BANK OF ENGLAND

Speech

Reform of the International Monetary Fund

Speech given by

Mervyn King, Governor of the Bank of England

At the Indian Council for Research on International Economic Relations (ICRIER) in New Delhi, Indian

20 February 2006

All speeches are available online at www.bankofengland.co.uk/publications/Pages/speeches/default.aspx

Sixty years ago delegates from around the world were gathering on Wilmington Island in Savannah, Georgia, to celebrate the baptism of the Bretton Woods twins, the International Monetary Fund, or, simply, "the Fund" and the World Bank, "the Bank". India was represented by Sir Chintaman Deshmukh, Governor of the Reserve Bank of India, and Britain by John Maynard Keynes, Lord Keynes as he had become. The two men got on well, as can be seen from their official reports on the Savannah Conference. As Sir Chintaman wrote later:

"this meeting remains memorable mainly as the occasion when the Indian delegation worked in effortless accord with the British delegation under Lord Keynes and there were many occasions when there happened to be agreement between us on the need to take some step which would increase the utility, independence and creativity of the international bodies".[1]

In his speech at this first meeting of the Fund, Keynes drew an analogy with the christening-party in *The Sleeping Beauty*, which, as Chairman of Covent Garden, he had seen danced at the reopening of the Garden only two weeks earlier. He hoped that the Bretton Woods twins, Master Fund and Miss Bank, would receive three gifts from their fairy-godmothers: first, a many-coloured coat "as a perpetual reminder that they belong to the whole world"; second, a box of vitamins to encourage "energy and a fearless spirit, which does not shelve and avoid difficult issues, but welcomes them and is determined to solve them"; third, "a spirit of wisdom … so that their approach to every problem is absolutely objective". Keynes warned the delegates that this was asking a great deal: "there is scarcely any enduringly successful experience yet of an international body which has fulfilled the hopes of its progenitors". So he hoped that the malicious fairy would not bring its curse upon the twins: "you two brats shall grow up politicians; your every thought and act shall have an *arrière-pensée*; everything you determine shall not be for its own sake or on its own merits but because of something else". And if the IMF were to become politicised then, Keynes said, it would be best for the twins "to fall into an eternal slumber, never to waken or be heard of again in the courts and markets of Mankind".[2]

Sixty years on, the wisdom of Keynes's position at Savannah is clear. In recent years, the critics have charged that all three of the virtues of universalism, energy and

wisdom have been lacking in the IMF. And if not in a deep slumber, then the Fund has appeared drowsy. It is an institution, it is said, which has lost its way. What is the truth of these allegations? Certainly, the Fund's remit is unclear. Its lending activities have waned, and its role in the international monetary system is obscure. The tasks given to it by the conferences at Bretton Woods in 1944 and Savannah in 1946 need to be adapted to the financial circumstances of the 21st century. That was attempted in 1976 with the Second Amendment to the Fund Articles. But 30 years later it is evident that there is still more to do.

We have an opportunity to return to first principles and ask some basic questions. Do we need an IMF? Is there a role for a multilateral institution in the management of the international monetary system? If so, what is it? Not before time are those questions now being asked in the corridors, if not the main floor, of international meetings which rotate endlessly around the world from one windowless room to another. Belatedly, the G-7 has started to discuss the future role of the Fund, and the IMF has initiated its own strategic review. Last October, the ministers and governors of the G-20 countries said that "more work is needed to develop a 'roadmap' for the future strategic reform of the Bretton Woods institutions". And speeches by several G-7 ministers and governors, and as recently as ten days ago from the Managing Director himself, show that the debate on the role of the IMF is live. Too often in the past, as on the fiftieth and sixtieth anniversaries of the Bretton Woods conference, the debate has simply faded away. But if the mission of the Fund is not examined and the institution revitalised, it could slip into obscurity. Just as in Savannah, the responsibility for the ideas and impetus for radical change lies firmly with all the shareholders around the world.

It is encouraging that the Fund and member countries are putting forward concrete proposals for reform. But unless we consider the fundamental question of what the Fund is for, then any such suggestions risk being piecemeal and ineffective. That is the issue I want to discuss with you this afternoon, and I shall try to answer three questions. First, in what way is the world of today different from that of Bretton Woods? Second, what role, if any, do we want an international monetary institution to play in today's world? Third, what changes are needed to enable the IMF to play that role?

What has changed since Bretton Woods?

Following the collapse of the Bretton Woods system in the early 1970s, the IMF came increasingly to be seen not as the guardian of the international monetary system but as the international lender of last resort. It hit the headlines as the initiator of large support packages to emerging market economies – so much so, that until the recent repayment of their loans by Argentina and Brazil, 70% of the Fund's outstanding lending was accounted for by loans to three countries. In turn, the growth of private capital flows and the build-up of massive foreign exchange reserves by many Asian economies have made redundant the idea that the primary function of the Fund is to be an international lender of last resort. The Asian economies, including Japan, have increased their foreign exchange reserves over the past fifteen years so rapidly that they are now nearly ten times as large as the combined reserves of the rest of the G-7. So the Fund urgently needs to ask what its main purpose is.

In 1944, when the Bretton Woods system was created, it was understood that sharp changes in capital flows were costly. Changes in capital flows can induce changes in trade flows. And to bring about large changes in trade flows often requires not only a reallocation of resources, which itself can be costly, but also in some cases sharp falls in national output. The international monetary system was built around fixed exchange rates and controls on capital movements. Each country met its international responsibilities by running a balanced current account. When 'imbalances' arose and countries were depleting or building their official reserves, a key feature of this system was supposed to be that both the creditor and debtor countries were obliged to adjust their imbalances. In practice, the obligations on creditor and debtor countries were asymmetric, and in part that explains why the system proved unsustainable.

One drawback of the system was that it did not allow countries to smooth their expenditure in the face of fluctuations in their income. The role of the IMF was to facilitate some smoothing, by lending pooled reserves. Alternatively, changes in exchange rates would be sanctioned by the IMF for those countries judged to be in "fundamental disequilibrium". In doing this, the IMF fulfilled its purpose to help achieve orderly world growth. The history of the United Kingdom illustrates these

features of the Bretton Woods system. Britain faced repeated challenges in achieving external balance during the Bretton Woods era. Sterling was devalued twice and four IMF lending programmes were necessary. Yet in 11 of the 17 years between 1955 and 1971, the UK ran a current account surplus, and its current account deficit peaked at around a mere 1% of GDP in 1964.

Over time countries realised that restricting their ability to save and invest overseas was a significant limitation on their wellbeing. Opening up capital accounts broke the link between current income and current expenditure, and enabled countries both to smooth consumption and to diversify risk.

The openness of capital accounts means that the world today is very different from that of the Bretton Woods era. Capital flows - both public and private – are very large. And, for many countries, private capital flows now dwarf official flows. Because domestic demand is no longer constrained by current national output, a current account deficit does not necessarily indicate any "fundamental disequilibrium" nor require any official help to finance. For example, New Zealand received the largest annual disbursement of any industrialised country as a share of GDP during the Bretton Woods era: 1.9% in 1967. That was associated with a current account deficit of 3.7% of GDP. Since 1990, New Zealand's current account deficit has **averaged** more than that, but it has had no need of an IMF programme to finance these deficits. Indeed, the need for official financing for industrialised countries has become redundant.[3]

Many of the "imbalances" that reflect private decisions to save and invest are desirable because they improve the efficiency with which capital is allocated throughout the world. Since it is difficult to measure “equilibrium” flows of capital from one country to another, it is equally difficult to define meaningfully “fundamental equilibrium” exchange rates. As Alan Greenspan has pointed out, current account deficits and surpluses are now the norm rather than the exception.[4]

Moreover, even if a country is not today running a current account deficit or surplus, past flows of capital mean that domestic residents have assets and liabilities in a wide

range of overseas countries. Countries now have asset positions quite distinct from their official reserves. The single most important difference between the old world and today's world is that in the former the financial position of a country was captured by the size of its current account surplus or deficit; now the financial position is best measured by the size and composition of its national balance sheet. The ratio of the sum of overseas assets and liabilities to GDP for major industrialised countries rose from around 70% in 1983 to around 250% in 2003.[5]

The willingness to hold those assets and liabilities depends on expectations of the economic "fundamentals" such as productivity growth and demographic change. It also depends on expectations of future economic policy – both at home and abroad. If any of those expectations change, desired international investment positions will alter, possibly leading to sharp movements in asset prices and capital flows. News about economic fundamentals and about economic policy decisions leads to fluctuations in world inflation, output and employment. To understand the transmission mechanism requires a study of national balance sheets. They tell us three things.

First, they tell us about the claims of one country on another. That will help to reveal how international capital flows respond to news. For example, as expectations about productivity growth in the United States have changed, so have the composition of capital inflows. Equity inflows into the United States were twice as large as debt inflows in 2000. By 2004, debt flows were nearly four times as large as equity inflows.

Second, balance sheets contain information about the potential speed of any likely adjustment. That speed is crucial in determining the intensity of the resulting changes in capital flows and hence, the costs associated with reallocating resources. For example, currency and maturity mismatches in the banking sector created the scope for a liquidity run on Korea in 1997.

Third, balance sheets contain information about how changes in relative prices will affect the values of both assets and liabilities. For example, both Australia and the Philippines were affected by the crises in Thailand, Indonesia and Korea. Between 1996 and 1998, their exchange rates fell by 20% and 35% respectively. Both had high

ratios of external liabilities to GDP. But whereas a significant proportion of Australia's obligations were denominated in local rather than foreign currency, the obligations of the Philippines were largely in the form of foreign currency debt. Australia was able to cut official interest rates, run a larger current account deficit and grew faster in 1998 than 1997. The Philippines, on the other hand, could not and went into recession with its current account swinging by 7.5% of GDP, from deficit in 1997 to surplus in 1998.

These balance sheet linkages have altered the risks we face but they are an inevitable consequence of the free movement of capital, which has brought with it new opportunities for us all. Any answer to the question of what role the IMF should now play must recognise these balance sheet linkages. The size and composition of balance sheets is crucial for determining how shocks are transmitted across national borders. And surprises about economic policy and news about economic fundamentals can, by generating changes in desired balance sheet positions, have large impacts on capital and expenditure flows.

Is there a need for an international monetary institution?

In the post-Bretton Woods world, do we need an international financial institution, and what would be its role? Or has the international capital market replaced the need for such a public institution by providing both finance to, and discipline on, countries?

National economic policies are – or should be – trying to create stable monetary and fiscal frameworks to condition expectations of future economic policy. Policy surprises should not add noise to the news about economic fundamentals. It is in each of our national interests to avoid sudden or large changes in capital flows induced by volatile or unpredictable changes in economic policy. We want the monetary and fiscal decisions not only at home, but also in other countries, to be boring.

Although domestic economic policies seem to have become increasingly boring over the past decade or two, their interaction has not. Consider two, related, examples. First, the rise in the US current account deficit to more than 6% of national income has raised fears of how the inevitable correction will eventually be achieved. Second,

for much of the past twenty years, as evidenced by the Asian crisis of the late 1990s, we have worried about emerging market countries accumulating excessive dollar **liabilities**. Now we seem to be worried about their accumulating excessive dollar **assets**. Capital has flowed "uphill" from poor to rich countries. The invisible hand of international capital markets has not successfully coordinated monetary and exchange rate policies.

Many countries are no longer the atomistic entities of textbooks whose policy choices have no effect on global prices: whether an exchange rate, a real interest rate, or the prices of particularly sensitive commodities such as energy. Rather, the actions of all major countries have sufficient spill-over effects on other countries that they will then react in turn. The international economic system is better seen as a "game" in which there are many players of varying sizes, each adopting their own strategy. This has important implications. A world of atomistic countries requires no assumptions to be made about the objectives of others. The impersonal prices that we face contain all the information relevant to our own decisions. But in the international economic "game" it is important to know about the objectives, strategies – "policy reaction functions" – and policy decisions of other countries. In as much as these reaction functions are not well understood, the consequences of policy choices may not be reliably priced by markets. Policy makers, therefore, are more likely to make incompatible choices if they make decisions independently relying solely on international prices as their guide for the consequences of their actions.

An international financial institution might, therefore, help in two ways. First, even if countries are not willing to cooperate in the formal sense that they agree jointly on macroeconomic policies, a forum which improves knowledge and understanding of other countries' objectives and policy reaction functions may lead to more compatible policies. Second, such an institution might provide the public good of a dispassionate and independent analysis of the spill-over effects of one country's policies on others. Some of the more idealistic aspirations for Bretton Woods – such as the creation of an international central bank and new currency – were never likely to be adopted and look impossible absent a world government. But an arbiter of the international monetary system can play a more limited role – not so much the referee brandishing the yellow and red cards of the football pitch, more the cricket umpire 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. Invoking the MCC's "spirit of cricket", when a country knows that a policy such as an exchange rate regime requires modification, the player should walk. Indeed, the players might in time come to realise that most games benefit when played according to a clear and agreed set of rules.

So although it is not an international central bank, and the SDR is not a currency, the IMF still has a role to play. Given that most systemically important countries allow their exchange rates to float, the Fund cannot have an independent remit for global monetary stability. Hence, the Fund's role should be to support national policy makers by providing expert analysis about external risks to their domestic monetary policy objectives. National policies which appear sustainable in terms of countries' own objectives may interact and, through the resulting balance sheet effects, create risks to those same countries further ahead. The Fund should be a forum in which countries can discuss these risks. It should also hold countries to account. In these ways, it can indirectly support global monetary stability. With countries naturally reluctant to cede any control over their own monetary and fiscal policies, it is likely that the IMF will have as instruments only the powers of analysis, persuasion, and, in Keynes' own favourite words, "ruthless truth-telling". That phrase does not conjure up many memories of any of the many international meetings I have attended. But unless the IMF has the self-confidence to play that role, its deliberations and statements will carry little weight. The Fund requires an independent, respected and clear voice.

The Fund should focus its work on the international monetary system around three tasks. First, it should provide and share information about the balance sheets of all major countries, their composition and size, and the links between them. The Fund has been in the forefront of the analysis of balance sheets for emerging market economies, and it needs to extend this approach to its surveillance of the industrialised world. In conducting this analysis, the Fund must look at countries' exchange rate choices. But no one price is a sufficient statistic for the effect of one country's policies on the rest of the world - even one as important as the exchange rate. Balance sheet analysis should be at the heart of the surveillance process. That analysis should lead to an assessment of the risks to the world economy as a whole.

The second task is to encourage countries to abide by their commitments to each other by promoting greater transparency about national policies. In agreeing the Second Amendment of the Fund's Articles, all member countries made a general commitment to each other to pursue policies consistent with the objectives of stable global growth and low inflation. Only in relation to exchange rate arrangements were members asked to specify what framework they would follow to be consistent with this commitment. As Tim Adams, Under Secretary for International Affairs at the US Treasury, has noted recently, the nature of those commitments was left unhelpfully vague and should be clarified. In doing this, we should not lose sight of the fact that the policies of all significant members have spill-over effects and all should be required to be more precise about their policy making frameworks. Clarity about the objectives of policy of member countries should make it easier for all countries to formulate their own policy. And by making their national policy frameworks sufficiently transparent, countries will be making it possible for the IMF to hold them to account and to fulfil its role as an umpire.

The third task is the provision of a forum for national authorities to discuss risks to the world economy. To build a common analysis of balance sheet positions and a shared understanding of the implications of that analysis for the world economy, a trusted, independent and expert secretariat is needed to facilitate those discussions. Only if countries are willing to share confidences with each other - discuss their "policy reaction functions" - will international meetings justify their cost.

Those three tasks do not exhaust the responsibilities of an international financial institution. From time to time, there may well be financial crises when it would be appropriate for the international community to provide temporary financial assistance to mitigate the costs of sharp adjustment in trade flows and output. But such a role should not be the principal focus of international monetary co-operation, and, as I have pointed out, it has not been the role for the IMF vis-a-vis any developed economy for many years. Moreover, nor is it likely to be true of many important emerging market economies in the future. As I argued in my K.B. Lall Lecture in 2001, following the Asian crisis of the late 1990s it was likely that countries might choose to build up large foreign exchange reserves in order to be able to act as a "do it

yourself" lender of last resort in US dollars. It is now clear that this is exactly what many Asian countries have done. Nevertheless, it is sensible to provide the Fund with the capability to act when necessary.

How should the IMF be reformed?

The treaty creating the Fund made clear that its founding purpose was "to promote international monetary co-operation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems". In reality, though, the Fund is not playing that role at present. Its surveillance lacks focus. Its lack of day-to-day independence hampers its ability to comment effectively on divergences between stated objectives and actual policies at the national level. And it lacks the legitimacy to be an effective secretariat. Despite strenuous efforts by its Chairman, Chancellor of the Exchequer Gordon Brown, to promote discussion, there is little genuine interaction between members of the IMFC (or the Interim Committee as it was) about the international monetary system.

I welcome the Managing Director's recent statement that he intends to examine Fund surveillance. One symptom of the Fund's decreasing effectiveness has been the proliferation of "G" groups –the G-5 that became the G-7, the G-22 that became the G-33 and then the G-20; the G-10; the G-24 and the G-77. All of these were attempts to create opportunities for serious discussions among countries in the international monetary system. But as the world economy, and hence the relevant issues, have changed so it has been necessary to set up new "G" groups. Such groups are perceived as exclusive and lack legitimacy, and their meetings have increasingly become communiqué-driven events. In February 2004, the G-7 met in Boca Raton in Florida. A key issue for discussion was the challenge posed by large current account imbalances and the role of exchange rate adjustment in any unwinding of the imbalances. As we looked around the table it was obvious that some of the key players, such as China and India, were not present. Since then a rather informal and ad hoc arrangement has ensured that the G-7 engages in discussion with a broader group. We need to take a multilateral approach to the key issues but that does not mean that every country needs a seat at the table to discuss every issue.

If the Fund is to make this possible, reform is necessary. Realistically, only meetings with a small number of participants can encourage the level of frankness needed to resolve the challenges in the international monetary system. All member countries will need to accept that the big players in the international monetary game must be able to meet at a relatively small table. But the membership of the top table must change with circumstances - the group of big players is no longer an exclusive group of rich countries. Low and middle income countries can now affect the global economy. India and China have to be at the table.

Reducing the size of the IMF Board itself to achieve this aim is likely to be problematic. An enlarged Board has been one way of providing a platform for smaller and poorer members. One solution could be to create more flexible groupings within the Fund to discuss particular topics. For example, the Managing Director's powers to initiate bilateral consultations about the policy choices of individual members could be expanded to cover multilateral issues discussed by the relevant group of members. If this does not prove practicable, other mechanisms will need to be found to introduce the requisite flexibility in how countries come together under the auspices of the Fund.

The institution itself, though, also needs to change. The IMF has the great merit of being a universal institution. But it needs greater focus, independence and legitimacy. In terms of **focus** the members of the Fund, through the IMFC, could usefully restate the Fund's mandate in terms of global economic and monetary stability. If it is to be able to meet its remit then surveillance should focus at least as much on balance sheets as on exchange rates. The mandate should make clear both what the IMF is responsible for and what it is not responsible for.

But producing more focussed surveillance cannot be achieved in isolation from more fundamental reforms of the Fund. In terms of **independence** the responsibility for the delivery of a new mandate should be placed more firmly in the hands of the management of the IMF. At present, the Board involves itself in every aspect of the Fund's activities. In 2004, for example, the Board met for about 500 hours, an average of over three hours for each of the three days a week on which the Board normally meets. Board members were given about 70,000 pages of material by IMF

staff and produced another 10,000 or so of their own in written statements and other documents – equivalent to 300 pages of reading for each and every working day. The direct costs of supporting the Board account for around 10% of the Fund's net administrative budget. And the indirect costs, in terms of staff time spent writing and reviewing papers, attending and following up meetings and so on, are much higher.

The Board should step back from much of this expensive micro-management, for example by ceasing its involvement in the day-to-day reviews of Article IV reports, and concentrating instead on holding management accountable for the delivery of the mandate. The Independent Evaluation Office, reporting on the Fund's lending to Argentina, pointed to the difficulty of knowing who was responsible for those decisions: management, the Board, or the national shareholders. The Fund is an institution with exceptionally high quality staff which is not best served by its current governance arrangements.

At Savannah, the main issue that divided the Americans and the British was the role of Executive Directors. Keynes argued that the Fund should be under the control of the Managing Director with oversight carried out by part-time Executive Directors. The latter should comprise people who help to formulate the policies of their countries in national capitals, and so could not be full-time in Washington. The main function of the Executive Directors was not to manage the Fund, but to act as an essential link between the Managing Director and the national treasuries and central banks from which they were drawn. In retrospect, Keynes's position seems sound. Given the ease of modern travel – at least in comparison with 1946 - serious consideration should be given to a non-resident Board, meeting some six to eight times a year with directors comprising senior finance ministry or central bank officials.

The process of shifting to a non-resident Board would bring the issue of the division of responsibilities to the fore. Member countries might conclude, for example, that they wanted to retain control of decisions to lend under the exceptional access framework. But in other areas, such as surveillance, it would make sense to delegate responsibility to the Managing Director in the context of a clearly defined remit. Moves in this direction would need to be accompanied by reforms to strengthen the accountability of the Managing Director. A first step in this direction would be to

instigate regular IEO assessments on the effectiveness with which the Managing Director and staff had discharged their surveillance responsibilities.

Finally, in terms of **legitimacy**, its members must feel that the ownership of the Fund is shared and that all have a voice. In practical terms, that means reaching a deal on quota shares and seats at the Board with all regions of the world appropriately represented. Such a deal will be extremely difficult to reach. Nevertheless shareholders should recognise that the collective benefits of reaching a deal would justify compromise on each of their parts. But even if an agreement is reached what would be the purpose if the Fund remained unreformed and the larger questions I have posed today were unanswered?

Conclusions

The extraordinary changes in global patterns of trade and production, in which India is playing a major part, have the potential to raise living standards around the world by exploiting the division of labour which, as Adam Smith told us many years ago, is the foundation of our prosperity. As those real economic changes unfold, it would be quite extraordinary if the institutions required to sustain and support that new open trading and financial system were not to adapt. After a decade of discussions on the "international financial architecture", it might be sensible to pause and ask what we are trying to build.

The world needs a strong and effective IMF to make us conscious of our responsibilities as members of the international economic system, and to provide a clear and cogent analysis of the challenges ahead. In the end, it is ideas that change the way people think and then act.

Those who founded the Bretton Woods institutions did so after a time of crisis, war and economic disaster. They had the vision to put in place international institutions that might help prevent the disintegration of the open trading system that they saw as necessary to a revival of economic prosperity. We have not had to go through a time of economic disaster. We have had the opportunity to experience an extraordinary flowering of the international trading system, and the entry into that of the world's

two largest populations. The expansion of trade, the rise in the number of qualified people entering the world's labour force, and the growing realisation that we can all benefit from trade has raised living standards and provided us with opportunities to reduce poverty around the world. That should make it easier, not more difficult, to design international institutions to sustain those developments. We will have only ourselves to blame if we fail to live up to that challenge and simply allow the IMF to evolve through a series of ever more bland communiqués and meaningless statements.

Today, I have tried to challenge the thinking behind the slow progress in reforming the IMF. But that should not be interpreted as any criticism of the extraordinarily talented and committed people who work for the Fund. On the contrary, the responsibility for reform lies fairly and squarely with the shareholders – the member countries.

Nor are the issues an arcane exercise in international finance. As Governor Deshmukh said in his speech in Savannah, agreements on the international monetary system and on trade go hand in hand. To eliminate poverty and improve living standards around the world will require progress both on the Doha trade round and on international monetary arrangements.

In 1946 Sir Chintaman Deshmukh lent his hand to the wheel of creating a new international monetary order. In 2006 the world needs the new generation of Indian policy-makers to contribute to the debate with a loud, clear and thoughtful voice. To borrow Amartya Sen's phrase, we need to hear from the "Argumentative Indian".

[1] "Economic Developments in India-1946-1956", the Dadabhai Naoroji Memorial Prize Fund Lectures, delivered at Bombay, February 1957.

[2] The Collected Writings of John Maynard Keynes, Volume XXVI, "Activities 1941-1946: Shaping the Post-War World", p. 216.

[3] This principle is also illustrated by the United Kingdom. Between 1946 and 1971, the UK had four IMF programmes. The maximum current account deficit at the start of those programs was 1% of GDP. Since 1998, the UK current account deficit has not been less than 1.5% of GDP but has been financed fully through private markets.

[4] Greenspan, A (2005), "International Imbalances", Remarks before the Advancing Enterprise Conference, London.

[5] Lane, P. and G. Milesi-Ferretti (2005), "Financial Globalisation and Exchange Rates", IMF Working paper 05/3.