-based international monetary order. Consider exchange rates, for example. Tim Adams, the U.S. Treasury's Under Secretary for International Affairs, recently called on the IMF to demonstrate "strong leadership on multilateral exchange rate surveillance." Specifically, he called on the IMF to "improve its tools and advocacy to persuade countries to exit unsustainable exchange regimes early on, rather than waiting for perfect circumstances that never come." More broadly, I would suggest that the IMF needs to bring pressure to bear on national public policies that thwart adjustment. Delaying adjustment does not make the need for adjustment go away. It simply increases the risk that the adjustment - when it comes - will be abrupt and disorderly.

A highly visible example of this risk is the issue of "global imbalances," which is shorthand for the large U.S. current account deficit that is mirrored by large surpluses in Asia and, increasingly, in major oil-exporting countries. If these imbalances are to be resolved in a way that is consistent with maximizing global growth, significant adjustments are required. Markets can lead these adjustments, but they need to be allowed to work effectively. This means letting real exchange rates adjust in countries with large current account surpluses, like China; reducing unsustainable fiscal deficits in the United States; and making labour markets more flexible in Europe. The IMF should play a lead role in bringing the right players together, facilitating discussion, and relying on markets to achieve the necessary adjustments.

Markets should also play a greater role in crisis resolution. The Fund has been accused of doing too much "exceptional lending." Indeed, in some cases, this lending has delayed the needed actions and adjustments. Essentially, both sovereign borrowers and creditors wait to see if the Fund will put new money on the table. Strict implementation of exceptional access limits - that is, clear rules of the game for the Fund's own activities - would reduce the uncertainty associated with Fund lending and create incentives for creditors and lenders to negotiate when negative economic shocks render debt levels unsustainable.

The Fund could facilitate these negotiations by offering its good offices to promote a timely, orderly restructuring of private claims. The Fund's effectiveness in this capacity depends critically, however, on its perceived independence. It will not be viewed as a disinterested adjudicator if it is also a major creditor. The Fund can reduce some of the uncertainty that impedes debt restructurings by providing independent analysis of the future growth prospects of the country concerned, advice on possible adjustment measures, and an assessment of the global economic and financial outlook. With this information at hand, creditors and debtors can then seek market-based solutions.

The fourth and final characteristic is *transparency and accountability*. I said earlier that the Fund needs to be clear about its main objectives and its policy framework. The IMF must also ensure that clear lines of responsibility within the organization support the framework. And it must be transparent about the reasons for its decisions. In other words, the Fund needs a governance structure that helps it achieve its goals and holds individuals accountable. Currently, decision-making responsibilities are divided among the Board of Governors, the Executive Board of Directors, and the Managing Director and staff. But the division of responsibilities among these groups is not, in practice, always clearly defined. Accountability is dispersed, and decision-making lacks transparency.

The IMF would be more effective if the Executive Board focused on setting strategic direction, as well as ensuring that policies are sound and that objectives are met. The Managing Director would then be responsible for policy implementation, and be accountable to the Board. This framework would help to ensure that the responsibility for policy formulation and implementation was clear and borne appropriately by the members of the Board and the Managing Director, respectively. Toward this end, Bank of England Governor Mervyn King has recently suggested establishing a non-resident Executive Board that meets periodically, rather than almost continuously, and that focuses on strategic direction and oversight. Accountability and transparency of the Board's decision-making would also be enhanced with more frequent and more timely reporting. Finally, and very importantly, surveillance and analysis must be, and seen to be, independent of political influence.

Conclusion

I'd like to conclude by underscoring a key point. The progress made by central banks in furthering the economic well-being of their citizens has largely been the result of determining the most appropriate objective - low and stable inflation - and determining how best to achieve it in a transparent and accountable fashion. For many central banks, this has meant inflation targeting. I've suggested that there are lessons here for the International Monetary Fund.

A more effective IMF really does matter. In a world of floating exchange rates, large private capital flows, and liberalized trade, we need an effective forum in which the issues that shape the global economy can be discussed with candour and good will, and in which problems can be resolved. The IMF *could be* that forum. But it needs to become more legitimate, that is, more representative of an international economic community where all members share responsibility for promoting the common good of international financial stability. The IMF needs to operate with clear objectives; effective, market-based tools to achieve these objectives; and a governance framework that supports sound decision-making and accountability.

The need for change is pressing. As the risks associated with global imbalances grow in importance, the IMF will be tested. I very much hope that a significantly more effective institution will emerge from the strategic review currently under way. If we can get it right, a more effective IMF will be central to maximizing the benefits of globalization.

Indeed, the renewal of the International Monetary Fund is tremendously important, not just for Americans and Canadians, but for all nations in this increasingly interdependent world.