Mervyn King: Do we need an international monetary system?

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No country, however large or small, is an economic island. Trade has always been the key to faster economic growth and higher living standards. Some of the most successful examples of economic development have followed the path of export-led growth, and some of the most unsuccessful have not. South Korea, for example, exports the same amount of manufactures in a day as Egypt exports in a month, and its GDP per head is now five times higher. And trade is not restricted to goods. The days when trade was measured by weight or volume of cargo through our ports have, by and large, gone. Services account for around a fifth of world trade, a proportion that is growing.

The expansion of trade in services is related to the rise of technologies that make it easier to transmit services around the world. Within a few miles of this conference room are companies like Apple, Facebook and Google that have transformed the way in which services can be provided worldwide. And even the older services have become tradable – over the course of a century the All England Lawn Tennis Club Championships at Wimbledon have grown from a small local tournament to the world's premier tennis event driven by a global television audience of around 400 million people in 187 countries (as many as are members of the IMF).

But international trade requires a monetary system to flourish – the rise of the successful Asian economies would never have occurred if they had been restricted to barter. If flexible exchange rates were allowed to determine the relative values of different currencies in competitive markets, why should there be any need for "rules of the game" or an international currency? Indeed, is the phrase "international monetary system" an oxymoron? That leads to the question I want to discuss today: what is meant by the international monetary system and do we need one?

Over the years, views on the need for "rules of the game" governing international payments have ebbed and flowed. So it is not surprising that France has chosen the international monetary system as a theme of its presidency of the G20 this year.

Why not leave these issues to market forces? What are the externalities in the international monetary system which mean that one country's actions distort the choices open to others? The main externalities in today's international monetary system are most visible in the interaction between the advanced and emerging economies. The rising importance of the emerging economies has perhaps been the most important development since the Bretton Woods framework of fixed exchange rates was abandoned in the early 1970s. China and India alone have brought 2 ½ billion people into the world trading system, with many more in other countries such as Brazil and Russia. And over the next five years, emerging economies are expected to account for almost three quarters of total growth in world output.

Trade has promoted development in China and other emerging markets, and has benefited the rest of the world as the costs of a range of traded goods and services, particularly manufactured goods, have been driven down. But the emergence of the accompanying imbalances in current accounts had huge effects on the global pattern of spending. Between 1998 and 2006, annual output in high-saving economies expanded by around $10 trillion – $1trillion more than the growth in domestic demand in the same economies. The rise in output relative to demand in the high-saving countries was only possible because there were matching capital flows. Capital flowed "uphill" from many of the emerging markets to advanced deficit economies, not an obvious sign of capital moving to exploit profitable investment opportunities. The deficit countries – predominately the US, UK, Australia and countries in the euro-area periphery – were borrowing almost $1trillion dollars more *each year* by 2006 than they had been in 1998. This created unsustainable paths for domestic demand, net debt and long-term real interest rates.

Whether households or policymakers truly understood how unsustainable these paths were is hard to know. But the extent of the resulting financial fragility became all too apparent in late 2008. Credit supply in many of the advanced economies froze, confidence collapsed around the world and private demand fell sharply. Output was cushioned only through an unprecedented policy response around the world. That did bring an end to the sharp falls in output, and allowed confidence to recover somewhat. And in many countries, particularly those that did not suffer directly from banking crises, output has bounced back.

Yet this extraordinary policy response has simply postponed much of the required adjustment in spending patterns around the world. And long-term real interest rates are unsustainably low.

The challenges of sustainability are most evident in vulnerable euro-area periphery countries. Unable to sustain domestic spending through further borrowing they are now struggling to substitute external demand for domestic spending. They face a major challenge to raise output by enough to allow them to service existing debt and to bring unemployment down. This is particularly difficult within a currency union because, without a flexible exchange rate, it is not easy for them to lower domestic prices relative to those overseas. And even if that were possible, the burden of debt, denominated in nominal terms, would rise relative to income. These countries, then, are heavily dependent on the pattern of spending elsewhere and would benefit greatly from an expansion in domestic demand in countries with stronger balance sheets.

The main lesson from the experience of the imbalances is that national policy frameworks alone were unable to prevent domestic demand from growing at an unsustainable rate. Inter-temporal budget constraints do not exercise the same discipline as constraints that are immediately binding. So unsustainable paths of spending and precarious stock positions developed. As a result, abrupt, and costly, adjustment at some point in the future was always likely.

Markets can enforce inter-temporal budget constraints only over a long-time horizon. As a result, countries can pursue inconsistent policies for long periods, and a range of imperfections in the financial system encourages them to do so. An example of those imperfections is that opportunities to insure against exchange rate fluctuations are limited – markets are incomplete. Exchange rates can move in surprising and unpredictable ways. Over the past twenty years, the ratio of the highest to the lowest dollar-yen exchange rate was almost 2 to 1, and the same was true of the dollar-euro rate. The difficulty in insuring against such swings means that this volatility can induce large fluctuations in output with unnecessary costs incurred in the relocation of resources and employment. Fixed, or managed, exchange rate regimes may help to limit the real economic costs of "excessive" volatility that reflects short-lived shifts in market sentiment, but if they impede desirable adjustments of real exchange rates, they contribute to unsustainable patterns of spending.

There are other reasons why emerging economies, in particular, have managed their exchange rates. Perhaps the most important is that pushing down on the exchange rate is a means to pursue a strategy of export-led growth. Another motive, important in the wake of the Asian financial crisis, was to build up large precautionary balances of foreign exchange reserves as a way of insuring against sudden reversals in capital flows, especially of short-term bank lending, that proved so damaging in the 1990s.

Such policies distorted saving and exchange rates, and created large capital flows unrelated to the distribution of profitable real investment opportunities. Given imperfections in financial markets in both borrowing and lending countries, such capital flows can lead to a degree of fragility, such that, when adjustment comes, there is a high probability that it will be abrupt. For example, the distortion from a "too important to fail" implicit subsidy to the funding costs of banks in the industrialised world led to excessive leverage in these countries. Creditors were prepared to lend at lower rates and on a greater scale than they would have without the implicit subsidy. In other countries, financial repression artificially raised saving rates by making borrowing too costly. This highlights the need to focus reform efforts on the international monetary ***and*** financial system (IMFS).

There are, therefore, both "good" and "bad" imbalances. On the one hand, the advantage of globalisation is that it allows savings to flow to where the rate of return on new investment is highest. On the other hand, imbalances can be a symptom of distortions to the price signals in the economy, leading to unsustainable patterns of capital flows and spending that are costly to correct. Distinguishing between them will never be easy, but is necessary when setting monetary, fiscal and financial policy. But we should assess imbalances in terms of whether their consequences are "good" or "bad" – that is, whether they are creating a distorting externality.

So how should we reform the current system of monetary arrangements? If problems abound, there is certainly no shortage of proposed solutions. Since Bretton Woods, there have been regular suggestions for changing from fixed to flexible exchange rates, or the other way round, returning to the gold standard, creating a new international currency, changing the composition of the currency basket comprising Special Drawing Rights (SDRs), abolishing or introducing controls on capital flows, and providing new ways of holding currency reserves.

What is much less clear, however, is the problem to which these proposed solutions are thought to be the answer. I have suggested that we need to analyse more carefully the imperfections, or frictional costs, which make a regime of floating exchange rates an insufficient answer in itself. The crucial frictional costs, it seems to me, are those associated with a sharp fall in output and employment following an abrupt adjustment in the current account, whether brought about by a sudden movement in exchange rates or the collapse of a financial system. They reflect distortions of the price signals for inter-temporal saving and financing decisions. Both the Asian and the recent financial crisis were vivid illustrations of how large those costs can be. Central to any solution is a problem that has not been resolved since the Bretton Woods conference in 1944, namely the asymmetric pressures on, and responsibilities of, deficit and surplus countries to adjust their spending patterns.

In trying to deal with this central question, we should not get sidetracked by issues such as changing the composition of the SDR basket. The SDR is a reserve asset, not a reserve currency, and as such has rather little to do with the emergence of unsustainable levels of spending and interest rates.

Our predecessors were well aware of the central issue. At Bretton Woods, both American and British officials presented proposals for schemes to impose more symmetric obligations on both surplus and deficit countries. For the United States, Harry Dexter White, an alumnus of Stanford, put forward the idea of a "scarce currency" clause for the Articles of the IMF. And his British counterpart, John Maynard Keynes, proposed an International Clearing Union with penalties on large surpluses or deficits (his suggestion of a new currency, the bancor, was included primarily because at the time national currencies were not convertible). His aim was to ensure symmetric obligations. As he wrote in 1941,

> "[T]he social strain of an adjustment downwards is much greater than that of an adjustment upwards. And besides this, the process of adjustment is *compulsory* for the debtor and *voluntary* for the creditor. If the creditor does not choose to make, or allow, his share of the adjustment, he suffers no inconvenience. For

> whilst a country's reserve cannot fall below zero, there is no ceiling which sets an upper limit. The same is true if international loans are to be the means of adjustment. The debtor *must* borrow; the creditor is under no such compulsion".

And ever since then, the absence of an effective symmetric framework of obligations on both debtor and creditor countries has led to periodic crises. The obstacle to the creation of a binding framework is clear. Governments know whether they are debtors or creditors today. So a framework that has economic and indeed moral force when seen from behind the "veil of ignorance", as suggested by John Rawls, is unlikely to appeal to governments.

Should we conclude, therefore, that in the absence of a world government, the identification of "new rules of the game" is likely to be no more than a theoretical exercise? Certainly, the fate of Keynes' proposal for an International Clearing Union is not encouraging. But the experience of the past twenty years shows that large imbalances mean that everyone suffers when there is a sharp adjustment.

So there is scope, if not for formal international policy coordination, then for an international conversation about how to improve a system that is fragile. Central banks were able to ensure, for a while, that the paths of output were sustainable – consistent with low and stable inflation. But the patterns of demand were far from sustainable. And when the sharp adjustment to demand eventually came, it inevitably had implications for the level of output. Reform of the IMFS, and of our domestic financial systems, is a necessary complement to the domestic price stability oriented policy frameworks of central banks.

The immediate issue of how to move to a more sustainable position requires a resolution of different countries' economic strategies for rebalancing. There can be only one path for rebalancing – with rebalancing in the deficit economies, by definition, just a mirror of that in the surplus countries. But the path that would be chosen by high-saving economies differs from that which the more indebted industrialised economies would prefer. Their need to deleverage and reduce borrowing means that if another abrupt adjustment is to be avoided, they cannot risk taking too long to rebalance their economies. In contrast, many of the emerging economies continue to require rapid economic growth and abundant employment opportunities in their export industries to ensure adequate levels of employment for their vast populations. As a result, policymakers in countries like China quite simply see limits to the extent and speed at which they should expand the share of domestic demand in their economies. They do not want to rebalance their economies too quickly. Of course, *ex post* there must be consistency between these two strategies as demand in the world as a whole must "add up".

The current pattern of demand in the world economy is unsustainable. The political tension generated by the divergent preferences of surplus and deficit countries risks moves towards protectionism, as happened in the 1930s. So there must be scope, in the short term, for a "grand bargain" to adopt a set of policies that would support an agreed path of rebalancing and avert a move towards protectionism.

Such a "grand bargain" should be the central objective of the G20's Framework for Strong, Sustainable and Balanced Growth. It would require a shared analysis, seemingly absent at present, of the relative importance of the "good" and "bad" aspects of the imbalances. And it should comprise (i) an agreed path for the reduction or increase of net exports relative to domestic demand; (ii) an agreed framework for allowing real exchange rates to support the path for unwinding the imbalances; (iii) a set of rules governing the circumstances in which countries would be able to limit short-term capital flows; (iv) macro-prudential policies to limit the build-up of imbalances and add to the instruments available to pursue financial stability; and (v) structural policies, including fiscal measures, to raise national savings in deficit countries and to lower savings in surplus countries. Some combination of all of these elements will be necessary in order to chart a path back to sustainability.

There are pitfalls to avoid. Too often the policy response to a sharp adjustment to an unsustainable position starts and ends with the provision of liquidity. Rarely, however, is the problem a temporary shortage of liquidity. As we have seen since 2007, and on many occasions before that, most players – whether financial institutions or countries – would like others to believe that greater provision of liquidity is the answer. Almost always the provision of liquidity works only when it is the bridge to a more fundamental solution.

Once rebalancing has been achieved, there will be the longer-term question of how we prevent a recurrence. There is no world government to impose "rules of the game" to internalise the externalities. So the solution can be found only in cooperation between nations. At present, the plethora of international meetings offers many chances to see the world, if not actually to save it. Ultimately, only the Bretton Woods institutions themselves – the IMF and the World Bank – have the legitimacy to represent all of their 187 member countries. But their governance is outdated. At the height of the crisis, the G20 and the G7 provided strong leadership. But legitimacy and leadership should go together. One without the other does not offer a sustainable vehicle for international cooperation. So allowing the G20 to metamorphose into the governing body of the IMF makes a good deal of sense. Such an evolution would, with a little commitment and imagination, create a single effective framework for international economic cooperation. And in the long run a more powerful and legitimate international body might be able to use its clout to deal with the imperfections and frictions that I have discussed. It might even be the vehicle for a more rules-based framework for the IMFS, based on a judgement about the sustainability of the pattern of world demand. Although that seems a distant prospect today, there is a precedent for a system of internalising cross-border externalities: the WTO already plays a similar role in international trade. So far, these rules have stood the test of time. Indeed, it is now more likely that protectionism would result from high unemployment, which the rules were not designed to prevent, than the pressures from producers which have been resisted.

There is much to do. None of the underlying causes of the current crisis have been removed. The problem of "too important to fail" banks is still with us. And even more intractable is the challenge of how to reconcile free trade with a stable international monetary and financial system.

Today, the most obvious problem at the global level is that the imbalances are growing again. And continuing high debt levels, although in many ways a natural response to low long-term interest rates, leave indebted countries particularly vulnerable to a rapid reversal of high saving rates in surplus countries and a rise in long-term interest rates – surely inevitable in the long run – which would drive down asset prices. It is clear that these vulnerabilities affect us all. So recognising our common interest in moving to a more sustainable pattern of world demand is in our self-interest.

The global community showed that it could work together when the world economy was close to the abyss in 2008. The challenge now is to prove that we can also work together when we are no longer in an immediate crisis, but still facing deep-seated problems. Will we create a more stable IMFS? The next few years will provide the answer. And they will, as our Chinese friends say, be interesting.