

Adjustments in World Payments: an Evaluation

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I. Many Types of Payments Imbalances

The postwar period has been replete with payments imbalances, which often evolved into payments and currency crises. But if we compare the postwar experience with that of the 1930s, there is no doubt that our international economic and financial system has up to now coped far better with such disturbances and crises than the prewar system under which the world economy disintegrated. One of several reasons for the better postwar performance has been the rules and institutions set up at Bretton Woods 40 years ago.

The International Monetary Fund was established largely in order to help the world overcome payments imbalances with a minimum of disturbance. The American Commentary on the proposed IMF Agreement, issued a few weeks before the Bretton Woods Conference of July 1944, stated very clearly that the Fund was designed to help maintain stability "by providing resources for meeting temporary adverse balances on current account, while giving a member country time to take appropriate measures to adjust its balance of payments," if necessary also through the alteration of the exchange rate.

We have experienced very diverse types of payments disturbances. At the risk of some oversimplification, I would classify them in three main categories: many of them were due to inflation differentials between countries; this has been rather typical of most intra-European payments imbalances, particularly those within the European Monetary System (EMS) and its predecessor. A second group of imbalances have had their origin mainly in the capital account and in interest-rate differentials: this has been characteristic of some major disequilibria where America and the dollar were involved. A third group of payments imbalances originated from external shocks, such as the two oil price explosions. This differentiation is rather important because the different types require different treatment.

Some international imbalances are difficult to classify; this happens to be true of the very first and the most recent of these disturbances, namely the "dollar shortage" after the last World War and the present international debt crisis. The first imbalance of worldwide importance, the "dollar shortage" of the immediate postwar period, which lasted up to the middle of the 1950s, had its origin to a large extent in the ravages of World War II. It is fascinating to compare this first major payments imbalance with the most recent American imbalance. At the time of the first "dollar shortage," the United States was the country with the largest payments surplus on current

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account, and the only major capital exporter in the world. Today, the capital gap is on the American side: the United States has the largest current account deficit ever recorded and is borrowing from the rest of the world on an unprecedented scale. And yet, the dollar has again been strong, this time on account of its attractiveness for investors.

II. Asymmetries of the Adjustment Process

There have often been complaints about the lack of precise rules for adjustment in the Bretton Woods system, and even more about the asymmetries of the adjustment process.

It is true that in the fixed rate system there were no clear rules about adjustment through alterations in the exchange rate. The notion of "fundamental disequilibrium" was vague and never clearly defined. But from my own experience—since I have been an advocate of timely exchange rate adjustment since the 1950s—I can say that we in West Germany, after some travail, recognized the danger of imported inflation as a powerful indicator for a surplus country. On the basis of this indicator we upvalued the Dmark a number of times—1961, 1969, 1971 and in the spring of 1973—quite apart from the numerous upvaluations in the European adjustable-peg system after 1973.

The alleged asymmetries of the adjustment process refer mainly to the difference between surplus and deficit countries, but also between reserve or key currencies on the one hand, and "normal" currencies on the other hand. In the fixed rate system surplus countries were, indeed, not forced to upvalue by the mere accumulation of reserves; but they were forced to act somehow, or else the adjustment took place through enforced inflation.¹ As concerns the special position of key currencies, I would accept an asymmetry only in the very special case of the U.S. dollar (to which I will revert later). When Germany had large current account deficits in 1980 and 1981, we had, like other deficit countries, to borrow abroad for temporary cover and conduct a restrictive policy. When in 1976 the pound sterling had to be bailed out by a large stand-by arrangement with the Fund, Britain had to accept a severe austerity program which raised quite strong political feelings in the country.

III. The Fund's Role—Adjustment versus Financing

The Fund has been involved in manifold ways in the major payments imbalances. But it was usually constrained to stand on the sidelines whenever the dollar was in the center of the affair. At the time of the first "dollar shortage," i.e., the long-lasting postwar dollar deficit of Europe, it was obvious that this was not a case for temporary payments assistance, but that long-term capital for reconstruction after the War was needed; thus for good reasons the Fund decided that countries receiving Marshall plan aid could not draw on the Fund. The necessary internal adjustment policies in Europe, as well as the intra-European trade liberalization, were performed under the

¹The Fund itself occasionally observed that the international adjustment process in a fixed rate system can have an inflationary bias (cf. *IMF Annual Report* 1964, p. 28).

surveillance of the OEEC and the European Payments Union (EPU). This first major payments adjustment in Europe came to a successful conclusion when in 1958 a number of European currencies were declared convertible in the sense of Article VIII of the Fund Agreement and the EPU dissolved itself as being no longer necessary (one of the most successful international institutions!).

In the second half of the 1950s the "dollar shortage" turned into a "dollar glut," partly because other industrial countries were catching up with the United States, but mainly because of persistent American capital exports which created a long-lasting payments problem for the United States. The uncertainty as to whether the Fund could count on drawing dollars when the United States was in deficit, was the main reason for setting up the General Arrangements to Borrow and the Group of Ten. With regard to the American deficit problem of the 1960s, the Fund's role was again a rather limited one. In the 1960s, the United States pursued a very active balance-of-payments policy, mainly directed towards control of its capital outflows; this policy included the famous interest-equalization tax and similar dirigist measures. A comparison of the dollar problem of the 1960s with the present dollar problem shows all the signs reversed: in the 1960s the American payments problem was mainly due to the fact that the United States was *the* low-interest country among the major industrial countries and had the best-developed capital market among the major countries. It had surpluses on current account during most of the 1960s, but large capital outflows. At present it has become a structural high interest country, not only because of its high budget deficit but also for other reasons and it has unprecedentedly large deficits on current account. This indicates a dramatic reversal in America's financial structure between the 1960s and the 1980s. In the face of the present American payments disequilibrium the Fund is again a nearly powerless bystander, apart from offering good advice and criticism.

What a contrast to the Fund's active role in handling other major payments imbalances! This is true of the payments problems created by the two oil price shocks of 1973 and 1979/80 and in particular of the present international debt crisis, where the Fund is involved up to the neck.

With the payments impact of the oil price explosion the problem of *adjustment versus financing* came up in a particularly acute form. Finding the right combination between financing and correcting a payments deficit is a problem which has challenged the Fund and the deficit countries from the beginning of the postwar period; it is reflected in the "conditionality" of Fund lending, which has become a central feature of the Fund's lending role. After 1973, the abrupt imposition of vastly increased oil import bills shifted the balance more towards financing, at least for a considerable transitional period (this was confirmed by a Ministerial meeting of the Committee of 20 at the beginning of 1974). It is, however, noteworthy that in 1976, at the Annual Meeting of the IMF in Manila, everybody seemed to agree with the Fund's Managing Director that from then on adjustment should again have priority over financing. In the meantime commercial banks, under the motto of recycling, had begun to expand their international lending enormously. This has added a new dimension to the problem of preserving the right balance

between adjustment and financing. Let me emphasize that—contrary to a widespread legend—the banks were not encouraged by governments or monetary authorities to continue their excessive lending to weak deficit countries. Already since 1977 there has been concern that easy unconditional lending by the banks might tempt deficit countries to postpone adjustment and avoid recourse to the conditional loans of the Fund until they were in a desperate plight. You know how this story has ended: the banks have gone from overfinancing (or “overlending”) to the present “underlending,” and their overlending has left a heavy legacy on the international financial system. The failure to restrain international bank lending in time has postponed necessary corrections and aggravated the imbalances.

The oil-induced payments imbalances have thrown two other adjustment problems into relief, namely: first, the need for structural adjustment—with successful oil conservation playing a great role in bringing the oil price down since 1981 and reducing the oil import bill; and second, the importance of letting the price mechanism play its full role.

The oil-induced imbalances are also good examples of inevitable temporary deficit financing. Many American experts seem to believe that in a system of floating all interventions in the exchange markets are just an “exercise in futility” and a waste of money. But for many countries selling dollars out of their reserves or from reserve credit can be an inevitable financing of a temporary payments deficit—a need which the United States does not have as a rule.

IV. Adjustment Problems of High-Debt Developing Countries

The oil price explosions and their consequences for the payments balances of oil-importing Third World countries have no doubt also contributed to the present international debt crisis. They were, however, not the only cause, as can be seen from the fact that a number of oil-exporting countries, like Mexico, Venezuela, and Nigeria, are involved in the debt crisis, too.

I refrain from describing how the international debt problem has developed and turn immediately to the question: what are the prospects of solving this problem by the present pragmatic methods? I think we can now see light at the end of the tunnel, in spite of recent aggravations due to the gyrations of dollar interest rates.

1. After the successful crisis management of the last two years under the courageous and imaginative leadership of the Fund, the threat to the international financial system as a whole seems to be on its way out.

2. Most of the non-oil developing countries have made an impressive adjustment effort, and in the two years between 1981 and 1983 have cut their collective current account deficit by half, namely from \$109 billion to \$56 billion (“current account” according to the IMF definition). The flaw in the picture has been that, at least up to 1983, this had mainly been achieved by massive cuts in imports which at least in the major high-debt countries were accompanied by declines in real national product.

3. In 1984, there has been a turnaround towards better prospects in real economic terms. With the economic recovery in the industrial countries, the

Third World countries have a genuine chance for improvement in both the external and domestic field for the first time in years. Exports of non-oil developing countries are estimated to increase this year by about 8 to 10 percent in dollar value. A crucial indicator of real improvement is the estimated average growth rate of these countries of 3.5 percent in 1984, and possibly more next year.

4. It will, however, still take several years to assure a lasting solution for all major debtor countries; and as their situation and prospects differ greatly, accidents of individual debtor countries cannot be excluded.

5. The Fund has recently come up with a rather optimistic medium-term perspective which shows that the debt burden is manageable and can be significantly reduced by the end of the decade, provided that

- a) the debtor countries continue to make forceful and comprehensive adjustment efforts in their domestic economies;
- b) economic growth in the industrial countries is maintained in the coming years at an average rate of at least 3 percent annually (which seems to be assured for 1984 and 1985), and their markets are kept open for the exports of the debtor countries;
- c) external finance continues to be available, although on a moderate scale;
- d) in view of present interest rate trends in the United States, I would add a further condition, namely that the high-debt countries are somehow protected against further large increases in dollar interest rates (the Fund, in its optimistic scenario, has assumed a moderate reduction of interest rates).

I want to emphasize several points:

First, the Third World's debt problem is not a generalized and uniform problem. The situation differs greatly both between areas and among the various high-debt countries of an area. The estimated economic growth rate of 3.5 percent in 1984 for the non-oil developing countries, which I quoted, conceals in reality wide differences: an average of about 6 percent for the Asian-Pacific region and a meagre 1.3 percent for Latin America. The debt service ratio in 1983 was 21.5 percent on average for all non-oil developing countries, but over 40 percent of export earnings for Latin America. One has to disaggregate the global average figures to discover the reality.

Second, developing countries need sufficient capital for their development, and bank lending has to make its contribution thereto. But there seems to be a consensus among experts that, instead of the exaggerated 20 to 25 percent increases in bank lending in former years (up to 1981), an annual net increase of 5 to 7 percent would be appropriate, having regard both to the debt capacity of borrowing countries and also to the limited capacity of commercial banks to increase their foreign exposure. Now in both 1983 and (probably) also in 1984 a net increase in bank lending of that magnitude, about \$20 billion, has taken and is taking place. But a large part is involuntary lending. So this involuntary lending has to be converted into voluntary lending. This presupposes a restoration of the creditworthiness of the high-debt countries. This is also necessary in order to attract sufficient other capital, in particular private direct investment. It is becoming clear that the

relative performance of the individual borrowing countries will in future be more decisive than before in attracting private foreign capital. There will inevitably be a growing differentiation between debtor countries according to performance. Thus there is no way around comprehensive adjustment in the debtor countries. Fund studies comparing debtor countries with and without critical debt problems have, indeed, shown that the more viable debtor countries are nearly always characterized by lower relative fiscal deficits, considerably lower monetary growth and inflation, and usually by an export-oriented economic policy and structure.

Third, all prospects for a solution of the debt problem without a major breakdown are predicated on the assumption that the economic improvement in the industrial countries is sustained over the next few years and their markets are open for the export goods of the debtor countries. Thus, the leading industrial countries also have a great responsibility for successful adjustment of the present Third World imbalances.

V. The Present American Disequilibrium

Let me now turn to the largest payments imbalance ever recorded for a single country: the present U.S. payments deficit on current account, which is likely to reach \$80 billion or more this year. There are connecting links between the international debt problem and the American current account deficit: the payments problems of the debtor countries have had an adverse impact on the U.S. trade balance; on the other hand the American demand push, which is also reflected in the American current account deficit, has alleviated the trade and payments position of the developing countries. But the recent upward movement in American interest rates has again partially offset this benefit; and the need for considering the international debt situation may even inhibit the conduct of American monetary policy.

Three main causes are put forward for the amazing growth of the U.S. current account deficit: the high dollar value, the large disparities in domestic economic growth between the United States and most other countries, and the payments difficulties of the developing countries. The abnormally high dollar value shows that at present the current account deficit is being over-financed by net capital imports—or has been until very recently. This means that *the capital account is the driving force and enforces the deficit on the current account of the balance of payments*. Or in other words: up to now the interest rates in the United States have been higher than necessary for its external equilibrium (taking into consideration also the safe-haven factor). But with a further increase in the current account deficit—or with changes in confidence—there may be a reversal, sooner rather than later. Then the huge current account deficit may become the determining force and may necessitate higher interest rates than compatible with the domestic equilibrium of the U.S. economy. But up to now the capital account has been the dominant influence, just as was the case in the 1960s for about eight years, only with all the signs reversed.

What does this huge trade and current account deficit mean for the international payments situation? It has certainly given the whole world economy a strong upward push as it is the transmission belt from the American locomotive to other countries. There is a negative counterpart in the form of the corresponding large net capital flows from the rest of the world to the United States and the impact of high American interest rates on the other countries. This is a particular burden on the highly indebted Third World countries. For a number of low-inflation industrial countries, like Japan and Germany, the impact of high American interest rates is mitigated by the fact that they have been largely (not entirely) able to "decouple" their interest rates, keeping them 4.5 to 5.5 percentage points below the American rates. But there are limits to this "decoupling," even in a floating rate system. On an overall balance, if one weighs the positive and negative elements against each other, the effects of the American economic evolution on the world economy as a whole has certainly been positive, at least in the short run.

My impression has always been that it is rather the American side which should be concerned about the negative effects of this enormous imbalance. Just think of the distorted competitive position of American exporters and import-competing industries, the unbalanced American recovery (which may be choked off by high interest rates and the increasing trade deficit), and the prospect that the United States will by 1985 or 1986 become a net debtor country against the rest of the world for the first time since 1916, with lasting negative effects on the invisible current account balance. But I have also heard that this current account deficit is fine as long as it is being financed by foreigners, for this capital inflow finances the American capital gap and alleviates the burden of the budget deficit on the American capital market (\$80 billion net capital inflow is equivalent to more than 40 percent of the Federal budget deficit!), and also that the spillover of excess demand into the external balance reduces inflationary pressures in the United States, and that the high dollar benefits the consumers. And is it not good free market economics to let capital go where in the opinion of investors it obtains the highest real return?

Does this mean that we should all be content with this huge international imbalance as long as it lasts (i.e., is being financed by foreigners)? This would be *short-sighted* for various reasons.

First, the enormous borrowing abroad of the richest country in the world remains an anomaly, especially if the attraction of foreign capital is at least partly due to an unsound budget policy as well as to extraordinary tax benefits which have made the United States a structural high-interest country. I would mention in this connection the general tax deductibility of interest on consumer and building loans, as well as the great tax advantages on new business investment due to the Tax Act of 1981. Structural changes in the American financial system have also pushed up the equilibrium interest rate.

Secondly, there are the protectionist dangers due to the distorted dollar exchange rate, as well as the special burden on the high-debt developing countries.

Thirdly, perhaps the major concern on both sides should be the fact that such an excessive current account deficit is *unsustainable in the longer run*. This also implies that the present exchange rate pattern among major currencies is highly fragile. The longer the disequilibrium lasts, the more fragile the present exchange rate structure becomes. Nobody is in a position to foresee whether an eventual correction of the exchange rate will come gradually, with a "soft landing," or whether there will be an abrupt change—with possible untoward consequences for American inflation and interest rates on the one hand, and for the world's exchange rate pattern and international trade on the other hand. It is, in one word, a *high-risk situation*, just as the debt problem is a high-risk situation.

What can be done to get the world payments situation out of this uncomfortable trap? Without going into details, I would say that neither the Bretton Woods system of fixed exchange rates nor the present system of floating rates has provided an easy way out of a heavy disequilibrium on capital account. In the 1960s as well as in the 1980s, adjustment has presupposed a change in the domestic policy mix of either the one or the other side. The Fund, in its most recent "World Economic Outlook," has stressed "that the single most beneficial change in the world economy in present circumstances would be a perception that the United States was taking action to contain and eventually reduce its underlying budget deficit." Indeed, a sound policy mix of fiscal and monetary policies, and a credible policy directed towards internal stability would certainly be the best foundation for smooth adjustment and lower interest rates.

With the notion of "*sound policy mix*" I have touched on a fundamental point concerning the stability of our system. Conventional wisdom has it, as the Williamsburg Communique also stated, that the key to greater stability of exchange rates and of the whole international financial system is a convergence of policies and performances in the larger countries towards domestic stability, or in the words of Mr. Sprinkel of the U.S. Treasury: "Sound non-inflationary economic policy is the most effective path to exchange rate stability." Such a convergence towards noninflationary policies was actually reached last year between the United States, Japan and West Germany. There has, indeed, been some diminution in the short-run volatility of major exchange rates (but mainly because of a diminished volatility of American short-term interest rates); however, the disturbing misalignment of the level of the dollar exchange rate even increased. I do not speak about an "overvaluation" of the dollar, because it is not overvalued if one takes the fundamental factors of the capital balance into account. But it is grossly misaligned as measured against price and cost relationships or the balance on current account, and it is not sustainable in the long term. *Convergence toward noninflationary domestic policies is evidently not sufficient for establishing a stable, sustainable exchange rate pattern*. It must be supported by a sound relationship in the fiscal-monetary policy mixes and in real interest rates. At present, fiscal policies in major countries are at odds: fiscal policy in Japan and West Germany is firmly headed for a reduction of structural budget deficits, while in America the structural deficit is still on the increase. Interest rates in Japan and Germany are significantly lower than in the United

States, although they are probably still somewhat higher than the domestic equilibrium rates in these countries.

It has sometimes been suggested that the payments disequilibria could be lessened if other major countries would revise their policy mix so as to align it more to the American one, such as pursuing a looser fiscal and a tighter monetary policy, or strengthening the profitability of investment in their countries so as to reduce the flow of capital to the United States. I am very much in favor of strengthening the profitability of business in Europe, but that is easier said than done. In no case, however, should "convergence" be interpreted to mean that the more solid fiscal policies of other countries should be given up. In view of the excessive public spending worldwide, this would make the whole world poorer and would drive interest rates even higher. So "convergence" should be interpreted also with a view to the overall needs of the world economy.

VI. The Exchange Rate as an Instrument of Adjustment

In the present American payments imbalance, the role of the exchange rate is quite extraordinary. The high external value of the dollar is chiefly determined by the capital account, and it has enforced an adjustment on the trade and current account which has moved it deeper and deeper into disequilibrium. This is hardly a stable, sustainable equilibrium. Its components are distorted, which reflects underlying imbalances and international disparities. But the dollar is an exceptional case in view of the predominance of the American capital account.

Ordinarily, the exchange rate should be an important instrument for adjusting payments disequilibria on current account. It should, however, be neither under- nor overestimated as a tool for adjustment. When the world adopted a system of widespread floating in 1973, many countries had illusory notions that flexible exchange rates would make the balance of payments self-equilibrating and also that they would provide complete insulation against external disturbances and make monetary policy fully autonomous. A decisive step in the transition to the new system was the German decision of March 1973 to suspend intervention at a fixed dollar parity; this was practically forced upon the German monetary authorities as the only means of shielding the domestic economy from the unbearable inflationary impact of destabilizing money flows from the dollar area. While our chief motive was to regain control over our money supply, we never had the illusion that floating would protect our economy against all destabilizing influences from abroad or make our monetary policy fully autonomous (this is not wisdom with hindsight, but is on record).² Moreover, the oil shocks and other incidents quickly proved that there are situations in which balance of payments adjustment cannot be left entirely to exchange rates, but when both temporary financing of deficits and domestic adjustment policies have a decisive role to play. This is, of course, also the lesson of the international debt crisis; here

²Cf. Otmar Emminger, "The D-Mark in the Conflict between Internal and External Equilibrium, 1948-75." (Essays in International Finance, Princeton University 1977) pp. 39-41.

the correction of artificially high exchange rates has been an absolutely necessary, but not nearly sufficient, part of the adjustment process. In many other cases, too, experience has shown that a satisfactory correction of payments imbalances has required a combined policy of exchange rate and domestic adjustment.

In evaluating the present exchange rate system it is, in my view, essential to recognize and take account of *the unique position of the U.S. dollar*. It is a fundamental mistake to try to set up uniform rules for exchange rate policy which do not differentiate between the dollar and other currencies. The unique position of the dollar is not only due to the fact that the American balance of payments is usually so much dominated by the capital account. The dollar has also other special and unique properties, e.g., as the universal reserve currency and the dominating currency in the international financial markets. The United States does not have, as a rule, a financing problem for its payments deficits, in contrast to nearly all other countries. While all other countries cannot but have some exchange rate policy (which does not mean an exchange rate target or intervention in the exchange markets), the United States can afford—or believes it can afford—the luxury of a passive balance of payments strategy (or of “benign neglect”).

All this means that the rules for exchange rate policies, adjustment and financing of payments deficits, intervention in the exchange markets, etc., which are applicable to the dollar, are often not applicable to other currencies. I want to illustrate this by a salient example: the dollar is the only currency of which it can be said with certainty that under present conditions of capital mobility it can only function as a floating currency. The chief reason is the enormous amount of highly liquid and volatile dollar holdings in the world, which would quickly topple any fixed dollar rate and derail even a mere target zone arrangement as soon as economic and financial uncertainties arise or psychological or political accidents occur. Floating is the only available protection against large volatile money flows. Other countries cannot dispense with letting their currencies float against the dollar for a number of other reasons as well, such as: the uncertainties connected with big external shocks (like the oil shocks); the introduction of strict money-supply policies (which have made monetary policies much more introverted); and the need to have at least some protection against disturbing interest rate developments in the United States.

As I said, what is appropriate for the dollar (or for the relationship vis-à-vis the dollar) is not necessarily appropriate for the relationship between other currencies for which the potential of destabilizing money flows is much smaller. Thus it does make sense for a group of European countries, for which intra-trade accounts for more than half of their total trade, to try to arrange among themselves an adjustable peg system (a “mini-Bretton Woods”)—as has been done in the former so-called “snake arrangement” and since 1979 in the *European Monetary System* (EMS). The EMS has disappointed exaggerated hopes of a fast convergence of monetary and fiscal policies and of inflation rates among member countries (although the system has exerted some constraints and discipline). But the necessary adjustment of mutual exchange rates was nearly always carried out in time and—what is

essential—was always oriented towards correcting the effects of inflation disparities and unsustainable current account trends. Thus, exchange rate relations within the EMS have not only been much less volatile in a short run, but—what is much more important—have never produced prolonged distortions of competitive positions of a magnitude even faintly comparable to recent experiences with the dollar. The adjustable peg of the EMS has proved to be a useful instrument for adjustment among its members. It has also prevented the use of exchange rates as a protectionist tool. These positive elements have compensated for some other disadvantages. But this is a strictly regional payments and adjustment system, with no possible application on a worldwide scale. There is perhaps one wider lesson which one could draw from experience of the EMS: just as a few nonmember countries have for quite some time attempted to keep their exchange rates stable in relation to the EMS currencies on an informal *de facto* basis, one could imagine that a sustained stability of the U.S. dollar and a stable American policy mix may one day attract a number of other major currencies into an informal dollar-oriented currency system (with the freedom to leave it in the event of large destabilizing capital flows).

VII. Conclusion

1. We have at the present time two major payments imbalances in the world, the international debt problem and the American current account deficit; both are of unprecedented magnitude and imply great risks to our international financial system.

2. In both cases, although in very different ways, adjustment of domestic policies is required. In cases where exchange rates have been artificially manipulated, as in many high-debt Third World countries, exchange rate adjustment, too, is a necessary, but not sufficient policy.

3. In both present payments imbalances, the capital account of the balance of payments is playing a dominant role, so that the current account must to some extent be adjusted to the prevailing balance on capital account. In the case of the American imbalance, the dominating factors have been interest rate differentials and confidence factors; they can, however, become rather unreliable and fragile elements in the balance of payments adjustment process. In the case of the high-debt Third World countries, the net capital inflows are to some extent determined by official loans and grants, while a smaller portion is provided by private foreign capital; this is, however, to some extent also an officially influenced element (“involuntary lending” in the framework of IMF rescue packages). The net capital flow into the United States of about \$80 billion in 1984 is considerably larger than the total net capital flows to the non-oil developing countries (which can be estimated at around \$50 billion for 1984). It remains to be seen how long the non-American industrial countries will be able to shoulder the burden of these two capital flows.

4. In a more general way it can be said that the evolution of large international money and capital markets, together with modern communication facilities, have vastly increased the importance of capital movements in our

world payments system. In this field, the commercial banks have become a powerful, but potentially unstable element, since the 1970s.

5. High capital mobility between developed countries has subjected our international system to new adjustment problems. Since the dollar is potentially much more exposed to unstable and unforeseeable capital movements than any other currency, floating against the dollar has become the inevitable reaction of practically all other industrial nations. Countries among which capital movements usually do not play a similar dominating role, and mutual trade is a decisive factor, have been able to set up a workable adjustable-peg system (EMS).

6. In a world of large money and capital markets of a high capital mobility, interest rate differences and other incentives for capital flows play a greater role in payments balances than formerly. They can provoke disturbing disequilibria in trade and current account balances.

7. In spite of these new sources of disequilibria and payments strains, our mixed exchange rate system has up to now been able to cope with enormous shocks, structural and institutional changes as well as sharp cyclical repercussions in a tolerable way, without any breakdown similar to the 1930s. The system has been better than its reputation (as Mark Twain said of Richard Wagner's music: "it is better than it sounds"). However, to overcome the present major imbalances without mishaps and accidents, better coordination and cooperation among the leading countries may be needed on a continuing sustained basis. "Adjustment" is an ever new and never-ending task. The question is: what role can the Fund play, in the framework of its statutory task of "surveillance," also in cases where countries do not need recourse to the Fund's resources?

Discussion

Rudiger Dornbusch*

Dr. Emminger's paper offers a practitioner's view of two key issues in postwar international monetary history: the "dollar-problem" and the "debt problem." The view is a privileged one since Emminger's has been prominent among those shaping Germany's financial policies in the 1960s and 1970s and as such he has, of course, occupied a central position in dollar diplomacy. The paper is interesting in two respects. First, because of what is not said but would normally be expected to appear in such a paper, particularly when it comes from Dr. Emminger. There is no mention of the yen; there is no suggestion that sterling is overvalued, and there is not even a remark to the effect that French financial policies are unsound. More surprisingly the word "money" is never mentioned. Indeed, the closest Emminger comes to mentioning money is a reference to Beryl Sprinkel.

But the paper is also worth noting in that it takes a very strong and decided position on a number of issues ranging from the need for a flexible dollar rate to U.S. deficits and LDC debts. These are the particularly interesting points in Emminger's paper and I will concentrate on them rather than on his interpretation of the historical record. The only point I wish to make in that context is that Emminger surely underplays the role of Germany's policies in the collapse of the Bretton Woods system. Surely it must be agreed that Germany's swing in money growth from more than 12 percent per year to only 6 percent opened the floodgates of speculation in favor of the mark and brought the end of Bretton Woods. It was Germany's choice to opt out of convergence that marked the end of Bretton Woods. This is, of course, very much in the spirit of what Emminger has to say: convergence is good provided it is convergence to the German range of policy targets.

On the exchange rate question Emminger offers a very strong position: the dollar must stay flexible. He notes that the EMS has been a success and within regions there is scope for exchange rate fixing but the North Atlantic rate must remain flexible. Interestingly, while the need for dollar flexibility is emphasized, there is no position on where Japan fits into the conception of the international monetary system. Now the dollar flexibility point is argued with emphasis: specifically Emminger rules out not only outright fixing but also target zones as have been advocated, for example, by the Institute for International Economics.¹ There is not much explicit basis for this position offered in the paper but it is easy to fill in the details. Unless there is coordination of monetary and fiscal policy—the emphasis is not only on money but particularly on fiscal policy—exchange rate targets cannot be defended. Setting exchange rate targets goes hand in hand with setting interest rate and

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¹See the study by J. Williamson, *The Exchange Rate System*, Washington, D.C.: Institute for International Economics, September 1983. See, too, the critical discussion in R. Dornbusch, "The Overvalued Dollar," *Lloyds Bank Review*, April 1984.

budget targets and there is no excuse for even thinking that it is optimal to narrow exchange rate targets if nothing is done at the same time to limit fluctuations in other key macro variables.

On the question of U.S. deficits Emminger's paper offers quite a surprise. He agrees, of course, that the deficits are a disgrace and he labels the current stance of U.S. policy "unsound," "unsustainable" and "high risk." In this he is in the best company. But where he parts company is in his judgment of the benefits of U.S. deficits for the United States and Europe. In his judgment the deficits are bad for the United States and good for the rest of the world: the inflationary effect abroad and high interest rates are overshadowed by these growth effects. These growth effects, he notes, were possible because within limits Europe and specifically Germany has been able to decouple from the U.S. high interest pattern. This is, indeed an important point and it is worth documenting.

Table 1 shows that German real interest rates in the last two years have been lower than those in the United States by a highly significant margin. Moreover, the spread has been widening, demonstrating the possibility of decoupling that Emminger notes. But he also emphasizes another point well worth bearing in mind: convergence of inflation, as has approximately been achieved between Germany and the United States is not enough for fixing rates when at the same inflation rates real interest rates and the full employment budgets are so far apart and when one currency is so ostensibly overvalued. Whatever convergence is to mean Emminger leaves no doubt about the U.S.-European options: "But in no case should 'convergence' be interpreted that the more solid fiscal policies of other countries should be given up."

Table 1.
Nominal and Real Interest Rates

	Germany			United States		
	1982	1983	1984:1	1982	1983	1984:1
Nominal	8.9	5.8	6.0	12.3	9.1	9.7
Real	3.6	2.8	2.2	6.2	5.9	5.5

Another point should be made on inflation convergence and the opportunities for fixing exchange rates. The present overvaluation of the dollar begs the question whether the United States has indeed already achieved a lasting disinflation. It might well be argued that the reduction in inflation is "borrowed" since it has been achieved to some extent by exchange overvaluation that will, when it comes undone, exert strong inflationary pressure. Estimates of the impact of exchange rates on inflation vary but it is not uncommon to argue that a 10 percent dollar devaluation would lead to an extra 2 percent inflation. There is thus quite an inflation backlog in store if the 20

percent or so overvaluation were to be eliminated.²

The LDC debt issue receives rightly prominent treatment in Emminger's review of the problems of adjustment in the world payments system. He sounds a cautiously optimistic note, although through the three drafts I have seen the optimism has become increasingly qualified. But the message is this: adjustment is essential; the international financial system and specifically the IMF have worked well to avoid a breakdown. Most importantly, "a durable solution can, however, only be expected if the restoration of a sound external balance is accompanied by reasonable economic growth in the debtor countries." The rest is a marathon of which we have as yet only seen the first few miles.

The image of the debt problem as a marathon is particularly fitting in view of what happens to the runners. We remember that the first runner did make it, surrendered the purse and collapsed dead. We also know that marathon-running is something that requires practice, not something to get into from one day to the next. Even practiced runners "hit the wall" or give up because they don't get "second wind." All this, of course is happening today. The large debts due to past policy mistakes of the debtors and events beyond their control combine with high interest rates due to U.S. policy mistakes today. The result is a vast transfer of income from poor people in poor countries to wealth holders in rich countries. The process is sustained by the U.S. Treasury that preaches to LDCs the need for belt-tightening and the sanctity of contracts while greasing the wheels for rolling debts.

The debt crisis has forced unusually strong adjustment efforts on debtor countries. Their incomes have been slashed so as to control imports and thus free foreign exchange to service at least part of their external debt. The duration and magnitude of the income decline are frightening in themselves. Adjustment has gone far beyond cutting fiscal extravagance. Indeed, as Mexico's Central Bank governor Mr. Mancera has said: "the more you cut fat, the closer you get to the bone." There can be little doubt that this campaign to transfer resources from poor to rich countries, whatever the legal justification, ultimately will cause the most violent anti-American feelings in the debtor countries. Table 2 shows the decline in per capita income for several Latin American debtors. It is quite clear that the magnitude of the decline is entirely of a different order than what is experienced over the business cycle in industrial countries. The debtor countries are in a full-fledged depression and there is no prospect that they will emerge rapidly. Even optimistic

Table 2.
Change in Per Capita Real Income (1983 as percent of previous peak)

Argentina	Brazil	Chile	Mexico
- 13.5	- 14.6	- 20.3	- 10.4

²The impact of the exchange rate on wage-price behavior in the U.S. is reported in R. Dornbusch and S. Fischer, "Monetary and Fiscal Policy in the Open Economy," forthcoming in R. Gordon (ed.), *Business Cycles*, NBER.

scenarios, such as the IMF's world economic outlook, show growth rates over the next few years insufficient to ensure that by 1990 the debtor LDCs will have reattained the standard of living of 1980.

The difficulties of debtor countries have become further aggravated, and entirely beyond their control, by the 250 basis point increase in interest rates over the last half year in the industrial countries. These interest rate increases lead to increased debt service and thus call for extra foreign exchange. It has been argued that interest rates do not count that much in the debt game, what counts is OECD growth with its beneficial effects on LDC export revenues. Since that growth is well underway, so the argument goes, increased interest rates do not put in question the path of increased credit worthiness spelled out in the adjustment programs. But there is no justification for this view. In the case of the large critical debtor countries—Argentina, Brazil and Mexico—the impact of interest rates on the evolution of the debt-export ratio is quantitatively comparable to that of growth. Specifically, assume a ratio of bank debt to exports of 2.5 which is the case in these countries. An extra percentage point on interest rates implies extra debt service of 3 percent of exports. An extra percent OECD growth increases LDC exports revenues by 2 to 3 percent. There is thus about a 1:1 tradeoff between OECD growth and interest rates. There is surely no basis whatsoever for a 1:6 that Cline³ has claimed in arguing that OECD growth is vital but interest rates are almost a secondary concern.

The increases in OECD interest rates raise the debt service requirements since a large fraction of debts are geared to short-term interest rates. Where does the extra revenue come from? In the long run it might come from expanded exports but in the short run that is surely not the case since export adjustment is time-consuming. It must therefore come primarily from reduced imports. The import reduction is achieved by further cutting economic activity, upsetting adjustment plans only a few months old and setting back the much needed resumption of growth and social progress.

Among the reasonable proposals for solving the debt problem I want to single out a variant of the interest rate cap idea. Of the three variants two seem implausible. One would provide automatic financing of interest charges above a certain level and thus amounts essentially to formalization of the current approach. At present, part of interest payments is borrowed, part is earned and this kind of proposal merely makes automatic the rescheduling process. The proposal is implausible because it entirely rules out debt relief and, indeed, is designed to remove the elements of friction that now work toward negotiations of more balanced debt service terms. But equally implausible is the idea of a concessional cap where all interest above a certain low level would automatically be forgiven. Such a scheme would be ruinous for the banks and hence unacceptable.

³See W. Cline, *International Debt: Systemic Risk and Policy Responses*. MIT Press, 1984 and *International Debt and the Stability of the World Economy*, Institute for International Economics, September 1983. An evaluation is offered in R. Dornbusch and S. Fischer, "The World Debt Problem," unpublished manuscript, MIT, 1984.

A balanced approach recognizes that the debt problem can be solved only if the present interest rate heights are transitory. Moreover it is recognized that both lenders and borrowers misjudged interest rate prospects and therefore should make some accommodation. The proposal is to forgive all interest above some level, say 10 percent, for a limited grace period of three years. Access to these terms would, however, only be available as part of an IMF stand-by agreement. This provision assures that only debtors badly in need would come to benefit and not countries that can service their debts without domestic depression. The advantage of the proposal is that it moves the debt problem toward the medium term, away from liquidity issues toward solvency. It focusses attention of banks, the IMF and policymakers in debtor countries on the need to seek trade-oriented adjustment programs to restore growth as the number one priority. There is no indication in Emminger's present paper that he would go as far as this but there may always be another draft.

General Discussion

Leonard Silk argued that certain interest-rate-capping proposals are not feasible. Without any limits on interest rates, a program that capitalized interest payments beyond some level would as a result of compounding of interest rates "kill" the debtor countries. However, if limits are too low, banks suffer. To what extent is capping a myth?

Dornbusch responded that some form of capping is necessary. Alternatively, a massive write down of loans would incapacitate the banking system. He warned that the real problem lies now with countries such as Bolivia and Peru, rather than Mexico and Argentina. The former are becoming politically radicalized as depressions are imported from the latter.

Otmar Emminger elaborated upon several points. First, a plan to capitalize interest payments above a certain limit, in the form of long-term fixed-interest bonds, might partly shield debtors from higher U.S. interest rates. It would also help banks to avoid burdensome annual reschedulings. Second, he suggested that 1 percent growth in industrial countries' incomes would contribute about \$11 billion to developing countries' export revenues, roughly three times the gain from a 100 basis point fall in the interest rate. Finally, as early as 1977 central bankers discussed how to supervise the rapid growth in net lending to the developing countries. But even in West Germany, it took more than five years to produce legislation that would only limit the growth of bank lending abroad.