

FORMULATING INTERNATIONAL ECONOMIC POLICY IN
THE TWENTY-FIRST CENTURY

Anne O. Krueger
Professor of International Economics
Paul H. Nitze School of Advanced International Studies
Johns Hopkins University

Keynote address to be delivered at the Conference on Chinese Policy Reform
Tsinghua University, Beijing, China
April 13, 2009

Beijing talk 4/15
4/8/09

FORMULATING INTERNATIONAL ECONOMIC POLICY IN
THE TWENTY-FIRST CENTURY¹

Anne. O. Krueger*

It is a great honor and pleasure to be here today and to address this distinguished audience. My subject is of great importance and concern for the entire world economy. Interdependence among countries, for trade, for capital flows, for sources of innovation, and much more, has increased greatly over the past half century, while governance has changed little. The current financial crisis has demonstrated once again how interdependent the entire world economy is and that we are all in the same boat.

Despite the crisis, as I shall argue, the international economy has provided a very hospitable environment for economic growth over the past sixty years for those wishing to take advantage of it. The governance structure formulated at the end of the Second World War served the international economy very well, but is, as is widely recognized, in need of updating to reflect changes in global realities.

I shall start with a discussion of the successful growth of the international economy over the past sixty or so years. I will then address the ways in which countries were able to benefit from the benign global setting, and the changes in relative economic positions that brought about.

*Professor of International Economics, School for Advanced International Studies, Johns Hopkins University, and Senior Research Fellow and Emeritus Professor of Economics, Stanford University.

¹ I am indebted to Lei Ye of Stanford University for very helpful research assistance in the preparation of this talk.

With that background, we can turn to the future. A first question is how much international governance there can be. The resolution of that issue goes far toward providing the outlines for international economic policy formulation in the twenty first century. Thereafter, I shall address the major issues that call for international economic cooperation: trade, capital and financial flows, monetary and exchange rate issues, and supporting development of the very poor countries that have failed thus far to avail themselves of the opportunities for rapid growth provided by the international economy.

On that basis, modalities for international economic cooperation, and the pressing economic issues that need addressing for a successful twenty first century, can be considered.

The Phenomenal Sixty Years

At the end of the Second World War, the economic geography of the world was very bleak, with the partial exception of North America and Australia/New Zealand. Europe, Japan, China, and Korea had experienced serious losses of capital stock and economic dislocation. Africa and South Asia were mostly still colonies and very poor (as were Japan, China and Korea). Latin American living standards were better, but that was largely the result of high commodity prices. The Soviet Union and the Eastern European countries had suffered major damage and dislocation during the war, and were then insulating themselves from the international economy, with negative effects, especially for Eastern Europe. As you know, the Soviet Union and the Eastern European countries in COMECON were effectively separate from the rest of the international economy until the 1990s, so I shall leave them out of the story until later.

As of the mid-1940s, the United States had the only large economy that survived the war without major damage (although even for the United States, many economists predicted a return to depression or at least recession immediately after the war with a doctrine known as secular stagnation). There was concern about prospects for Europeans' ability to survive the winters of 1945 and 1946, as earnings from exports were small, and both food and heating materials were in very short supply. Japan, too, was war-ravaged.

The United States was able to provide the necessary leadership as the only major economic power. The U.S. was estimated to be producing more than 40 percent of the world's GDP, held about 75 percent of the world's gold (then the major form of international reserve), and in 1948 accounted for almost 22 percent of world exports (and a large, but much smaller, percentage of world imports). The country had large current account and balance-of-payments surpluses as it was virtually the only source of food and other necessities for the war-torn countries.

Even with sixty years' hindsight, the American role in shaping the postwar international economy looks impressive in its farsightedness. In 1945-46, European countries were so short of foreign exchange that they traded primarily with each other in (highly inefficient) bilateral, often barter, trading arrangements. The equipment and other goods necessary to repair the capital stock materialized slowly. Finally; the U.S. adopted the Marshall Plan, which financed many of the necessary imports and enabled European reconstruction to begin in earnest.

Relative to the behavior of victors in earlier wars, American behavior was far more altruistic. Instead of reparations, the U.S. extended aid for reconstruction, while also using its influence to persuade the European governments to move to more effective

economic policies. These included the abandonment of bilateral for multilateral clearing arrangements, as well as reduction of other barriers to trade. It is often forgotten how restrictive trade and payments regimes were in the immediate postwar period: barter trading arrangements, quantitative restrictions, and other controls were pervasive for current account transactions. Even as of the late as the late 1950s, only 4 countries had currency convertibility on current and capital account.

Even before the end of the war, however, Americans had provided leadership in devising a postwar international framework in the hope that the economic disasters of the 1930s and the political disasters leading up to the Second World War would not be repeated. The United States took the leadership in organizing a multinational conference in San Francisco in 1943 which founded the United Nations, while the Bretton Woods conference in 1944 agreed on the Articles of Agreement for the International Monetary Fund and World Bank. Preparations were made during the war for a separate conference late in 1945 that was convened with 23 countries. There, the articles that later became the charter for the General Agreement on Tariffs and Trade (GATT) in 1947 and then part of the charter for the World Trade Organization (WTO) in 1994 were drawn up.²

Lack of time precludes more than a summary of the main characteristics of the organizations. The World Bank was intended to provide long-term capital for reconstruction and development, largely because it was believed that private long term capital flows would not resume after the experiences of the 1930s. The International Monetary Fund was intended to enable international monetary cooperation so that the

² The 1945 conference proposed articles for an International Trade Organization but these were never ratified. The part of the proposed Articles pertaining to trade arrangements was taken to form the GATT

calamitous beggar-thy-neighbor competitive devaluations and protectionist measures of the 1930s could never again happen.

As you know, the IMF articles initially called for nations to maintain fixed exchange rates (under a gold exchange standard, although the degree to which the dollar would become the premier, or key, currency was not anticipated) that could be changed only “in cases of fundamental disequilibrium” with the consent of the IMF; if countries encountered temporary balance of payments difficulties, they were to consult the IMF and receive financial support to enable them to bridge them by consulting with, and receiving financial support from, the IMF..

The Bretton Woods system of fixed-but-adjustable exchange rates lasted until the early 1970s. During the first 25 years of the system (with reductions in trade barriers that were undertaken both unilaterally and under GATT), the system delivered magnificently relative to past economic history for the developed countries. I shall recount some of the salient features of that growth in a few moments, but first, attention must turn to the governance of the system during the first twenty five years.

The governing structure of the IMF and the World Bank differed from that of the GATT. The GATT (and now the WTO's) structure was based on the principles of one country-one vote and unanimity. In effect, everything agreed in a multilateral tariff negotiation had to be agreed by all parties before a round of trade negotiations could be completed. With its earlier small membership, this regime worked partly because of the economic importance of a few countries, and partly because, as I shall discuss below, developing countries in effect benefited from tariff reductions and other trade liberalization undertaken by industrial countries but were not expected to reciprocate and

were in effect exempted from GATT discipline. As developing countries have grown in importance, governance of the WTO is also in need of amendment, as I shall discuss later.

The IMF and World Bank governance structures were to be very similar to each other. For most purposes, they can be regarded as being the same, and I shall discuss IMF governance here. In both cases, countries became members by purchasing their “quota” in the organizations. The quota of a country as a percentage of all quotas determined its share of the votes. Quotas were “paid in” by subscription, partly in local currency and partly in convertible currencies. Quotas were based on a formula in which there were “basic votes” (the same number for each country which in effect meant that smaller countries were somewhat overrepresented relative to the other criteria), and then a share based on the country’s importance in world trade and its share of world GDP.

Once quotas were determined (and they were to be reviewed every 5 years), countries participated in the governing structure.³ All members (usually through their Finance Ministers, who were the Governors) participated in the Annual Meetings of the Bank and the Fund. But because membership was large and growing, an Executive Board and a Committee representing the members were formed.

The Executive Board was appointed by the members; the five members with the five largest quotas were entitled to individual seats on the Executive Board; other countries banded together to select their Executive Director (there are currently 24 seats on the Executive Board and 185 members of the IMF). The Committee earlier called the Interim Committee and now the International Monetary and Finance Committee (IMFC) meets just prior to the Annual Meetings and once halfway through the year. Its

³ In the 1940s, the United States and the United Kingdom jointly held more than 50 percent of the votes. As other industrial countries grew rapidly, their shares increased and the shares of the U.S. and U. K. each declined. The U.S. share is now just over 15 per cent

membership is the Governors of the countries represented on the Executive Board of their designees (usually the Finance Minister of another member of the constituency if the Governor must absent himself for part of the proceedings).

For many decisions, a majority vote of the Board (or the Governors) is sufficient. For some issues, however, larger majorities are called for. For some major decisions, 85 percent approval is required (which gives the United States, or any group of countries with more than 15 percent of the vote, an effective veto).

For many purposes, this governance structure worked well. Political scientists believe that the IMF and World Bank functioned as well as they did in significant part because the voting structure more accurately reflected the economic power of the members than would an alternative one country-one vote structure. Certainly the large industrial countries had the lion's share of the votes; they were also, however, the countries with the resources that were needed to enable the IMF and World Bank to play their roles.

Indeed, in the early postwar years, the United States eclipsed the IMF, as that country alone had the resources to finance post-war recovery under the Marshall Plan. U.S. financing dwarfed that of the Fund in its early years and the Fund's role in the international economy did not become highly significant until reconstruction had been largely accomplished.

Before considering governance further, it is worthwhile to return to the main theme for the earlier period; the quarter century from the late 1940s to 1973 was a "golden era" in the international economy. European countries' growth accelerated in the late 1940s and early 1950s, spurred both by the Marshall Plan support and their own

reconstruction efforts. But when prewar levels of production were reattained in the mid-1950s, growth did not slow. Japanese growth had also been strong in the 1950s, and averaged above 10 percent annually in the 1960s; the other industrial countries, whose per capita incomes were much higher in 1960, nonetheless averaged 4.5 percent annually between 1960 and 1970, while Euro area countries grew at 5.7 percent.

All these growth rates were well above those experienced even in the heyday of rapid growth in the late 19th century. A major driving force, once reconstruction had been accomplished, was the rapid growth of international trade. Industrial countries' annual growth rates for exports averaged above 9 percent in the 1950s and 1960s and an incredible 20 percent annually during the 1970s.

The growth of trade was stimulated by a "virtuous circle": rapid growth of incomes enabled the lowering of trade barriers among the industrial countries, which in turn further spurred the growth of incomes. The lowering of trade barriers came about because of the multilateral rounds of trade negotiations under the GATT (tariffs among industrial countries on manufactured goods had averaged almost 50 percent in 1947 before the first round of trade negotiations); because of the policies associated with the Marshall Plan; and because of the European decision to form a Common Market (which led to a slightly faster rate of decrease in tariffs among the European countries than of their external trade barriers).⁴ American leadership in supporting successive trade rounds resulted in a reduction in tariffs among industrial countries from their average level of around 50 percent in the late 1940s to 5 percent today. That reduction has been a major factor in enabling the rapid growth of the international economy.

⁴ It should be noted that little attention was paid to agricultural protection in the "golden era", as countries were struggling to increase agricultural production and agricultural exporters faced growing overseas markets

The developing countries (underdeveloped, as they were then known) also experienced higher growth rates in the 1950s and 1960s than they had earlier, but for very different reasons. Although their growth rates were satisfactory, they were about the same as in industrial countries, so that there was lower per capita income growth and no “catch-up” for developing countries as a group. Many were newly independent and almost all initially adopted “inner looking” state-directed economic policies that were intended to produce rapid “modernization” and industrialization. Within the GATT, the developing countries negotiated “special and differential” treatment. In practice, that meant that they did not actively “offer” tariff cuts in successive rounds of multilateral trade negotiations, but benefited from the tariff cuts negotiated among the developed countries (which were subject to the most favored nation – MFN – GATT/WTO rule). Rapidly growing world markets and steady terms of trade in a healthily growing world economy enabled inward-looking developing countries to achieve results they regarded as reasonable, although the developing countries were falling further behind.

During the first twenty-five years, the IMF supported fixed exchange rates with lending both to industrial and to developing countries. When exchange rates were deemed to be fundamentally misaligned, the IMF lent money to the country in question when policies were adjusted so that the problems would not immediately recur. The IMF supported policy changes (such as reductions in fiscal deficits) that were necessary if the new exchange rate was not quickly to become overvalued. IMF resources enabled countries to be less restrictive in their monetary and fiscal policies than they otherwise would have without financial support not been available.

By the late 1970s, the industrial countries had adopted policy stances which enabled them to grow rapidly and to manage their economic policies that they no longer (until 2008) came to the IMF for support. Whereas the intent of the Bretton Woods founders was that all countries would be both financial contributors and beneficiaries of IMF resources, the IMF became in fact a source of financial and other support for developing countries, as no industrial countries were seeking support.

The inflation of the early 1970s, followed by the quadrupling of the oil price in 1973-74, led to several key changes in the international economy. First, chronologically, was the abandonment of the “Bretton Woods system of fixed exchange rates,” as the United States announced that it would no longer exchange gold for dollars upon request. This measure was a consequence of the worldwide inflation that was accompanied by a run up in commodity prices. As worldwide inflation took hold, countries wanted to increase their reserves which could be achieved only by running surpluses in terms of U.S. dollars, and the U.S. current account deficit rose as American reserves fell. In those circumstances, the U.S. abandoned the gold tie.

During the same period, the increase in oil prices meant that the oil exporting countries were experiencing large current account surpluses; the counterpart was predominantly the deficits of the poor oil-importing developing countries. Those countries, in turn, needed to find financing for their imports, while the oil exporters wanted a safe haven for their additional foreign exchange. The exporters deposited their proceeds in the main financial center banks, while the importers borrowed from those same banks. The banks had therefore become the “recycling agents” for the world economy.

It should be noted that almost all capital flows to the developing countries until the 1970s had been official flows, with the exception of short-term trade credits and some foreign direct investment, especially in mineral resources. With the onset of commercial bank lending to developing countries, private sources of capital began to be more important.

Over the several years after the 1973-74 oil price increase, the industrial countries experienced simultaneous inflationary pressures and recession and they adapted their fiscal and monetary policies accordingly. While the United States recovered by 1975, the major European oil importers and Japan remained in the doldrums at least until 1977. Among the developing countries, those few (especially in East Asia) that had shifted their economic policies in the 1960s toward an outward orientation, and had promoted growth through exports fared much better than those that remained inner oriented.

A second oil price increase in 1979, combined with the efforts on the part of the industrial countries to curb inflation, plunged the world into the deepest postwar recession it had had until the present time. The anti-inflation battle led to a sharp increase in interest rates (rising from an average of about 5 percent in the late 1970s to 14 percent by 1981) on developing countries' debt. The consequence was widespread inability to service debt and the debt crisis of the early 1980s. The "crisis" concerned predominantly the debt of middle-income countries, and none of the East Asian exporters had to pursue debt rescheduling or other measures, again reaffirming the apparent preferability of outer oriented trade strategies.

Throughout the period since the late 1940s, the World Bank had been lending to developing countries and supporting their development. With the debt crisis (mostly

official debt) of the early 1980s, it seemed to confirm the expectations of the Bretton Woods founders that debt to official creditors would remain the dominant source of developing country finance in the future.

But after the mid-1980s growth of the international economy resumed strongly. Developing countries outside the East Asian tigers (and a few others, such as Chile), observing the more satisfactory economic outcomes in outer oriented economies, moved unilaterally to remove their quantitative restrictions and lower their trade barriers. And policy makers in many developing countries noted the greater success of these outer-oriented economies with growth and in coping with the changes in the international economy.

By the 1990s, the face of the international economy was beginning to change. Industrial economies were growing somewhat more slowly (at 2.9 per cent annual average excluding Japan, whose own growth slowed from an average of 10.5 percent in the 1960s to 4.5 percent in the 1970s and 4.0 per cent in the 1980s) while developing countries in East Asia and the Pacific, whose outer oriented economic policies had begun earlier, were growing at average rates of 7.6 percent in the 1980s and 8.4 percent in the 1990s. China's rapid development began in the 1980s and was accelerating. Developing East Asia's share of world GDP rose from 1.7 percent in 1960 to 3.2 percent in 1990 to 5.4 percent in 2000 and 7.9 percent in 2007. Japan's share, meanwhile, grew from 9.2 percent in 1960 to a peak of 17.1 per cent in 1990 and has since fallen back to 13.2 per cent. The experience of other developing countries was mixed. Some undertook a few policy changes to reduce their reliance on state-led inner-oriented growth, while others undertook more fundamental changes. India's reforms began in 1991 and her growth rate

began accelerating. Other developing countries outside East Asia, whose share of world GDP in 2000 was slightly below that in 1960, had reached a 15 percent share by 2007.

The fortunes of developing countries as a group obscure large differences between them. I already noted the rapid growth of developing countries in East Asia. South Asia fared less well than average until the 1990s; since then, India's share of world GDP has almost doubled (having fallen from 1.1 percent in 1960 to 0.9 percent in 1980, it then rose to 1.4 per cent in 2000 and 2.0 percent in 2007). Sub-Saharan Africa's economic performance was well below that of other regions, although there were significant differences between countries.

In 2000 U.S. dollars in 1960, sub-Saharan Africa's real per capita income is estimated to have been \$435 while East Asia and the Pacific's developing countries was \$141. By 2007, sub-Saharan Africa's per capita income was \$598 (about the same as in 1980) while East Asia and the Pacific developing countries averaged \$1626.

Time prevents an analysis of all the reasons for the profound changes that have occurred. But they are dramatic and many. Asia's share of world GDP (including Japan) has risen dramatically, to about 21 percent in 2007. China's alone has risen to 6 percent. The U.S. share, which stood at 35 percent in 1960 (already well down from the immediate postwar years and Europe recovered) had fallen to 29 percent, and the Euro area had dropped from 22 percent to 17.9 percent. The share of all developing countries excluding East Asia and the Pacific had risen somewhat, from 13.6 percent to 15 percent. But the big change was between the western industrial countries and Asia.

Trade has grown dramatically as well, averaging a rate of growth of manufactures exports almost twice that of real GDP. The share of industrial countries peaked at 63 percent of merchandise trade in 2000, and has since fallen.

The Need for International Economic Cooperation

Fear of a repetition of the 1930s was a major motivation of the founders of the postwar international economic system. The importance of international economic cooperation was a vivid lesson. Even in the 1930s, when the world was much less interdependent than it is now, the competitive devaluations, beggar thy neighbor increases in tariffs and other protective measures, and failure to find means for international economic cooperation greatly intensified the tragedies of the 1930s.

And the Bretton Woods system, although not perfect, served the world well. The IMF adapted well to the change in its role when the fixed-but-adjustable exchange rate system among the major currencies was abandoned. The international financial institutions (IFIs) were also instrumental in bringing the countries of the former Soviet Union and Eastern Europe successfully into the international economic system in the 1990s. The reduction in trade barriers has been extremely important for all countries.

Not only do the three major international economic organizations (the WTO for trade and the two IFIs) enable cooperation among countries, they also provide a forum where officials can meet both formally and informally, learn from each other, and reach agreement on informal cooperation as well as the institution's agenda. Some measures, such as uniform customs procedures, are of benefit to all, and are not as contentious as reciprocal tariff reductions. These additional benefits (including technical assistance, assessments of the global economy and increasing knowledge) should not be

underestimated. Even constituted as they now are, the IFIs and the WTO are invaluable as means of communication as well as of agreement.

Until the 1990s, the institutions and their role were the subjects of criticism, but there was little questioning about the overall thrust of their activities and organization.

But, as should be clear from the above discussion, the international economy has changed sharply since the early 1990s. The countries of the former Soviet Union and Eastern Europe have integrated into the world economy. China's success has increased her relative and absolute importance enormously. The growth of private capital flows has raised a host of questions regarding how they should be treated internationally.

As the substantive aspects of the international economy have changed, so has the relative importance of different countries and the effectiveness of the current governance structures.

On substantive issues, there are several concerns. First, and certainly most pressing at the present time, is the need to achieve a better functioning World Trade Organization – trade, which has been a major engine of world growth since the second World War is projected by the World Bank to decline 9 percent in 2009. And, despite pledges made at the first G-20 Heads of Government meeting last November, that all would eschew any increase in protectionism during the current crisis, the World Bank now estimates that 17 of the 20 have since increased one or more aspects of their protection against foreigners.⁵ Moreover, many of these increases are quite legal under WTO rules, as countries have tariffs set below the levels at which they are bound under

⁵ In a report issued in March, the World Bank reported that since the G-20 pledges last November, the 17 countries had taken 47 trade-restricting measures. See New York Times, March 23, 2009, Mark Landler, "Trade Barriers Rise as Slump Tightens Grip," p. A1.

the WTO. If ways could be devised to bind tariffs at levels existing before the current financial crisis, the prospects for an upturn globally would be significantly enhanced.

Should protectionism increase, it will accentuate the severity of the current downturn and, perhaps even worse, presage lower growth rates for trade and world output over the intermediate run. That is bad news for all, but especially bad for those countries that have yet to abandon their protectionist stances and integrate more closely with the world economy.

A major measure that can greatly reduce the chances of increased protectionism and all its consequences would be the completion of the Doha Round. The structure is there, and what is required is leadership on the part of the large trading countries. Reaching such a conclusion in the near future would remove uncertainty about the near-term future of the international trading system, which itself would give a boost to the recovery.

But beyond that, much needs to be done. Some of the key issues can only briefly be pinpointed here. First, there is the unanimity rule, and the fact that all members have a say on all items. Changing to majorities of different sizes for different issues, and creating a more effective small body (Council) to take decisions between plenary meetings would help. It may also be desirable to split issues that need to be addressed in multilateral trade negotiations from those which can be addressed by the general membership, or groups within the general membership on an individual basis. Finally, but certainly not least important, is addressing the issue of proliferating preferential trading arrangements (PTAs) These clearly violate the multilateral spirit of the GATT/WTO, and raise questions about the functioning of the multilateral trading system

in the future. Agreement must be reached as to rules that can be followed in PTAs to insure their compatibility with the multilateral trading system.

Little needs to be said about the World Bank. Issues of governance are the same as those for the Fund, to be discussed a little later. Otherwise, a major set of issues concerns the division of labor between the World Bank and the IMF, on the one hand, and the role of the World Bank in middle income countries, on the other.

Perhaps the most pressing questions surround the IMF, both because many questions have been raised as to its role and because in the current crisis situation, cooperation, or at least a meeting of minds, on international financial issues is urgently needed.

Starting first with the substance, issues regarding the Fund's role were raised long before the current crisis. Some of them focused on the absence of crisis, and were based on the belief that the Fund had "become irrelevant." Even before the financial crisis, it was straightforward to note that there would inevitably be future circumstances in which individual countries would find themselves in crisis circumstances and would need support. The fact that so many countries have already sought support from the IMF since the onset of the crisis is itself testimony to the fact that the Fund was not, in the sense that the critics used the term, "irrelevant." Indeed, the Fund finds itself coping with multiple challenges shortly after having been downsized.

But the more important "relevance" issue has to do with the reported desire of many developing countries, especially in Asia, to accumulate reserves to insure that they would not, regardless of circumstances, need to go to the Fund. In the aftermath of the Asian crises of the late 1990s, it is often asserted that the huge current account surpluses

of many emerging market economies were being generated in order to provide insurance to those countries that regardless of their future circumstances, they would never again be “forced” to go to the Fund.

Here, the issue is fairly clear: if each individual country’s authorities wish to hold enough foreign exchange and other assets to tide them over any conceivable economic misfortunes, the macroeconomic impact of that accumulation will be substantial, with macroeconomic consequences, while simultaneously, the holding of those assets will be costly for individual countries. A better understanding of Fund programs, as well as agreement between the Fund’s members as to appropriate policy measures in response to unanticipated crises is urgently needed.

But in addition to the costs of excess reserve holdings for individual countries, there was a major macroeconomic impact of reserve accumulation. That is, so-called ‘global imbalances’ developed and increased over time, as the counterpart of reserve build-up in emerging market economies had to be current account deficits in one or more major industrial countries. In the event, the United States bore the major part of the industrial countries’ imbalances, as its current account deficits mushroomed.

I cannot go deeply into the argument here, but it must be evident that had the United States undertaken sufficiently restrictive monetary and fiscal policy actions significantly to reduce or to eliminate the U.S. current account deficits, that would have resulted in global recession had other countries not taken offsetting actions to increase their aggregate demand. Yet there was little scope in most other industrial countries for expansionary policies, and, of course, those countries accumulating reserves and

incurring current account surpluses were unwilling to shift their expenditures sufficiently toward domestic demand to reduce the imbalances.

While there can be disagreement as to how much adjustment should have been done by the United States (and other industrial countries) and how much should have been undertaken by emerging markets (and oil exporters), there can surely be no disagreement that a rebalancing of demand whereby the excellent growth of the international economy in the 2002-2006 period did not have to end in grief would have greatly increased world welfare. Yet, despite the IMF's repeated analyses of "global imbalances" and even attempted consultations among the major players, neither the surplus nor the deficit countries were willing to adjust prior to the crisis. I shall argue below that the experience of the financial crisis has demonstrated how interdependent we all are, and that mechanisms of coordination to reach agreement avoiding this sort of imbalance are badly needed.

A second substantive issue for the international financial system concerns financial regulation itself. As is currently being discussed, the excesses of the past several years clearly demonstrated regulatory failures, and their impact was certainly felt across national boundaries.

Closely related to the issue of prudential and supervisory regulation of the system is the issue of international capital flows. At the present time, there is no international institution to which purview is extended for these flows. There is no provision that regulations governing international capital inflows and outflows should be nondiscriminatory; there is no multilateral protocol governing host country treatment of

capital inflows. With the increasing importance of these flows, the issue will require considerable attention in the twenty first century.

It is evident that these, and other, substantive issues, are of vital importance for the international economy and are urgently in need of addressing. Yet much of the world seems focused on the issue of representation which is important but not quite so pressing in the current financial crisis. I have tried to show how successful the international economic institutions were in the international economy in the sixty years after the Second World War. Until the 1990s, the representation at the institutions by individual countries was broadly representative of economic importance, although complaints were long heard that developing countries' interests were underrepresented.

But with the rise of Asia, there is little question that Asia is underrepresented relative to economic importance (and on present growth trajectories could be expected to become increasingly so), while Europe is overrepresented. Interestingly, the United States is slightly underrepresented on the basis of her share of world trade and world GDP, as the U.S. has voluntarily given up some share to enable small increases in the shares of some of the rapidly growing developing countries.

There is no question that this problem must be addressed. To a considerable degree, it is not as urgent as measures addressing the current crisis. But because of the concerns of those that are currently underrepresented, and the fact that this underrepresentation seems to have been a contributing factor to global imbalances, urgency is significantly increased.

The International Economy in the Twenty First Century

The challenge for the twenty first century is to address the shortcomings in the system that enabled the current financial crisis to be as severe as it has been, while simultaneously preserving those features of the international economy that enabled sixty years of global economic growth and creating a global economic environment in which those countries that have yet to achieve satisfactory performance can utilize the international economy, as others did before them, to do so.

A first issue is how much can be done, formally, through multilateral institutions, and how much must be achieved at the level of individual countries. To name just a few: it is evident that many issues cannot be handled in isolation: global imbalances required and require addressing multilaterally; financial regulation has important international dimensions when banks have foreign subsidiaries or branches; preventing discriminatory trade barriers is in the interest of all; discrimination in capital flows is highly undesirable; and there is agreement that some degree of coordinated fiscal stimulus is desirable.

Yet, on these and other issues the IFIs do not currently have the ability to bring discussions to any satisfactory conclusions among members. And it seems clear that members are unwilling to cede sufficient authority (or, as some state, lose some of their sovereignty) to enable a resolution of these issues. It is possible that the current financial crisis may lead all to recognize their joint interest in international agreements on procedures for reaching binding agreements on issues such as cross-border financial regulation, achieving a nondiscriminatory international regime governing capital flows, and other issues.

However, if – as seems more likely – some of the large nations are unwilling to agree on international procedures for resolving these issues, leadership and global

citizenship on the part of the large countries will obviously be necessary. There was, and is, disagreement about how global imbalances are to be resolved, although there is unanimity that their continuation would represent a continued threat to stability in the global economy. There is also agreement that cross-border financial institutions are in need of multilateral regulation, or else the “race to the bottom” could destabilize the financial system yet again. And the IMF’s role as a major resource in time of crisis has yet again been recognized as vital for the international economy.

In the short run, policies must be adopted to address the current crisis without waiting for any reshaping of the mechanisms for formulating international economic policy. But once we are out of the present crisis, the challenge will be to agree upon processes and rules by which countries can agree to, and carry out, policies and procedures that will reduce the likelihood or at least the magnitude of future crises.

Any such agreements must be based on an understanding by all countries of their mutual interest in a well-functioning world economy. For most if not all small countries, there is adequate acceptance of its importance. It is up to the larger countries of the world to recognize their mutual self-interest in the system, and likewise to understand that they cannot, despite their size and importance, go it alone.

Obviously, reaching agreements will be difficult, and will require a larger voice for countries whose economies are growing most rapidly. For the past sixty years, the countries of the world individually and collectively have successfully – if not always perfectly - addressed various challenges as they arose. I am hopeful that the same sort of statesmanship and leadership will enable the preservation of the healthy aspects of the

international economy in the future, while simultaneously forging new understandings and processes as the system evolves and new challenges arise.

If these issues of cooperation can be resolved, so that global imbalances and other unsustainable multilateral issues are addressed while global trade is liberalized and capital flows are subject to regulation that enables their efficient utilization, the outlook for the 21st century should be as favorable as was the experience of the past sixty years.

Asia's role in all this is central. The emerging countries must be brought fully into the system, both as cooperative partners and, for large countries – especially China - as leaders. There is every prospect that Asia's economic success will continue, and her relative importance in international economic activity will increase. That economic success depends on the health of the international economic system, which in turn will depend on strengthened and healthy international cooperation through the IFIs, the WTO, and elsewhere.