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Global: Economic Comment

Time for a New Global Architecture

What's new: Globalization — and the institutions charged with being its stewards — is in need of a new architecture. However, the powers that be are taking only baby steps in that direction. With the odds of a disruptive global rebalancing high and rising, the world can ill afford to gamble with a piecemeal approach to architectural reform. Some recommendations follow.

Analysis: The architecture of globalization was designed for a different world in a now ancient time. (1) It is framed around the Bretton Woods institutions — the IMF and the World Bank — established in 1945. (2) The WTO and the OECD round out the picture. (3) Collectively, these four institutions employ about 16,000 individuals with administrative expenses that easily total around $2.5 billion per annum. (4) There are also the Gs — the G-7, G-8, G-10, and G-20 — who gather periodically with great fanfare yet produce increasingly vacuous, market-following communiqués. (5) The latest G-7 communiqué issued over the weekend was a classic example of that.

Conclusions: There are three principles that should be adapted in framing a new architecture for globalization: (1) *Consolidation* — merging the IMF, World Bank, the WTO and OECD. (2) A *policy mandate* — explicit objectives with respect to global imbalances, price stability, sustainable growth, full employment, the elimination of poverty, and protection of a fragile environment. (3) *Accountability* — a semi-annual report on policy compliance issued by each G-20 country — involving their central banks, fiscal authorities, and foreign exchange reserve managers.

Market implications and risks: Today's interconnected and still fragile world is lacking the steward of globalization it so desperately needs. With oil prices surging, the liquidity cycle turning, and global imbalances mounting, the risks of a disruptive adjustment to the global economy are rising. Sadly, no one is in charge to prevent what could be a dire outcome — or to suggest how to pick up the pieces.

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Time for a New Global Architecture

The world has avoided a major financial crisis for more than seven years. This is due more to luck than design. With oil prices surging, central banks leaning against the upside of the liquidity cycle, and global imbalances mounting, that luck may now be running out. Globalization is, by definition, a dynamic process. That's especially the case in today's era of IT-enabled globalization that is redefining the very concept of economic and financial market integration. Globalization is in need of a new architecture, but the powers that be are taking only baby steps in that direction. With the odds of a disruptive global rebalancing high and rising, the world can ill afford to gamble with a piecemeal approach to architectural reform.

Governance of the global economy, if you want to call it that, currently rests in the hands of the Bretton Woods institutions — the IMF and the World Bank. Established in the immediate aftermath of World War II, these massive bureaucracies were designed for a different world in a now ancient time. The 11-year-old World Trade Organization is the newest kid on the block, but with protectionist risks rising and the Doha Round of trade liberalization going nowhere, this is one of the shakiest elements in the global architecture. There's also the Paris-based OECD, established in 1961, that tabulates statistics and issues reports that focus mainly on its 30 member countries in the developed world. Finally, there are the infamous and rapidly proliferating Gs — the G-7, G-8, G-10, and G-20 — groups of large and important nations who come together periodically with great fanfare, yet produce increasingly vacuous, market-following communiqués on the major issues of our times. The latest such effort, just issued over the weekend, is a classic case in point. Not only did the G-7 make the audacious statement that "…exchange rates should reflect economic fundamentals" but they even went so far as to issue a separate annex on global imbalances that proclaimed these disequilibria were "…the product of a wide array of macroeconomic and microeconomic forces throughout the world economy." Egads! Lest I get accused of being too hard on this council of the world's wise men, I am gratified that at least rebalancing is finally getting the attention it deserves — including the IMF's concomitant endorsement at its just-completed spring meetings of a multilateral consultation process on cross-border imbalances. This are steps — albeit baby steps — in the right direction.

Over the years, there have been frequent calls for the reform of the international financial architecture. These efforts usually come in the aftermath of financial crises, typically cited as failures of an antiquated Bretton Woods arrangement. In that vein, the recent reform movement, timed to coincide with the just-completed annual meetings of the IMF and World Bank, is something of an anomaly — it is off-cycle insofar as not being part of a typical crisis-following effort. Mervyn King, Governor of the Bank of England, led the recent charge, arguing in a speech earlier this year that the IMF was in danger of slipping into obscurity (see his 20 February 2006 speech, "Reform of the International Monetary Fund" available at www.bankofengland.co.uk). IMF Managing Director Rodrigo de Rato has pushed one aspect of this debate forward, proposing a revamping of the voting rights of IMF membership to reflect more equitable participation of the developing world (see his 5 April 2006 paper, "The Managing Director's Report on Implementing the Fund's Medium Term Strategy" available at www.imf.org). Several aspects of this report, including the voting rights revamping proposal, have now received tentative endorsement of the US Treasury as well as the full IMF membership at the recent annual meeting. The wheels of reform turn slowly when it comes to the institutions charged with safeguarding global prosperity.

Far be it from me to have the magic answer. But it strikes me that the four institutional pillars of the global financial and economic architecture — the IMF, the World Bank, the WTO, and the OECD — have lost their way. These huge bureaucracies, who collectively employ about 16,000 individuals with administrative expenses that easily total around $2.5 billion per annum, are hopelessly out of step with the new character and unprecedented hyper-speed of today's IT-enabled globalization (see my 20 March 2006 essay, "Perils of a Different Globalization"). The composition of the euro-centric G-7 — the centerpiece of the global political power structure — says it all: To exclude China and India but to include four European countries — Germany, France, Italy, and the UK — plus Canada is completely out of step with the new infrastructure of the global economy. Europe is one entity — or is at least trying to be; there is no reason for multi-country representation of one economic bloc in modern global institutions. Nor is Canada exactly a dominant player on the global stage. At the same time, China and India, with their combined 40% of the world's population, remain on the outside looking in. They are, in many respects, driving the very globalization that is shaking the world's power structure. But they are brought into the process only as outsiders or observers. Little wonder the anti-globalization protectionists are on the ascendancy. The same can be said for the world's oil producers.

Also missing from the debate over architectural reform is a key point that Harvard President Lawrence Summers has raised recently — the management of excess foreign exchange reserves by developing countries (see his 24 March 2006 speech, "Reflections on Global Account Imbalances and Emerging Markets Reserve Accumulation," available at www.president.harvard.edu). By Summers' reckoning, excess reserves in the developing world — holdings above those that are needed for "financial protection" in the event of another crisis — have soared from around $500 billion in 1999 to more than $2 trillion today. He makes the provocative point that since this huge overhang of excess reserves is parked largely in low-yielding sovereign debt — especially US dollars — the developing world is, in effect, foregoing much higher rates of returns that could be used to boost living standards. Recycling of excess reserves into dollar-based assets may well be a conscious policy choice by export-led developing countries that are fearful of currency appreciation. China is, of course, a leading example of this phenomenon. But Summers asks the questions that should be near the top of the global agenda: Are current reserve management practices making the world a safer place or a more dangerous one? Is the developing world impeding its growth and reforms by clinging to mis-aligned currency values?

These are not academic questions that should be relegated to commissions and think tanks. They require the real-time focus and attention of the stewards of globalization. There are several things that can be done immediately to update the architecture of globalization. I would suggest three principles to guide a long-overdue revamping: First, *consolidation*: The world does not need a multitude of institutions charged with dealing with different facets of the same problem. The IMF, World Bank, WTO, and OECD should be merged and radically streamlined. They have become bureaucratic fiefdoms, ripe for turf wars, which work at cross-purposes and dilute the message. Second, a global economy and its steward need a *policy mandate*. Just as central banks have policy rules, so too should the institutions of the global architecture. In my view, this mandate should include objectives with respect to global imbalances, price stability, sustainable growth, full employment, the elimination of poverty, and protection of a fragile environment. Global goals should be updated in the context of this mandate at least one a year. Third, the new global architecture needs *accountability*. The catch, of course, is that global institutions are lacking in policy instruments. Nations talk globally but act locally. As such, they are unwilling to abdicate control over interest rates, budget deficits, or exchange rates. Someday that may well happen, but for now that's not in the realm of consideration.

The accountability issue is the big sticking point in all this. Why create a new global superstructure if it doesn't have any clout? I think the groundwork is already being laid in this area. Both Mervyn King and Rodrigo de Rato have stressed that the IMF can do a much better job on the monitoring and surveillance fronts — in effect, identifying the points of tensions in the global economy and world financial markets. At the just-concluded annual meetings, the IMF membership came to agreement on the heretofore-messy concept of multilateral surveillance and consultations. While that is encouraging, I would take this process a good deal further. The world needs a clear and coherent statement at least twice a year from one global organization — and it may not end up being the IMF — that both identifies the stresses and strains of globalization and also states what is required of individual countries to temper the risks. The next step will be even trickier. I would propose that the major players of globalization — starting with those at the G-20 level — be required to submit biannual reports on policy compliance with the global mandate. These reports should be submitted by each country's central bank and fiscal authority — as well as by those charged with the task of foreign exchange reserve management. It would be the global counterpart of the Federal Reserve's biannual report to the US Congress on the state of monetary policy.

I am convinced that the world is headed in this direction. I doubt if I will be around, however, to set foot in the Promised Land. In the meantime, I worry that globalization is occurring at such lightning speed that the world's antiquated policy architecture will be incapable of dealing with the inevitable next strain of global problems. The financial crisis of 1997-98, with a currency contagion that spread around the world like wildfire, was but one example of an unprepared world. Unfortunately, as evidenced by the extraordinary compression of emerging market debt spreads, those lessons are now all but forgotten. Meanwhile, oil prices are at levels that were unimaginable just a few years ago, and one nation is running a current account deficit that hit an annual rate of $900 billion in the fourth quarter of 2005 — a shortfall that is actually larger than the GDP of all but nine nations in the world today.

One thing is clear: The next crisis never looks like the last one. Yet we live in a very autoregressive world. Not only do ever-myopic financial markets play the momentum game more than ever, but policy makers always fight the last battle — as evidenced by the ascendancy of inflation targeting at just the moment when inflation is all but dead. Maybe a new global architecture will suffer the same fate. But rest assured, the current one doesn't have a clue. With oil prices surging, the liquidity cycle turning, and global imbalances mounting,

the risks of a disruptive adjustment to the global economy are rising. Sadly, no one is in charge to prevent what could be a dire outcome — or to suggest how to pick up the pieces.

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