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# Institutional Strategy for the Global Economy

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The scope and function of international economic institutions evolved considerably over the second half of the last century. Formal organizations and less formal cooperative arrangements expanded in size, membership, and complexity as global economic integration progressed. This expansion gave rise to overlapping regimes and tiered governance, with steering groups to guide decision making in the organizations more effectively. Increasing size and complexity created greater distance between international organizations and domestic electorates, accentuated by tiered governance, raising in turn questions about these institutions' democratic accountability and even legitimacy. Thus international economic collaboration, both formal and informal, now faces many more domestic political and democratic-legitimacy challenges than during the half century after World War II.

C. Fred Bergsten is without doubt the most prolific proponent of innovations in formal and informal international economic institutions of his generation. As an analyst, Fred's institutional proposals have covered the substantive waterfront (trade, money, and finance) and multiple levels of governance (multilateral, regional, plurilateral, and domestic). As a practitioner, both in and out of government, he has reinforced existing institu-

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tions and built new forums and organizations. A review of Fred's institutional contributions thus provides a useful backdrop for analyzing the accomplishments, shortcomings, and future challenges of institutionalized economic cooperation.

In this chapter, first, I review the highlights of Fred's contributions to institution building in international economic relations. Second, I discuss the essential institutional strategy that underpins most of these proposals, a strategy shared largely by what will be referred to here as the "second generation" of postwar economic internationalists. Third, I explore the limits of that second-generation strategy and the challenges posed by institutional complexity, domestic politics, and the backlash against globalization in the future. Fourth, in light of these limits, I examine the merits of several current proposals to reform the International Monetary Fund (IMF), warning against simply hardening rules. The final section offers suggestions for key elements of a new institutional strategy. Overall, I argue that the institutional strategy of the second generation, with which Fred's work and that of the Institute are closely associated, while outstandingly successful, has reached a point of diminishing returns, suffers from important shortcomings, and should be strengthened by, among other things, a more robust domestic political strategy and by efforts to reinforce democratic accountability.

## Fred Bergsten's Contributions

Without covering Fred's contributions to institution building exhaustively—and setting aside his creation of the Institute as a nonprofit rather than a policy institution—consider the salient themes of his scholarship.

First, in his writing and as a policymaker, Fred has been consistently supportive of the multilateral institutions: the IMF, the World Bank, the General Agreement on Tariffs and Trade (GATT), and the Organization for Economic Cooperation and Development, among others. After resigning from the Nixon administration, he published his first *Foreign Affairs* article in January 1972 sharply criticizing the international component of the president's New Economic Policy. Fred lamented the marginalization of the IMF by the suspension of gold convertibility the previous August and called for strengthening the IMF's rules on exchange rates and surveillance and placing the special drawing right (SDR) at the center of the international monetary system—themes he reiterated in his 1975 book, *The Dilemmas of the Dollar*. He has revisited the subject of the IMF frequently in subsequent publications and most recently, in 2000, as a dissenting member of the International Financial Institutions Advisory Commission. Proposals that would similarly strengthen the other multilaterals surface and resurface throughout his published work.

Second, Fred has supported many, although by no means all, regional arrangements. He has been consistently supportive of European integration, including its Common Market, Single Market, and Economic and Monetary Union. He was of course similarly supportive of the North American Free Trade Agreement (NAFTA), the Free Trade Area of the Americas (FTAA), and multiple bilateral and subregional trade agreements. (By contrast, he opposes the North Atlantic Free Trade Agreement proposal.) His greatest contribution to regionalism has been in the Asia-Pacific, where he promoted the Asia Pacific Economic Cooperation (APEC) forum, created and chaired its Eminent Persons Group (EPG), and was instrumental in launching its first summit meeting (held in Bogor, Indonesia, in November 1994) and defining the goals endorsed there. Regionalism has of course been controversial among trade economists, many of whom argue that such agreements undercut the multilateral trade regime. Fred sought to reconcile regional arrangements with multilateralism by developing a particular concept of open regionalism, embodied in the EPG reports (Bergsten 1997, APEC 1993, 1994, 1995). He also encouraged “competitive liberalization” among open regional arrangements, the subject of his *Foreign Affairs* article of 1996.

Third, Fred has been an enthusiastic advocate of informal official plurilateral groups and forums. The patchwork of multilateral and regional institutions needed effective leadership, which could be provided through “steering committees” of various configurations—the “Group System.” First as assistant secretary for international affairs at the Treasury, then as director of the Institute, Fred has consistently pushed the G-7 and G-8 summit process to achieve ambitious results (see, for example, Bergsten et al. 1982). He has done so most recently as cochair of the “Shadow G-8.”

He promoted the G-5 and then G-7 meetings of finance ministers and central bank governors, including in a book he and I coauthored, *Global Economic Leadership and the Group of Seven* (Bergsten and Henning 1996). In his contribution to the Institute’s volume on IMF reform, however, Fred gives up on the Finance G-7: “The time has come to recognize that the G-7 will remain ineffective . . . and replace it with a new steering committee that can infuse . . . new vision and leadership into the world economy. . .” (Bergsten 2005, 284). The new steering committee that he proposes would be composed of sixteen finance ministers, an “F-16.”<sup>1</sup>

Finally, Fred has been a prolific—some colleagues would say “notorious”—proponent of “G-2s” in varying configurations. The first instance that I recall of such a proposal in Fred’s work was for a US-Germany group in 1975. At least two proposals for a US-Japan group followed in

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1. The 16 would represent Argentina, Australia, Brazil, Canada, China, the European Union (presumably the chairman of Ecofin or the Eurogroup), India, Indonesia, Japan, Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, and the United States. He does not specifically call for inclusion of central bank governors in this group.

the 1980s and 1990s. He advocated another US-EU G-2 in his *Foreign Affairs* article of 2004 (Bergsten 2004). In his overview chapter for *The United States and the World Economy: Foreign Economic Policy for the Next Decade*, Fred outdoes himself by advocating no fewer than four G-2s, adding US-China and US-Saudi Arabia to the mix (Bergsten 2005). All configurations include the United States—although he invites others to collude benevolently against the United States when he believes that his own government is inappropriately obstinate—with each configuration designed to prod a recalcitrant third party into constructive action.

In offering multiple proposals for institution building, Fred has been undaunted by criticism that some proposals, such as those for the G-2s and regional trade agreements, contradict others, such as those to strengthen the Finance G-7 and the multilateral institutions. Fred's institutional philosophy is based on an underlying premise: that cooperation between national governments in international economic relations, a public good, is chronically undersupplied. Under these circumstances, the best institutional arrangement should not be the enemy of improvements in second-best cooperative and consultative forums. The main problem is not that an institutional "spaghetti bowl" will result from the creation of too many forums—he reasons that these complications can be sorted out by steering committees when they become binding—but the failure to use enough of them.

Before critiquing the broad strategy, I would like to highlight four additional elements of Fred's contributions with respect to institutions. First, when making institutional recommendations that would advance his economic policy objectives, Fred draws on academic work in both economics and political science with pragmatic eclecticism. Second, Fred has not shied away from advocating the use of coercive instruments when that has been necessary to defend international economic openness (elaborated below). Third, Fred takes domestic politics seriously: Rather than dismissing the US Congress as economically unsophisticated, as some analysts do, he acknowledges its responsibilities for international economic policy in the American political system. Where Congress's role complicates policymaking, Fred has sought to inform and include members rather than insulate policy from congressional purview. Fourth, Fred has long been sensitive to the importance of legitimacy in institutions and the policy process, particularly at the international level, and has sought to embed the group system in a broader political context.

## Second-Generation Strategy

Fred is one of the second generation of postwar international economic policy leaders. The first postwar generation attended the Bretton Woods and Havana/ITO conferences as young aides and assisted their principals in

creating the IMF and World Bank and launching the GATT. The second postwar generation inherited these institutions, brought them into their own—with the switch to convertibility in Europe and the launch of the first successful large-scale round of trade negotiations in the 1960s, the Kennedy Round—and creatively adapted them in the face of new challenges. The creation of steering groups in these organizations and outside them (the “Group System”) was one of this generation’s important innovations. North America, Europe, and Japan, among other regions, each contributed prominent people to this generation of economic internationalists, meeting sometimes, but by no means always, as the Trilateral Commission.

The second generation shared concepts of how institutions and international consultations among governments work to produce liberalization and cooperation. Not all of the members of this generation subscribed to a common strategy, of course, but they shared many core elements of it. This core strategy overlapped with those of academic institutionalists in political science—to which we return below—but were pragmatic and operational.

First, the second-generation internationalists were united in the belief that cross-border trade and investment were fundamentally beneficial to countries individually and the world economy as a whole, and they recognized a need for information, analysis, and rules regarding acceptable and unacceptable national policies to underpin a liberal economic order. The first-best option, in their view, was to vest those functions and rules in multilateral institutions.

Second, however, they remained acutely conscious that domestic politics, in the United States and elsewhere, often limited what could be achieved. So a tension between the desirability of robust international regimes and domestic politics was perceived to permeate international economic relations almost perpetually. Internationalists steered clear of some, though not all, domestic political obstacles for much of the second half of the twentieth century by negotiating liberalization through issue area-specific groups of national officials (often confidentially) and presenting only the final result for domestic ratification.<sup>2</sup>

Third, international commitments constrained backsliding, and international consultation could prepare the ground for more binding commitments when domestic politics were favorable. International collaboration works opportunistically in the spaces between domestic politics of key states to ratchet up members’ obligations over time. Regimes can thus be strengthened by locking in existing commitments, facilitating further liberalization, and generally supporting openness.

The conception of how international regimes and organizations bring policy change—that is, how institutions cause member states to pursue

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2. See Keohane and Nye (2001), who refer to this pattern as the “Club Model” of international cooperation.

policies that are different than they would otherwise pursue—is critical to this approach. The channels are several: information, moral suasion, threats to revoke reciprocal concessions, issue linkage, and scapegoating, among others. Meanwhile, domestic politics is conceived as divided between those favoring an internationally consistent policy and those favoring domestic determined, internationally inconsistent policies. Working through such channels, institutions can augment the coalition in favor of the internationally consistent option, tipping the balance of domestic politics on the issue (see, for example, Putnam and Henning 1989). The influence of institutions and domestic politics on international cooperation is the focus of a very large academic literature.<sup>3</sup>

Scapegoating became a particularly important element of the strategy: By taking the lead on enforcing a commitment to liberalization, the WTO and IMF were used by national governments in the domestic political arena as the excuse for pursuing policies that officials wished to pursue independent of international constraints. Examples of scapegoating, which are legion, include leaders of crisis-stricken emerging-market economies blaming the IMF for having to reduce government spending or raise taxes and finance ministers blaming the World Trade Organization (WTO) for having to deny domestic petitions from uncompetitive industries for protection. In Europe, they include blaming the European Commission for having to eliminate state subsidies to national champions and allowing unpopular cross-border acquisitions to proceed. In this way, governments and prime ministers often reduced their domestic political costs of compliance with international regimes. International civil servants within these organizations usually accepted their service in this scapegoating role in the belief that the damage to their institution was minor or an acceptable sacrifice for better national policies—a belief that requires reconsideration.

Second-generation economic internationalists borrowed from, and contributed to, the work on international economic cooperation by scholars in political science and economics. But the second-generation agenda was primarily applied rather than academic, leaving the overlap between the two bodies of work, while substantial, still partial. Some of the key differences between practitioners' strategy, on the one hand, and two schools of international political economy on the other—neoliberal institutionalism and neorealism—are worth highlighting.

Neoliberal institutionalists argue that states create international institutions in order to overcome dilemmas of collective action. In the classic formulation, Keohane (1984) argued that under conditions of high transaction costs and uncertainty, institutions could help states overcome market failure in efforts to reach international agreements, such as that modeled by the prisoner's dilemma game. "Chiefly by providing information to

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3. A few of the highlights include Krasner (1983), Keohane (1984), Ruggie (1993), and Keohane and Milner (1996).

actors (not by enforcing rules in a centralized manner), institutions could enable states to achieve their own objectives more efficiently. Institutions would alter state strategies by changing the costs of alternatives; institutionalization could thus promote cooperation” (Katzenstein, Keohane, and Krasner 1998, 662). Institutions affect outcomes by (a) providing information, (b) monitoring compliance, (c) increasing iterations, (d) facilitating issue linkages, (e) defining cheating, and (f) offering salient solutions. When the coordination problem among member states has multiple equilibria, institutions can provide mechanisms for solving distributional conflict (such as side payments in the form of EU cohesion funds for accession to the Maastricht Treaty), signaling salient solutions, and reducing bargaining costs. Once a particular equilibrium solution is chosen, institutions tend to lock it in (Katzenstein, Keohane, and Krasner 1998). This logic applies similarly at the regional and multilateral levels.

A key argument advanced by this approach is that international institutions should not be understood as coercive enforcers of hard rules against the will of member states. Instead, international and regional institutions are the instruments of states in their pursuit of mutually advantageous cooperation and integration. To conceive of institutions as hard constraints on national governments rather than their tools is to begin the analysis on the wrong foot.

Second-generation internationalists in the policy realm, by contrast, have often had an ambivalent attitude toward hard rules: Most members thought such rules were desirable in principle but recognized that they were usually out of reach in practice. The exceptions, cases where rules were in fact hardened, have occurred primarily in two particular situations. The first is where cross-issue bargains were particularly dense and the costs of renegeing to reputation correspondingly high, such as in Europe—although the fate of the Stability and Growth Pact demonstrates that the experience with hard rules is mixed even there. The second situation is where enforcement had the benefit of national instruments, as in the case of authorized retaliation in the WTO.

Second-generation internationalists also rested their institutional strategy on national power, the province of neorealism.<sup>4</sup> The coercive resources of the United States were particularly important in reinforcing the norms and rules of international institutions and economic regimes more broadly. Fred’s work provides several examples of advocacy of coercion

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4. Neorealism’s analysis of international institutions emphasizes their subordination to the interests of powerful states. When hegemons create strong international institutions, in this interpretation they do so to support and defend a liberal international economic order from which they benefit. The distribution of power in the international system is thus critical to creating and sustaining both international institutions and market liberalism. A corollary, the hegemonic stability thesis, posits that liberal international economic orders cannot survive decline of the hegemon and rise of multipolarity. For a classic treatment, see Gilpin (1987).

in defense of international economic regimes, sustaining criticism from some economists in doing so. He has advocated threats of trade measures to pry open foreign markets when that has been important to sustaining domestic political support in the United States for liberal trade. Fred has also advocated depreciation of the dollar as a tool to induce foreign governments to stimulate domestic demand when that has been needed to achieve balance of payments adjustment and avoid protectionist legislation in the United States.<sup>5</sup> Second-generation internationalists part company with many neorealists in intending to bind the United States to the same rules and norms as the rest of the global community.

## Assessment of the Strategy

By almost all relevant measures, the second generation's strategy was dramatically successful in spawning liberalization of international trade and investment. The completion of the Uruguay Round of trade negotiations (to which regional initiatives such as NAFTA and APEC contributed), establishment of the WTO and its Dispute Settlement Understanding (DSU), follow-up multilateral/plurilateral agreements such as the International Telecommunications Agreement, and expansion of the membership of the European Union represent its most recent major successes.

The strategy's record in actually *managing* the macroeconomic and financial conditions of the integrated world economy was mixed. By and large, the global macroeconomic environment has been favorable for growth and economic expansion. When growth slowed or payments imbalances became unsustainable, the G-7 countries sometimes scored successes in international coordination, such as the Bonn summit of 1978 and the Plaza-Louvre process of 1985–87. But on many occasions—managing the transition economies, the 1992–93 European currency crises, and the Asian financial crisis of 1997–98—international coordination fell short (see Bergsten and Henning 1996 and Aslund 1995).

By the mid-1990s, sectors, firms, and social movements that had suffered as a result of globalization mobilized a “backlash.” Whereas the internationalists had been better organized across countries, the backlash coalition—groups knitted together across borders through internationally active nongovernmental organizations<sup>6</sup>—was now also able to organize with some effectiveness. The backlash movement mounted a broad, substantive challenge to the globalization agenda and the international organizations—extending beyond the problems of economic dislocation aris-

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5. I refer to this instrument as the “exchange rate weapon” (Henning 2006).

6. The coalition that formed in the early 1990s to oppose the IMF and World Bank, “Fifty Years Is Enough,” was an early prominent example.

ing from liberalization, and even beyond the labor and environmental issues linked to trade, to encompass regulation of national economies generally, democratic control, and sovereignty.

The first response of many members of the second generation of internationalists was to dismiss the backlash movement as naïve in terms of both international economics and the multilateral institutions. Some took false comfort in the diversity of political groups involved and in the decentralized character of the movement. While a number of economists have seriously analyzed backlash arguments,<sup>7</sup> including in publications by the Institute, it is fair to say that international economists in general have had greater difficulty than some other disciplines, such as sociology and political science, in wrapping their minds around this movement. During the previous decades, these economists had won intellectual and political fights against traditional, firm- and union-led, sector-based protectionism and had steered themselves for more of the same. Some of them were thus blindsided by criticism from social movements in developing countries, which most economists believed would benefit greatly from globalization on the whole, and criticism on the basis of democratic accountability, sovereignty, and legitimate governance in advanced countries. By addressing these arguments largely after they had entered the public discourse, the second-generation internationalists, including Fred Bergsten, missed an opportunity to influence the terms of the debate over globalization.

As of this writing, the future of the global multilateral agenda appears quite uncertain. Notwithstanding some successes—such as reasonably broad acceptance of the WTO’s dispute rulings (including in the United States)<sup>8</sup> and rejections by Congress of proposals to withdraw from that organization—failures are accumulating and challenges dominate the landscape. The progress of European integration was slowed dramatically by rejection of the Constitutional Treaty by referenda in France and the Netherlands in spring 2005. The Doha Round of trade negotiations collapsed in July 2006, with at best dubious prospects for revival.

The IMF faces a critical test: Its members must agree on reform of its governance, surveillance, and financial facilities to secure the organization’s relevance in the coming decades (Truman 2006). Asian countries’ ac-

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7. See, for example, Baldwin and Winters (2004); Elliott, Kar, and Richardson (2004); Rodrik (1997); Stiglitz (2002); Barfield (2001); and Graham (2000). The classic treatment of the political backlash against the first wave of globalization is Polanyi (1957 [1944]). For contemporary treatments by noneconomists, see Mittelman (2000), Kahler and Lake (2003), and Broad (2002).

8. The case of the WTO inspired extensive work on “legalization” of international relations. See, among others, Goldstein et al. (2000). One current of the literature highlights the danger of overlegalizing international economic regimes, undermining institutions politically by moving from a “negotiation model,” where decisions are made politically, to a “judicial model,” where decisions are restricted to the legal and technical merits. See Howse and Nicolaidis (2001), Keohane and Nye (2001), and Alter (2003).

cumulation of foreign exchange reserves raises the specter of the Fund being sidelined in that region and places a premium on increasing Asian countries' quota shares and votes on the Fund's Executive Board and Board of Governors. The Board of Governors took a significant step in this direction during the 2006 annual meetings in Singapore by enlarging the quotas of four particularly underrepresented members. But the Singapore decisions only launched consideration of broader reallocation of quotas, on which obtaining consensus will be politically difficult, and these in turn represent only part of the reform agenda. Whether the membership can agree on the institutional changes needed to save the Fund from gradual erosion of standing and relevance remains very much an open question.

Softness and unpredictability of political support for trade liberalization and international institutions in the United States, among other countries, compound the difficulties facing internationalists. Congress has not offered robust support for trade promotion authority (TPA) since the Uruguay Round. President Bill Clinton did not secure such authority, and President George W. Bush secured it only in a razor-thin vote. Congressional approval of the Central American Free Trade Agreement (CAFTA) passed by a similarly narrow margin (Destler 2005). Congressional support for extension of TPA in a hypothetical effort to breathe extended life into the Doha negotiations seems unlikely.

Congressional support for the IMF has become similarly problematic. Congress agreed to the last quota increase, in 1998, only as the Asian financial crisis spread to Russia and Latin America and in the face of the collapse of the Long-Term Capital Management hedge fund and a flight to liquidity in financial markets. Softness of support on Capitol Hill will probably weigh significantly on any Treasury decision to seek a quota increase and could constrain the administration in current negotiations with other member countries over IMF reform.<sup>9</sup> The dubious congressional support, which stands in sharp contrast to the strong position of the United States within the institution and Fund policies that closely match US preferences, means that second-generation internationalists cannot count on being able to construct congressional coalitions in support of their agenda as they once did.

If pessimism for the globalization agenda proves to be justified, the period 2005–07 could well mark the end of the road for business as usual under the second-generation institutional strategy. Most of the generation's achievements are reasonably secure: Widespread closure of markets does not appear to be in the cards. International trade and investment will probably continue to expand relative to world output, as it has done for most of the last half century, for some time to come. Regional trade and economic arrangements will probably also continue to proliferate. How-

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9. On congressional influence over the IMF, see Woods (2006, 27–33). For analysis of congressional voting on the Fund, see Broz and Hawes (2006) and Broz (2005).

ever, the efforts of second-generation internationalists to further develop multilateral institutions, strengthen international disciplines over national economic policies, and delegate monitoring and enforcement to these institutions could be decidedly more difficult, if not stymied.

## Shortcomings of the Second-Generation Strategy

In the present environment, the standard strategy suffers from three gaps or problems that limit its effectiveness and are likely to persist. First, international organizations suffer from weak links to domestic politics. Support from domestic groups, constituencies, and bureaucracies were arguably the key to the political success of the European Union over the decades (see, for example, Kahler 1995). Most international organizations lack the kind of domestic political support from member states that the European Union commands with its members (notwithstanding the failure of the Constitutional Treaty). Moreover, the IMF and WTO, for example, have been constrained in cultivating such support by national ministries or executive agencies that insist on intermediating that relationship.

A second key weakness revolves around democratic responsiveness and accountability.<sup>10</sup> International organizations were constructed on the normative theory that they are responsible to their members, which are governments of member states for the most part. Their legitimacy should therefore be viewed as derived in principle from the legitimacy of their member governments; although indirect, the chain of delegation from electorates to governments to international organizations is formally unbroken. Defenders of the WTO, World Bank, and IMF argue, moreover, that markets, press and public discourse, budgeting conventions, and civil society, among other channels, can serve as alternative mechanisms of accountability for these institutions.<sup>11</sup>

This defense is incomplete, however, for several reasons. Not all the member governments of these institutions are democratically elected. But, even where it has a democratic source, the chain of delegation from electorate to international organization is attenuated, and slippage between the preferences of the principal and the actions of the agent is compounded at each stage. In addition, as the scope of international organizations widens and their intrusiveness into domestic policy deepens, domestic groups that prevail in national politics more often see their victory compromised or overturned by decisions at the international level. But decision making at the international level is often opaque, not sanc-

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10. Political scientists' analysis of this problem includes Keohane and Nye (2001), Kahler and Lake (2003), and Caporaso (2003).

11. See, for example, Keohane and Nye (2003) and Grant and Keohane (2005); for similar arguments applied to the European Union, see Moravcsik (2002).

tionable for mistakes, and out of reach of these groups' political influence. In this way, political scientist Robert Dahl (1999) has argued, the degree to which the system as a whole is democratic declines.

Third, and finally, the scapegoating technique has probably reached the limits of effectiveness in smoothing the way for internationally consistent policy adjustment. When national political leaders blame international organizations for actions they must take domestically, disaffected interest groups do not simply throw up their hands and walk out of the political arena: They retarget their opposition to the organization used as the pretext for denying their demands. Thus when bills to fund the World Bank and IMF come before the US Congress, for example, members hear ample testimony from interest groups and NGOs in opposition. As this pattern is repeated over decades, scapegoating contributes to erosion of domestic political support for international organizations and a decline in their perceived democratic legitimacy. Because political support for these organizations is now tenuous in many key countries, scapegoating has become at best risky and at worst completely counterproductive.

## Rule Hardening Requires Political Reinforcement

Given these shortcomings, second-generation internationalists must exercise caution when addressing the challenges facing international organizations and when building new institutions. In particular, hardening rules without also strengthening domestic political support and accountability mechanisms runs the risk of reinforcing the backlash against the international organizations that oversee international economic regimes.

Recent proposals to strengthen the IMF offer a set of examples that, in my view, run this risk. The managing director has launched "multilateral consultations" among the United States, euro area, Japan, China, and Saudi Arabia on current account adjustment.<sup>12</sup> John Williamson proposes world reference rates, established by the Executive Board on the basis of analysis by the Fund staff, that would guide not only intervention policy but also adjustments in other external policies (such as international borrowing) and macroeconomic policy (Williamson 2006). Bank of England Governor Mervyn King advocates a nonresident Executive Board and independence for the staff in fulfilling a mandate established by the Board.<sup>13</sup>

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12. As authorized by the International Monetary and Financial Committee; see IMF (2006).

13. Mervyn King, Reform of the International Monetary Fund, Speech delivered to the Indian Council for Research on International Economic Relations (ICRIER), New Delhi, India, February 20, 2006. See also David Dodge, Lecture at the Woodrow Wilson School of Public and International Affairs, Princeton, NJ, March 30, 2006; and Tiff Macklem, Renewing the IMF: Some Lessons from Modern Central Banking, Speech delivered at the Global Interdependence Center, Philadelphia, March 9, 2006.

Morris Goldstein laments the lack of enforcement of the IMF exchange rate rules, in the case of Chinese foreign exchange intervention, and urges the Fund to act more forcefully as “umpire” by citing violators in semi-annual exchange rate reports and by convening special consultations (Goldstein 2004, 2005, 2006). Bill Cline proposes that the Fund determine whether members “manipulate” their exchange rates and that the WTO take the determination into consideration in trade cases (Cline 2005, 279–80). In testimony before Congress, Fred Bergsten has argued that the Fund has “violated” its mandate with respect to exchange rates, and he has pressed it to take a similarly assertive role.<sup>14</sup> Going a significant step further, he advocates that the US government adopt an escalating series of measures—including ultimately across-the-board tariffs on Chinese imports if necessary—to persuade the Chinese government to revalue.<sup>15</sup>

Although none of these authors propose the establishment of multilateral sanctions for violations, each of their proposals would harden existing rules substantially and constrain national policy more tightly. Consider Goldstein’s proposal to stiffen the spine of the IMF with respect to exchange rate rules. I single this out not because I disagree with its economic merits; rather, because Morris’s economic case is compelling and his proposal is clearly specified, his recommendation presents the most useful illustration of the incompleteness of this class of proposals. His position has the second benefit, for the purpose of this Festschrift, of being shared by Fred. Goldstein describes his proposal as “modest.” During the authors’ workshop for this Festschrift, Michael Mussa adds that no new amendment to the Articles of Agreement would need to be approved to implement the Goldstein proposal. Instead, the managing director must simply apply a literal interpretation of the plain language of the Second Amendment to the articles, the 1977 Executive Board decision implementing it, and the more recent reviews of that decision.

But make no mistake about it: Literal interpretation of the plain language of Article IV would be a *radical* departure from the interpretation and application of the Fund’s guidelines with respect to surveillance of exchange rates since the introduction of the Second Amendment. In its interpretation of these guidelines, the General Counsel of the Fund highlighted *intent* to prevent balance of payments adjustment and gave considerable weight to members’ declaration of their own intent (IMF 1977). This interpretation vitiated any effort to cite a member for manipulation,

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14. C. Fred Bergsten, *The IMF and Exchange Rates*, Testimony to the Committee on Banking, Housing, and Urban Affairs, May 19, 2004 (Washington: US Senate); and *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).

15. C. Fred Bergsten, *The US Trade Deficit and China*, Testimony before the Finance Committee, March 29, 2006 (Washington: US Senate).

because any member could be expected to disavow intent to block adjustment even when that might be the consequence of government policy. Rejecting a member's declaration of intent as unpersuasive, thereby paving the way for formally citing the member for manipulation, would impose a new, far less deferential rule. Goldstein's review of the history of (non)enforcement of the exchange rate provisions makes it quite clear that the literal interpretation he proposes would be unprecedented.

Proposals such as this to harden soft rules reason implicitly by analogy to domestic law: They seek to create among member states something approaching the international equivalent of legal constraints on firms and individuals in the national context. Domestic legal systems, however, have the benefit of a domestic political system, court jurisdiction, enforcement capability, and mechanisms to convey legitimacy on the enforcement apparatus. Hard law and domestic politics work together as two pillars in a democratic system. Raising one without also raising the other at the international level could destabilize the structure and threaten its collapse. While solving a substantive problem, tightening the rules would compound the problem of sovereign control by member states and raise challenges to the international legitimacy of the institution.<sup>16</sup>

From the standpoint of institutional strategy, in my assessment this class of proposals to strengthen the IMF is incomplete, and dangerously so. They would create or strengthen rules without also giving the institution the political resources or instruments to follow through, enforce them, and protect itself against backlash from the target. If adopted alone, these recommendations run the risk of leaving the organization worse off rather than better off—more susceptible to domestic political opposition and charges of unaccountability and illegitimacy. Hardening rules without also reinforcing the institution politically would be a mistake; each such proposal should be accompanied by corresponding measures for political reinforcement.

Citing countries for violating exchange rate rules by frustrating adjustment, irrespective of the economic merits of doing so, would probably place the IMF at the center of a political maelstrom. Revaluation of the Chinese renminbi, which among other adjustments the Goldstein proposal is designed to produce, will benefit some groups and harm others, both in China and among its trading and investment partners. There is little reason to believe that national governments will be responsible and avoid using the Fund as a scapegoat. Crucially, there is little reason to believe that the Fund's supporters will outnumber the Fund's opponents. Under these circumstances, it would be completely reasonable for the managing

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16. The Fund's political problem with respect to legitimacy was highlighted in Pauly (1997) and is also addressed by Lombardi and Woods (2005), Woods (2006), and Best (2006).

director to insist on credible commitments of enduring support from key members as a condition for applying the rules as Goldstein proposes.

Proponents of hardening the IMF's exchange rate rules point to the success in reinforcing WTO dispute settlement under the DSU and the acceptance of some key rulings by countries such as the United States. However, the WTO has several advantages over the IMF with respect to rule enforcement. First, members have negotiated periodic rounds of multilateral trade liberalization and ratified them in detail through the domestic political process, giving them multiple opportunities to review and reaffirm their consent to new and existing rules. Members' periodic approval of quota increases for the IMF does not constitute a similar domestic political review and ratification of their obligations in the Fund. Second, the economic stakes in each trade case are small on a macroeconomic scale, affecting particular sectors rather than the economy as a whole. The economic stakes of exchange rate and balance of payments rules are far larger. Third, the prospect of retaliation by national governments substantially reinforces compliance with dispute rulings. Such retaliation, "compensation" for losses arising from violations of trade agreements, is authorized by the WTO.<sup>17</sup> No similar national instrument reinforces IMF decisions. Unilateral action by the United States, prompted by discontent in Congress with respect to the Chinese exchange rate regime, for example, would take place outside the ambit of the Articles of Agreement and could perhaps violate other international agreements, such as the GATT/WTO. These differences render the transfer of the WTO/DSU model of rule enforcement to the IMF deeply problematic.

## Conclusion

The second-generation institutional strategy, to which Fred has made leading contributions, was highly successful in sustaining and building international economic cooperation during the last three decades of the 20th century. But now the strategy is increasingly incomplete in the face of changing political conditions and, in unaltered form, faces the prospect of diminishing returns. Some of the elements of the standard strategy, such as the core functions of institutions, are worth keeping; some, such as scapegoating, should be summarily jettisoned.<sup>18</sup> But the general strategy must be fundamentally modified, if not replaced. Although this chapter does not offer a full replacement, it has diagnosed the directions in which

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17. The DSU is examined in detail in Barfield (2001), Lawrence (2003), McRae (2004), and Leitner and Lester (2006).

18. A recommendation rather than a prediction.

the strategy should be developed and offers some more specific measures that I believe have promise.

When strengthening international rules and enforcement,<sup>19</sup> it is vital to strengthen the international organizations themselves by addressing their problems of legitimacy and accountability, by giving them links to and constituencies in domestic politics, and by developing alternative, international mechanisms of accountability. Several angles are worth pursuing and here again I use the IMF as the organizational example.

First, we must consider how key members can credibly commit their enduring support. Second, international organizations can be given deeper roots in domestic politics among groups with convergent interests. Political support for the IMF is too important to be mediated by midlevel officials in national treasuries. The managing director of the Fund should be able to testify before the US Congress, for example, or telephone the US president. The managing director should also meet with and listen to domestic interest groups and NGOs that wish to lobby the Fund on a variety of issues, including the exchange rate. Article IV missions should engage a wide variety of domestic actors at the initiative and discretion of the Fund staff.

Third, the Fund should develop deeper relationships to financial markets, which serve both as a channel for accountability and as a political constituency. Although the Fund has consulted with private financial institutions for some time on an informal basis, Fund officials should meet directly with banks, Wall Street firms, and firms based in other financial centers, for example, in the course of surveillance exercises. Finally, greater investment should be made in good old-fashioned grass-roots political activism for the Fund within member countries, of the kind that generated support for the original Bretton Woods Act in the United States. The essential point is that international institutions must be strengthened in these ways *before* they are burdened with further important responsibilities.

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19. An alternative is to accept that international rules and institutions, while useful, are inherently limited and instead develop domestic institutions and policymaking processes to facilitate internationally consistent policy adjustment.

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