
The International Monetary System in the Work of the Institute

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The search for ways to improve the operation of the international monetary system and, in particular, to prevent and manage crises in emerging economies—including through the work of the International Monetary Fund (IMF)—has been an enduring theme in the research agenda of the Peterson Institute for International Economics. It has likewise been a topic close to the heart of its director, C. Fred Bergsten, who has made a number of valuable contributions to this long-running debate.

A review of the Institute's work in this area amply demonstrates both the wide range of issues covered and their importance among the broad range of international economic policy issues that are the *métier* of the Institute. This review provides the foundation for more extensive discussions of key policy issues that are at the heart of the debate over the functioning of the international monetary system and the role of its central international institution, the IMF. Several of these issues are taken up in the following chapters.

John Williamson reexamines the continuing debate over the appropriate nature of the exchange rate regime, both from the perspective of individual countries and from a more systemic viewpoint. Edwin Truman then takes up a question that is a logical precursor to the analysis of target zone proposals for major currency exchange rates, long advocated by Fred

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Bergsten and John Williamson—namely, whether large variations in the real effective exchange rate of the US dollar over the past three decades provide useful messages concerning desirable adjustments in economic policies or other efforts to influence the exchange rate of the dollar. Martin Baily and Robert Lawrence then analyze the much discussed issue of whether the United States is losing international “competitiveness.” They propose a way to measure fundamental shifts in a country’s underlying trade performance in terms of shifts in the schedule relating a country’s terms of trade (or real effective exchange rate) to its trade balance. Next, William Cline reviews and updates his landmark work on the problems of emerging-market debt and the functioning of the international financial system in light of recent experience with emerging-market financial crises and debt restructurings.

These discussions are followed by three chapters on the role of the IMF in the international monetary system. The first, by Michael Mussa, takes up two recent controversies concerning the role of the IMF in providing financial assistance to countries with balance of payments difficulties: (1) the widely expressed concern that IMF financial assistance generates substantial moral hazard by inducing emerging-market countries and their external investors to undertake undue risks, and (2) the controversy over very large-scale IMF assistance packages that began with assistance to Mexico in 1995. Next comes my chapter on the issue of exchange rates and specifically on the role that the IMF needs to play as the global umpire of exchange rate policies under its clear mandate to “exercise firm surveillance over the exchange rate policies of members.” The chapter by Randall Henning takes more of a political science perspective on the role of the international financial institutions (IFIs), particularly the IMF, and disagrees to some extent with my prescription for the IMF.

The Institute’s very first publication, *The Lending Policies of the International Monetary Fund* (1982) by John Williamson, presented the conclusions of an Institute conference that examined the Fund’s role in the international financial intermediation process, its cooperation with the World Bank, and the appropriate design and monitoring of IMF adjustment programs.¹ This was soon followed by a set of studies on the developing-country debt crisis of the early to mid-1980s authored by Fred Bergsten, Bill Cline, Donald Lessard, and John Williamson (see Cline 1983, 1984, 1987; Williamson 1983c, 1988; Lessard and Williamson 1985, 1987; Bergsten, Cline, and Williamson 1985).² In Bergsten, Cline, and Williamson

1. The papers presented at that conference appeared in Williamson (1983a).

2. In 1995, the Institute published Cline’s comprehensive reexamination of the international debt problem (Cline 1995). The bulk of these studies dealt with the middle-income developing countries (now typically known as “emerging” economies). The Institute has also done some analysis of debt problems in low-income developing countries; see, for example, Lancaster and Williamson (1986), Lancaster (1991), and Williamson and Birdsall (2002).

(1985) the authors focused on the nature and terms of past and future bank loans to debtor countries and evaluated a large set of policy proposals based on their prospects for averting a costly collapse of the international banking system, sustaining the economies of the debtor countries, facilitating a return to voluntary lending by banks, and preventing future crises.

During the 1990s and extending into this decade, the Institute focused on many of the hot “crisis issues” facing emerging economies, including, *inter alia*, how to minimize the costs for transition economies following the collapse of the Soviet Union, how to design better currency regimes for the area’s emerging economies, how to reduce the frequency and severity of future emerging-market banking crises, what policy lessons to draw from the most prominent emerging-market financial crises of the past dozen years—i.e., Mexico in 1994–95, the Asian financial crises of 1997–98, and the Argentinian crisis of 2001–02, and how to strengthen what has come to be known as the international financial architecture (IFA).³

Recognizing the importance of the political dissolution and economic collapse of the Soviet Union, in the early 1990s the Institute launched a set of studies on its main implications—for the countries in the region as well as others. In *Currency Convertibility in Eastern Europe* (1991a), John Williamson brought together the main lessons from an Institute conference on this topic, soon followed by other studies that analyzed the external aspects of the economic policies adopted by the transition economies (Williamson 1991b); the likely impact of developments in Eastern Europe and the Soviet Union for the United States, the European Community, Japan, and the developing countries (Collins and Rodrik 1991); the prospects for establishing an Eastern economic community that would promote the preservation of trade links within the region (Havrylyshyn and Williamson 1991); and options for maintaining a payments system to finance inter-public trade (Williamson 1992).

The collapse of the Mexican peso in late 1994 ushered in a wave of currency and banking crises in emerging economies that subsided only in 2003 (see Bergsten and Williamson 1994; Bergsten, Davanne, and Jacquet 1999; Bergsten 2005).⁴ Not surprisingly, the Institute offered a menu of

3. In Goldstein (2001) I defined the IFA as the institutions, policies, and practices associated with the prevention and resolution of banking, currency, and debt crises, primarily but not exclusively in emerging economies.

4. In addition to analyzing currency regimes in emerging markets, the Institute kept up its tradition of evaluating currency regimes for the major reserve currencies and making recommendations for improving those regimes. In this connection, Fred Bergsten has long been an advocate of “target zones” for the major reserve currencies—a view he first outlined in Bergsten and Williamson (1983) and that he has continued to espouse with only minor modifications ever since; see, for example, C. Fred Bergsten, “How to Target Exchange Rates: G-7 Countries Should Allow Their Currencies to Fluctuate within Agreed EMS-Style Ranges,” *Financial Times*, November 20, 1998; C. Fred Bergsten, *Alternative Exchange Rate Systems and Reform of the International Financial Architecture*, Testimony before the Committee on

policy recommendations. On the currency front, John Williamson assessed the pros and cons of currency boards (Williamson 1995), identified the lessons from the experiences of Chile, Colombia, and Israel with crawling band currency regimes (Williamson 1996), and completed the trilogy (Williamson 2000) by endorsing an “intermediate” currency regime for many emerging economies that has subsequently come to be known as the “BBC” regime (for currency *basket*, currency *band*, and crawling peg) (Williamson 1995, 1996, 2000). In Goldstein (2002), I focused on emerging economies that are heavily involved with private capital markets and argued for a currency regime of “managed floating plus,” where “plus” is shorthand for a framework that includes inflation targeting and aggressive measures to combat currency mismatching.⁵

As discussed further in the next chapter, a host of Institute publications have also explored the methodology for estimating equilibrium exchange rates and have calculated exchange rate misalignments, increasingly including the currencies of prominent emerging economies (Williamson 1994; Wren-Lewis and Driver 1998; Bergsten and Williamson 2003; Goldstein 2004, 2006; Cline 2005; Bergsten and Williamson 2004). Fred Bergsten, whether in Institute publications, congressional testimony, or in numerous op-eds in the financial press, has been a leading participant in the ongoing debate about which currencies are most out of line and what needs to be done to reduce those misalignments (Bergsten 2005; Bergsten and Williamson 1994, 2003, 2004).⁶

It has been estimated that the fiscal costs of banking crises in developing countries over the past 25 years have exceeded \$1 trillion (Honohan and Laeven 2005); in addition the lost output costs of banking crises are substantial, and banking crises have proved to be one of the better performing leading indicators of currency crises in emerging economies. In Goldstein (1997) I laid out the case for an international banking standard, identified the main elements that such a standard should contain, and discussed the operational issues involved. Many of these proposals were subsequently included in the Basel Core Principles of Effective Banking

Banking and Financial Services, May 21, 1999 (Washington: US House of Representatives). Other notable Institute work on currency regimes for the major industrial countries includes Williamson (1983b), McKinnon (1984), Bergsten (1988, 1991), Marris (1985), Goldstein (1995), Williamson and Miller (1987), Funabashi (1988), Cline (1989), Krugman (1991), Dominguez and Frankel (1993), Kenen (1994), Henning (1994), Bergsten and Henning (1996), Mann (1999), Bergsten and Williamson (2003, 2004), and Posen (2005).

5. More recently, Goldstein and Lardy argued for “two-stage” currency reform in China, while Williamson (2005a) has spelled out the advantages of an East Asian currency basket. See Morris Goldstein and Nicholas Lardy, “Two-Stage Currency Reform for China,” *Asian Wall Street Journal*, September 12, 2003.

6. See, for example, C. Fred Bergsten, “Let the Dollar Fall,” *Financial Times*, July 17, 2002; C. Fred Bergsten, The IMF and Exchange Rates, Testimony before the Committee on Banking, Housing, and Urban Affairs, May 19, 2004 (Washington: US Senate).

Supervision (the official international banking standard). Liliana Rojas-Suarez (2001a) evaluated whether international capital standards alone could be expected to strengthen banks in emerging markets.

More often than not, when there has been a major emerging-market financial crisis, the Institute has analyzed it to uncover the lessons for crisis prevention and management. The implications of the Mexican peso crisis—particularly for private capital flows to emerging economies—were analyzed in Calvo, Goldstein, and Hochreiter (1996). President Clinton characterized the Asian financial crisis as “the greatest financial challenge facing the world in the last half century.” The Institute published a trio of studies on that crisis: I examined its origins, policy prescriptions, and systemic implications (Goldstein 1998); Marcus Noland and several colleagues, using a general equilibrium model, estimated the effects on the rest of the world from the large currency devaluations experienced by the Asian crisis countries (Noland et al. 1998); and Stephen Haggard (2000) studied the political aspects of the crisis in the countries most affected.⁷ John Williamson (2002) and Morris Goldstein (Goldstein 2003) also offered perspectives on Brazil’s currency and debt crisis of 2002, while Michael Mussa (2002) investigated what went wrong in Argentina’s catastrophic crisis of 2001–02 and what important errors the IMF may have made either in supporting inappropriate policies or in failing to press for alternatives that might have avoided catastrophe.⁸

After the Mexican peso crisis, efforts to improve crisis prevention and resolution in emerging economies began to be grouped under the heading of IFA. Here, too, Institute management and staff have been very active. In 1998 the Council on Foreign Relations (CFR) convened a blue-ribbon task force on the future IFA. Institute Board Chairman Peter G. Peterson and board member Carla Hills cochaired the task force; I served as project director and drafted the report, and both Fred Bergsten and Nicholas Lardy served as task force members.⁹ The task force’s report (Council on Foreign

7. In addition to these studies, Noland (2000) explored how the Philippines avoided falling into a more serious crisis at the time of the wider Asian financial crisis; Fratzscher (2000) looked at the contagion of currency crises; Graham (1999) proposed a workable restructuring plan for South Korea; Posen (1999) laid out the policy measures Japan needed to take to implement a recovery; and Bergsten, in several shorter pieces, examined the policy actions needed to exit from the Asian financial crisis as well as the case for a revival of the Asian Monetary Fund. See C. Fred Bergsten, *The International Monetary Fund and the National Interests of the United States*, Testimony before the Joint Economic Committee, February 24, 1998 (Washington: US Congress); C. Fred Bergsten, “How to Target Exchange Rates: G-7 Countries Should Allow Their Currencies to Fluctuate within Agreed EMS-Style Ranges,” *Financial Times*, November 20, 1998.

8. Gelpert (2005) also examined the implications of Argentina’s approach to debt default and restructuring.

9. It is a testimony to Fred Bergsten’s powers of persuasion that he was able to convince 10 of the other 28 members of the CFR task force to support a dissenting view calling for the establishment of target zones for the G-3 currencies.

Relations 1999), published jointly by the Institute and the Council, included recommendations on, inter alia, access limits on IMF lending, collective action clauses, and emerging-market currency regimes. Fred Bergsten was also at the time a member of the International Financial Institutions Advisory Committee (IFIAC)¹⁰ and, when the IFIAC submitted its report to Congress in 2000, he was the principal author of a minority dissenting report. Bergsten¹¹ criticized the IFIAC report (2000) for painting a very misleading (negative) picture of the IFIs over the past 50 years, for failing to include appropriate monetary and fiscal policy elements in its prequalification criteria for IMF loans, and for prohibiting Fund support for countries that were of systemic importance but had not met the prequalification criteria.

Given the controversy over the use of the US Treasury's Exchange Stabilization Fund in the Mexican crisis, Randall Henning (1999) conducted an appraisal of its usefulness for future international financial support operations. Barry Eichengreen (1999) rejected radical reform and offered in its place a practical, post-Asian crisis agenda for the IFA that emphasized changes in private loan agreements, in emerging-market exchange rate policies, and in policies toward the capital account. In Goldstein (2000, 2001) I presented a comparison and evaluation of proposals for reform of the IFA and also made the argument for streamlining IMF structural conditionality. Henning (2002) put forward the case for and against regional financial arrangements in East Asia.

Morris Goldstein, Graciela Kaminsky, and Carmen Reinhart (2000) provided a comprehensive battery of empirical tests on early warning indicators of emerging-market currency and banking crises, and Liliana Rojas-Suarez (2001b) demonstrated and explained why indicators of individual bank failure that worked well in industrial countries did not perform as well in emerging markets.

Reflecting the view that there cannot be excessive borrowing from international capital markets without excessive lending, Wendy Dobson and Gary Hufbauer (2001) recommended a range of supervisory reforms in G-10 countries that would (via changes in both the Basel II framework and in official safety nets for G-10 banks) lower the incentives to offer emerging economies short-term, cross-border debt finance. John Williamson (2005b) argued that the boom-bust cycle in private capital flows to emerging markets could be tamed by undertaking a set of reforms in both creditor and debtor countries, including forward-looking provisioning by banks, retention of capital controls in some cases, and introduction of new financial instruments.

10. The IFIAC, created by the US Congress in 1988, was chaired by Allan Meltzer and came to be known as the Meltzer Commission.

11. C. Fred Bergsten, *Reforming the International Financial Institutions: A Dissenting View*, Testimony before the Committee on Banking, Housing, and Urban Affairs, March 9, 2000 (Washington: US Senate).

In the last five years, Institute work on the IFA—including reform of the IMF—again intensified. Peter Kenen (2001) reviewed progress on the IFA during the 1994–2000 period and concluded that there had been useful innovations but also that bolder efforts were needed: He recommended focusing more on IMF surveillance, narrowing the scope of IMF conditionality, and using IMF resources more effectively. Philip Turner and I (Goldstein and Turner 2004) developed a new measure for aggregate effective currency mismatches in emerging economies and put forward a set of proposals for controlling them. Nouriel Roubini and Brad Setser (2004) provided a comprehensive analysis of how the international community and the IMF should respond to financial crises in emerging economies; they argued that a return to low levels of access at the IMF was not realistic, that there has been too little differentiation in the official sector’s response to crisis, and that the IMF should be willing to use its lending capacity to soften the flow during a debt restructuring. In Goldstein (2005b) I maintained that further reform of the IFA should place the highest priority on discouraging beggar-thy-neighbor exchange rate policies, controlling currency mismatches in emerging economies, giving debt sustainability a larger role in IMF surveillance and policy lending, improving the quality of compliance evaluation for international standards and codes, developing a better early warning framework for financial crises in emerging economies, and limiting extension of very large IMF loans to cases that are truly exceptional. And in Goldstein (2005a) I addressed the following question: If there was a new financial crisis in emerging economies, how would it start and spread, and which economies would be most affected? Ted Truman recently completed two studies on IMF reform. In the first (Truman 2006a) he contends that the IMF is under stress, that it risks declining into irrelevance, and that it must be reformed to restore its central role. He outlines a small set of key reforms, including those that would address the distribution of voting power in the Fund and representation on the IMF Executive Board, reaffirm the central role of the Fund in the resolution of external financial crisis, and upgrade its capacity to provide analysis and policy advice on members’ internal and external financial sectors. The second study (Truman 2006b) brought together a set of papers on IMF reform presented at an Institute conference held in September 2005.

Throughout his career, Fred Bergsten has been both a strong supporter and a constructive critic of the IMF;¹² he also has been a champion of global governance reform—including replacing the G-7 with a steering committee for the global economy that would be more effective and more

12. See, for example, C. Fred Bergsten, *The International Monetary Fund and the National Interests of the United States*, Testimony before the Joint Economic Committee, February 24, 1998 (Washington: US Congress); C. Fred Bergsten, *Alternative Exchange Rate Systems and Reform of the International Financial Architecture*, Testimony before the Committee on Banking and Financial Services, May 21, 1999 (Washington: US House of Representatives);

consistent with changes in economic weight, particularly for the larger emerging economies.

Bergsten has emphasized consistently the positive long-term contribution that the Fund has made to the operation of the world economy, the ways in which Fund policies promote vital interests of the United States, the zero cost of the Fund to the American taxpayer and to the US economy, the need to ensure that the Fund has adequate financial resources to do its job, and the desirability and practicality of improving Fund policies and programs when there are shortcomings (rather than either shutting down the Fund or replacing or merging it with another institution). At the same time, he has frequently and vigorously prodded the Fund—for example, to promote the adjustment of external payments imbalances more, to enforce its guidelines against currency manipulation, to make the publication and management of equilibrium real exchange rates the fulcrum of international economic policy coordination, to invest more in early warning and early action systems for emerging-market financial crises, and to pay more attention to its comparative advantage vis-à-vis the World Bank (e.g., by transferring the Poverty Reduction and Growth Facility [PRGF] for low-income countries to the Bank).

On global governance reform, Bergsten has long argued (e.g., Bergsten and Henning 1996) that the G-7 has become increasingly ineffective and illegitimate. A mutual nonaggression pact essentially eliminates constructive peer pressure for policy reform, and today's international imbalances require substantial adjustment initiatives by countries outside (as well as inside) the G-7 (namely China and some other Asian economies) on exchange rates, key oil-producing countries (along with China and India) on global energy issues, and chief debtor countries (Brazil, Mexico, etc.) on debt problems. His latest proposal is to replace the G-7 with what he calls the "F-16" (that is, the finance G-20 countries, with the modification that there would be consolidated Euroland representation instead of representation by four individual European countries) (see Bergsten 2006).¹³ The F-16 countries would account for about 80 percent of world output,

C. Fred Bergsten, Reforming the International Financial Institutions: A Dissenting View, Testimony before the Committee on Banking, Housing, and Urban Affairs, March 9, 2000 (Washington: US Senate); C. Fred Bergsten, Reforming the International Monetary Fund, Testimony before the Subcommittee on International Trade and Finance, Committee on Banking, Housing, and Urban Affairs, April 27, 2000 (Washington: US Senate); C. Fred Bergsten, The IMF and Exchange Rates, Testimony before the Committee on Banking, Housing, and Urban Affairs, May 19, 2004 (Washington: US Senate); C. Fred Bergsten, "An Action Plan to Stop the Market Manipulators Now," *Financial Times*, March 14, 2005.

13. C. Fred Bergsten, Reform of the International Monetary Fund, Testimony before the Subcommittee on International Trade and Finance, Committee on Banking, Housing, and Urban Affairs, June 7, 2005 (Washington: US Senate). Although Bergsten's criticism of the G-7 has been long running, he has at various times discussed steering committees for the global economy other than the F-16, including several versions of the G-2 or G-3.

would include the key players needed to address current systemic problems, and would represent, in Bergsten's view, the best compromise between legitimacy and efficiency.

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