The Role of International Organizations in Creating a More Stable World Economy[1]

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A main impulse behind the creation of international economic organizations in the postwar years was the received wisdom concerning what had transpired in the 1930s. That era is remembered as one of competitive policies as countries sought to export their unemployment by engineering current account surpluses through devaluation and trade restrictions. One can argue that the real problem was the overvaluation of most national currencies in terms of the basic reserve asset (still gold), but that does not alter the basic reality that the Great Depression and the various decisions to counter it at the national rather than the world level cost the world a substantial proportion of world output, and it has also been persuasively argued that this anarchy played a major role in inducing World War II. The IMF in particular was largely created with a determination to never again let such foolishness wreak havoc with the world. The design impinged on national sovereignty (because the IMF, in principle, had the right to overrule countries regarding exchange rate policy), but in the circumstances of 1945 it was recognized that it was worth sacrificing a part of sovereignty in order to minimize the danger of a return to the 1930s.

Thus I see two ways in which international organizations may contribute to the creation of a more stable world economy. The first, and in my opinion the most important (though I am not sure this view is widely shared), is by specifying rules of behavior that countries are expected to follow and that are such as to reconcile the policies of different nations. The second is by persuading them to alter their policies in order to respect the interests of other countries. It is common (especially among the political science profession) to assert that no country can be expected to changes its policies in order to further the concerns of some other party. This may be true, although there is surely also the possibility that countries will simultaneously modify their policies if, but only if, they know that other countries are also doing so. It also ignores the possibility of intertemporal bargains: A country may conclude that it would be worth modifying its current policy in the interests of others if it thereby gains an expectation that they would be equally accommodating in the future. (Of course, the most natural way of building such an expectation is by modifying the rules of behavior that countries are expected to respect, which is why I regard the first way sketched above as more promising.)

The first part of this paper presents a simple description of the determination of aggregate demand in the world economy, which shows the importance of the mechanisms that were thought to be responsible for the misfortunes of the world economy in the 1930s. The second section discusses the evolution of the world economy in the postwar period. The third section then describes two possible ways of reconstructing the international monetary system designed to ensure consistency of the interests of different countries, and explains why I am not optimistic about the world adopting either (or any other proposal that would avoid

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inconsistent actions). The last section then records the various attempts that have been made to persuade countries to take account of the interests of others, and takes note of their general record of failure. The conclusion is that the world has little hope of creating a more stable world economy.

The Determination of World Aggregate Demand

World aggregate demand is the sum of national aggregate demands. National aggregate demand is determined at the national level, inter alia by fiscal and monetary policy, but the national output can differ from national aggregate demand, by the current account surplus or deficit. The distribution of this demand around the world (and therefore the current account) depends upon relative prices, i.e., upon many factors that can be taken as constant or predetermined (like productivity) plus protection and exchange rates. The General Agreement on Tariffs and Trade (GATT, and now the WTO) in the postwar world was intended to prevent protection being used to augment national demand, and has been unexpectedly successful in this objective. Under Bretton Woods, countries conceded that their choice of exchange rate was a matter of international concern; their initial choice of exchange rate plus any subsequent change required endorsement by the IMF. It transpired that the postwar world was one of inflation so the decision to give the IMF the power of approving changes in the nominal exchange rate did not give it much power to determine what matters, which is the real exchange rate. The problem in the postwar world was a reluctance to change exchange rates as soon and as often as necessary to preserve realistic real exchange rates, but even the powers nominally given to the Fund could not help in this respect.

But that is running ahead of the story, which at this stage concerns the noninflationary 1930s. The problem then was of a general insufficiency of aggregate demand. Consequently each country had an incentive to seek a boost to aggregate demand. This could come about either because of national actions that expanded world demand at the cost of worsening its payments position, or by increasing the current account balance. There was no additional incentive to seek the former because the world was short of demand, or even to seek a combination of the two that left current account balances unchanged. On the contrary, many countries sought to divert demand to themselves by improving the current account balance, by protection or devaluation.[2] They could not all succeed, by definition. Because neither the rules of the game nor any existing international organization told them they should focus on actions that would increase world demand rather than redirect it for their own benefit, or that they had a duty to avoid beggar-thy-neighbor acts, this went down in history as an era of beggaring-thy-neighbors.

The principles are the same in the 2010s as they were in the 1930s. That is, world demand is the sum of national demands, but national output can differ from national demand by the current account surplus or deficit. If one is to secure a desirable level of demand for the world as a whole, then: (1) ex ante the sum of surpluses must equal the sum of deficits; and (2) countries must aim at securing a level of demand that James Meade (1951) dubbed "internal balance." The latter feature is essential because otherwise the world economy could reach equilibrium with an inadequate level of output.

The Postwar Years

The vision that the authors of Bretton Woods sought to implement for the world economy was one in which the pursuit of national self-interest within the rules of the system would result in an outcome that was good

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[2] It has been argued by Eichengreen and Sachs (1985) that one should distinguish protection from devaluation because the former, if generalized, ultimately leads to a loss of real income while the latter ultimately corrected the general undervaluation of gold and thereby served to increase world real income. This is true, but the contrast made in the text is between cooperative international action (which would presumably have involved a joint move to gold revaluation) and what actually happened, which was a series of national devaluations.

for the world as a whole. They created GATT (now the WTO) to outlaw increases in bound tariffs (which prevents the use of protection for conjunctural purposes), an aim in which it has been extraordinarily successful. (The G-20 has periodically called on countries to avoid resorting to protectionist responses to the pressures created by the financial crisis, and to the surprise of many there has been no large-scale resort to such measures.) They legislated the adjustable peg exchange rate regime, and as pointed out above, they also endowed the IMF with the duty of disciplining changes in nominal exchange rates. Countries could only change their nominal exchange rate in a situation described as "fundamental disequilibrium." While never formally defined, it was pretty clear that by this was meant a situation in which it was impossible to secure a satisfactory balance of payments outcome at the same time as a reasonable approximation to "internal balance" at the going exchange rate. Given that in their own self-interest countries also pursued internal balance, having exchange rates close to a level that is consistent also with external balance guaranteed that a change in demand was in the interests of the world as a whole. The idea of stealing demand from other countries was outlawed.

In due course Bretton Woods collapsed, though not because of the fact that the IMF had limited ability to influence real exchange rates, but because the development of capital mobility had made the adjustable peg unworkable. But the 1970s differed from the 1940s in lacking a vision of what needed to be accomplished by an international monetary system, and it therefore legalized an international monetary nonsystem in which any exchange rate system (except pegging to gold!) was permissible, with no IMF supervision save for the "guidelines for floating." Consequently instead of gaining a power to influence real exchange rates, the IMF lost even the power to control nominal rates. What it lost through the elimination of any formal rules it failed to regain through surveillance, where the major powers simply refused to listen, on the grounds that they employed better economists. What this fails to recognize is that the IMF represented an international interest whose influence should be brought to bear if policy is to be based on a rational appraisal of the full range of factors. And the IMF was consequently left solely with the responsibility for shepherding weak countries back to prosperity (a task in which it managed to make itself extremely unpopular, in part because of its mistakes).

It was easy to dismiss the need for strong international influences in an inflationary era when there was minimal incentive to run a current account surplus. Countries had to pay attention to their balance of payments position for fear of exhausting their reserves, but they had no incentive to run larger surpluses than were needed for this since a larger current account surplus meant less domestic spending. Hence the disappearance of the Bretton Woods discipline made no great difference to the operation of the world economy so long as the latter was dominated by the old industrial powers driven by the desire to use growth in order to augment consumption.

Two developments changed this picture. The first was the emergence, from the 1990s on, of a new wave of dynamic economies driven by a new interpretation of what drives industrial growth. In place of the former emphasis on the desirability of consumption, the emerging economies came to subscribe to a belief in export-led growth, interpreted not—as when the doctrine of export-led growth was pioneered by the likes of Béla Balassa—as a supply-side doctrine, nor even as giving the ability to ride out temporary problems, but as a way to generate demand all day and every day. The result was to induce the countries to see export surpluses as a virtue, rather than being at most a regrettable necessity. This was reinforced by the desire of many emerging markets to accumulate reserves so as never again to have to rely on the goodwill of the West, which they concluded in 1997 was singularly unreliable. Those emerging markets that had not adopted floating exchange rates were therefore induced to hold exchange rates that would generate export[3] surpluses. Given the

[3] Strictly speaking, current account.

Balassa-Samuelson fact that a dynamically growing economy needs an appreciation of some 2 or 3 percent per year to avoid undervaluation developing, they became undervalued and liked it.

The second development can be dated from 2008, when Lehman Brothers collapsed. The collapse led to a far deeper and more dangerous recession than had been in prospect beforehand. Many of the developed countries had previously come to rely on bubbles to sustain demand, so as they concluded that it was unsafe (for both public debt and external reasons) to perpetuate this pattern of demand, it seemed that the era of full employment in the developed countries was over. They are now faced by a lengthy period of Keynesian conditions.

The world as I see it is now bifurcated between the old developed economies (the "West") with unmanaged exchange rates and Keynesian unemployment, and emerging markets with a mix of exchange rate regimes but all with good growth prospects and no shortage of demand. Those with floating exchange rates have appreciated and now face threats to an ability to preserve even the Balassa version of export-led growth. Those with managed exchange rates are undervalued (Cline and Williamson 2010) and consequently reducing demand for the industrial products of other countries, at the same time as facing inflationary threats. The rational response to this situation seems to me to be a major[4] revaluation of the managed currencies, accompanied by expanded demand on their part so that they do not suffer unemployment or loss of growth momentum, and continued demand restraint on the part of the West. This ought to go far enough to replace the "uphill" flow of capital by a renewed capital flow from the old industrial countries to the emerging markets. The advantages of this outcome would include: A relief of inflationary pressures accompanied by continued growth in countries like China; an end to Keynesian unemployment in the West; an elimination of continued buildups of unsustainable debt; and a resumption of capital flows that could both accelerate the development of emerging economies and ease the blow of the forthcoming aging of the population in the West. But I see little hope of such an outcome. Let me explain why.

Two Proposals for Reconstructing the International Monetary System

Both proposals are ones that I have been active in propagating. The first is a logical development of my thoughts over many years, known as the Reference Rate Proposal, and is presented in Williamson (2007). It assumes that every country would accept, and have its actions bound by, a reference rate. The nature of the constraint countries would accept is to not act so as to push their rate deliberately away from the reference rate. Thus they could float freely if they wished to do so. Or if they did not fancy floating they could push their rate *toward* the reference rate, maintaining it as close as they desire to the reference rate, including pegging it at that rate. Or they could intervene only on one side of equilibrium if they so choose. What it commits them to is *only* pegging to, or intervening to push the market rate toward, a rate that has been internationally agreed. One assumes that the international community would seek reference rates that it would judge to be consistent with equilibrium, and that countries would object if they thought that the international community had got things seriously wrong because it would preclude them from acting in their perceived interest.

Adoption of the reference rate proposal would require profound changes in attitudes on the part of two groups of countries. Most obviously, it would require countries that have been pegging, or managing, their exchange rates to seek international consent for their parameters. China would have to agree that its exchange rate commanded the consent of the majority of its trading partners, rather than its rate against some other currency being a topic of purely national decision. But secondly, perhaps less obviously, it would require a major change in attitude on the part of the countries with floating currencies. They would have to consent to an official estimate of their equilibrium exchange rate. No longer would they be free to declare that they

[4] Major is not the same thing as unstaggered.

were indifferent as to what the market rate is and to shrug off as entirely the fault of the market a misaligned rate. And it would certainly prevent US Treasury Secretaries averring their love of a strong dollar when the dollar is already stronger than its reference rate.

A central question is that of how the reference rates should be determined. It is implicit in the macroeconomic model of just about every finance ministry and central bank in the world that, given prices inherited from the past plus a focus on achieving "internal balance," the reference rates would be uniquely determined by a set of target current account balances. These targets play the role of "external balance" in the framework made famous by James Meade (1951), which implies that their selection would be of critical importance. The subject is discussed in detail in Williamson (2007, chapter 5), but suffice it to say here that I envisage an iterative process between IMF staff and the executive board in which one hopes there would normally be agreement at the end of the day, but if not countries would have to agree to be bound by a majority vote in the board.

I can conceive of a second approach to reorganizing the international monetary system that might result in a rational response to the current situation, described in Williamson (forthcoming). This involves agreement on some mechanism for disciplining surplus countries. The original proposal along these lines was made by Keynes (Moggridge 1980, pp. 21–40) in his proposals for the postwar monetary system, but rejected by the United States, which then regarded itself as a permanent creditor country. The essence of Keynes's proposal was to charge interest on cumulated reserves above a certain level, and to permit the international community to compel appreciation of the currency of a chronic surplus country. Ironically, in view of its role in rejecting Keynes's proposals during the war, during the Committee of Twenty negotiations in 1972–74 the United States advanced a fairly similar though less elaborated set of proposals, described as a "reserve indicator" system. In recent years a series of proposals for compelling surplus countries to adjust has come, mainly from the private sector, notably my Institute. Thus Mattoo and Subramanian (2008) have suggested that the Doha negotiations be enlarged to include allowing the possibility of trade retaliation against surplus countries that refuse to adjust (as well as to ensure a right of investment by sovereign wealth funds). Goldstein (2010) has proposed that any country running a current account surplus in excess of 3 percent of GDP should be obliged to accept a Fund mission to examine the appropriateness of its exchange rate, and a chronic surplus country that refused to revalue should suffer trade retaliation. Bergsten (2010) has proposed allowing the issuer of a reserve currency the right of counterintervention against a chronic surplus country (subject to veto by the IMF). In the one proposal from the official sector, the US Secretary of the Treasury has suggested that the G-20 countries commit themselves to aiming to achieve a maximum ratio of current surplus to GDP of 4 percent. This proposal was widely welcomed by those who engage in wishful thinking about the determinants of current account balances including short-term endogenous variables other than incomes and prices, on the specious ground that it sidesteps the need to press China to revalue the renminbi, but quickly ran into disagreements, especially strongly voiced by Germany, another chronic-surplus country. Daniel Gros (2010) has proposed that reserve currency countries introduce a reciprocity requirement allowing foreign official holdings of their public debt only by countries that similarly allow foreign holding of public debt, but appears to have overlooked the fact that there is ample private debt that could be bought instead by countries like China. Gary Hufbauer (2010) suggests withdrawing Chinese tax privileges, giving the US authorities the right to impose a withholding tax on the interest income from holding dollar reserves in the United States.

All those proposals that envisage using the IMF to discipline surplus countries would need Chinese acquiescence in being disciplined. It is one thing to believe that if those rules had been in effect when China joined the IMF it would have signed on and subsequently obeyed the rules, and quite another to believe that China would now approve of changing the rules. That is water under the bridge, a price the world is now paying for its insouciance in agreeing to the nonsystem in 1977. In view of the reverence that China periodically expresses for that bad 16th century European invention of national sovereignty, it is unrealistic to expect Chinese consent. (And there is a second country whose opposition would have to be expected, namely the United States, whose congressmen frequently express similar archaic sentiments.) That seems to me the fundamental reason for seeing no hope in writing rules of the game that would induce countries to strive for cooperative solutions.

An Alternative Approach?

But there is a second way in which international organizations can, in principle, contribute to stability. This is by consciously exerting pressure in a stabilizing way, on the model that has (perhaps) been seen in the various groups.

The main international vehicle for coordinating economic policy in the immediate postwar years proved to be the OECD rather than the IMF. In its 1960s heyday, when Working Party No. 3 became its main organ, there was no big divergence between national and world interests, and therefore peer pressure proved quite an effective instrument. And one should recognize that these were all developed countries.

During the 1970s the need for a directorate for the world economy became appreciated, and the G-5 started to meet. Initially substantive matters were seriously discussed and real bargains were struck. One may or may not regard the Bonn Summit as having produced a good bargain, but there can be no doubt that the Germans expanded more than they would otherwise have done and that the American Congress would not otherwise have scrapped price controls on energy. Similarly, at the Plaza in 1985 there was a real agreement to intervene with a view to bringing the dollar to a realistic level. And in the subsequent years the IMF staff provided a de facto secretariat for the G-5 and G-7.

But the problem with any restricted international grouping is always to be found in the marginal excluded country, which in the case of the G-5 was clearly Italy. Since the United States did not relish the thought of being one of six, it then insisted on also bringing in the seventh economy, Canada, so we got the G-7. In due course, after the collapse of the Soviet Union, the G-7 got further enlarged to the G-8. But, whether enlargement was responsible or not, the G-7 and G-8 degenerated into a nonaggression pact. The members accepted what they were told by the other members with little criticism and less bargaining.

In due course the failure of the G-7 and G-8 led to an attempt by the IMF to provide a substitute. Five principal economies (the United States, Japan, and Euroland with France, Germany, and Italy all as members of Euroland, plus the new boy China and Saudi Arabia representing the oil producers, but pointedly excluding the United Kingdom) were challenged by the IMF to work out a path to a more sustainable payments outcome. In the end they agreed to declare that if each of them continued doing exactly what it was already doing they would reach this blessed state in due course. The latest attempt to get the major countries to pay attention to the need for mutual consistency in their policies is the G-20's mutual assessment process, but it remains to be seen whether this is more effective.

Thus attempts to persuade the major countries to modify their macroeconomic policies to secure international consistency have not recently been terribly impressive.

Conclusion

I remain convinced that the most hopeful path to getting the individual countries that compose the world economy to pay attention to the need for consistency of policies internationally is to draft rules that oblige them to behave that way, but I see no hope of legislating such rules except as a response to a major crisis. Perhaps one should hope that the inconsistent policies currently being pursued will result in such a crisis, but it is more likely that the world will muddle through. If asked to guess how, I would regard as most probable a scenario in which China comes to be taxed on its reserve currency holdings (à la Hufbauer) sufficiently heavily that it loses its taste for running large current account surpluses. This does not strike me as an ideal outcome, but as one that we may have to live with.

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