For The International Economy, March 1, 2007

Jeffrey Frankel, Harpel Chair of Capital Formation and Growth, Harvard University; and Director of the Program in International Finance and Macroeconomics of the National Bureau of Economic Research.

Q: Have Financial Developments Made the International Monetary Fund Obsolete?

A: The IMF is by no means obsolete. That its resources are dwarfed by the magnitude of international financial markets is nothing new. It has redefined it mission not just once, with the break-up of the Bretton Woods system, but repeatedly: by switching emphasis to the balance of payments problems of developing countries who ran up large debts in the late 1970s, by adding the problems of the transition economies after 1991, and by adding above-quota rescue packages and structural conditionality in its response to the emerging market crises of 1995-2002. The Fund has always evolved with the times. This is appropriate and not primarily an example of mission creep. It is foolhardy to think, just because emerging market spreads have been very low recently, that there will be no more crises in the future; the international debt cycle tends to take 15 years to repeat itself. It is likewise foolhardy to let the absence of outstanding business dictate the scope of operations; by all means sell gold if necessary to finance the institution.

That said, the Fund was handed a new mandate in the spring of 2006, both by its governing body and by the G-7, which could restore it to central importance in the management of the world monetary system. But it would have to seize the opportunity more aggressively than it has, while yet continuing to navigate the treacherous big-power politics carefully. The mandate was to reconsider the 1977 Decision on Surveillance, and thereby look into the issue of global current account imbalances through a multilateral consultation process. In practical terms, this means that the US Treasury in early 2006 passed the RMB hot potato on to the IMF, giving that institution a rare potential opportunity to help mid-wife or broker a multilateral agreement over the Chinese currency and also G-7 imbalances. Many economists identify the large US current account deficit as far more a result of deficient US national saving than of China's support of the dollar against its own currency. A cooperative agreement might entail concrete steps by the US government to raise national saving, together with a decision by China jointly with other Asian countries -- and oil-exporters which are running even larger surpluses -- to allow their currencies to appreciate simultaneously. Negotiations over such an agreement cannot take place in the G7 because China, Korea, Saudi Arabia and the others are not members. The IMF is the logical place.

Agreeing on such multilateral cooperation will not be easy. Neither side can be dictated to, and both will be reluctant to make the necessary concessions voluntarily. The United States will not give up easily on the politically attractive idea of China as scapegoat for its trade imbalance, represented numerically by the bilateral deficit. China for its part will not give up easily on its sovereign right to move as slowly on currency reform as it deems in its interest. But the idea need not be "stillborn." Both sides also have something important to lose if the issue is not settled. China's leaders run the danger of losing free access to the largest and most important export market. The American leaders run the risk of the political momentum behind the scapegoat strategy backfiring, in the form of either self-inflicted protectionist legislation or a hard landing for the dollar and US securities in global financial markets, or both. The RMB/dollar rate and associated imbalances is a better subject for multilateral surveillance and international cooperation than any subject to come along in many years, and it is more likely to be amenable to progress in the forum of the IMF than anywhere else.