BANK OF ENGLAND

Speech

International Monetary Stability – Can the IMF Make a Difference?

Lecture by

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Next month will be the thirty-fifth anniversary of the Smithsonian Agreement – hailed at the time by President Nixon as 'the most significant monetary agreement in the history of the world'. Today it is remembered, if at all, as a stage in the collapse of the Bretton Woods system of pegged exchange rates. But it also inaugurated a period of intense debate about the future of the international monetary system and the role of the International Monetary Fund, which culminated in the Second Amendment to the Fund's Articles in 1976.

Thirty years on, the Fund's role in promoting international monetary stability is again under scrutiny. The world economy and the international monetary system have been transformed since the late 1970s. The Fund has evolved to deal with new situations and fresh crises. But much more change is needed if it is to meet the challenges of the 21st century. That much is common ground.

Proposals to reinvigorate the Fund's oversight of the international monetary system – surveillance – lie at the heart of the Medium Term Strategy endorsed at this year's Spring Meeting of the IMF. Together with the more widely publicised, and politically charged, commitment to reform the Fund's governance, by rebalancing the quotas that determine member countries' voting rights, they represent a serious attempt, in the words of the Fund's Managing Director Rodrigo de Rato, to 'meet the challenges posed by globalisation.'

The main purpose of my lecture tonight will be to explain the role which a refocused Fund could and should be playing in promoting international monetary stability, and to outline some steps to build on the agreements reached at the Fund's Annual meetings in Singapore in September. The next six months will be critical. It is important that we use them to think hard about what the Fund does, as well as to push forward the second stage of the governance agenda.

The changing role of the IMF

The IMF was originally set up at the end of the Second World War 'to promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems'. The collapse of the system of pegged exchange rates in the early 1970s precipitated a lengthy debate between those, led by the French, who favoured a return to managed exchange rates, and others, led by the Americans, who favoured floating exchange rates. When a compromise was eventually reached, the Fund's Articles were amended to allow Member countries to choose between fixed, floating or managed exchange rate regimes, as long as they fulfilled certain commitments.

Members agreed to collaborate with the Fund and other countries to assure external stability through 'orderly exchange arrangements and … a stable system of exchange rates'. They also assumed specific obligations relating to their domestic and external policies. They agreed to avoid manipulating exchange rates to prevent effective balance of payments adjustment or to gain an unfair competitive advantage. And they agreed to direct their domestic policies toward fostering orderly economic growth and price stability.

The Fund's role was also redefined. It was required: first 'to oversee the international monetary system in order to ensure its effective operation', and second to 'exercise firm surveillance over the exchange rate policies of its members and to adopt specific principles for the guidance of all members with respect to these policies'. These principles were subsequently spelt out in a 1977 Surveillance Decision, which focussed narrowly on exchange rate policies.

Surveillance duly became one of the Fund's core activities, alongside lending and providing technical assistance. But over the years, the focus of surveillance drifted away from exchange rate issues, as the Fund's central role in promoting international monetary cooperation went into eclipse. Its public profile was dominated by its frequently controversial role as a provider of financial assistance to countries facing external payments crises. International monetary policy coordination, on the few occasions when it was actively attempted, became the preserve of small inter-governmental groups of

leading industrialised countries, the G5/7 – most famously in the Plaza and Louvre Accords in the mid 1980s.

Over time, the international monetary system has evolved into a patchwork of different approaches to policy, in contrast to the uniformity of the Bretton Woods system. Many large developed countries with open capital markets now pursue independent monetary polices and let their exchange rates float freely, while smaller and less developed countries tend to peg or heavily manage their exchange rates, effectively surrendering control over domestic inflation. There are regional monetary unions – notably the euro zone. And some emerging and developing economies still combine managed exchange rates with restrictions on capital flows, in an attempt to retain a degree of monetary independence.

How has the world economy changed?

The backdrop to these developments has been a transformation in the world economy over the past thirty years. For the present purposes, there are two major aspects to what is commonly known as 'globalisation'.

First, there has been a very rapid integration of the world economy. Trade liberalisation, new technology, falling communication costs, and the resulting globalisation of supply chains have contributed to a great opening in national markets. Since 1970, trade openness – defined as the ratio of exports and imports to GDP – has risen from around 25% to over 40% for industrialised countries, and from 15% to 60% for emerging markets. The growth and integration of financial and capital markets has been even more spectacular, especially over the past 20 years. Financial openness – defined as the ratio of external assets and liabilities to GDP - has risen seven-fold for both groups of countries.

Second, the dramatic rise of new economic powers has been simultaneously adding to global productive capacity, and changing the balance of world trade and economic activity.

The entry of China, India and Eastern Europe into the global market economy has effectively doubled the world's supply of labour. The sheer scale and speed of economic development in China alone has been quite without precedent. After 25 years of double-digit growth, it is now the world's fourth largest economy, having overtaken the UK this year. Its share of world trade has more than doubled over the past decade, making it the third largest trading country behind the US and Germany.

Increasingly, a small group of industrialised countries will no longer dominate the world economy in the way they did 30 years ago. Measured at market exchange rates, the G7 still accounts for 60% of world output. But if current growth differentials persist, this share will fall to 40% within the next 20 years. And if output is measured using purchasing power parities – to give a higher, and arguably more accurate, weight to relatively cheap non-traded goods and services in emerging markets - the G7 world share has already fallen to that level.

Emerging markets are already a major force in the world economy. Together they make up 80% of the world's population, use half the world's energy and produce over 40% of the world's exports. And over the last five years they have accounted for well over half of total world growth.

Implications for policy

Taken together, these developments have profound implications for policy-makers. The linkages between one economy and another are now wider, deeper and more complex than ever before. One country's policy is more likely to have 'spill over' effects on other countries. The interpretation of economic developments has become more challenging. And the rapid emergence of new economic superpowers is creating a new generation of policy issues.

For example, the addition of large supplies of low cost labour to the world market is affecting global relative prices, especially of manufactured goods and natural resources, as well as intensifying competition in labour and product markets. This seems to be affecting wage and price setting behaviour in developed countries, as well as their terms

of trade. Domestic policy-makers have been left struggling to comprehend how globalisation is changing the behaviour of their own economies, and thus the likely impact of their own policy actions.

From a global perspective, the coexistence, in recent years, of low long-term real interest rates, massive, and rising, US current account deficits and the build up of huge foreign exchange reserves in Asia has been a source of particular puzzlement and some concern to policy-makers.

How confident can we really be that the international monetary system can cope with the stresses and strains of a fast integrating global economy? Deep and liquid financial markets have made it possible to finance huge global imbalances, and may have helped to stabilise the world economy in recent years. But there must be a risk, even if it is fairly remote, that imbalances will unwind in an abrupt or disorderly way which could damage growth and push up inflation.

Globalisation is raising the stakes for policymakers. Closer collaboration should help them to take better informed decisions. It can deepen their understanding of the impact of global developments and policy spillovers, and give them insights into the likely responses of other policy-makers to different scenarios. In a more closely integrated world economy, there is a greater shared interest in identifying the risks to international monetary stability and in discussing the policy responses that might help to mitigate them.

The Fund and international monetary co-operation – the issues

But even if we accept the case for intensified international monetary collaboration in today's highly inter-connected world, does the Fund still have a central role to play? And if so, what is it?

There are two main reasons why, in my view, it does.

First, there is an important role for a permanent institution as a provider of internationally consistent information, impartial expert analysis, assessment and advice. Today's world economy is no longer dominated by a small group of like-minded industrialised countries at similar stages of development; tomorrow's will be even less so. A shared knowledge base will facilitate effective consultation and collaboration on complex and politically charged issues. This is essentially a public good. And while it is possible to envisage alternative arrangements for supplying it, a permanent international institution is likely to offer clear practical advantages.

Second, the Fund already exists. It has the reach and experience to respond flexibly to the changing structure of the world economy. It has nearly universal membership, (now totalling 184 sovereign nations), an agreed legal framework, extensive relevant institutional capacity and a reputation built up over sixty years. Given the costs of acquiring such unique capacity from scratch in the modern world, the benefits of starting again would need to be very substantial indeed.

This adds up to a strong pragmatic case for working with what we have.

So what role should the Fund be playing? Mervyn King, in his speech in Delhi earlier this year, likened the role of the IMF to an umpire in cricket, 'warning the players not to attack each other verbally and making it clear publicly when they believe the players are not abiding with the spirit of the game'.

While I would be the last person to argue with Mervyn, at least about cricket, I initially found this analogy rather unconvincing. In my mind, the term umpire conjures up a portly old gentleman in a white coat and straw boater. Surely the modern IMF should have a more dynamic and up to date image? But it turns out that even cricket has moved on. I am not referring to the recent abandonment of the England Pakistan match, for the first time ever, after a heated disagreement between an umpire and players. No, what I have in mind is the advanced computer technology which I gather now exists, aptly named Hawk-Eye, which could assist umpires in making the most difficult calls – those about which the players of the game are most likely to disagree.

So we should think of the IMF as the cricket umpire of the future, with Hawk-Eye in her toolkit – where the Fund's Hawk-Eye will be its impartial analysis, assessment and advice, enabling it to dissect the most difficult policy issues in the global economy.

Reforming the Fund's surveillance

If that is the vision, the relevant questions are whether the Fund's current surveillance activities are well designed to meet the need; and if not, what can be done to improve matters?

The answer to the first question is clearly no. Despite many reviews, the underpinning Surveillance Decision, agreed three decades ago, has never been revised. And over that time Fund surveillance has drifted a long way from its original – narrowly defined – purpose. Fortunately, there is now broad agreement about the main problems that need addressing.

First, the Fund does not devote enough time and effort to overseeing the system as a whole, through assessing global economic prospects and analysing international economic linkages and policy spillovers (so-called multilateral surveillance). Instead, the great bulk of the Fund's effort has been devoted to producing reports on individual member countries (so-called bilateral surveillance).

Second, these individual country assessments have often lacked focus. The subjects covered have ranged widely, reflecting the preoccupations of the day, including much detail on so called 'structural' issues. Nor has bilateral surveillance been good at picking up multilateral issues - areas where a country's policies might have wider effects, or where it might be particularly exposed to global risks.

The Fund's analysis needs to be better focussed on the big global issues, including financial issues and on the interactions between different regions and countries. This means devoting more effort to analysing multilateral issues and to integrating bilateral and multilateral surveillance; and it means being ruthlessly selective in dealing with structural issues, by testing their relevance to external stability. It also means putting

more emphasis on the surveillance of those countries with the most potential to create waves in the international monetary system.

Finally, the relatively puny effort devoted to multilateral surveillance is not having enough influence on members' policies. According to the Independent Evaluation Office (IEO) report published earlier this year, there is 'too much weight on providing information on economic developments and too little on analysing economic policy linkages and identifying scope for collective action'. The Fund needs to make more of its presence at inter-governmental groups such as the G7 and the G20. And it needs to experiment with more flexible ways of exploring key policy issues with relevant groups of members, to add depth to the formal exchanges typical of large set-piece international gatherings.

After a couple of years debate, the prospects for achieving meaningful reform now look promising, following the Fund's Annual meetings in Singapore. The agenda for reforming surveillance includes a new focus on multilateral issues, including global financial issues and a new procedure for multilateral surveillance. The Managing Director has launched a first round of multilateral consultations on global imbalances. These are a potentially important innovation in the way the Fund interacts with key policy-makers, but as they are still under way, I shall not comment further.

Instead I want to focus on the other key area for reform, where there are some important outstanding issues. This is the work now in hand to clarify and update the operational guidance on surveillance, through a thorough review of the 1977 Decision and by designing a new annual remit for surveillance. This is aiming to provide a clear, up-to-date set of guiding principles, and a firmer operational foundation for surveillance.

This matters because the Fund can only be effective in encouraging countries to fulfil their obligations if there is a clear and shared view of what those commitments are, and a coherent and transparent operational framework for assessing compliance. There also needs to be greater clarity about the Fund's obligations, and how it is to be held to account for fulfilling them.

A new Surveillance Decision

The 1977 Surveillance Decision needs to be replaced by a coherent and comprehensive set of principles covering all aspects of the Fund's surveillance. A new Decision should start from the overarching objective to promote external stability. Consistent with this, it should shift the emphasis toward multilateral surveillance and the analysis of policy spillovers. And, unlike the 1977 Decision, it should cover both exchange rate policies and domestic policies insofar as they may affect external stability, rather than exchange rate policies, per se.

This is a key area where the consensus has moved on since the late 1970s.

It is now well recognised that exchange rate policies cannot be divorced from domestic policies. Where exchange rates are allowed to float freely, the paths they take will be affected by a wide range of domestic factors, including both monetary and fiscal policies. These policies can have significant foreign exchange and spill-over effects even when they are not implemented for an explicit balance of payments purpose. But even where nominal exchange rates are pegged, competitiveness and hence trade flows depend crucially on relative inflation rates, which reflect domestic monetary and financial policies. So both the effects of a fixed exchange rate, and questions about whether such a peg is sustainable at a given level, depend fundamentally on other domestic policies.

In short, what is now needed is a new decision which will provide a comprehensive framework for surveillance; which will approach members' obligations explicitly from the perspective of external stability; and which will do so in terms which can readily be made operational. And it must be written in clear and unambiguous language.

This is a tall order I know – so here are some suggestions.

One very simple way of keeping surveillance focused would be to include a 'selectivity principle' in a new Decision. This would say that the scope of all surveillance activities should be based on their relevance to external stability: and that what matters is how a member's policies could affect the rest of the world.

The most difficult challenge will be to state members' commitments in terms that are both general enough to take account of their very different economic circumstances, and specific enough to provide a clear focus for IMF surveillance. Striking the right balance is essential if a new framework is to provide a useful basis for assessing industrialised countries, emerging markets, and developing countries alike in a way that will be accepted as even handed.

A good way of meeting this challenge would be to ground surveillance in a more structured analysis of the policy frameworks which countries themselves choose to adopt. The Fund could then focus on identifying areas where a member's policy frameworks might be unsustainable or inconsistent with external stability, and then offer policy recommendations tailored to the circumstances of the country or countries concerned.

How might this work in practice?

Member countries would each provide a systematic description of their chosen policy frameworks in key areas - relating to monetary, fiscal, financial, and exchange rate policies. For these purposes, a policy framework is just a more or less formal description of a country's policy objectives and the policy instruments that have been assigned to meet them, including any policy rules, targets or strategies that may be used as a guide to decision-taking.

This approach would exploit the Fund's already significant access to information about members' policy frameworks, and if necessary its power to request more. And it would also avoid prescription and explicitly recognise members' undoubted right to choose their own policy frameworks, providing that they are consistent with their commitments under the Articles.

Given this starting point, Fund surveillance could then focus on two key sets of issues.

First, is an individual country's set of monetary, fiscal, financial, and exchange rate frameworks internally consistent?

The key questions would be: is this a sustainable approach to policy? And is policy being implemented in a way which is consistent with the stated framework? Taken together are the policy frameworks adopted by a member consistent with its obligations under the Fund's Articles, including the member's overarching commitment to collaborate with the Fund and other members to assure external stability?

The Asian crisis of the late 1990s illustrates the problems that can develop from internally inconsistent financial and exchange rate policies. There were fundamental inconsistencies between rapidly-liberalised capital accounts, still under-developed financial systems, and pegged exchange rates. This led to excessive investment through financial intermediaries, and the accumulation of a great deal of foreign-currency debt, much of which was un-hedged. When the full extent of this vulnerability became apparent, there were full-blown currency and financial sector crises.

Second, are different countries' policy frameworks consistent with one another?

If different members' policy frameworks are inconsistent, this could inhibit external adjustment, and pose a potential threat to external stability. So the key area for multilateral surveillance would be to identify where different countries' policy frameworks might conflict with one another and to propose remedies before this threatened the stability of the international monetary system.

You can argue that inconsistent policy frameworks lay at the root of the European Exchange Rate Mechanism crisis in 1992. German monetary policy successfully targeted domestic price stability. The UK was pegging its exchange rate to the DM in order to import this stability. But when the Germans adopted a new approach to fiscal policy, running a structural deficit to finance infrastructure investment in the east - essentially adopting a new fiscal policy framework - German interest rates had to rise to keep domestic inflation in check. But keeping UK interest rates high enough to maintain the exchange rate would have been very contractionary. Arguably, the UK and German policy frameworks had become incompatible. Something had to give – in this case sterling's membership of the ERM.

This analysis of policy frameworks would help to focus bilateral surveillance, and provide a better basis for multilateral surveillance, and for integrating the two. It should throw up issues that could be pursued either with individual members or broader groups as appropriate.

An annual remit

Better guidance for Fund surveillance should be buttressed by strengthened accountability for performance. For this, we need a clearer definition of what the Fund's surveillance is expected to deliver. A good way of doing this would be to set an annual surveillance remit for the Fund's Managing Director - an idea endorsed by the IMFC last April.

There are a number of overlapping mechanisms for setting priorities and assessing performance which now operate across the broad range of the Fund's work programme, through the Executive Board. But a surveillance remit would provide a sharper means for holding Fund management and staff to account for their performance on this key aspect of their work.

Of course, it would need to work with the grain of the Fund's overall governance arrangements. This throws up two tricky issues. First, who sets the remit and how? And second, how is the Fund's performance to be evaluated, and by whom? These issues require detailed consideration, but let me offer a few thoughts.

First, the process for setting the remit probably needs to involve both the Fund's Executive Board and the IMFC: the Board, because it is the body formally charged under the Articles with the oversight of surveillance; and the IMFC, because of its heavyweight political composition. The involvement of the most senior policy-makers matters, because by endorsing the remit they are effectively giving the Fund a license to discuss their policies. This is empowering to the Fund. One way for this to work might be for the Board to present a draft to the IMFC for discussion at the spring meeting each year, taking its cue from the IMFC communiqué issued the previous autumn.

Second, one obstacle to relying exclusively on the Executive Board to evaluate the Fund's performance arises from the position of the Managing Director, who is both Chair of the Board and Head of the Fund Staff. But the MD's position is embedded in the Articles and raises much wider issues of governance. In the short term at least, this argues for giving a significant role to the IMFC.

Third, the technical challenges in assessing the effectiveness of surveillance are formidable. This points to giving an important role to the IEO which, since its foundation in 2001, has been building up relevant expertise in assessing various aspects of the Fund's work.

How much difference can IMF surveillance really make?

This brings me to the crux of the matter: can IMF surveillance really make much difference, even if it is reformed in the way I have described?

It is important to recognise that surveillance - especially multilateral surveillance - is a very different kind of activity from the monitoring of reform programmes that may be linked to Fund financial assistance packages. Lending programmes have exerted considerable apparent leverage over countries' behaviour at least in the short term, through so called 'conditionality'. In recent years the Fund's lending activities have gone into steep, and possibly irreversible, decline. But leverage of this kind has never been available to force policy change on countries who do not borrow from the Fund, a category which for the past 25 years has included all large industrialised countries.

The 'traction' of surveillance depends critically on the Fund's ability to influence the policies that countries choose to pursue. But is it realistic to suppose that the Fund can any have real influence over the countries whose policies matter most?

The Fund's constitution is cast in terms of the obligations that members owe to each other and to the Fund. Such obligations are not without legal content, still less without value. But the effectiveness of surveillance cannot rest on the strength or otherwise of any treaty-based sanctions that might be used against members who fail to meet their obligations.

The Fund's chief weapon is persuasion, exerted through a combination of channels: private advice, peer pressure, and public debate. But is this enough?

Excellent analysis can frame the issues that policy makers focus on; and it can shape and inform the public debate, domestic and international, that leads to action. Ideas and analysis, widely and well-communicated, can be very powerful in the modern world, especially in the largest democracies. As Keynes reportedly remarked 'Ideas shape the course of history'.

The Fund can also facilitate dialogue between countries on issues where unilateral or even bilateral decision-making may not be the best way forward. On the biggest global issues, policies need to be designed with some depth of understanding about how others will act.

But ultimately much turns on members' confidence and trust in the Fund, and on the depth of their continuing commitment to its original first purpose: 'to promote international monetary co operation through a permanent institution'. The support and commitment of those countries whose policies have the greatest impact on the world economy is clearly critical.

So the Fund's ability to shape and facilitate the debate is intimately bound up with its legitimacy. All countries need to feel they have a real stake in the governance of the Fund and an effective voice in shaping its activities and the decisions taken by its Board. This is why the governance agenda is so important and why there is a close link between the surveillance agenda and the second stage of quota reform.

The broader point is that everyone needs to have confidence that the Fund is fair and impartial in the way it goes about its work. Surveillance needs to be free from any perception of bias if it is to be credible. This is sensitive territory. Members are prohibited from attempting to influence staff as they discharge their functions. But present arrangements offer plenty of scope for misperceptions. There is a fuzzy boundary between legitimate concern for the quality and relevance of surveillance and improper pressure on staff to fudge difficult issues or water down unpalatable conclusions. A surveillance remit would clarify the boundaries between staff and members without sacrificing accountability.

The role and performance of the Executive Board is clearly a critical issue. Putting to one side the long-running debate about the case for shifting to a non-resident Board, there is ample room for modernisation and improvement. Could the conflicts inherent in the MD's dual role be more transparently managed? And could the Board refocus it own efforts to better support the wider surveillance agenda? Last year, for example, it spent just 5% of its time mulling over multilateral surveillance issues – at a time when global imbalances and energy prices were headline news.

Finally, reform is a process not an event. The structure, processes, incentives and culture of an organisation whose core activity is surveillance are likely to be significantly different from one whose primary focus is on lending to countries confronting financial crises. Like many other organisations facing major change in its core business, the Fund will need to be sure that everything it values and rewards is tuned to support its new priorities.

Conclusion

Over the past fifteen years, the Great Inflation that followed the end of the Bretton Woods system has been replaced by the Great Stability. Globalisation has brought great benefits, but it is creating major challenges for policy makers.

How will such issues be handled in future?

The Fund certainly has the potential to act as an authoritative medium for international monetary collaboration, providing its surveillance activities are re-focused on external stability and the big global issues. The Managing Director's current reform agenda is on the right lines. But the Fund's effectiveness in promoting international monetary stability will depend critically on the organisation's stature as a trusted and respected source of dispassionate analysis and impartial advice. And it will rest above all on the willingness of its members – large as well as small - to use it as their instrument to improve the quality of their own policy making.

Equipping the Fund with its own version of Hawk-Eye will not be enough. In the end it will be down to them – or more accurately, us.

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