Mervyn King: Through the looking glass – reform of the international institutions

Text of the Inaugural International Distinguished Lecture by Mr Mervyn King, Governor of the Bank of England, to the Melbourne Centre for Financial Studies, Melbourne, 21 December 2006.

*   *   *

1. What does globalisation mean?

Humpty Dumpty said to Alice, "When I use a word, it means just what I choose it to mean – neither more nor less". So let me explain first what I mean by "globalisation". In his excellent book *Why Globalization Works*, Martin Wolf remarks, "Globalization is a hideous word of obscure meaning, coined in the 1960s, that came into ever-greater vogue in the 1990s". I think of globalisation as a process of increasing international economic integration accompanied by political agreement on the rules of the game which govern that process. The rise of China and India as trading powers is an example of increasing integration. And the accession of China into the World Trade Organisation is an example of the application of the rules of the game.

Globalisation is the driving force of many of the most significant changes in our economies. But it is far from a new phenomenon – it is as old as the human race itself. The European settlement of Australia represented the globalising forces of migration and capital flows over several centuries. To me one of the most poignant symbols of globalisation is the Australian War Memorial at Hyde Park Corner in London. In the first half of the twentieth century – described by Isaiah Berlin as "the worst century there has ever been" – thousands of Australians went to fight on the other side of the globe and to give their lives to a cause that transcended national interests.

One of the consequences of globalisation is that the impact of change in one part of the world on the lives of people in other parts is growing. In areas as diverse as trade, energy, combating terrorism, climate change, and the economic consequences of massive global imbalances with capital flowing from poor to rich countries, there are now growing spillovers from decisions in one country to the lives of people in others. In contrast to the horrors of two World Wars and the Great Depression, the strains and stresses of today's world do not seem insurmountable. How can we best deal with these challenges?

When the movement of people in Manchuria from subsistence rural agriculture to industrial employment influences which industries flourish in Manchester and Melbourne, and when changes in attitudes to asset management in Beijing affect currency values and hence living standards from Birmingham to Brisbane, it is in the interest of all nation states, recognising their growing interdependence, to make commitments to each other about what they will and won't do. Such commitments are embodied in international institutions – they are the rules of the game. Impressive offices and grand meetings are not the test of whether our international institutions are successful. The test is whether member countries are ready to make genuine commitments to each other. Without that the institutions lack any real purpose. So the subject of my talk today is why we need rules of the game to govern globalisation, and the institutions that are necessary to oversee those rules.

2. Is the post-war settlement still relevant today?

At the end of the Second World War, a new global order was put in place by the United States, Britain and their allies. One of those primarily responsible, US Secretary of State Dean Acheson, described his time as being "present at the creation" of a new global order. A range of new international institutions was created – the United Nations, the two Bretton Woods institutions (the IMF and World Bank), the OEEC that implemented the Marshall Plan (and later became the OECD) , NATO, and GATT (which has subsequently been succeeded by the World Trade Organisation).

Those institutions are now, for the most part, past their 60th birthdays. And there has been much heart-searching over the past few years as to their role and governance. Unless the spirit of the original founders is rekindled, there is a real danger that the present institutions will wither on the vine leaving us with a more unstable and fragile international environment. As Martin Wolf pointedly wrote, "To defend a liberal world economy is not to defend the International Monetary Fund, the World Bank, the World Trade Organisation or any specific institution. These must be judged – and reformed or discarded – on their merits". My argument is simple. Existing institutions were designed for a world radically different from that of today. The cost of closing them down and building new institutions is high. So we must work with our existing institutions and make them more relevant to today's problems. Unless we do so it will be harder to defend an open and liberal international economic order which has brought benefits to hundreds of millions of people around the globe.

The generic challenge facing all the post-war institutions is to find a role relevant to present circumstances, and to decide on the operational capabilities and instruments which that role requires. Holding meetings and issuing communiqués is not enough. As a central banker, I naturally focus more on the IMF, and I shall do that today. But the lessons are general. It is worth noting the scale of the challenge. The specific commitments made at the end of the Second World War are no longer relevant. The shared experience of the Great Depression, protectionism and two World Wars has faded. And the majority of current nation states were not "present at the creation".

The world has certainly changed since 1945, and it is the nature of those changes which underpins the case for reform. The world today is different from that at the creation of the post-war settlement in two important respects.

First, despite the increasing integration of the world economy, which might appear to reduce the effect of national policies, the nation state has in fact flourished since 1945. The collapse of ideology and empire, and the triumph of the ideas of a liberal market economy, have been accompanied by an extraordinary expansion in the number of countries in the world. In 1946 there were fewer than 80 countries. Now there are 192 members of the UN. Much of that increase represents the division of empires, such as the former Soviet Union, into new states, as well as growing ethnic separation. Most of these new countries were not "present at the creation" and see no reason why they should acquiesce in governance arrangements made in their absence. And the economic weight of countries has changed greatly since the post-war international institutions were set up. In 1950, Asian countries accounted for a sixth of world GDP measured at purchasing power parity. Now they account for more than a third.

Second, the world economy is very different today than when the IMF, the World Bank, and the other international economic institutions were set up. At the end of the Second World War, the international monetary system was built around fixed exchange rates and controls on capital flows. The rules of the game were simple. Countries were supposed to balance their current account. When "imbalances" arose, they were under an obligation to correct them. In practice, however, the obligations on creditor and debtor countries did not prove to be symmetric. Over time the advantages of capital flows, particularly in the private sector, became apparent, and in a world without capital controls, it is possible to maintain independent monetary policies only by allowing exchange rates to float. So the Bretton Woods system eventually proved unsustainable, and today most advanced industrial countries have floating exchange rates and free movement of capital. Private capital flows now dwarf official flows. And "imbalances" can apparently persist almost indefinitely. The US current account deficit, now almost 7% of GDP, has been over 3% ever since 1999. Australia has run a persistent current account deficit since 1973. Accordingly, the international institutions have shifted the focus of their attention from current to capital account flows and to the fragility of national balance sheets.

Those changes have meant that, over time, the post-war settlement has become less relevant. But the need for international institutions has increased. Our own standards of living are now, more than ever, affected by decisions elsewhere. And many people already feel they are losers from globalisation. The number of workers in the world trading system has more than doubled in a short period, with inevitable consequences for real wages of the unskilled in the industrialised world. Governments are having to work harder to explain what the principle of comparative advantage means to people in their daily lives.

In fact, most people are winners from globalisation. China is now the second largest buyer of Australian exports. And the Australian terms of trade have risen by 40% since 2000, providing a substantial boost to the growth rate of real incomes. Nothing could be more damaging to the prospects of developing and developed countries alike than the abandonment of further trade liberalisation. But protectionist sentiments are abroad again, even with high employment rates around the world. In Europe they are concealed as cries for "national champions"; in Latin America as populism; in the United States as complaints about unfair competition. But the damage that protectionism can wreak is clear – the experience of the Great Depression should be enough to ring alarm bells.

If that is to be avoided and we are to maintain widespread support for an open international trading system, it is in all our interests to establish clear rules for what we will and won't do in areas where our decisions affect stability elsewhere. And if those commitments are to be upheld, we will need international institutions.

The role of international institutions was thrown into sharp relief last week by the visit to Beijing of the new US Secretary of the Treasury, Hank Paulson, and a high-level team for a “strategic economic dialogue” with the Chinese Government. The issues discussed – the Chinese strategy for economic development and its implications for the pace of the shift of labour from rural agriculture to urban industry, saving rates in the United States, financial reform in China, and certainly the dollar-renminbi exchange rate – are all in the purview of several multilateral bodies, such as the new IMF multilateral consultation, the bi-annual IMFC meetings, the BIS, the G7, the G20, and so on. Progress at bilateral meetings is to be welcomed. Indeed, the existing multilateral forums may simply be too cumbersome or inefficient for any useful dialogue to occur. But many of the most pressing economic concerns cannot easily be handled in a bilateral setting. For example, even the infamous international “imbalances” can no longer be seen as a bilateral phenomenon: a large US trade deficit matched by a large Chinese trade surplus. Following the rise in oil prices over the past two years, the largest current account imbalances are to be found in the oil-producing countries. The combined trade surplus of OPEC in 2006 is likely to be around $400 billion, compared with a surplus in China of $150 billion. The pattern of trade imbalances and exchange rate movements is inherently a multilateral one, and real progress requires dialogue in a multilateral setting.

3. What are the principles of institutional design?

Changes to the number of nation states and the way they interact mean that reform of our multilateral institutions is needed. But piecemeal reforms are unlikely to work. In my view, there are five principles that should be followed.

First, create international institutions only when there is a need to do so. International institutions should focus on those areas of global governance where we need to tackle problems collectively – whether on trade, the environment, or large spillover effects of changes in macroeconomic policy.

Second, ensure that the commitments countries enter into are clear. The job of institutions is to support those commitments. In many cases, like an umpire, their job will be to uphold them. That will only be possible if the players – countries – are very clear about the agreed rules of the game. Without that, any further design is pointless.

Third, provide institutions with the necessary tools to umpire the commitments of nation states. But, just as umpires are accountable for their performance to the whole community of cricket-playing nations through the International Cricket Council, the staff and management of the international institution should be accountable to the whole community of nation states for their performance in upholding the rules.

Fourth, recognise that we do not start with a blank sheet of paper. We must accept the constraints of history. Existing institutions have an institutional memory, talented staff and much of the infrastructure that will be needed in the future. But that is not to say reform will be easy – there are far too many vested interests for that to be the case.

Fifth, avoid unnecessary duplication. Because the cost of abolishing institutions is high, the number of international groupings and institutions has proliferated in recent years. Many of them tread on each others toes. As a result, the IMF, World Bank and OECD, have all been bruised. Duplication of roles is wasteful of time, money and focus. Each institution should have one very clear remit, and focus on it. Of course, countries which play a role in one institution but not in another will have an incentive to build up the role of the former at the expense of the latter. So it is up to the member countries to limit the battle for turf.

There are few examples where all these principles appear to have been followed. The World Trade Organisation has been an effective umpire of countries’ commitments about trade restrictions and comes close. But the example of the WTO highlights the importance, above all else, of clear commitments from nation states themselves. The failure of countries to conclude a multilateral trade round since the WTO was formed more than a decade ago is worrying. The Doha round has continued past its expected completion date and only a brave commentator would forecast eventual success. The fault does not lie with the WTO. Instead, it reflects the fact that national governments have not been willing to make the necessary commitments.

4. What do those principles mean for the IMF?

With those principles in mind, I want to consider the challenge of reforming the IMF.

(a) Do we need an IMF?

The apparent success of central banks has led some economists to argue that the widespread adoption of inflation targets and floating exchange rates is sufficient to ensure the smooth running of the international monetary system – a regime which Professor Andrew Rose calls the ‘reverse Bretton Woods system’. There is no need for an international institution such as the IMF to watch over the system.

It is certainly true that the most important thing any nation state can do to minimise the spillover effects it has on others is to maintain domestic economic stability. And that is exactly what Australia, Britain, and other countries have done during the recent period of economic success, known as the “Great Stability”.

But domestic stability is not sufficient to eliminate spillover effects. The impact of national macroeconomic policy decisions is transmitted to other countries through important prices in the world economy: real exchange rates; real interest rates, and prices of important commodities like oil. Changes in spending by US households affect export demand in the rest of the world, both directly and indirectly through movements in the dollar. Changes in saving by governments in Asia affect spending in the rest of the world through movements in real interest rates. Changes in the supply of oil from the Middle East affect incomes and spending elsewhere through movements in oil prices.

Moreover, not everyone has a floating exchange rate and an inflation target, and countries that try to prevent adjustment of their real exchange rates have exacerbated the problem of spillover effects.

Businesses in every country are conscious of how quickly their plans can be disrupted by unpredictable swings in exchange rates, asset prices and commodity prices. When those spillovers are sufficiently large and widespread, countries will want to engage with each other in a multilateral setting to discuss how they should be resolved.

(b) What commitments are needed?

Before the collapse of the Bretton Woods system, the specific commitments made by countries to each other were very clear: fixed exchange rates and capital controls. In the wake of the collapse of Bretton Woods, the members of the IMF attempted to re-define their commitments. But the exercise of defining what practical commitments were needed focussed primarily on exchange rates and had rather little effect in practice.

Two broad commitments are particularly important. First, countries should make public commitments about their targets for macroeconomic policies – fiscal, monetary and financial. That still allows countries considerable discretion in their choice of policy framework – for example, whether to adopt a fixed or floating exchange rate. Second, policy frameworks must be consistent across countries. Policies which try to prevent changes in real exchange rates in response to changes in fundamentals, or lead to an unsustainable build-up of external debt, are properly the concern of the international community.

(c) What tools are needed?

The main tool to monitor those commitments is surveillance. The surveillance activities of the IMF have been criticised because they pay insufficient attention to spillover effects and instead examine in unnecessary detail microeconomic issues. For example, the sharp rise in oil prices over the past two years has posed a risk to economic stability in many countries. But there is no reference in the IMF’s Article IV report on China to the role that Chinese demand may have played in pushing up world oil prices. And the report on the United States this year singled out the electricity sector and competition among auto manufacturers and airlines as areas warranting special examination by IMF staff. It would be better if those microeconomic issues were examined within the OECD, and, in turn, issues of macroeconomic spillovers and global “imbalances” were left to the IMF. But even when IMF surveillance has been well-focussed, as in the analysis of Thailand’s exchange rate policies in 1996, it has not always carried sufficient weight to influence countries’ policies.

These short-comings must be remedied in two ways. First, the focus of IMF surveillance should be on spillover effects and the consistency of macroeconomic policy frameworks. By the Spring Meetings of the IMF in Washington in April, we shall know whether this is likely when we see the results of the current review of the 1977 decision on exchange rate surveillance.

Second, IMF surveillance should be more independent of member countries. That will allow clear messages to be delivered about whether countries are living up to their commitments. A remit should be set annually. It will play two roles: it will give the IMF a clear mandate to guide its surveillance activities and it will give the shareholders a yardstick against which to hold the IMF staff accountable. Greater independence for staff should be accompanied by greater accountability.

(d) What are the constraints of history?

The Bretton Woods conference at which the IMF was established was attended by the governments of just 44 countries. Yet even that was fraught. It would be vastly more difficult to agree a complete new treaty with 184 countries. The IMF has much of the infrastructure and expertise that will be needed to do the job I have described – and an annual budget of $1 billion to do it. That is why it makes sense to attempt to reform the IMF that we have inherited rather than to build a new institution.

But the inherited governance structure of the IMF and other institutions complicates matters. The founders of the post-war settlement encumbered several of the new international institutions with unwieldy full-time resident boards. And the distribution of voting rights no longer reflects the economic and political weight of member countries. The task of agreeing on a new system will be enormously difficult. But if we fail, the influence of the institutions will diminish further, possibly irreparably.

Reform of IMF surveillance and voting rights of member countries complement each other. Voting rights are an area where hard work and many hours of persuasion will be needed if countries are to be convinced to see the bigger picture and relinquish some degree of direct control over the IMF in return for the creation of a more effective institution. Hard work, perseverance and dogged determination have been characteristics of this year’s Australian presidency of the G20 under Peter Costello, Ian MacFarlane and Glenn Stevens. Their efforts have been crucial to the progress that has been made towards quota reform over the past year. It is important that the Australian legacy be carried forward if the process of quota reform is to be completed.

(e) Are there overlaps with other institutions?

Unnecessary duplication is a waste of both time and money. I have already spoken about the respective comparative advantages of the IMF and OECD. There has also been some discussion about the roles of the IMF and the G7 in respect of exchange rate issues. Over the past three years – especially since the Boca Raton G7 summit of February 2004 – the inability of the G7 to deal with the major spillover effects in the world economy has become more and more evident. Adding new members, even if they were willing to join, is not the answer. More productive would be to use the IMF as flexible forum to bring the relevant group of countries together to handle issues as and when they arise.

5. Conclusions

The meetings of the IMF in Washington and Singapore this year marked the beginning of an attempt to define more clearly the role of the Fund in the world economy. Whether that will prove successful is too early to tell. But the challenge is clear. Globalisation increases our dependence on each other. It is no longer sufficient to rely on the commitments made sixty years ago – the world has changed too much since then.

It is up to the member countries to make a multilateral trading system work. As Joseph Conrad wrote a century ago in his great novel *Nostromo*, “Action is consolatory. It is the enemy of thought and the friend of flattering illusions”. The frenetic activity of international meetings and the flattering illusions of a stream of communiqués do not add up to a coherent set of commitments.

Failure to reform the international institutions will condemn them to irrelevance and obscurity. We are at that point. If this generation fails, then the work of those who were “present at the creation” will have been undone. It is our duty to re-create the institutional framework that we inherited.

It will not be easy. But in case like Alice you are tempted to think that, “There’s no use trying; one can’t believe impossible things”, remember the Queen’s reply: “Why, sometimes I’ve believed as many as six impossible things before breakfast”.