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International Economic Institutions and Arrangements: New Choices in a New World

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In 1944, as World War II was coming to an end, an international conference was convened in Bretton Woods, New Hampshire, to plan the structure of the postwar international economic environment. Earlier arrangements for international trade and payments had collapsed disastrously during the 1930s, and the conferees sought to devise a set of institutions and arrangements for the future that would prove more robust. The conferees also recognized that the end of hostilities would face the world with a reconstruction task of unprecedented magnitude. All nations had a stake in the success of this reconstruction, and means had to be found for channeling global resources into the reconstruction effort. The institutions and arrangements that grew out of the Bretton Woods conference—the International Monetary Fund (IMF), the International Bank for Reconstruction and Development (IBRD or World Bank), and, less directly, the General Agreement on Tariffs and Trade (GATT)—have served as the principal pillars of the international economic environment for the past 45 years.

For the most part, these institutions and arrangements have served us well. In most of the world (or at least in most of the countries that participated in the Bretton Woods institutions), overall economic activity has expanded and material welfare has improved at rates that are high by almost any historical standard. International trade and investment have flourished. The economies devastated by World War II were rebuilt, and development assistance has been extended to many other countries. Most important, we have avoided economic catastrophes on the scale of the Great Depression.

But both the nature and the scale of international economic activity have changed enormously in 45 years, and it would be surprising indeed if institutions and arrangements first designed in 1944 were still adequate to the task of managing today's international economy. The Bretton Woods institutions have changed, of course, with the times. Old roles have been abandoned and new ones undertaken. New institutions have been created. Policies have changed in the face of new thinking, new circumstances, and new problems. Much of this change has been ad hoc in nature, though, and uncoordinated. What was once a more or less coherent set of institutions and arrangements for managing the world economy has begun to show gaps, redundancies, and misalignments. The system of international economic institutions devised at Bretton Woods is beginning to show its age, and there is a growing perception that the time has come

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for a comprehensive rethinking of how we manage the international economy.

We are today at a crossroads not entirely unlike the one perceived by the original Bretton Woods conferees. The collapse of the Soviet empire and the end of the Cold War provide an opportunity for a reconsideration of all international relations—political, military, and economic. Confronted with a new world, we have a chance to shape a new system of international economic institutions as part of a new system of overall international relations—as part of a "new world order." More ominously, the end of World War II presented the Bretton Woods conferees with the real prospect of political and social turmoil if reconstruction efforts failed. The collapse of communism presents the current generation of policymakers with a similar specter. We face, then, not only an opportunity but also an urgent need to consider the adequacy of existing international economic institutions and arrangements.

The Need for Cooperative Action

More so than ever before, national economies are interdependent. Economic forces do not stop at national boundaries, and developments in any part of the increasingly integrated global economy are likely to have consequences elsewhere. The notion is widely accepted that a smoothly functioning international economic environment is an "international public good"—an end that cannot be achieved solely through unilateral actions by individual nations—and the need for some degree of international cooperation is not disputed. The original Bretton Woods conferees recognized the need for international cooperation and concerted action to achieve three primary ends: to create a system of exchange rates and international payments that would facilitate international trade and investment; to establish a set of rules to govern international trading relations; and to provide the international credit necessary to support national efforts at economic reconstruction and development. Today, we might add to these tasks the effective regulation of transnational economic activity, which is increasingly beyond the reach of purely national authorities. Although there is general agreement about the need for some international cooperation to accomplish these four tasks, there is considerable controversy over the nature, the extent, and the specific objectives of this cooperation and over the international institutions required to manage it.

In each of the four principal areas in which international economic cooperation is potentially desirable, fundamental policy choices will have to be made in the next few years. These choices will go a long way toward determining whether and how international economic institutions and arrangements will need to be restructured to manage the world economy in the 21st century. Let us consider what these policy choices are likely to be and the fundamental differences in outlook that lie behind debates over them.

Exchange Rates, International Payments, and Macroeconomic Coordination

In 1973, the worldwide system of fixed exchange rates that had grown out of the Bretton Woods conference collapsed. With it collapsed any consensus on whether or how exchange rates should be managed. Many countries continue to fix the value of their currencies in relation to one or a group of major currencies. But since 1973, the world's major currencies—the dollar, the yen, and the deutsche mark—have floated more or less freely against each other, with exchange rates among them determined primarily by market forces.

Early proponents of floating exchange rates had hoped that market forces would bring about automatic and continuous adjustments of exchange rates. Overall exchange-rate stability would be enhanced, they hoped, because continuous adjustment of exchange rates would keep pressures for large changes from building up. The world would be spared, it was argued, the politically and economically wrenching currency crises that so often preceded exchange-rate adjustments in the overly rigid Bretton Woods system of fixed exchange rates. Floating exchange rates would also give national authorities the freedom to engineer at least temporary changes in the real purchasing power of their currencies and thereby provide opportunities to cushion somewhat the consequences of occasional supply and demand shocks.

But the theoretical promise of floating exchange rates has not been realized. Day-to-day, week-to-week, and month-to-month volatility of exchange rates has been much higher than most proponents of floating exchange rates had expected. Real exchange rates—the relative purchasing power of currencies[1]—have shown very large swings that have persisted for years at a time,

[1] Changes in the real exchange rate between two currencies are calculated by adjusting the changes in the nominal exchange rate for changes in the overall price levels in the two countries. Thus, changes in real exchange rates reflect changes in the relative purchasing power of the currencies in question. If, for example, the general price level in the United States rises by 5 percent while the general price level in Japan remains unchanged, and if the nominal yen/dollar exchange rate remains the same, then the real value of the yen will have fallen by 5 percent relative to the dollar because a fixed number of yen converted into dollars will buy 5 percent less than it did previously. Because real exchange rates reflect costs faced by consumers in one country who are contemplating buying goods produced in another country, they are viewed as important determinants of trade flows.

only to be subsequently reversed. The real value of the dollar, for example, rose 72 percent against the yen from late 1978 to early 1985 and then declined by 46 percent in a space of just three years, from early 1985 to early 1988.

Exchange rate swings of this magnitude can play havoc with investment decisions and production plans. An investor considering the construction of a new automobile plant, for example, faces the prospect that an exchange-rate change sometime during the five years or so it may take to build the plant and bring it into operation could wipe out any prospect of profitably competing with foreign auto producers. It would not be surprising in these circumstances if investors were reluctant to commit themselves. If investment in new plant and equipment lags, productivity growth will also falter. While it is impossible confidently to attribute causality in these matters, and while many other factors are obviously at work, some observers have noted that the much-discussed worldwide decline in growth rates of manufacturing productivity is at least roughly contemporaneous with the period of floating exchange rates.

When investment decisions have been made, a major exchange-rate swing can wipe out the competitive viability of entire industries. The dollar's sharp appreciation in the early 1980s made U.S. products very expensive in world markets, with dire consequences for many industries and communities in the U.S. "rust belt."

Large exchange-rate movements may also pose a threat to the maintenance of a liberal trading regime. National governments cannot easily remain indifferent to the fates of major industries injured by exchange-rate swings and may be hard pressed to resist calls for protectionist policies in the face of major exchange-rate movements. Worse, because tariffs will provide little protection against the consequences of large exchange-rate swings, governments may be increasingly prone to rely on quantitative import restrictions—generally regarded as the worst of all possible trade restrictions—to protect domestic industries threatened by exchange-rate changes. Some observers have suggested that it is no accident that we are seeing an increased reliance on quantitative trade restrictions and managed trade arrangements since the collapse of the system of fixed exchange rates.

Few would argue with the proposition that more stable and predictable exchange rates would be desirable. There is great controversy, however, over how best to pursue increased stability. One camp favors setting explicit targets for exchange rates and adjusting national economic policies as necessary to maintain them. Another camp would place renewed emphasis on efforts by all nations to pursue policies designed to foster noninflationary growth. Such policies, this second camp argues, will eventually bring more stable exchange rates, without the need for formal targets. Where one comes out on this issue hinges critically on one's beliefs about the principal problems that economic policymakers will face in coming years.

Proponents of explicit targets for exchange rates and direct pursuit of these targets fear that continued exchange-rate instability poses a severe and immediate threat to the maintenance of a liberal, market-driven international trading regime. It may well be that sound national economic policies will eventually bring about exchange-rate stability, but we may not have the luxury of waiting for this desirable result. The threat to the trading regime is clear and present, manifested in the increasing resort to quantitative trade restrictions and preferential trading arrangements. Moreover, there is no guarantee that nations will in fact pursue the kinds of policies conducive to noninflationary growth and which will lead eventually to stable exchange rates. (Indeed, there is not yet any clear consensus on what sorts of policies will produce these desirable outcomes.) In this view, the kinds of economic shocks that are most likely in coming years will be generated by erratic national monetary policies, precisely the sorts of policy mistakes that the discipline of having to maintain stable exchange rates would make less likely. Proponents of formal arrangements to stabilize exchange rates believe that the major nonmonetary shocks—shocks in the supply of or demand for real goods and services—that affect countries differentially and necessitate major exchange-rate realignments will be rare in the future. (The most recent example of such a shock is German reunification, which placed a unique burden on Germany and in September 1992 wrought havoc with efforts to maintain fixed exchange rates among European currencies.)

Opponents of targets discount the dangers to international trade posed by floating exchange rates. The causal link, they say, between volatile exchange rates and protectionist policies has not been demonstrated; and since the postulated link is political in nature, it is most correctly broken by political measures. They argue further that the world is an uncertain place, that shocks of all sorts can come from all directions, and that it is politically naive to believe that national governments will abide by international agreements that limit their freedom of economic policy maneuver. As circumstances change, exchange rates *should* change, and no international agreement is likely to prevent a nation's going its own way when an adjusted exchange rate will serve its national interests. (The recent collapse of the European Exchange Rate Mechanism will provide a strong argument for this view.) Much better, they suggest, to take the long view, to make noninflationary growth the primary target of

national and international economic policy, and to let exchange rates take care of themselves.

The International Trading Environment

The vision of an international trading structure that emerged from the Bretton Woods conference and that was later codified in the General Agreement on Tariffs and Trade (GATT) rests on the basic principles of multilateralism and nondiscrimination. Trade concessions are to be negotiated in a multilateral setting, and concessions granted to one country are generally to be granted to all countries acceding to the GATT. In recent years, however, questions have been raised about the continued viability of this approach to setting international trade rules.

Well suited to negotiating reductions in visible and easy-to-quantify trade barriers such as tariffs, the GATT process is in danger of falling victim to its own past success. The task of eliminating explicit tariffs is largely finished, and trade negotiators now must deal with a bewildering multiplicity of nontariff obstacles to trade that are almost impossible to quantify and sometimes hard even to identify. Broad agreements of the "We'll all cut tariffs by 50 percent" sort are no longer of much use. Instead, individual national policies that (intentionally or otherwise) restrict trade in specific products have to be discussed one by one and remedies identified and agreed to, often on a bilateral basis. Multilateral negotiations do not provide the best forum for such painstaking and highly specific horse trading. It is perhaps not a surprise that the current round of multilateral trade negotiations (the so-called Uruguay Round) has been effectively stalled for more than three years. Further, remedies agreed to in bilateral negotiations (for example, an agreement by the Japanese government to encourage increased imports of U.S.-made auto parts) are often inherently discriminatory, favoring the products of a particular exporting nation.

Even the most fundamental principle underlying the GATT—that trade patterns should be determined primarily by market forces and not by government policies—is under considerable attack these days. Despite serious questions about the practical effectiveness of such policies, enthusiasm seems to be growing worldwide for "strategic" trade policies, through which governments provide assistance—usually in the form of subsidies or protection from foreign competition—for "key" or "critical" industries where capturing a large share of the initial world market may bestow important competitive advantage.

For all its creakiness, however, and for all the difficulties we face in adhering to GATT principles in the modern environment, the GATT still provides the only practical foundation for trade policy in the coming years. Few serious observers question the importance of bringing the current round of GATT-sponsored trade negotiations to a successful conclusion. Surely, though, the GATT by itself will not be adequate to meet all the challenges we will face in the early years of the new century. The real policy questions are whether and how GATT should be supplemented by other kinds of international trading arrangements.

Debates have arisen about the wisdom and practicality of extending GATT coverage to agricultural trade and trade in services, both now effectively excluded from the GATT. Proposals have also been floated to create a "GATT-like" framework of rules to govern international investment. Other proposals include the establishment of some rules to define allowable governmental actions in pursuit of "strategic" trade policies and the creation of a "GATT-within-GATT" that would allow some countries to extend additional trade concessions to each other without having to wait for all countries to agree on the concessions or rules of conduct in question. Almost all observers agree that the enforcement powers of the GATT should be strengthened, but there is little consensus about specific enforcement mechanisms.

The sharpest debates over the future course of trade policy, however, are over the wisdom of pursuing, outside of the larger GATT framework, preferential trading arrangements or free-trade arrangements among small groups of countries. The models for such preferential arrangements are the single European market and the North American free-trade area. Other preferential arrangements—not all of them regional in nature—have been proposed and discussed.

Proponents of free-trade zones tend to emphasize the cumbersome nature of the GATT process and the difficulties of applying GATT principles to the realities of modern trade. To postpone all progress toward expanded international trade until all parties to the GATT can reach agreement on a broad agenda of reforms (if such agreement is in fact possible) is to needlessly delay achievable progress and to increase the danger that growing trade friction will undermine the trade we already enjoy. Proponents of preferential trading arrangements propose to seek trade expansion on a piecemeal basis, seeking mutually beneficial (although inevitably discriminatory) agreements among groups of like-minded and politically committed nations whenever the opportunity arises. At the core of support for this approach lies a judgment (or a hope) that over time, additional countries will associate themselves with free-trade arrangements and that piece-by-piece progress will cumulatively approach the ultimate

objective of freer world trade. Proponents of preferential trading arrangements favor efforts by the United States and the European Community to add additional countries to their existing free-trade areas. Asian or Pacific Rim free-trade arrangements might also prove profitable.

Opponents of preferential trading arrangements consider these hopes naive and dangerous. In their view, increased trade among participants in a free-trade arrangement will come largely at the expense of countries outside the new arrangement; parties to the free-trade agreement will buy from each other what they used to buy from other countries. As these opponents see it, the creation of political and administrative mechanisms to advance the common interests of members of a trade bloc are more likely than not to lead to actions that will discriminate against and restrict imports from nonmembers. (Nonmembers, after all, will typically not have a seat at the table when members sit down to discuss trade policies.) In the natural course of political events, opponents argue, preferential trading blocs will tend to become increasingly exclusionary. Pursuit of special trading arrangements will not, therefore, advance the GATT ideal of freer world trade. It will instead promote the division of the world into a number of isolated trading zones, each maintaining barriers against imports from the others. These opponents think it foolish for the United States or the European Community to waste their political and bureaucratic energies on negotiating expansions of existing trade blocs. They urge the United States and Japan to do what they can to discourage talk of Asian or Pacific Rim free-trade areas. At the very least, these opponents argue that Article XXIV of the GATT—the article that specifically authorizes the formation of free-trade areas—be strengthened to specify that, after the formation of a free-trade area, common barriers against imports from outside the area must be no higher than the lowest barriers that prevailed in the participating countries before the preferential trading deal was concluded.[2]

Access to International Credit

At the time of the original Bretton Woods conference, private international capital and credit markets were only poorly developed and completely inadequate to meet the financing needs of countries contemplating large-scale reconstruction or development programs. Consequently, the conferees established an official source of credit for reconstruction and development efforts: a multilateral development bank, the World Bank, backed by national governments and managed by international civil servants. The multilateral nature of the World Bank allowed it to extend credit without the political baggage that might be associated with direct loans from one government to another. In the years that followed, a number of other regional but still multilateral development banks were also created.

Today, private international capital and credit markets are well developed. They can and do provide credit to developing countries in amounts far larger than can be had through official channels, and questions have legitimately arisen as to whether there is any longer a need for substantial official development lending. Underlying the debate over this issue is a fundamental difference of views about the relative abilities of official and private lenders to recognize and to fund promising development efforts.

Proponents of official lending argue that private credit and capital are not realistic possibilities for some kinds of long-term development financing needs. Direct investors will never be attracted to major infrastructure projects (like building roads, bridges, or irrigation systems) or social development efforts (like improving health facilities). And few developing countries are able to float long-term bonds. Consequently, developing and reforming economies will typically be dependent on medium-term bank credit. But international banks are fickle in their willingness to lend. Further, they can display herd-like behavior, being too willing to lend at some times and much too reluctant at others. As a result, occasional liquidity crises will threaten national development and reform efforts and international financial stability (as during the international "debt crisis" of the early and mid-1980s). Official lenders, it is argued, will be less subject to wide swings in market sentiment, can provide liquidity during credit droughts, and can thereby stabilize both development programs and international financial markets when private lenders run for cover.

Opponents of official international lending argue that the subsidy implicit in lending from these sources may encourage overborrowing by developing countries, and that the willingness of official institutions to lend allows countries to postpone needed economic reforms. The discipline of the private market, they suggest, would force a more rapid adoption of necessary reforms and hence more rapid economic development. Also troubling to opponents of official lending is the fact that, because the multilateral development banks are creations of governments, they most naturally deal with

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[2] Article XXIV currently requires only that barriers to goods produced outside the area be no higher than the *average* of barriers that prevailed in the participating countries. The article does not specify how the average is to be calculated.

and lend to national governments. Increasingly, though, governments in reforming and developing economies are seen as part of the problem, not the solution. Rather than lending to entrenched governments that may have done much to cause existing problems, the argument goes, it may be preferable to lend to private enterprises, which may then set a new, more market-oriented tone for the economy.

Opponents of official lending recognize that even today all countries do not have access to private international credit markets. They argue, however, that access is denied to some countries because they are viewed (usually correctly) as poor credit risks with little prospect of repaying loans. Official assistance to such countries is desirable, and there are advantages to providing it through multilateral channels. But the assistance should properly come in the form of grants rather than loans. Making loans to countries that are not creditworthy is at best dishonest (because there is little likelihood that they will be repaid) and at worst counterproductive (because debtor countries may in fact try to repay them). Better, these opponents conclude, for official institutions to get out of the international lending business, restricting themselves to collecting, analyzing, and disseminating information about specific borrowers and specific projects, providing technical advice to developing and reforming countries, and possibly serving as a channel for grants (not loans) to countries that have no realistic access to private credit markets.

Also contentious is the role that international financial institutions—and the IMF in particular—have come to play in determining which countries have access to private credit and capital markets. Originally intended to provide short-term financing to countries facing liquidity problems arising from their responsibilities to maintain fixed exchange rates, the IMF has been searching for a new institutional purpose since the collapse of the fixed-exchange-rate system in 1973. In the 1980s, the Fund became the focal point for efforts to manage developing-country debts: helping to negotiate reschedulings and debt restructurings, providing some interim financing from its own resources, encouraging private lenders to extend further credit, setting standards for macroeconomic policy in debtor nations, and monitoring adherence to these standards. In the 1990s, the Fund is emerging as the principal international agency assisting in the restructuring of the formerly centrally planned economies. In both of these new roles, the IMF stands as the principal international arbiter of what constitutes acceptable economic policy for developing and reforming countries. Private lenders are frequently reluctant to extend credit to countries whose policies have not been vetted by the IMF. Some observers find this a useful role for the IMF; borrowing countries find it harder to escape market discipline by playing one private lender off against another. Others, however, are uncomfortable with dominance the IMF has gained in this regard. They note that there is no monopoly on wisdom about the nature of successful economic reform or development programs and that there is no reason to believe that IMF prescriptions will be optimal in all cases. They would prefer to see the IMF play a less central role in determining reform and development strategies.

International Regulation

Recent years have seen a rapid internationalization of economic activities. Firms now straddle international boundaries, fully integrating operations located in multiple countries. Production, information, finance, and people have become increasingly mobile. As a consequence, national authorities are no longer able effectively to regulate some kinds of international business.

This is not altogether a bad thing. Governments frequently attempt to over-regulate economic activities, and the ability to move activities to other countries serves to check more extreme regulatory tendencies. But in some industries (banking is a currently painful example), the need for at least some regulation is widely accepted. When banks operate in many countries, however, effective regulation by national authorities in any single country becomes problematic. The result is an occasional debacle, like the recent BCCI scandal. In such cases, some degree of international regulatory cooperation may be required.

Although there is general agreement on a number of basic principles regarding when and how to seek international regulatory cooperation, there remain intense disagreements about how to apply these principles in particular cases. Among the more controversial proposals for international cooperation are: cooperation among national tax authorities to guarantee the taxation of overseas capital and to discourage "capital flight" from national taxes or regulations; efforts to control the trade in arms and "dual-use" technology; and general efforts to "harmonize" national regulatory regimes.

In these debates, differences in outlook with regard to the competence and benignity of governments become critical. Those who believe that governments (or at least many governments) are generally to be trusted to act wisely and to advance the interests of their citizens are typically in favor of increased international regulatory cooperation. Such cooperation will allow

these governments to pursue their laudable ends more effectively. On the other hand, those who are disposed to be suspicious of government motivations and methods prefer to weaken some kinds of international regulatory cooperation because they fear that concerted action will increase the ability of governments to pursue foolish or wrong-headed policies.

A New Bretton Woods?

The international economic environment is much changed from the way it was when the original Bretton Woods conference was convened in 1944. Largely, these changes have been for the better. International trade and investment have expanded rapidly, creating wider choices for consumers and new markets for producers. The global economy has become more integrated, and economic activity may now proceed with much less concern for artificial (at least for economic purposes) political boundaries. Although no one would describe the current international economic environment as tranquil, we have managed throughout the postwar years to avoid the sort of global economic collapse that marked the 1930s.

To a large extent, the salutary changes in the international economic environment came about because of the structures and institutions first envisioned at Bretton Woods. But the new environment poses challenges for the management of international economic relations well beyond what the Bretton Woods conferees imagined. The time has come to revisit the discussions and debates that shaped the original conference. Doubtless, some components of existing international economic institutions will continue to serve us well in the 21st century. Just as certainly, though, other components are in need of a major overhaul. The task of structuring the international economic environment for the 21st century is necessarily a collective undertaking. Unlike the situation in the late 1940s, when the U.S. economy dominated the world, no nation is in a position today to dictate this new structure to the rest of the world or, through its forbearance, to make the structure work despite deviations by other nations from agreed policies. The time has come to begin a new Bretton Woods process, in which scholars and policymakers from all over the world debate the character and purposes of international economic institutions in the next century.

For a more complete discussion of these issues, see C. R. Neu, A New Bretton Woods: Rethinking International Economic Institutions and Arrangements, *RAND, MR-116-RC, 1993.*

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