International institutions in a global economy

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Abstract. Global economic integration has increased tremendously. But the political instinct to think globally has eroded. This is a particular problem in the context of the world economy’s worrying dependence on American spending and Chinese saving and volatile exchange rates. We need heightened international coordination on currencies and, in the long run, perhaps a global currency.

A changing world

In the 1960s and early 1970s, when I worked in the US Treasury, economic doctrine seemed pretty settled along Keynesian lines, and international monetary cooperation and multilateralism were strongly stressed. The framework of fixed exchange rates was taken for granted—or perhaps better described as an article of faith. The Bretton Woods institutions—the IMF and World Bank—were enjoying their heyday. It was, institutionally speaking, a pattern that reflected the hopes and ideals of those who shaped a new world order out of the shattering years of depression and world war.

Fresh as those images may be for me, I suspect that for most of you they seem historical artefacts with little current relevance. We live in a world with a degree of economic and financial integration surpassing anything anticipated a generation ago. This is true of trade in goods and services and, even more strikingly, of the enormous international flows of capital that characterise today's financial markets.

The opening up of markets and internationalisation of finance are in part a culmination of policies set out decades ago, but the reality has exceeded reasonable expectations. And what has force-fed the change—what has made it practically impossible to contemplate reversing course—has been technological explosion. We have only begun to come to grips with the policy and institutional implications of an electronic world of efficient and instantaneous communication and information processing.

New paradoxes

What seems paradoxical is that this new reality of a globally integrated financial system has been accompanied by erosion in the political instinct to think multilaterally, to coordinate national policies and to build consensus. In particular, the role of the Bretton Woods institutions is both unsettled and downgraded. Think, for instance, of the proliferation of bilateral and regional trading arrangements, in concept antithetical to the principles behind the General Agreement on Tariffs and Trade (GATT) and its successor, the World Trade Organization (WTO). Moreover, the breakdown of pegged exchange rates has not been replaced by a coherent new system: the Friedmanite vision of freely floating exchange rates smoothly adjusting to the vagaries of national policies or underlying economic realities has not been borne out.

The flow of international private finance, now dwarfing lending by the official institutions, is another oddity; the flow today runs more in the direction of developing country to developed, emerging to emerged, than in accord with textbook models of development. Perhaps the oddest thing of all is the enormous net flow of private capital and monetary reserves into the US dollar. The United States has been absorbing about 80 per cent of the net flows of international capital; the world’s largest developed economy is also its biggest debtor, spending 6 to 7 per cent more than it produces.

A retreat from multilateralism?

What has been going on? First, the apparent retreat from multilateralism and international cooperation. It is important to make clear that, even in the 1960s and early 1970s heyday, the actuality of cooperation often fell short of the rhetoric. Now, paradoxically, in important ways the practice of cooperation and coordination is ahead of what is generally acknowledged. But that coordination is forced at least as much by market needs as by official rhetoric or initiative. The simple fact is that this integrated world, by its nature, has demanded practical measures to move...
towards convergence in policy and practice in important areas. It is not typically dependent on the negotiation of new treaties or parliamentary action. It proceeds by fits and starts. But it is happening.

Let me give three specific examples. First, one with which I happen to be closely involved – international accounting and auditing standards. This may sound dull, mind-numbingly complex, and removed from the big issues of the day. But, if the issues of the day are defined as those on the front pages of the world's press, consider the attention given to flows of direct investment and the exposés of scandal and corruption in the business world. These suggest that, if we are to rely upon free and open markets and informed investors as the driving force for economic growth, then we have a lot to do.

Twenty years ago, if Alec Cairncross or I thought about these technical issues of accounting and corporate governance at all, they would have been placed on the back burner, without any sense of urgency or prospect of agreement. Now it’s a matter of priority for big companies facing varying regulatory and accounting standards in the countries where they operate. Understanding and convergence is a necessity for all those recognising that corruption is a festering sore, discouraging confidence in the integrity of too many business enterprises. While full success is still years ahead, a lot of progress is now being made, typically with governments providing support but with non-profit and ad hoc groups both conceptualising and negotiating solutions.

Second, consider the related area of financial regulation. There is now broad acceptance of the basic concept that financial regulatory standards cannot be left entirely to individual countries or to national regulators without jeopardising financial stability and fair competition. The work to achieve common standards for bank capital is the leading case in point, but not the only area of progress. Closer cooperation among banking and security market authorities in developing common approaches and exchanging information is developing without much fanfare, responding constructively to the complexities and risks inherent in today’s financial markets.

Finally, in my own work investigating the Oil-for-Food programme for the UN I have become more conscious of efforts in the OECD and elsewhere to develop and enforce common approaches towards dealing with corporate corruption and money laundering. Again, it is a highly complex area, without drama or the stuff of headline news. But the success and acceptance of market capitalism as an organising principle of the international economy surely rests on the sense that a private market-driven economic system can perform with integrity and honesty. It is in that context that these varied but inter-related approaches are critically important.

The role of Bretton Woods

What about the roles of the IMF, the WTO and the World Bank – the central institutions of the Bretton Woods vision – in this new market-dominated global economy? Here, in the spirit of Alec Cairncross, allow me to be a bit provocative.

In the framework of GATT (and now the WTO), striking progress has been made towards the growth and integration of the world economy. There are substantial doubts about the ultimate success of the latest round of negotiations, initiated at Doha, as it is focussed on the particularly difficult issues of agriculture and services. But, ‘win’ or ‘lose’ (or most probably a compromise in between), we shouldn’t lose sight of the simple fact that, over the years, the efforts to reduce trade barriers have been a huge success. As a consequence, the potential for further progress is limited. Instead, I would suggest that efforts now might be better directed towards the less dramatic, but necessary, task of ‘good housekeeping’. By that I mean policing and rationalising the proliferation of bilateral and regional trade agreements and strengthening procedures for reconciling trade disputes. It is in these areas that political pressure can threaten to bring about a retreat away from the precepts of multilateral trading and the rules of most-favoured-nation treatment that have provided the backbone of that approach.

In broad outline, I think the message for the World Bank and its regional brethren is similar. Large-scale official lending to well-developing and plainly creditworthy economies – China, Brazil, India and others – plainly is no longer critical to the growth process. At the other end of the spectrum, lending to heavily indebted poor countries, even on generous terms, has come into question. Arrears have piled up and lending countries have been increasingly willing to forgive debts. Meanwhile, the range of concerns of the World Bank has broadened; the focus has shifted to corruption, education, opportunities for women, the environment, human rights, corporate governance and others. All worthy causes, but diffuse and not characteristic of the traditional banking concerns, nor issues where the Bank’s role is central. Keynes famously remarked that the International Monetary Fund was essentially a bank, and the World Bank should be essentially a fund. Well it seems probable that the truly banking elements of the World Bank will fall into disuse. The strongly-growing economies will have alternative borrowing opportunities, while the poorest countries may increasingly rely on grants.

While the WTO and World Bank have gradually evolved, the role of the IMF has been transformed. Decades have passed since balance of payments financing of developed countries had any significance. The IMF cannot enforce discipline or particular policy approaches on the countries of systemic importance. Nor can it readily impose policies on the largest emerging market economies,
though its influence as a lender and adviser to smaller and more vulnerable economies remains considerable. This is not, however, sufficient to dictate, or much influence, the shape of the international financial system. That is not for lack of trying – every opportunity has been taken to encourage the use of floating exchange rates and free capital markets, turning on their heads the original IMF principles.

Exchange rates

There is, indeed, significant flexibility in exchange rate practice today. But as I read the record, experience raises grave doubts about the realism of the floating exchange rate doctrine as an organising principle for the world monetary system. First, exchange rates left to fluctuate in response to market forces have been surprisingly volatile. In the past decade, the yen/dollar rate has moved over a range of 60 to 70 per cent twice, by close to ten per cent in the last few months alone. Similarly, the dollar/euro rate moved from $1.17 to 0.80 to 1.30, now to 1.20 or so. Is there any underlying economic rationale for that degree of fluctuation among the three leading world economies, all of which have enjoyed relative price stability?

Second, whatever the theoretical motives behind floating exchange rates, in practice most countries do not follow the practice consistently, if at all. Take the example of Europe. I am aware that there were and are powerful political reasons for the adoption of the euro. But it is equally clear that individual EU members felt that floating exchange rates were inconsistent with the essence of a single European market. I know there are exceptions to that sweeping statement. But in this case I suspect the exception proves the rule. The UK can for the time being feel comfortable with staying floating so long as there is one European currency, not a dozen or more. It is also clear that small exposed open economies, heavily dependent on external trade and without any well-established home currency cannot comfortably maintain a floating exchange rate. Time and again, we see extreme shifts in exchange rates, with major adverse repercussions. In fact, many countries have taken away the lesson that, to ensure stability, it is key to attract and hold large foreign exchange reserves.

The perception is different with respect to large, well-diversified economies with well-established records of price stability. The United States and the euro area are the main cases in point. They seem to be relatively untroubled even by large swings in the bilateral exchange rate, since bilateral trade is small relative to their size, domestic financial markets are massive and fluid, and there are satellite currencies that maintain a fixed – or near-fixed – relationship.

In my view, these differing perspectives account for part of the oddity mentioned above – the flow of money from the underdeveloped to the highly developed economies, and particularly into the US dollar. Emerging economies want to insulate themselves from exchange rate volatility by holding large reserves. So they are attracted to the dollar with its large liquid markets, a variety of investment outlets and the perception of stability – political, economic and financial. At the same time, international businesses, whether in large or small countries, need both flexibility and stability, and they perceive those qualities in the dollar. Finally, the global investment management industry naturally advises its clients to diversify into the world’s largest economy.

A global currency

The inference I draw from all of this is that a central implication of a truly global economy is a global currency. We are far from implementing that vision today. We think of such a global currency as an institutional and legal liability. We have no global government, no international central bank, no mechanism for cooperation and coordination among sovereign states. What we do have, in a spontaneous, unplanned manner, not fully articulated or understood, is an increasingly accepted international currency, the US dollar. For the time being, this has served us well. The American propensity to spend has helped to sustain world growth at a time of sluggishness in Europe and Japan, while the availability of low-priced imports has contained inflation pressures in the US. At the same time spending has been supported by the flow of funds, official and private, into the dollar, maintaining high investment at low real interest rates. Under the circumstances, there is little political and economic pressure to adopt new policies or to build a stronger foundation.

But how long can confidence in the dollar be sustained? If there needs to be a larger exchange rate adjustment, how can we avoid undermining the confidence and circumstances that have made the dollar so useful? I do not know the answers to those questions. What I do know is that the current monetary arrangements are unsustainable. If we need monetary reform in some basic sense, if we do need to find a way to satisfy the logic of a world currency, then we simply do not have the institutional apparatus capable of working to that end.

As things stand, a likely development is the further regionalisation of currency markets. That works reasonably well for countries that have particularly close trading and financial relations with the US or Europe – or, looking ahead, with China. But it does not solve the problem for those small developing countries that have well-diversified markets, including most Asian economies. And any regional monetary agreements are likely to have political as well as economic implications, possibly unsavoury ones. Hence, it seems to me that the case is strong for cooperation.
among the major currencies, not to eliminate but to limit the volatility among them.

Of course, this kind of approach raises issues of practical control, issues which would taken another paper or two to analyse fully. For now, it suffices to say that the key problem is the absence of institutional structure to promote and oversee such an arrangement. The IMF has long ago abdicated such a role, or perhaps more fairly to them been side-tracked away from it. The G7 simply has not had the will to act. So a lot needs to be done to provide understanding and political leadership.

Unfortunately, history suggests fundamental progress will only be made in response to a crisis, bringing me back to the current shaky foundations of the international order. Will the US be able to maintain economic leadership with so little domestic savings? Is the flow of capital towards the US consistent with stronger expansion in Europe and Japan, and with sustained vigorous growth in the developing world? Will the US continue to be seen as a bastion of open markets and the free flow of finance as the trade deficit deepens and indebtedness increases? And perhaps most fundamentally, is the image of the United States as a relatively benign hegemon strong enough to sustain a commitment by most countries to a dollar-centric world? I don't think any of these questions can be answered with a confident ‘Yes'.

I do know that the drift towards greater disequilibrium needs to be checked. I do think some central issues of the world monetary system need to be rethought. And finally I sense the importance of one thing that is surely within the control of the US – and that is the importance of maintaining price stability, an imperative that also applies to Europe, to Japan, to China and to the developing world. We are, after all, dealing with paper currencies. Their value depends upon confidence and credibility. To lose that would surely undermine any prospect of dealing with the present problems. But with success, we can begin to put in place the foundations of a monetary system consistent with the logic of a global economy.

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