David Dodge: The evolving international monetary order and the need for an evolving IMF

Lecture by Mr David Dodge, Governor of the Bank of Canada, to the Woodrow Wilson School of Public and International Affairs, Princeton, 30 March 2006.

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Yesterday, I was in New York City, where I had the opportunity to talk to the New York Association of Business Economics about global current account imbalances, and about the pressing need to allow market-based mechanisms to resolve these imbalances. Most of my remarks dealt with what policy-makers should do to allow market-based mechanisms to work. But at the end of my speech, I mentioned that there is also an important international aspect to this issue. The world needs an international institution to promote a new monetary order—a well-functioning, market-based global financial system. This will be the subject of my remarks today.

Recently, Martin Wolf of the U.K. *Financial Times* used his column to pose an interesting question: If the International Monetary Fund did not exist, would we invent it?[1] His answer, if I may oversimplify, was no, because today's world does not have the courage and vision to create powerful multilateral institutions. I'm not sure that I agree with his answer or with his reasoning for it. But I am sure that this is exactly the kind of fundamental question we need to be asking.

Today, I'd like to take a slightly different approach to Wolf's question. Let me put it this way: If the IMF did not exist and we set out to create it from scratch, what would be its fundamental role in the global economy? What should an ideal IMF do, and what should it not do?

Some might suggest that these very questions are being asked and answered right now within the IMF, in the context of the internal strategic review initiated by Managing Director Rodrigo de Rato. Mr. de Rato is to be commended for taking on this task. The Executive Board of the IMF will discuss the internal review next week. But it seems to me that the review, while important and useful, has been focused on finding better ways for the existing institution to do what it already does. I want to approach this issue from a more basic level and ask what is required for the IMF to evolve into the best possible institution, designed for the global economy of the 21st century. For that evolution to take place, the key shareholders of the institution need to show leadership and vision.

To set the stage for my remarks today, I will briefly review how and why the current IMF came into being, and then I will consider how the global economy has evolved since the founding of the IMF. I will next elaborate on what I see as the fundamental role for the IMF in today's global economy, and then discuss the changes that would need to take place in order for the institution of today to evolve into the "ideal" IMF. I hope that my remarks will then lead to a vigorous discussion in the time remaining.

The rise and fall of Bretton Woods

So let me begin by going back 60 years to the original United Nations Monetary and Financial Conference at Bretton Woods, New Hampshire. The delegates—representing 45 nations—were nothing if not ambitious. They ended up creating two, almost three, international institutions. There was the International Bank for Reconstruction and Development—now known as the World Bank—charged with providing aid for the rebuilding of Europe. Delegates also came close to creating the International Trade Organization, which was to be dedicated to keeping protectionism in check and facilitating freer international trade in goods and services. This organization eventually came into being a couple of years later as the General Agreement on Tariffs and Trade, which subsequently morphed into the World Trade Organization. And, of course, the third institution was the International Monetary Fund.

The IMF was meant to create an international monetary order that would allow trade to flourish again and post-war reconstruction to take place. The institution that these delegates created was very much

[1] M. Wolf, "The World Needs a Tough and Independent Monetary Fund." U.K. *Financial Times*, (22 February 2006).

a creature of its time, and its roles and responsibilities reflected the experience of the Great Depression. The great policy failure of the 1930s was the competitive "beggar-thy-neighbour" currency devaluations to which nations resorted. The Bretton Woods delegates sought to prevent countries from adopting such policies. The first of the Articles of Agreement that govern the IMF called on it "to promote international monetary co-operation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems." Exchange rates were to be fixed, and were to be adjusted only in the case of "fundamental disequilibrium." The delegates also correctly identified liberalized trade in goods and services and the development of economic specialization as crucial for the creation of wealth.

Permeating the Bretton Woods conference was a vital sense of co-operation, identified as the "spirit of internationalism" by Raghuram Rajan, the current Director of the IMF's Research Department in a recent lecture.[2] The Bretton Woods delegates were able to see how their own country's interest was clearly wrapped up in a collective interest. All represented nations understood that their own countries might sometimes need to shun politically expedient policies and, instead, "play by the rules of the game," thus promoting the common good of a well-functioning international monetary and financial order. Delegates also saw that the Fund could act as an impartial arbiter or umpire to call out countries that violated the rules by pursuing policies that impeded the free flow of goods and services.

The prime focus of delegates was to encourage trade flows, rather than to rebuild or develop international capital markets. This is understandable when you recall that as a legacy of World War II, governments controlled international capital flows tightly, and private capital flows were a tiny fraction of what they are today. Capital controls were symptomatic of the enormous faith that delegates had in the power of the state to direct economic activity and to control economic variables, including the correct exchange rate values among the world's major currencies. The controls were also symptomatic of the fact that outside the United States, capital markets had either atrophied because of the war, or simply were not yet well developed. Because of the stresses brought on by the war, the allocation of capital was much more state directed than market directed. These controls stayed in place for some years after the war, persisting longer in Europe than they did in the United States or Canada.

The Bretton Woods system of fixed exchange rates did not work all that smoothly, and its framework led to several crises along the way. During the quarter century that the system operated, Canada developed a reputation as the "bad boy" of the international financial system when we "temporarily" opted out of Bretton Woods in 1950. By that time, strong capital inflows into our resource sector, as well as sharply higher commodity prices, led to upward pressure on the Canadian dollar. In addition, there were speculative short-term capital inflows, which added to the pressure on the currency. To maintain the fixed exchange rate, Canadian authorities first intervened on a massive scale. Foreign exchange reserves rose by 40 per cent in less than three months, and the money supply grew rapidly at a time when the domestic economy was already operating at capacity. Ultimately, Canadian authorities decided that the best way to resolve these emerging imbalances was to let the Canadian dollar float. The alternative would have been higher inflation.[3]

One of the key lessons the Canadian authorities learned was that in an open economy, a market-based floating exchange rate was not at all incompatible with the goal of free international markets for goods and services. Indeed, we came to realize that allowing the relative price of the currency to be set in the market meant that we could concentrate on conducting monetary policy in our own best interest, rather than being preoccupied with aiming for balance in our external current account. In a rapidly changing global economy, it did not make sense to assume that the "correct" exchange rate could ever be known in advance. And even if the correct exchange rate could be identified at a point in time, the economic situation would soon change, and the level of the pegged exchange rate would no longer be appropriate. A market-based exchange rate proved to be useful as a "shock absorber," helping the economy react to shocks more efficiently than a fixed exchange rate.

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2 R. Rajan, "The Ebbing Spirit of Internationalism and the International Monetary Fund." The 2006 Krasnoff Lecture, Stern School, New York University (New York, 8 March 2006).

3 After repegging the Canadian dollar in 1962, Canada again chose to float its currency in 1970. For a thorough discussion of the Canadian dollar through the Bretton Woods era, see J. Powell, *A History of the Canadian Dollar* (Ottawa: Bank of Canada, 2005).

The evolution of the world economy and the role of the IMF

In 1971, the Bretton Woods system collapsed. Domestic capital markets in many countries had been restored and modernized. As well, there was recognition by some major industrialized economies that the Bretton Woods paradigm wasn't working. But the alternative was not yet clear. Just as central banks around the world spent much of the 1970s and 1980s searching for a monetary policy anchor, much time was spent searching for a new framework for the international financial system. By the 1990s, policy-makers—particularly in the OECD countries—started to come around to the idea that a framework of market-based policies was best both for national economies and for the global economy. This shift in paradigm, from the distrust of markets to the primacy of markets, set the stage for the rise of economic globalization.

If we held a new Bretton Woods Conference today, it is clear that delegates would design a different IMF, because both attitudes and circumstances are fundamentally different than they were at the end of World War II. International trade flows now constitute a much greater share of most countries' GDP. The transfers of goods, services, and technology, and the existence of supply chains across national borders, have brought enormous benefits in terms of growth and efficiency. As well, financial markets have become vastly larger and deeper—in economists' words, more complete. Private capital flows are now dominant, dwarfing the size of official flows.

Today, we need an international monetary order that does more than just facilitate trade. We need a system predicated on the idea that markets—not just for goods and services but also for capital—need to be free and open. And so let me now go back to my original question: What should the fundamental role of the IMF be in today's economy? The answer is that the role of the IMF must be *to promote a well-functioning, market-based, international financial system*. By "well-functioning," I mean a financial system that is both efficient and stable, so that markets can do their job in allocating savings to investments through the pricing of capital, and in smoothing economic adjustments through movements in relative prices.

Sixty years after the original Bretton Woods conference, now is the time for policy-makers to agree once again on the fundamental objective of the IMF. We need to agree that its role should be to promote a well-functioning, market-based, international financial system. We need to agree that the IMF should be the forum where we as shareholders collectively develop the appropriate framework—the rules of the game—to support the international financial system. And we need to agree that the IMF should be an independent, impartial umpire, ready to call out countries that are breaking the rules by imposing policies that distort trade flows, or policies that inhibit capital flows unnecessarily.

What does this mean in concrete terms? Before getting into detail, there is a complication that we need to deal with. We live in a world where all industrialized economies now profess to accept the market-based paradigm for the international financial system. But today's global economy consists of more than just the industrialized economies. There are emerging-market countries that are systemically important. These countries, particularly China, have the clout to influence the entire world economy. So, in developing the appropriate framework for the international financial system, in setting out the rules of the game, we need to make sure that everyone is at the table. We also need to recognize that some emerging-market countries are, and have, just that: markets that are emerging. And so while the principle of a market-based international financial system should be accepted by all, we need to recognize that some economies are in transition, and that until their markets fully develop, the rules of the game need to take this into account. For example, the removal of capital controls needs to be done with proper sequencing.

An ideal IMF: what would it do?

So, if we were to create the IMF from scratch today, we would want it to have as its ultimate objective the promotion of a well-functioning, market-based international financial system. But how should we turn that objective into concrete action? What would this ideal IMF actually do? How would it operate? And how would that differ from what the IMF does now? I will discuss four related issues here: surveillance, lending, representation, and governance.

First, let me talk about how surveillance can support a market-based international financial system. There are several points to be made here.

It is absolutely critical that surveillance take into account the growing interdependence of the global economy in order to maintain the stability of the international financial system. When policy errors in one country can lead to a financial crisis halfway around the world, we need to better understand the linkages between countries. Therefore, the IMF should use its surveillance, not just nationally but internationally, to identify externalities and potential policy spillovers. This would be invaluable in helping policy-makers to understand the implications of their actions. I am pleased to see that there has been progress in this area. Indeed, IMF staff have been working to develop GEM—the Global Economic Model—that can help to model spillover effects in the global economy. This work is tremendously valuable in that it provides authorities with a broader, multilateral perspective on their own policies. Policy-makers can see how their actions affect the global economy and, in turn, how these global repercussions will be felt back at home. This is a good start. But it is critical that greater emphasis be placed on this type of work in the future, to help us better identify spillovers.

A few minutes ago, I said that the IMF should be the forum where shareholders gather to collectively develop the appropriate rules of the game. I also said that it should be an independent, impartial umpire, ready to call out countries that break the rules. In other words, the IMF should have a *secretariat* function and an *umpire* function. IMF surveillance can, and must, do a better job of supporting both of these functions.

Let me start with the so-called umpire role. This is one area where the IMF has consistently fallen short of the mark. Too often, surveillance has shied away from the "ruthless truth-telling" that Keynes—one of the main architects of Bretton Woods—called for.[4] Instead of making the tough calls about the rules of the game, the IMF has sat in the umpire's chair and simply asked the players whether they thought that their shot was in or out. This needs to change. The IMF needs to be able to make calls impartially about whether countries are playing by market-based rules of the game. This would help policy-makers sitting around the table to decide what actions should come next. It would also help the market to apply the appropriate discipline to a country not playing by the rules.

Like any good umpire, the IMF should apply the same judgment to *all* players in the global economy. Much has been said about the way China and other countries continue to operate with a fixed exchange rate. I have previously argued that while greater exchange rate flexibility would be good for China, its citizens, and the global economy, the Chinese authorities must be allowed to choose the exchange rate regime they feel is best for them. But what the authorities should not do is frustrate market forces by thwarting the adjustment of real exchange rates through sterilization of their foreign exchange interventions. By "sterilization," I mean offsetting the effect of those interventions on the domestic money supply. Last month, U.S. Treasury Undersecretary Tim Adams called on the IMF to put more emphasis on exchange rates in its surveillance activities.[5] I certainly agree that the IMF needs to put greater emphasis on the interdependencies in the system, and exchange rates are clearly a part of those interdependencies.

But we have also seen examples of industrialized economies choosing to break the rules of the game. As I said yesterday in New York in the context of global imbalances, we now see examples of industrialized countries following policies that impede market forces—for example, restrictive labour policies in Europe. We have also seen unsustainable fiscal policies here in the United States. In Canada, we still have restrictions on foreign ownership of firms in certain sectors. And recently, we have seen legislators in the United States and Europe propose new restrictions on foreign investment flows. Again, the IMF as umpire should not shy away from making tough calls whenever they see the rules being violated, be it with respect to trade, capital flows, or other policies that distort financial markets. Making these calls loudly and forcefully could, as I said, help IMF members apply pressure for policy reform, and could certainly help the market to apply its own pressure, thus maximizing the chances that welfare-enhancing, market-based policies would be adopted.

In a world where stability can be easily threatened by capital flows, we need to have a better sense of national balance sheets, a point that Bank of England Governor Mervyn King recently made.[6] Surveillance needs to answer questions such as: What is a country's net foreign asset position? How is it being financed? What are the currency and maturity mismatches? The goal is to better integrate financial sector surveillance into country reviews so that potential risks are identified earlier. This

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4 Quoted by M. King, "Reform of the International Monetary Fund." Speech to Indian Council for Research on International Economic Relations, New Delhi, India (20 February 2006).

5 T. Adams, "Working with the IMF to Strengthen Exchange Rate Surveillance." Speech to the American Enterprise Institute, Washington, D.C. (2 February 2006).

6 M. King, op. cit.

would also help the IMF in its secretariat role, allow national authorities to address problems early on, and give capital markets more information to help them price risk appropriately.

Earlier, I spoke about the need for capital markets in emerging-market economies to fully emerge. Ultimately, we hope that all countries will develop capital markets and the infrastructure to allow them access to global private investment flows. But in the transition period, we need to bear in mind that these markets work imperfectly at best, and are susceptible to overshooting and sudden reversals of capital flows. The IMF, therefore, has a role to play in furthering financial market development through its surveillance, through its advice and technical assistance, and through appropriately structured lending activities. I'll return to this point in a minute.

Let me make one more point about surveillance. We all know that markets work less efficiently, and can even fail, in the absence of the right policy framework. Markets can fail when they are impeded by information asymmetries or by a lack of proper transparency. The IMF has an important role here in helping to support markets so they can work at peak efficiency. The talented staff of the IMF certainly have a long history of expertise in this area from years of conducting surveillance, and this expertise should be used to maximum potential. Currently, it is not. The IMF could be a key supplier of an important public good: reliable information on, and judgment about, the performance of national economies. In addition, as I said, the IMF has a very important role to play in providing analysis of spillovers and interdependencies. The IMF has taken a good step in this direction through its Financial Sector Assessment Program and its Reports on the Observance of Standards and Codes. But it needs to do more—not to duplicate what markets provide, but to supplement it.

Having discussed surveillance, I will now turn to the second issue, which is lending. In a world where countries have unprecedented access to international capital flows, and where those who have borrowed from the IMF are doing everything they can to repay their loans early, some have argued that an ideal IMF should do no lending whatsoever. I certainly agree that the prime purpose of the IMF is *not* to make loans. In particular, long-term lending for development clearly falls outside of its mandate. Until such time as all countries can develop their own capital markets, it is the World Bank that should play this role, just as the European Bank for Reconstruction and Development recently helped many Eastern European countries make the transition to market economies.

However, as I mentioned earlier, a number of emerging markets do not have robust financial systems. And so there may still be a role for the IMF to maintain stability by providing temporary liquidity in extreme cases. But this very limited lending must take place only when it can be shown that the borrower is illiquid but not insolvent. And I would stress that there must be clear rules as to when this liquidity can be accessed, as well as clear lending limits that are known by all parties in advance.[7]

In terms of "emergency" lending, it would be far preferable to have the IMF focus on helping countries avoid problems in the first place, rather than lending funds to help them resolve balance-of-payments problems. The IMF could best support a market-based international financial system by working with countries to put mechanisms in place that help resolve problems before they turn into crises. In this regard, the institution has taken some steps in the right direction by stressing the use of collective-action clauses and encouraging parties to adhere to basic principles during debt restructurings.[8]

By restricting its lending role, the IMF can make a much greater contribution to a market-based financial system. Too often in recent years, Fund lending has impeded the very same market-based adjustments that the IMF should be encouraging. There are three important points to be made here. First, a lack of clear rules about when the IMF would lend—and in what amounts—has caused uncertainty and unnecessary delay, thus making the timely and efficient resolution of crises more difficult. Second, there is nothing inherently wrong with the IMF providing financing which, if it occurred in the private sector, would be called "debtor in possession" financing. In those circumstances, the IMF can expect to be treated as a "preferred creditor," standing at the head of the line with respect to subsequent debt servicing. However, as in the private sector, this should only occur when this action would preserve or increase the value of outstanding claims. This brings me to my third point. Too often in the past, assistance was provided to countries that were assumed to be suffering only from

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7 See A. Haldane and M. Kruger, "The Resolution of International Financial Crises: Private Finance and Public Funds." Bank of Canada Working Paper 2001-20, published jointly with the Bank of England.

8 See *Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets*. (Washington, D.C.: Institute of International Finance, 2005).

temporary illiquidity, but which later proved to be insolvent. IMF lending in these cases simply added to an already unsustainable debt burden, placing additional costs on both debtors and creditors. As I said before, emerging-market economies may occasionally face problems for which timely financial assistance from the Fund would help. But this lending needs to be clearly delineated and constrained if it is to do more good than harm. All of this is to say that we need a fundamental review of the IMF's lending activities. Lending should not be the major focus of the IMF's mandate. Instead, it should play only a supporting role.

Next, let me talk about representation. For the IMF to successfully promote a well-functioning, market-based international financial system, it must be an effective forum, where global economic issues are discussed and solutions are found.[9] The IMF should be *the* place where national authorities gather around the table for a frank exchange on policy issues common to all. We need to rekindle the "spirit of internationalism" seen at Bretton Woods 60 years ago, and also seen at the OECD during the 1960s and 1970s, as that organization did its part to build a liberal economic order and a framework for freer trade. But it is difficult to build a shared sense of trust and responsibility if key players feel that they don't have an adequate voice. In this respect, it is clear that the IMF needs to give a larger voice to China and some other emerging-market economies, as they become more systemically important.

But as my colleague at the Bank of Canada, Deputy Governor Tiff Macklem, said recently, "with a larger voice comes greater responsibility."[10] Membership in the IMF carries with it a responsibility for supporting the goals of the institution. Members must have a shared understanding of how the international financial system should function, and of the IMF's role in supporting that system. So it seems to me that there really is no point for countries to demand, and receive, greater quota and voting power unless they believe in, and actively support, a market-based international financial system. It is absolutely true that Asian nations need to have greater quota and voting power to make the institution more legitimate in their eyes. But this should happen only if it will lead to an increased willingness among all countries to respect the rules of the game that are developed.

Having discussed surveillance, lending, and representation, the final issue I want to talk about is governance. Good governance begins with clear objectives. So, after establishing the IMF's fundamental objectives, the institution must improve its governance structures.

The IMF must ensure that it has clear lines of responsibility internally, and that it is transparent with respect to the reasons for its decisions. In other words, the IMF needs a governance structure that helps it achieve its goals and that holds its officials accountable. Currently, decision-making responsibilities are divided among the Board of Governors, the Executive Board, and the Managing Director and staff. But in practice, the division of responsibilities among these groups is not 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, and ensured that policies are sound and that objectives are met, rather than focusing on the day-to-day business of the institution. The Managing Director would be accountable for the secretariat and surveillance functions and be responsible for policy implementation. This framework would help to clarify that the responsibility for policy formulation rests with the Executive Board, and that the responsibility for implementation rests with the Managing Director. Towards this end, Mervyn King recently suggested establishing a non-resident Executive Board that meets periodically, rather than almost continuously, and that focuses on strategic direction and oversight.[11] This suggestion certainly merits consideration. We also need to consider how to enhance the vital role of the IMFC—the International Monetary and Financial Committee—within the institution. As well, we should think about whether there could be some useful role for various working committees to deal with specific issues as they arise.

Conclusion

Ladies and gentlemen, let me conclude. I've argued today that there is a role for the IMF in today's global economy. We need an institution to promote a market-based international financial system that

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9 D. Dodge, "Reflections on the International Economic and Monetary Order." Speech to la Conférence de Montréal, Montréal, Quebec (30 May 2005).

10 T. Macklem, "Renewing the IMF: Some Lessons from Modern Central Banking." Speech to the Global Interdependence Center, Philadelphia, Pennsylvania (9 March 2006).

11 M. King, op. cit.

works efficiently and is stable. This ideal IMF would have a sharper focus and a more international aspect to its surveillance, with clear rules governing a greatly reduced lending role. It would also be more representative than the current IMF, and would have an overhauled governance structure.

The prescription I have outlined today may sound radical. But we cannot afford to be put off by the size of the task. Progress may come only over time, but it does need to happen. The first and most important step on the path is to have all players in the global economy agree on the fundamental objective of the IMF. As IMF members gather next month in Washington for the institution's spring meetings, my great hope is that we will have a real discussion of these fundamental issues.

Let me close by recalling Martin Wolf's column in the *Financial Times*. Ultimately, Wolf agreed that the world needs to create a tough and independent IMF. But Wolf said it could not be done. It is up to us to prove him wrong. It is up to us to show that we do have the courage and the vision to build this important institution.