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A Vital Task for The IMF

By David Ignatius

Here's a big idea for the next U.S. Treasury secretary: Reform the International Monetary Fund so that it can help the world balance its checkbook -- reducing America's deficits and Asia's surpluses -- before there's a financial crisis that hits everyone from Beijing to Boston.

The leaks and rumors are flying that Treasury Secretary John Snow is on his way out. But replacing the incumbent won't accomplish much if his successor doesn't have a strategy for reducing America's nearly trillion-dollar trade deficit and its counterpart, the huge trade surpluses in Asia. Economists have been arguing about which is the chicken and which the egg -- a "savings glut" abroad or a spending binge in the United States -- but the real point is that these imbalances are inherently unstable. America is buying the rest of the world's products only by writing IOUs on our future. At some point the rest of the world will stop taking our cheap paper.

A starting point for thinking about these global financial issues is a speech given Feb. 20 by Mervyn King, the governor of the Bank of England and, with the departure of Alan Greenspan at the Fed, probably the world's most respected central banker. King argued that the IMF today is an institution without a clear mission. "If not in a deep slumber, then the Fund has appeared drowsy. It is an institution, it is said, which has lost its way."

The IMF's disorientation is in part a result of globalization's success in creating a largely self-regulating system. Under the old Bretton Woods regime and its fixed exchange rates, the IMF's job was to act as financial cop -- imposing austerity measures in exchange for its assistance to countries that consumed more than they produced and ran trade deficits. Back when the IMF was young, the dominant surplus country was the United States, and it could insist that deficit countries make any necessary adjustments. When postwar Britain, say, went into deficit, the IMF could demand policy changes to raise unemployment and suppress consumer demand until balance was restored.

The old financial architecture collapsed during America's last big unfunded war, in Vietnam. When the United States abandoned the gold standard in 1971, the rigid backbone of the system disappeared. It was replaced by flexible exchange rates, which usually allowed gradual adjustment of imbalances. A country that was importing more than it was exporting would suffer a decline in its exchange rate. Domestic demand for more expensive imports would drop, and foreign demand for cheaper exports would rise, until the deficit was erased. In this self-balancing world, the IMF's main role was lending money to profligate countries that fell into chronic deficit.

The problem with this new system can be summed up in two words: America and China. The United States began running very large trade deficits, while China began accumulating very large surpluses. Some analysts argued that this is an unwritten "Bretton Woods II" deal to encourage export-led growth in China. But it lacks the usual self-balancing mechanisms. Since the deficit country (America) maintains the world's reserve currency, and the surplus country (China) is willing to hold these dollars, the usual debtor-creditor pressure doesn't exist. The imbalances have gotten larger and larger -- and analysts fret that the adjustment, when it finally comes, will bust the world financial system like a broken piggy bank.

King's speech set off a lively discussion of how a revitalized IMF might take the lead in organizing a global effort to reduce these imbalances before they reach a crash point. Lawrence Summers joined the debate last month with a speech that showed why he remains one of the world's best economists, even as he prepares to depart as Harvard's president. His address forcefully explains why the current situation, in which the world's most powerful economy funds its huge deficits by sucking in the world's savings, "cannot go on forever."

King argues that the IMF, as a neutral convener, could bring all the financial parties to the table and coordinate a gradual adjustment process. It could encourage European nations to stimulate their domestic economies; it could press China to raise exchange rates and make domestic demand its growth engine, rather than continuing the export binge that has triggered a protectionist reaction in America and Europe; and, perhaps most important, it could foster a gradual increase in U.S. savings and a corresponding reduction in U.S. demand for imports -- so that the towering American deficit shrinks gradually, rather than toppling in a cataclysm.

America is still the leader of the global financial system, but it hasn't been acting like one. Now is the time for the Bush administration to help create a new IMF that can repair the international structure before the hurricane hits.