The International Monetary System:

Forty Years After Bretton Woods

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Summary

Jeffrey H. Bergstrand*

During the course of the conference, two themes surfaced frequently. First, several participants argued that the present arrangement of floating exchange rates among major industrial countries needs to be reformed to mitigate exchange rate misalignments and instability. Reforms such as exchange rate target zones were proposed to promote fuller international policy coordination. However, several flexible rate supporters stressed greater international policy coordination as a precondition to exchange rate reform. Second, many conferees maintained that we need to undertake measures that will enable the international monetary system to cope with the debt crisis. Interest rate caps, economic austerity programs in debtor countries, increased capital flows to debtors, and other measures were discussed as alternative—but not mutually exclusive—methods for dealing with the crisis.

I. Is There a Need for Reform?

After summarizing the key features of the Bretton Woods exchange rate system and the reasons for its breakdown in 1973, Richard Cooper discussed the strengths and weaknesses of the current "nonsystem" permitting various exchange rate arrangements. He proposed an alternative framework for international monetary relations for the twenty-first century, after speculating about how the world economy would change over the next 25 years.

For the past decade, the international monetary system has exhibited a higher degree of exchange rate flexibility than under the Bretton Woods adjustable peg system and has sustained a relatively open trading environment, according to Cooper. While the economic performance of the 1970s was inferior to that of the 1950s and 1960s, the overall performance of the past decade would likely have been worse if the inflexibility of the Bretton Woods exchange rate system had been retained.

Yet Cooper alleged that existing monetary arrangements are inherently unstable for two reasons. First, exchange rates often vary without regard to underlying economic fundamentals, especially relative inflation rates. In fact, economists have generally failed to explain short-run exchange rate movements. Consequently, exchange rate impacts of domestic policy actions are often unpredictable, making macroeconomic management more difficult. Second, flexible exchange rates allow governments to try to manipulate these rates for domestic gains. Despite the uncertainty in exchange rate

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responses to domestic policy actions, governments will be tempted increasingly to try to pass problems such as excessive inflation or unemployment on to other countries.

Cooper then presented a possible scenario for the world 25 years from now. The year 2010 is far enough ahead so that major reforms can be seriously contemplated. However, it is not so far ahead that certain technological advances and economic changes cannot be anticipated. In his view, manufacturing will likely have followed the path of agriculture whereby a declining share of the labor force will be necessary to produce the industrial goods that society needs. Financial transactions will take place virtually instantaneously as a result of developments in the computer and electronics industries. These developments will facilitate firms' managerial control of production locations around the world, lowering transport costs and encouraging trade.

Given the intrinsic flaws of the current exchange rate system, Cooper argued that such an environment would induce governments to try to restore control over national economic activity by instituting domestic controls over trade and capital flows—in the absence of any internationally coordinated reforms. The growing impact of external disturbances on national economic activity would increasingly frustrate governments, which would likely institute controls over capital movements to try to insulate their economies from foreign influences. Because capital transactions and current account transactions are inextricable, controls over the latter would likely evolve also. Consequently, international trade would diminish.

Cooper suggested that a credible system of fixed exchange rates, by contrast, could maintain an open trading environment in the presence of such technological and economic innovations. Exchange rates could be most credibly fixed if they were eliminated altogether, that is, if international transactions took place using a common currency. Yet a common currency would be viable only with a common monetary policy. While implementing a single world currency may seem overambitious for the year 2010, a common currency for a large community of nations would be feasible. The U.S. Federal Reserve System could serve as a model. The number of votes that a participating country would have on the governing board of this supranational monetary authority could be proportionate to the country's share of the nations' combined income. Like the Federal Reserve, the supranational monetary authority could engage in open market operations and issue broad minimum guidelines for bank regulation. Governments could still pursue fiscal policy at the national level. But having given up substantial control over domestic monetary policy, they could not engage in inflationary financing of budget deficits. Financial markets would coordinate national fiscal policies via interest rate changes. Balance of payments adjustments between countries would be comparable to those between regions of the United States.

Since this idea is so far from being politically feasible at present, Cooper noted that it will require many years of consideration before people become accustomed to the concept. Yet the economic effect could be approximated in the near future by giving more emphasis to exchange rate

movements in setting national monetary policies. This recommendation applies largely to the United States, Canada, Japan, the United Kingdom, and the community of European Monetary System (EMS) countries rather than the many free-market economies currently maintaining fixed exchange rates.

Lord Eric Roll agreed with Cooper that the international monetary framework did need reform, although he suggested that the world economy may not be able to wait 25 years. Roll noted ostensible similarities between the world economy at the time of the Bretton Woods agreement and the world economy now, such as a preceding decade of exchange rate instability, increasing pressure for protectionism, and large amounts of indebtedness. Yet many differences also exist. The convergence of views on macroeconomic theory and objectives widespread then is absent now. The Third World's economic ills were relatively less important then than now. The concentration of world economic power in the United States and the United Kingdom in the mid-1940s has since been diffused.

Ariel Buira commented that Cooper's framework could founder upon several political and economic realities. At any time, countries are at different stages of the business and electoral cycles. Moreover, countries have different economic and political goals. Will a country with a high growth rate and a low inflation rate be willing to give up its monetary policy independence for external reasons? Perhaps, Buira suggested, a less formal framework than Cooper's—stressing the need for greater policy convergence internationally and increased foreign exchange intervention—is appropriate.

In any case, reform should emphasize symmetry in the adjustment process, according to Buira. Surveillance over domestic economic policies should apply to industrialized as well as developing countries. The IMF should be granted greater authority to enforce symmetry in global adjustment. Policies for adjustment among developing countries should stress production and investment in strategic sectors as well as demand management.

Anthony Solomon argued that much of the current misalignment of exchange rates is attributable to expansive U.S. fiscal policies. Greater exchange rate stability would likely evolve from greater international coordination of fiscal policies. National monetary policies would be easier to frame once fiscal policies were coordinated. Yet fiscal policy coordination cannot be brought about through the back door by simply reforming the exchange rate system. He added that some reform of existing financial mechanisms and arrangements is necessary in light of the current debt crisis to ensure adequate financing for developing countries.

Richard Cooper acknowledged the conventional wisdom to be that an overly expansive fiscal policy largely explains high U.S. nominal and real interest rates and the overvalued dollar. The U.S. budget deficit in 1982, however, was not out of line when adjusted for the recession's severity with those in previous years of recession, notably 1958 and 1975. But the positive short-term real interest rates estimated for 1982 are in sharp contrast to the

zero or negative rates estimated for 1958 and 1975. Consequently, U.S. monetary policy may have been notably tighter in 1982 than in the other two recession years.

II. Liquidity and Lending

John Williamson addressed the issue of international liquidity:[1] Is its level adequate to sustain world economic recovery? If not, how should it be augmented? On the first question, Williamson's answer was negative; the debt crisis being experienced by so many developing countries is—practically by definition—evidence of a global reserves shortage. Using a buffer stock approach, he estimated that the capital-importing developing countries faced an international reserves shortage of about $22 billion as of mid-1983. Responding to the second question, Williamson proposed a new allocation of special drawing rights (SDRs) to expand world liquidity.[2] An SDR 21 billion allocation (roughly U.S. $22 billion), distributed according to IMF quotas, would suffice as long as the reserve-surplus countries allow the reserve-deficit countries to earn the extra reserves that the latter need. The size of the allocation could be adjusted for the earliest feasible issuance (January 1985) and for expected reserve supply increases arising from alternative sources. The adjusted figure for the new allocation would be SDR 10 billion. Without such a reserves expansion, the industrial countries would need to bear a greater share of the adjustment burden because the developing countries would be forced to reduce imports of goods and services further.

Williamson noted that the world financial community has passed up previous opportunities to alleviate the current global reserves shortage through new SDR allocations. Opponents have warned of potential inflationary consequences, though even conservative estimates suggest there is a liquidity shortage. Others argue that an SDR allocation would deter developing countries from pursuing the necessary adjustment policies—that is, the appropriate policies to restore internal and external balance. However, the proposed allocation is dwarfed in size by recent bank loans that were conditioned upon austerity programs already underway. Some perceive a new allocation as providing more aid. Yet such an allocation would tend to alleviate the present dilemma of "reverse aid;" that is, the net resource transfer is now from the developing countries to the rest of the world, according to Williamson. A penalty interest rate on SDR use or a new reconstitution requirement might be desirable. Finally, the author

[1]International "liquidity" is largely synonymous with international "reserves." The latter are defined in the Ossola Report (according to Williamson) as "those assets of [a country's] monetary authorities that can be used, directly or through assured convertibility into other assets, to support its rate of exchange when its external payments are in deficit." Group of Ten, *Report of the Study Group on the Creation of Reserve Assets,* 1965, p. 21.

[2]A special drawing right (SDR) is a reserve asset ("paper gold") which was created by the International Monetary Fund in the late 1960s. SDRs are mutually acceptable among member countries for settling official debts. An SDR's value is calculated as a weighted average of 16 countries' exchange rates. In May 1984, one SDR was equivalent to (U.S.) $1.06. SDR allocations were made on January 1 of each of the following years: 1970–72, 1979–81.

noted that the limited usability of SDRs would be mitigated once SDRs were adopted for settlements within the private sector and between official and private sectors. The creation of an SDR clearinghouse would facilitate such settlements in SDRs, enhancing the SDR's role as an official intervention medium in foreign exchange markets.

In his discussion, Max Corden focused on the significance of a new SDR allocation for the industrial countries, for the debt-burdened developing countries in the near term, and for all capital-importing developing countries in the long run. First, Corden suggested that such an allocation would have an insignificant impact on industrial countries' net total reserves. The level of international liquidity among these countries is determined by their demand for and supply of reserves. If more SDRs were issued, industrial countries could merely adjust their holdings of foreign exchange reserves, leaving the level of their total reserves virtually unchanged. While causing no harm, the allocation would be inconsequential. Furthermore, even if the SDR increase expanded international liquidity, world inflation need not be affected because exchange rates are flexible among the industrial countries. Second, an SDR increase allocated proportionately across countries according to their IMF quotas would be akin to using a "very broad sledgehammer to crack an admittedly large but narrow nut." While the debt-burdened developing countries would benefit from an expansion of their liquidity, the SDRs allotted to them would be too small to help them materially in the immediate crisis. Third, even if the debt crisis dissipates, Corden agreed that an SDR allocation, perhaps directly to the developing countries, *would* be feasible for the long run under either of two assumptions. First, private capital markets might have incorrectly appraised many developing countries as not creditworthy. Alternatively, there might be a need for aid.

During general discussion, Henry Fowler[3] asserted that a single compelling *new* reason for an SDR issue has yet to surface. Yet an old reason still exists. Regular and modest SDR creations would encourage the SDR's use as the primary international reserve medium, as recommended in the second amendment to the IMF Articles of Agreement. Williamson added that if the vast external debt incurred by certain developing countries had been denominated in SDRs rather than dollars, the local currency costs of servicing and repaying these debts would not have risen as sharply.

Pedro-Pablo Kuczynski's paper also addressed the problems facing the capital-importing developing countries, particularly the Latin American nations (and the Philippines). He pointed out the striking contrast between these countries' external payments situation and that of other developing countries. While the total external debts of Latin American countries and of other developing countries were roughly equal in amount at the end of 1983, Latin America's ratio of debt to merchandise export earnings was more than triple that of other developing countries. Furthermore, for Latin American countries the cost of servicing their external debt was 42 percent of merchandise export earnings in 1983, compared with only 12 percent for other developing countries.

[3]Limited Partner, Goldman Sachs & Co.

According to Kuczynski, Latin American problems will not be manageable without lower world interest rates, higher primary commodity prices, greater capital inflows, and economic reform. The large interest payments of the debtor countries must be reduced without curtailing the net lending by commercial banks of the industrial economies. A lowering of the lending rate to the cost of money—say, the Certificate of Deposit (CD) rate—could reduce the debtor countries' interest payments by $8 billion, or over a third of their combined current account deficit for the coming year. While this would lower the commercial banks' income stream, it would concurrently lower the risk of default on such loans. Sustained world economic growth would help to raise primary commodity prices and would expand debtor countries' exports. The reduction in net lending by banks to these countries from $29 billion annually over the period 1979 to 1981 to only $7 billion in 1983 and a projected $10 billion in 1984 is a disturbing trend that should be reversed. Finally, austerity programs have been undertaken in most of these countries, with notable success in Mexico. However, the intensity of such programs fans social unrest, particularly within the urban lower-income populations, and increases the risk of political upheaval. The continuing decline in real per capita income—a 13 percent decrease between 1980 and 1983—cannot be sustained indefintely without even greater turmoil.

Charles Kindleberger agreed with Kuczynski on the need to limit interest payments for most Latin American countries. Kindleberger favored a negotiated approach, initiated by Latin American countries, with interest rate caps applied only to outstanding debts. An interest rate reduction agreement would initially shift more of the burden to the banks' stockholders. However, the values of their shares could ultimately exceed the levels commensurate with a default. Such a program to aid the international finances of developing countries would be consistent with the asymmetric standards apparent in international trade, which also favor developing countries. Kindleberger suggested that rolled-over loans that were conditioned upon IMF-approved austerity programs should not permit interest rate increases but should allow interest rate declines.

While recognizing the importance of the IMF, Kindleberger expressed concern that the Fund did not respond swiftly enough as lender of last resort for the capital-importing developing countries. He had more confidence in ad hoc measures such as the Bank of International Settlements' bridging loans and the industrialized countries' swap networks. Consequently, he suggested that "we concern ourselves with mending fences, stitches in time, and similar old wives' tales."

III. Exchange Rate Arrangements

The next two papers returned to the longer-term focus initiated by Cooper: How should current exchange rate arrangements be reformed? Robert Roosa suggested the adoption of target zones for exchange rates initially among the currencies of the United States, Japan, and West Germany. The three governments would have to choose initial values (within

some band) for the three exchange rates. The governments would then have to maintain desired exchange rate values using coordinated monetary and fiscal policies and joint foreign exchange market intervention. They would also have to meet regularly to set objectives. According to the author, the United States, Japan and West Germany would have to "accept responsibility for bringing their national economies, and their currencies, into a pattern of compatibility...." The target zone plan would require extensive consultation among the three countries beyond the exchanges of information that currently occur, as well as "harmonizing the domestic and the external economic performance of each country with the other two...."

The presumed consequences of this proposal would be the restoration of certain beneficial aspects of the Bretton Woods gold-exchange standard. Roosa expects that exchange rate fluctuations would decline as the three countries jointly intervened to smooth exchange rate movements, a development which would also benefit other countries pegging to any of these three rates. Smaller exchange rate oscillations would reduce fluctuations in the SDR's value, because these three currencies dominate its valuation. The smoothing of the SDR's value would encourage its use as an internationally accepted unit of account. A target zone system would also enhance the role of economic fundamentals in determining exchange rate movements. Finally, Roosa suggested that the very process of organizing and implementing such an arrangement would "impel a shaping of domestic policy [by each country] to sustain a viable international position for each of the three."

In his discussion, Jacob Frenkel pointed out that the strongest argument for such an approach, in principle, is that the existence of target zones would force governments to adopt policies that conform to the system. But in practice, democratic governments that have had to choose between domestic economic goals and external commitments have typically selected the former. The issue of discipline should thus be placed in perspective. To enforce target zones, participating governments would have to coordinate monetary and fiscal policies or actively intervene in foreign exchange markets. However, recent empirical evidence suggests that sterilized intervention has little lasting impact on exchange rates, since such intervention leaves the domestic monetary base unaffected. Furthermore, Frenkel doubted that these governments would be willing to subordinate domestic monetary policies, and maybe even fiscal policies, to these supranational goals.

During the subsequent discussion, Roosa added that foreign exchange market intervention would be an essential but minor aspect of a target zone system. Instead, a target zone system would encourage a "mutual acceptance of a joint responsibility" for exchange rates prevailing among a group of participating countries. These countries would exchange ideas and design domestic economic policies taking into account their external commitments. Frenkel rejoined that he also wants to address the problem of exchange rate misalignments actively, but he sees poor macroeconomic policies rather than a poor exchange rate system as the source of these misalignments. If

macroeconomic policies were modified and coordinated first, a flexible exchange rate system would "deliver the right thing."

Robert Triffin's paper also addressed reform of present exchange rate arrangements, emphasizing the lessons to be drawn from the evolution of the European Monetary System (EMS). Established in 1979, the EMS was created to reduce the dependence of members' economies on "the vagaries of an unstable dollar" and, in the longer term, to propel members toward a full monetary, economic and political union. Triffin claimed that the EMS has achieved partial success in reaching the first objective. Over the past five years, the EMS has preserved, or at least quickly restored, real exchange rate stability among members by periodically adjusting exchange rates to offset persistent inflation rate differentials. Progress toward the second objective has been slow because policymakers in member countries have been reluctant to concede control over domestic monetary and fiscal policy.

Yet much progress toward making the European Currency Unit (ECU) the dominant currency among EMS countries has been achieved.[4] Private use of the ECU has grown spectacularly during the early years of this decade. International contracts are increasingly denominated in ECUs. Triffin speculated that if and when the dollar depreciates, the role of the ECU in official and private settlements within and outside the EMS will be further advanced. Growing use of the ECU should encourage a harmonization of economic objectives within the EMS, enhancing the possibility of a full economic union. He noted that the success of the EMS should even "inspire a renewed drive for a reformed world monetary order...."

Robert Solomon commented that international economic systems are not "God-given and immutable;" such arrangements can be reformed and improved. He pointed out that the intrinsic flaws of the Bretton Woods system concerned the balance of payments adjustment process and the lack of a provision for expanding international liquidity. Yet the original conference participants should not be blamed entirely; responsibility must be shared by the subsequent generation, which provided only sporadic reforms. Solomon agreed with Triffin that the creation of the EMS was one of the more successful reforms. He questioned, however, whether the real exchange rate stability achieved by the EMS might not have been gained at the cost of lower employment and income than might otherwise have been attained.

Triffin responded that observers on the whole have been surprised at the success of anti-inflationary policies within the EMS, but he has come across little support for the view that employment and income have been lower in the EMS countries than would have been the case in the absence of the system. Lord Eric Roll asked whether the EMS has induced greater policy convergence among member countries than otherwise would have been attained. Triffin expressed no doubts that it has. He added that opportunities for regional coordination exist even where wider international economic cooperation is not feasible.

[4]The ECU is a weighted average of the exchange rates of nine Common Market countries. In April 1984, one ECU was equivalent to (U.S.) $0.82.

IV. Capital Flows, Trade Flows, and Exchange Rates

Henry Wallich's paper focused more narrowly on the relationship between exchange rates, international capital movements, and goods and services trade. According to Wallich, at least one-half of the total U.S. current account deficit should be attributed to the rise in the foreign exchange value of the dollar through the end of 1983. Yet the higher value of the dollar also indicates to Wallich an "overfinanced" deficit. That is, for the foreign exchange value of the dollar to have risen the demand for dollar-denominated assets abroad must have exceeded the U.S. supply. Consequently, Wallich addressed two questions: First, are capital flows determining exchange rates and thereby driving goods and services transactions, or vice-versa? Second, will the strong demand for dollars in foreign exchange markets continue and, if so, for how long?

Wallich suggested that the foreign exchange market may shed some light on the first issue. Daily foreign exchange transactions in the New York exchange market alone, expressed at an annual rate, are about 10 times the sum of annual U.S. exports and imports. He conjectured that foreign exchange transactions for capital flows are potentially large enough to swamp such transactions for goods and services trade. Thus, capital flows are likely to dominate exchange rate movements and consequently to drive current account transactions.

Regarding the second issue, Wallich noted that the projected $80 billion U.S. current account deficit for 1984 could wipe out most of the (positive) U.S. net foreign investment position, reducing the U.S. role as a net creditor to the rest of the world. But he added that, given the very large stocks of claims on and liabilities to the United States, the demand for these claims and liabilities may be elastic enough to accommodate such a deficit without an extreme change in the value of the dollar. Furthermore, since the market has long taken into account existing and projected U.S. deficits, exchange rate movements in the near future could reasonably be expected to be gradual. He added that the outcome will depend on U.S. financial policies, especially regarding a reduction in projected budget deficits which the market probably expects.

Robert Aliber in his discussion expressed dismay that the richest country in the world is headed toward being a net debtor to the rest of the world. This development reflects mounting U.S. current account deficits, which could be attributed to relatively high real U.S. interest rates resulting from projected large U.S. budget deficits. However, these high U.S. interest rates cannot be explained entirely by the projected domestic budget deficits. Aliber believes there is a need for an alternative explanation of the level of real U.S. interest rates.

In reforming the system, Aliber suggested four factors that should be recognized. First, economists should not try to solve political problems pertaining to monetary reform. Second, international reform should be attuned to present circumstances; that is, a return to Bretton Woods would not work. Third, the larger the size of a proposed economic union the less likely is its

success. Fourth, great reforms do not emanate from mediocre political leaders.

In general discussion, Edward Bernstein[5] expressed doubt about a near-term fall in the dollar's value. Without some fundamental improvement in the perceived creditworthiness of developing countries, Bernstein did not foresee any massive shift internationally out of dollar-denominated assets. Scott Pardee[6] added that foreigners do not enjoy the tax breaks on domestic interest payments that U.S. residents do. Consequently, a high real interest rate on U.S. loans to foreigners is consistent with a zero, or even negative, real interest rate paid by U.S. residents. William Poole[7] expressed surprise that Wallich paid little attention to the issue of efficient allocation of capital. Poole suggested that the strength of the dollar and high real U.S. interest rates are consistent with a relatively high real rate of return on investments in the United States now—in contrast to the late 1970s. The seeming paradox is that the United States, a relatively mature economy which should have a low rate of return, is experiencing a high rate of return on investments, while developing countries are now experiencing atypically low rates of return.

V. Adjustment

Otmar Emminger's paper evaluated balance of payments adjustment and financing in the postwar era. Throughout this period, most external deficit countries continually faced a tradeoff between financing external deficits and adjusting domestic policies to eliminate these deficits. These countries persistently leaned toward financing rather than adjustment. For instance, after the 1973 oil shock many countries paid for their larger oil import bills by shifting the balance more towards financing. Even after a 1976 Fund meeting stressing the importance of adjustment, commercial banks rapidly expanded their international lending to finance developing countries' deficit spending. Yet Emminger sensed that the medium-term situation now is manageable, assuming continued forceful adjustment among troubled debtor countries and sustained growth in the industrial countries.

In the case of the U.S. current account deficit, Emminger suggested that the United States rather than its trade partners bore the greater burden of this imbalance as a result of foregone U.S. exports. Since such a large external deficit is unsustainable in the long run, the current exchange rate pattern has become highly fragile. However, large projected U.S. structural budget deficits do not alone explain high U.S. real interest rates relative to Japan and West Germany. The latter two countries have been heading toward lower structural budget deficits. He added that the more solid fiscal policies of these two countries should be continued.

In concluding, Emminger noted that a flexible dollar exchange rate vis-à-vis the EMS currencies is essential to the system of world payments adjustment. For European countries, floating relative to the dollar provides partial protection against large external shocks such as oil price rises and against

[5]Guest Scholar, The Brookings Institution.
[6]Executive Vice President, Discount Corporation of New York.
[7]Member, Council of Economic Advisers.

U.S. policies that diverge from European ones. More importantly, the vast amount of liquid dollar holdings in the world could "quickly topple any fixed dollar rate and derail even a mere target zone arrangement, as soon as psychological or political accidents happen."

Rudiger Dornbusch's comments focused on two aspects of the paper: the dollar problem and the LDC debt problem. Dornbusch agreed with Emminger that converging inflation rates are not enough to ensure stable exchange rates among industrialized countries. Diverging fiscal policies and real interest rates can create exchange rate misalignments. Regarding the debt problem, Dornbusch agreed that adjustment is necessary and that the IMF has helped to avoid a breakdown in the international monetary system. Yet adjustment, according to Dornbusch, has gone far beyond cutting fiscal extravagance. The current campaign could breed strong anti-American feelings. Standards of living in the adjusting developing countries may not reattain their 1980 levels for more than a decade. A solution to the debt problem must recognize that present high interest rates are transitory. For instance, a plan to forgive interest above some level (say, 10 percent) for a limited grace period—subject to IMF conditionality—would help debtors in dire need, but it would dissuade countries able to service their debt from incurring domestic depressions.

Adolpho Diz focused on the issue of conditionality in balance of payments adjustment. Conditionality refers to the stipulation of policy reforms that the IMF expects a country to adopt before drawing upon its resources. These policies usually entail economic austerity measures and currency devaluations. During the IMF's early years from 1946–52, its resources were scarcely used and conditionality was virtually absent. By 1968, the IMF's Articles of Agreement had been amended in two important respects. First, the Fund was required to adopt policies regarding allocation of its resources. Second, the IMF could challenge a country's proposed drawing on these resources (except gold tranches) if such use was perceived to be incompatible with Fund policies. The concept of conditionality had become fully developed.

Two techniques became prominent in the practice of Fund conditionality: designing economic programs and having consultations. Economic programs helped countries—especially developing countries—to focus on the relationships among fundamental economic variables in their economies. These programs encouraged the development of data collection and statistical analysis and the implementation of objective performance standards for these countries. Consultations helped to initiate personal contacts. They gave Fund staff members better perspectives on a member's policymakers, institutions, and political climate. Furthermore, they improved members' understanding of the Fund's diagnoses and recommendations.

During the 1970s, the Fund's capacity was expanded to develop special policies for special balance of payments problems, as the international monetary system changed in fundamental ways. According to Diz, the IMF's reaction to the economic turbulence of this period could be summarized as follows: the degree of conditionality was relaxed for certain short-term financing facilities, the degree of conditionality was maintained for extended-term

facilities, and additional facilities were provided. Yet this reaction had two negative features. First, since the Fund had to borrow heavily to meet its commitments, the cost of borrowing for members rose significantly. Second, as more members borrowed, conditionality became more stringent, on average, owing partly to the constraints on nonborrowed Fund resources.

Since 1979, the practices of the Fund have benefited from few innovations, despite a dramatic increase in the demand for its resources. The bulk of the Fund's assistance to members has been under facilities requiring stringent conditionality. Yet the Fund has facilitated cooperation among commercial banks, central banks, and creditor and debtor governments. Diz concluded that a new perspective on conditionality may be forming, with a greater emphasis in the Fund on developing early warning procedures.

In his discussion, Eduardo Wiesner stressed that he had seen no fundamental change in the principles underlying the concept of conditionality in the past four decades to the benefit of the international monetary system and individual countries. Wiesner attributed this continuity partly to a fundamental maxim: resources are scarce. Conditionality is the implicit cost of obtaining scarce Fund resources. Borrowing countries knowingly face a tradeoff between a gradual, planned adjustment using the Fund's conditional resources or a sudden, perhaps calamitous, adjustment in the absence of conditional resources.

Wiesner noted that consultations and comprehensive economic programs surfaced as important Fund techniques because of the progress made in the 1950s and 1960s toward understanding the adjustment process. If balance of payments problems were temporary and self-reversing, there would be no need for extensive IMF assistance or for conditionality. Conditionality would be appropriate only when payments imbalances were caused by persistently inappropriate monetary and fiscal policies. Wiesner agreed with Diz that conditionality became more stringent on average during the 1970s owing to increased use of Fund resources and a limited nonborrowed Fund resource base. According to Wiesner, the only way to lower conditionality is to increase Fund resources.

VI. The Role of the Fund

In the final paper, Jacques Polak discussed the role of the IMF in the international monetary system. Initially, Polak reviewed how the Fund's role has evolved in the face of changes in the world financial system and in opportunities for action. For instance, regarding exchange rates among the major currencies, the Fund's influence persistently declined during the past decade of flexible rates. Yet the Fund has steadily encouraged the use of exchange rates as a component of the adjustment process in small and medium-sized countries.

The dominant problem of the Fund, according to Polak, has been choosing the appropriate relative dosage of adjustment and financing. In the 1960s, too much attention was devoted to the problems of financing rather than to those of adjustment. Even after the first oil shock in the early 1970s, several industrialized countries—notably, the United Kingdom, France and

Italy—preferred to offset the contractionary impact of a rise in oil prices and resisted adjustment. When the second oil shock occurred, however, numerous countries responded with a much stronger dose of adjustment. Ironically, the growing international awareness in the late 1970s of the need for adjustment was accompanied by an increasing reliance of LDCs and small OECD countries on unconditional commercial bank credit. The inadequacy of the Fund's nonborrowed resources at the time contributed to the enlarged role for commercial banks as creditors to these economies. Despite quota increases, the total of Fund quotas as a percent of world trade in the late 1970s (3.4 percent) was less than half that in the late 1960s (9.1 percent).

In 1980, the Fund adopted measures to expand its conditional lending capacity and subsequently enlarged its role in financing among countries with adjustment problems—stimulated, of course, by the debt crisis. With the recent expansion of the IMF's influence and available resources, Polak felt the Fund had begun to fill an international void. The Fund now prevails upon commercial banks to roll over debt and maintain open lines of trade credit. It works with central banks and governments to reschedule debt and to provide additional credit. It helps debtors obtain bridging loans from the Bank for International Settlements. Despite the IMF's increasingly decisive role in channeling financial flows to the Third World, Polak did not foresee a long-term role for the Fund as a regulator of the growth of international credit and liquidity. He indicated that the Fund could make a long-term contribution through periodic unconditional SDR allocations, although such allocations should not undermine the importance of conditionality and adjustment in general Fund lending.

C. Fred Bergsten commented that the Fund has successfully demonstrated global leadership during the recent international lending crisis. However, the IMF has not satisfactorily handled other important responsibilities pertaining to the international financial system. First, the Fund should exert greater influence on policies within and among the major industrialized countries. Although critical of the size of U.S. budget deficits, the Fund has ignored the excessive fiscal tightening common among other major industrialized countries, notably Japan and West Germany. Bergsten suggested that a target zone system, implemented and managed with Fund assistance, would be a promising way to encourage IMF surveillance over industrial as well as developing countries. Second, the Fund has failed to improve the LDCs' reserve position. Bergsten recommended a large one-time SDR allocation, followed by more modest allocations at annual intervals. With inflation now subdued, a "rear end loaded" SDR allocation, say, in 1985, could help alleviate the LDC reserves shortage with little impact on world prices. Third, the IMF should now enter private capital markets to prepare for any future borrowing emergencies. Fourth, the Fund should coordinate its activities with the World Bank to benefit from the latter's expertise and to pool resources for lending. In general, the Fund should expand its role as coordinator of the global economic and financial system.

Polak remarked that the costs to the IMF of entering the world capital market could well exceed the benefits. Once the IMF entered that market, the perceived quality of Fund paper (SDRs) held by central banks might

diminish. Consequently, the SDR's value could be substantially reduced. He noted that the Fund's ability to improve surveillance over global economic policies is constrained by existing mechanisms. The prevailing forums for discussion—economic summits, OECD meetings, IMF interim committee sessions, and the like—are handicapped basically by conflicting views on what good policy is. Consequently, surveillance has been very broad but not very deep.

VII. Summary

Several conference participants recommended that the major industrial countries improve coordination of their domestic macroeconomic policies. Projected U.S. budget deficits were often criticized as potentially harmful to world economic recovery by raising real U.S. interest rates above current levels. In addition, Japan and West Germany might have to ease their fiscal policies to ensure sustained world economic growth. Furthermore, exchange rate movements could be increasingly taken into account in framing domestic monetary policies.

Supporters of exchange rate target zones emphasized that such a system would encourage participating countries to consult regularly and to design domestic economic policies taking external commitments into account. Opponents suggested that such a system could be blown away unless countries first coordinated their macroeconomic policies. Furthermore, once policies were coordinated, there would be no need for such zones.

Some conferees argued that the international debt crisis could be managed with some policy reforms and under certain plausible assumptions—especially sustained world economic growth. The IMF was cited as having filled an international void by prevailing upon banks and governments to reschedule debts and by arranging consultations and economic adjustment programs for debtor countries. Economic austerity measures have been successful in some countries, notably Mexico, in reversing the deterioration of their external accounts. However, the declines in per capita incomes have been substantial. According to some conferees, such declines cannot persist without increasing social unrest and the risk of political upheaval and default.

SDR allocations, interest rate caps, and greater capital flows to debtors were among the policy recommendations that surfaced at the conference. One author argued that the banking crisis is a manifestation of a liquidity shortage and that an SDR allocation could help to alleviate this shortage. Alternative suggestions were made to limit, defer or forgive interest payments for certain debtors. According to some participants, any of these measures would likely reduce short-term profits of the commercial banks affected. However, the value of bank stocks could rise in the long run as the risk of default declined. Finally, the reduction in commercial bank net lending to these countries should be reversed, according to some conferees. Greater capital inflows are necessary to finance the debtors' adjustment to the more restrictive monetary policies of the industrial economies—notably the United States—in the 1980s relative to the late 1970s, and to promote a sustained recovery among the debtor nations.

Reflections on Bretton Woods

Edward M. Bernstein*

To those who had experience with the difficulty of getting international cooperation after World War I, the Bretton Woods Conference seemed like a miracle. The half dozen or more conferences on economic, monetary, and reparations problems from 1920 to 1933 accomplished nothing except the establishment of the Bank for International Settlements to deal with the transfer of reparations. The economic section of the League of Nations had a committee of experts that studied the gold question for several years, but their report came after Britain abandoned the gold standard and, in any case, was not unanimous. By contrast, the Bretton Woods Conference was very successful. One reason was the thorough technical preparation which began two and a half years before the Conference was held. Another reason was that the failure to agree on a plan would have had a serious effect on morale in the allied countries.

This does not mean that there was general agreement on what the postwar problems would be. One widely held view was that the greatest problem was the danger of a recurrence of a deep depression in the United States. Those who held this view wanted the resources of the new institution to be very large, to expand steadily, and to be available automatically. They also wanted considerable freedom for countries to change exchange rates, to maintain exchange restrictions, and to postpone convertibility. At the time Keynes wrote his proposal for a Clearing Union, he probably leaned to this pessimistic view of the postwar world. At a dinner he gave to Walter Gardner and me in 1943, Keynes said that the United States would be glad that the new institution would allow control of capital flows, as there could be a flight from the dollar after the war. I asked whether that was because there might be a depression in the United States and a fear of a possible devaluation of the dollar. Keynes said that was what he meant. After Bretton Woods, however, Keynes came to believe that the dollar payments problem would be solved by expansion in the United States.

Harry White thought that the most important postwar problem was the threat of competitive exchange depreciation and discriminatory exchange controls. He thought that Britain would quickly recover its capacity to produce and that the $4 billion of sterling balances accumulated during the war would give her an unfair advantage in exporting to the countries that held these balances. White also feared that Britain might devalue sterling immediately after the war and thus add to its competitive advantage in world export markets. After the Bretton Woods Conference he testified before the Senate Banking Committee that if the International Monetary Fund were established, Britain would need no help from the United States after the war.

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When I wrote the report of the Senate Banking Committee on Bretton Woods, I said plainly that the Committee did not agree with White's testimony and that Britain's need for a loan would have to be determined in the light of conditions at the end of the war.

Even within the U.S. technical group there were differences of opinion regarding the White Plan for an International Stabilization Fund. At that time, many economists in this country held the view that the U.S. economy was doomed to stagnation, and they preferred a bolder plan. Even Professor Jacob Viner thought that the White Plan was too cautious. He described it as providing an umbrella when the world needed a bomb shelter.

On the other hand, the Federal Reserve Board believed that the White Plan did not impose enough discipline. My notes on the meeting that White and I had with the Federal Reserve Governors and the staff contain this statement: "Mr. Gardner raised the question whether it wouldn't be desirable to require so much gold to be paid into the Fund that no country would have sufficient free gold to be able to disturb the international balance of payments without being subject to the discipline of the Fund." White and I also met with the directors and officers of the Federal Reserve Bank of New York where John Williams expressed the view that the structure of the White Plan was too elaborate. He thought the practical approach would be an agreement with Britain to stabilize the dollar/sterling exchange rate—the two key currencies. He later changed this, perhaps in response to our criticism, to the key-country approach.

Both the United States and the United Kingdom discussed their plans with other countries. My notes show that we held discussions with 28 countries, some brief and some extended. The longest discussions, as would be expected, were with the British and covered both the White Plan and the Keynes Plan. The Canadians produced some proposals of their own to bridge the differences in the U.S. and British plans, with some new ideas not in either plan. The Treasury amended the White Plan on the basis of these discussions to take account of the main concerns of other countries. Although we did not believe there would be a postwar depression or that the U.S. balance of payments would cause difficulties for other countries, we agreed to include a scarce currency provision in the White Plan. This would allow other countries to impose discriminatory restrictions against the United States if the dollar holdings of the Fund became scarce because of a large and persistent U.S. surplus as a result of a depression in the United States. By these compromises we reached agreement on the main features of the new institution.

The agreement was put in the form of a Joint Statement of Experts on the Establishment of an International Monetary Fund. It covered the purposes and policies of the Fund, par values and changes in exchange rates, scarce currencies, and the transitional arrangements on exchange controls. These were the principles for which the Bretton Woods Conference would provide the details. A wide range of detail can be said to embody the same principle, so that there was plenty of work to be done at Bretton Woods. The Conference had two commissions, one on the Fund over which White presided, and the other on the Bank over which Keynes presided. The Fund

Commission had four committees which considered the relevant parts of the Joint Statement and alternative provisions that the participants submitted.

The work went surprisingly well. The U.S. delegates, the chief technical adviser and the chief legal adviser met every morning to discuss the questions that came up and to instruct our representatives on the committees as to the U.S. position. There were a few questions that the Fund Commission could not resolve and they were finally referred to a Special Committee on Unsettled Problems. The greatest credit for resolving all problems, however, should go to the drafting committee which found the right words to reconcile lingering differences. At a dinner in Ottawa last year, I heard Governor Rasminsky, who was chairman of the drafting committee, explain that there were no unintentional ambiguities in the Fund Agreement.

It says much for the skill and tact of the drafting committee that there was universal satisfaction with the Articles of Agreement. Even Keynes, who had fought hard in the discussions with the United States to have the new institution in the form of the Clearing Union, stated later in the House of Lords that "the new plan... [is] in some respects... a considerable improvement on either of its parents." I am glad to second that view. The Fund Agreement that came out of Bretton Woods was simpler, clearer, and more workable than either the Keynes Plan or the White Plan.

I have sometimes wondered whether Keynes really wanted everything that he argued for in the Clearing Union. At a meeting in the Treasury in October 1943, Keynes announced that Britain was willing to accept the amended White Plan, but that he wanted to rewrite it in terms of the bancor. If the British were willing to accept the White Plan, I asked, what was the need to rewrite it. Because, Keynes said with vehemence, your plan is written in Cherokee. Later, in a speech in the House of Lords, Keynes said that with the new agreement "there is no longer any need for a new-fangled international monetary unit. Your Lordships will remember how little any of us liked the names proposed—bancor, unitas, dolphin, bezant, daric and heaven knows what." I think Keynes would have liked SDRs but not the name.

I am not sure that Keynes really wanted as large a fund as in the Clearing Union proposal—about $30 billion initially and about $2,500 billion now. Even the initial sum was too large to let countries have unconditional access to such quotas. In the Clearing Union proposal, Keynes said that "there should be the least possible interference with internal national policies... [but] since such policies may have important repercussions in international relations they cannot be left out of account." His conclusion was that the proposed institution "should be limited to recommendations, or at most, to imposing conditions for more extended enjoyment of the facilities which the institution offers." And in a letter to me after the Conference, Keynes wrote: "I should like to see the Board of the Fund composed of cautious bankers, and the Board of the Bank of imaginative expansionists." Of course, Keynes was talking about the bankers of 1945, not those of 1983.

What was unique about the International Monetary Fund? The provision of reserve credit to central banks was not a novelty. The Bank of England had borrowed gold or dollars on several occasions in the past when its reserve position was strained. And several writers had suggested in the

1930s that the deflationary effects of gold settlements could be avoided if surplus countries acquired foreign currencies rather than gold. Even the concept that exchange rates are a matter of international concern was not new. Marshall noted it in 1887, and the 1936 Tripartite Declaration of the United States, the United Kingdom and France, to which Belgium, the Netherlands, and Switzerland adhered, gave formal recognition to this principle.

What was most novel in the Fund was the concept of a system of fixed but adjustable par values without the rigidity of the gold standard. The Fund Agreement had numerous provisions on gold, including the requirement that the par value of a currency be stated in terms of gold as a common denominator. Furthermore, to fulfill its obligation to maintain exchange stability under the Fund Agreement, the United States notified the Fund that it would buy and sell gold freely for settlement of international transactions. These provisions, however, were not enough, in my opinion, to make the Bretton Woods system a new form of the gold standard.

In his speech in the House of Lords, Keynes said that the International Monetary Fund is the very opposite of the gold standard. "The gold standard, as I understand it," he said, "means a system under which the external value of a national currency is rigidly tied to a fixed quantity of gold which can only honourably be broken under *force majeure*; and it involves a financial policy which compels the internal value of the domestic currency to conform to this external value as fixed in terms of gold... [The Fund] plan introduces in this respect an epoch-making innovation in an international institution, the object of which is to lay down sound and orthodox principles. For instead of maintaining the principle that the external value of a national currency should conform to a prescribed *de jure* external value, it provides that its external value should be altered if necessary so as to conform to whatever *de facto* internal value results from domestic policies."

In spite of the Gold Reserve Act of 1934, the United States was not really on a gold standard. The essence of the gold standard is that the money supply must be limited by the gold reserve. The last time that the Federal Reserve tightened monetary policy because the gold reserve ratio fell close to the legal minimum was in March 1933. Since then, whenever the gold reserve neared the legal minimum, the required reserve ratio was reduced and finally eliminated entirely. A country that loses more than half of its gold reserve, as the United States did in 1958–71, without reducing the money supply is not on the gold standard. What happened in August 1971 was the abandonment of the anomoly of dollar convertibility into gold when the United States was not on a gold standard.

If the Bretton Woods system was not a variant of the gold standard, how could exchange rates be kept stable? It was assumed that if the United States maintained reasonable stability of prices and costs, other countries would be impelled to follow similar policies because of the emphasis they placed on maintaining the dollar exchange rates for their currencies. They could finance cyclical changes in their balance of payments through changes in their own reserves and by drawings on and repayments to the Fund. They could add to their independent reserves without depleting U.S. gold reserves through gradual additions to their official holdings of dollars and by acquiring most

of the newly mined gold that was not absorbed in the arts and industry. A trend change in a country's international payments position, however, would have to be met by a change in the par value of its currency.

The system did work more or less that way until 1957. At the end of that year, the gold reserves of the United States were the same as they had been at the end of 1950. For the rest of the world, reserves had increased by about $500–600 million a year in official dollar holdings and by about $400–500 million a year in gold from current production and sales of the Soviet Union. The system broke down after 1957, but not because the United States failed to maintain stability of prices and costs. In fact, the 1958–65 period may have been the most stable in our history. The wholesale price index of industrial goods was virtually unchanged and unit labor cost in manufacturing declined slightly. The balance on current account in 1961–65 averaged nearly $5 billion a year and was equal to 20 percent of merchandise exports. A comparable surplus now would be $40 billion.

The U.S. deficits were caused by the enormous increase in capital outflow. From 1951 to 1955, U.S. private foreign investment averaged less than $2 billion a year and was equal to 15 percent of merchandise exports. U.S. private foreign investment rose sharply after that. In 1961–65, it averaged $6 billion a year and was equal to 25 percent of merchandise exports. In 1971–75, it averaged $23 billion a year and was equal to 31 percent of merchandise exports. In the past five years, U.S. private foreign investment averaged $76 billion a year and was equal to 36 percent of merchandise exports, although the figures are inflated by book transfers of the International Banking Facilities. It should be noted that in recent years the foreign capital inflow, including official funds and unrecorded transactions, was far in excess of U.S. private investment. In other countries the payments difficulties have been aggravated by the widespread and uneven inflation, by the huge increase in the price of oil, and by the burden of debt in some of the developing countries.

No system of fixed parities can function with such a pattern of international payments. The surpluses and deficits on an official reserve basis would have been far beyond the capacity of the monetary authorities to manage. Under the gold standard, it would have necessitated an intolerable deflation in the deficit countries. Under the Bretton Woods system it would have led to an unacceptable monetary expansion in the surplus countries. With the present system of floating rates, it has resulted in large fluctuations in the exchange rates for the major currencies, most notably in the enormous appreciation of the dollar since mid-1980. This has been very disturbing, but it has not been accompanied by an exchange crisis, or worse, that would have been unavoidable with fixed par values.

What remains of the Bretton Woods system that was born here 40 years ago? The Fund is still the center for consultation and cooperation on international monetary problems and it has been very helpful in dealing with the payments difficulties of some countries. But it has not found the right role to carry out its responsibilities in the present system of floating exchange rates. The second amendment to the Articles of Agreement, which formalized the

end of the Bretton Woods system, states that "the Fund shall oversee the international monetary system in order to ensure its effective operation." I should like to see the Fund take a more positive view of this responsibility. Perhaps this meeting at Bretton Woods can tell us what the Fund should do.

Is There a Need for Reform?

Richard N. Cooper*

I. Introduction

The very notion of "reform of the international monetary system" is a very modern one in two respects. "Reform" is a conscious act, an act of volition and coordinated will, as distinguished from a series of piecemeal changes that occur as individual actors—banks, business firms, governments—respond to new circumstances, leading over time to change, but not to conscious reform. Second, the notion of an "international monetary system" reflects a distinctive perspective, an overview of how all of the pieces work together and a focus on the ultimate results from the behavior of individual agents, taken collectively, to be distinguished from how individual firms, banks or governments will or should behave in the international monetary domain, given its major features.

These two notions come naturally to us. But it was not always the case. It was perhaps the distinctive characteristic of the original Bretton Woods conference, and of the negotiations leading up to them, that this system-wide perspective, to be reformed, was adopted in full for the first time. The architects were addressing the structure of the international monetary system as a whole; and they were, as a collaborative act of volition, attempting to reform the entire system from the ground up. They had been shaken by the performance of the "nonsystem" of the 1930s and the short-lived gold exchange standard of the 1920s, and they wanted to build a stable, durable structure that would accommodate both the new commitment to activist macroeconomic policy at the national level, and a high degree of freedom for international trade at the international level.

To be sure, antecedents can be found here as in virtually all domains. There were several discussions during the nineteenth century of bimetalism, and how best to preserve it, but they were somewhat desultory. The 1922 Genoa conference was convened to figure out how to restore the prewar gold standard in view of the perceived global shortage of gold at postwar price levels. That conference clearly took a system-wide perspective, but the changes suggested were limited and piecemeal, designed to preserve as much as possible of the old structure. It was English-style evolutionary reform, rather than American-style constitutional reform, starting with the fundamentals rather than with what was inherited from the past.

In what follows I will comingle both types of reform. American-style or constitutional reform has the advantage of forcing thought with respect to what objectives are to be served. What do we really want out of the international monetary system? Evolutionary reform has the advantage of avoiding radical changes and building on what we are already accustomed to, yet

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adapting to new circumstances over time. It has the disadvantage that we can engage in it and at the same time avoid thinking about what are our basic objectives, running the risk that divergences in objectives become a hidden agenda in the efforts at piecemeal reform.

The plan of the paper is as follows. Part II offers a brief sketch of the main features of the Bretton Woods system and why it failed, drawing attention to two intrinsic flaws in the original conception. Part III briefly characterizes the present system and suggests that it is workable and even useful, but unstable in the long run—again, it suffers from two fundamental weaknesses. Part IV offers a technically workable scheme for the twenty-first century, which however calls for major political commitments to international collaboration by the key countries, commitments which are much too ambitious for the present time. Part V brings us back to the present and suggests what steps we might take in the near future with a view to reaching the longer term objective as it becomes politically possible. Part VI offers a few concluding remarks.

II. The Bretton Woods System

The system that emerged from Bretton Woods had five key structural features:

First, it provided a great deal of freedom consciously to pursue national economic objectives, with the objective of assuring full employment, price stability, economic growth, and so forth. The Bretton Woods agreement was produced in the same climate of opinion which resulted in the Beveridge Report in the United Kingdom, the Full Employment Act in the United States, and comparable legislation or statements of national policy in other countries, deriving directly from the experience of the 1930s and from the determination that that experience should never be repeated.

Second, the Bretton Woods system stipulated that exchange rates between currencies should be fixed. It was taken for granted that fixed exchange rates were desirable against the background of the turbulent periods of flexible exchange rates that prevailed in the early 1920s and again briefly in the early 1930s.

Third, currencies should be convertible one into another for current account transactions. Again, that stipulation was against the background of extensive use of exchange controls by Nazi Germany during the 1930s and the tight wartime restrictions on trade and payments levied by many countries and which the Bretton Woods architects considered it desirable to end as quickly as possible.

These three features taken together—autonomy of national policies, fixed exchange rates, and convertibility of currencies—were in conflict with one another. Countries could not frame their national economic policies independently and still maintain fixed exchange rates and currency convertibility except by luck and coincidence. The Bretton Woods architects recognized this conflict and therefore added two further features:

Fourth, provision was made for medium-term international lending to cover balance of payments deficits that might result temporarily from the

combination of the first three features. A new institution, the International Monetary Fund, was created as a vehicle for this new lending.

Fifth, countries were allowed, and in time came to be encouraged, to alter their exchange rates if it became clear that imbalances in payments were not temporary in nature. In other words, if a "fundamental disequilibrium" emerged, the exchange rate was to be changed by a discrete amount, with international agreement, in recognition that it would be inappropriate to finance such imbalances indefinitely.

These then were the basic features of the Bretton Woods system. There were of course many additional details. Interestingly, however, there was no provision in the Bretton Woods system for secular growth in international liquidity beyond a somewhat ambiguous provision permitting what was called a "uniform change in par values," that is to say, a deliberate discrete rise in the price of gold. It was implicitly assumed that new gold production taken into monetary reserves would be sufficient to provide for a growth in international liquidity. In the event, the U.S. dollar came to provide for the needed liquidity, as well as emerging as the currency of intervention in a regime in which some operating mechanism was necessary to assure that exchange rates remained fixed.

During the quarter century between 1945 and 1970, world reserves outside the United States grew by $54 billion, averaging 4.5 percent per annum. Gold provided $13 billion of this increase, of which $9 billion was from the high gold reserves of the United States (70 percent of total world monetary gold reserves in the late 1940s) and $4 billion was from new gold production. Foreign exchange, which was overwhelmingly dollars, provided $30 billion of the growth in reserves. The IMF provided $11 billion, including $3 billion of the new SDRs in the last year, 1970. U.S. reserves of course declined during this period because a substantial part of its gold stock was lost to other countries.

As it emerged—though not as it was designed—the Bretton Woods system might be said to have involved a bargain between the United States, which in the late 1940s accounted for about half of world industrial production, and the rest of the world. The bargain was that the United States would maintain domestic economic stability, and other countries would fix their currencies to the dollar and would accumulate their reserves in gold-convertible dollars. After a relatively brief period of postwar redistribution of the world's monetary gold stock, they would not actually convert their dollars into gold. Under this bargain, other countries would import economic stability from the United States. If a country got out of line with the world norm, it would have to change the par value of its currency. The United States allegedly gained some seigniorage from this bargain, but that is far from clear. The dollar reserves were not held in currency or even for the most part in demand deposits; they were in dollar-denominated assets that carried market interest rates. But what is true is that the United States gained certain room for financial manoeuvre. That is to say, it did not have to be as concerned as other countries did about how to finance a balance of payments deficit. Indeed, the very notion of balance of payments deficit was an ambiguous one for the United States under these circumstances, although that

did not keep the Commerce Department from publishing figures which it called the "deficit" for many years.

A second characteristic of this arrangement was that the dollar was overvalued relative to what it would have been without steady accretion of dollars in the reserves of other countries. That feature permitted some export-led growth by the rest of the world which would not have taken place under different monetary arrangements in which the United States itself would have been somewhat more competitive in world markets.

On this view of the world, the United States broke its part of the bargain in the late 1960s by inflating too much in connection with the Vietnam War and the Great Society programs. Some Europeans thought that the United States was inflating too much even in the early 1960s. On this point, they would have found much less agreement from Americans. Indeed, the disagreement over U.S. policy in the early 1960s indicated one of the weaknesses of the supposed bargain which I have just described, namely disagreement around the world over what represented economically stabilizing behavior by the United States.

The structure of the Bretton Woods system had two intrinsic flaws in it, so that it would have broken down sooner or later even without the burst of U.S. inflation in the late 1960s. First, the gold convertibility of the dollar was bound to become increasingly doubtful as dollar liabilities rose over time relative to the U.S. gold stock. To halt the accumulation of dollars in reserves would have stifled growth of the world economy. Yet to allow the accumulation to continue would have moved the system to an increasingly fragile foundation. Robert Triffin pointed out this dilemma as early as 1959. SDRs were finally created in the late 1960s as a long-run substitute for the dollar, thus offering a solution to the dilemma. But the solution came too late. This part of the system broke down in 1971 when gold convertibility of the dollar was suspended indefinitely. Two points are worth noting in passing. The first is that the U.S. dollar was the only currency that was convertible into gold, even though the Bretton Woods agreement was formally symmetrical with regard to all currencies. The second is that countries continued to accumulate dollars in their international reserves even after gold convertibility of the dollar was suspended.

The second flaw in the Bretton Woods system was its reliance on discrete changes in exchange rates to correct imbalances in payments. Once a disequilibrium persisted long enough to be "fundamental" rather than temporary in nature, it was clear to everyone and the system thus produced the celebrated one-way option for currency speculation. Since the remedy to a fundamental disequilibrium was a jump in the value of a currency, speculators could move into or out of the currency at relatively low cost when they thought the jump would occur and take their gains after it occurred. It is interesting to note that the architects had appreciated this problem, at least in principle, and they had stipulated that currencies should be convertible for current account transactions, but not for capital account transactions. The possibility was envisioned that countries might maintain controls on capital flows under the Bretton Woods system, and indeed countries were even enjoined to help other countries maintain and enforce their systems of capital

controls. So capital controls were in principle allowed under the Bretton Woods system, and indeed in a certain sense they were required by the internal logic of the system.

This feature of the system did not anticipate the changes both in the nature of trade and in international capital movements that took place over time. With improved and cheaper communications, it became easy to move capital through telegraphic transfers around the world at relatively low cost. In addition, many firms, especially American firms, began to invest heavily abroad in the postwar period, so that many intracorporate transactions became international in nature. Finally, international trade gradually evolved away from traditional commodity trade toward trade involving special orders and long-lead time items in which payments for trade and credit terms become inextricably mixed. For all of these reasons, it became increasingly difficult to separate capital from current account transactions and to maintain control on capital transactions.

The movement of funds that was associated with anticipated discrete changes in exchange rates became quite enormous and greatly complicated the management of domestic monetary policies. In many countries, they threatened the autonomy of domestic national policy which was to have been preserved by the Bretton Woods system. For example, Germany in 1969 experienced a 25 percent increase in its money supply in a single week due to the inflow of speculative funds across the foreign exchanges and the requirement that Germany maintain the fixed value of the mark in terms of other currencies. That was more than could be effectively sterilized given the instruments available to the German authorities at that time.

In truth, the free movement of capital is incompatible with a system of exchange rates that are occasionally changed by consequential amounts and in a predictable direction. This part of the Bretton Woods system broke down definitively in 1973, although the breakdown started earlier with the move to floating exchange rates by Canada in 1970 and by Britain in 1972.

The U.S. inflation of the late 1960s resulted in large dollar outflows in the early 1970s that strained the Bretton Woods system to the breaking point. But it should be clear by now that this was only the proximate cause of the breakdown of the Bretton Woods system. It was not the fundamental cause. The intrinsic flaws in the system would have come to the surface sooner or later, in response to one strain or another. It happened to come to the fore in 1971–73.

It is worth remarking that the breakdown of the Bretton Woods system was only partial. The International Monetary Fund is an important survivor, both as a lender and as a forum for managing the international monetary system. The convertibility of currencies and the continuing autonomy of national economic policies—both features of the Bretton Woods architecture—are still taken as desiderata in a well-functioning international monetary system. It is a measure of the success of that system that we take them for granted. It was the exchange rate features of the system that broke down, and the psychologically important but technically tenuous link to the historic gold standard via the gold convertibility of the leading currency.

III. Present Monetary Arrangements

For the past decade, the world has had monetary arrangements that have permitted a variety of exchange rate arrangements, but in practice with a much higher degree of flexibility than prevailed under the Bretton Woods system. This "nonsystem" has served the world economy rather well during a turbulent decade. It is true that the overall economic performance during the past decade, whether measured in terms of inflation rates, growth rates, or unemployment rates, has been far inferior to what it was during the 1950s and 1960s. But it probably would have been even worse if governments had tried to maintain the Bretton Woods system through the period. In view of the large disturbances which the world economy has undergone, an attempt to maintain fixed but adjustable exchange rates would almost certainly have required a much higher degree of controls over not only capital but also current transactons than in fact prevailed. Thus exchange rate flexibility helped to preserve a relatively open trading and financial system.

During the decade, moveable exchange rates have generally corrected for differentials in national inflation rates, as economists predicted they would, but the movements in exchange rates have gone beyond that and affected "real" exchange rates as well—that is, the relative prices at which the goods of one country on average trade against the goods of another. An evaluation of the period as a whole is complicated and difficult. Many of the movements in real exchange rates followed textbook patterns, responding to imbalances in current accounts, or to dramatic changes in resource endowments (such as the discovery of North Sea oil), or they followed divergent movements in aggregate demand. But some of the movements in real exchange rates have not followed textbook patterns, and even when they have, they have often been viewed as unwelcome disturbances by some countries, especially following the sharp depreciation of the U.S. dollar in 1978, and again following the sharp appreciation of the dollar in 1981 and 1982. Perhaps for this reason, most countries of the world in fact have not allowed their exchange rates to float. Rather, they have fixed their exchange rates against something—against another currency, or a basket of currencies, or, in the case of the European Monetary System, against one another. Thus it is not entirely accurate to characterize current arrangements as involving floating exchange rates. In practice, the exchange rates of several major currencies—the U.S. dollar, the Japanese yen, the British pound, the Canadian dollar—do float more or less freely, but other currencies do not float, although they have shown greater flexibility than they would have under a Bretton Woods regime.

Movements in some key bilateral exchange rates have shown sharp short-run variations on occasion during the past decade, not keyed to fundamental economic developments in any obvious way. There have been occasional weeks of average daily variations in excess of 3 percent. Why such great variability? The asset approach to exchange rate determination emphasizes that stocks of foreign exchange are like other financial assets, whose current price reflects all the information available that may have a bearing on its future value. New information may then affect market prices (in this instance

exchange rates) sharply as the "market" reappraises the future in the light of new information.

This focus on financial assets represents a valuable insight, and no doubt helps to explain the abruptness of some movements in exchange rates. But it hardly helps to explain month after month of sharp variability, up and down. Much "news" in a longer perspective in fact is noise, whose bearing on the price in question can reasonably be expected to be reversed in the near, if not immediate, future.

Abrupt up and down movements in exchange rates are not, by themselves, likely to affect trade and production very much, since they should reasonably be expected to be reversed soon if they are not clearly linked to more fundamental economic developments. The difficulty with flexible exchange rates is that another influence is also at work, which can transmute the influence of noisy news into larger changes in exchange rates than otherwise would take place. It is the presence of crowd or bandwagon effects in the trading community. Few know how to interpret the news. Many use a movement in the exchange rate itself as a source of information about market sentiment. So as to avoid being left behind, they jump on the bandwagon, thus pushing the exchange rate further in the direction it tended to go initially. Expectations feed on expectations. Economic theorists have lately discovered this phenomenon and have called it a bubble, in which prices can be rationally pushed beyond their long-run equilibrium values so long as the participants expect the risk of relapse to fall short of the prospect of further gain.

When this process is operating, even those who suspect the exchange rate has gone too far will have an interest in holding their investments so long as the prospect for further gain outweighs the probability of reversal. Thus a secondary judgment, oriented toward market dynamics, is superimposed on the reassessment based on the new information, and may come to dominate the movement in exchange rates for a time. This would not be troublesome if there were no consequential effect on the real economy. But in some periods expectations about the "fundamentals" may be so weakly held that the rate can be dominated by purely market dynamics for longish periods, measured in weeks or months. When that is so, the exchange rate may in turn affect new information, such as the recorded change in price indices that include a heavy imported content. Or it may set in motion urgent risk-avoiding behavior, as when multi-national firms move to protect their quarterly balance sheet (at the expense of the operating earnings of the firm). So a vicious circle may temporarily be set in motion. And this vicious circle may aggravate inflation rates and hence inflationary expectations or may divert management attention away from real long-term investment to short-term balance-sheet considerations. In either case an unnecessary and avoidable element of instability is introduced into national economies.

Two features of present exchange rate arrangements will not be satisfactory over the long run. First, movements in real exchange rates have major effects on national economies, effects which are not always welcome. Yet movements in real exchange rates, while they can be influenced by national economic policy, cannot be easily controlled by use of the usual instruments

of national economic policy because the determinants of exchange rates are diverse and complex. The result is that at any moment the influence of policy actions on exchange rates is uncertain. Portfolio decisions with respect to financial assets play a key role in the short-run determination of exchange rates; but the influence of today's policy on portfolio decisions, via expectations, is uncertain. This marks a substantial contrast with the influence of policy actions on the aggregate demand for goods and services, where the linkages with policy are clearer. Despite this, we have not to date been able to eliminate the so-called business cycle. Unpredictable movements in real exchange rates and unpredictable responses of real exchange rates to government action greatly aggravate the problem of macroeconomic management.

At the same time, under a regime of flexible exchange rates there is a temptation, hence some tendency, to manipulate the exchange rate for macroeconomic purposes. This can be done either to fight inflation, since monetary tightening produces an immediate reward—at the expense of other countries, so long as others do not respond in kind—in terms of a decline in the inflation rate brought about via an appreciated currency. Or it can be used to combat unemployment, when expansionary monetary policy depreciates the currency—again, in general, at the expense of other countries. Of course, the same configuration of exchange rates may be satisfactory to all or most countries. But that would be a coincidence. In general, these represent self-centered national actions which simply pass the problem, either of inflation or of unemployment, to other countries. Members of the IMF have a general responsibility to avoid such manipulation of exchange rates, and the IMF has a general responsibility for surveillance over exchange rate practices, presumably with the aim of preventing such practices. But surveillance has not really gotten off the ground, and it is not clear under today's arrangements what the IMF can do, for example, when a Sweden deliberately depreciates its currency in order to increase output and employment, or when a United States achieves a substantial reduction in its inflation rate through a policy of tight money which has inter alia greatly appreciated the dollar against other currencies.

Just as present exchange rate arrangements are not really sustainable over the long run, neither are present arrangements for reserve management and in particular for reserve creation. The principal reserve medium is a national currency, the U.S. dollar, dependent in large part for its supply on the policies of the United States. This has been accepted, more or less grudgingly, because it has worked reasonably well and there is no clear feasible alternative. But it leaves a deep sense of uneasiness around the world, even when the United States in the judgment of others is relatively well-behaved; and the uneasiness grows dramatically when in such periods as 1970-71 and 1978 the rest of the world, or some parts of it, believe the United States is not well-behaved. Moreover, as the United States shrinks in relation to the rest of the world, as it is bound to do, the intrinsic weaknesses of reliance on the U.S. dollar will become more apparent, especially in the United States, where the possible reaction of foreign dollar holders will become an ever greater constraint in the framing of U.S. monetary policy. The United States is bound to shrink relative to the rest of the world, not because it is doing

badly, but because the rest of the world may be expected to do well. The natural growth in the labor force and the rate of capital accumulation are both higher in many parts of the world than they are in the United States. Moreover, the possibility exists for closing the technological gap between the United States, which operates on the frontiers of modern technology, and the location far behind those frontiers at which many countries find themselves. Thus the simple arithmetic of economic growth will insure a gradual relative decline of the United States, for instance from about one-fourth of world GNP at present to around one-sixth 25 years from now if the United States grows on average at 3 percent a year and the rest of the world grows on average at 5 percent a year, both plausible numbers.

In short, the present set of monetary arrangements, while not in any immediate danger of collapse from their intrinsic features, as distinguished from some external unforeseen event, is not stable in the long run. It is not a durable system. It must evolve into something else. It must be "reformed."

But what will or should it evolve into? One possibility is that the frustrations arising from the sense of loss of control by national governments will lead to significant attempts to reassert national control by sharply reducing the openness and permeability of national economies to external influences. In a sense, the move to flexible exchange rates can be interpreted as such a response, since countries enjoyed even less control, especially as regards monetary policy, under a system of fixed exchange rates with high capital mobility. But we have now learned that flexible exchange rates, while they offer some greater national autonomy, do not do an effective job of insulating national economies from external influences, and may indeed in some instances, especially as regards worldwide shifts in preferences of asset holders, exacerbate the impact of external influences on national economic developments. So the frustrations at loss of national control continue, and alleviating them would require much stronger insulating material than flexible exchange rates alone provide. It would probably involve a reversion to extensive use of controls over capital movements. And since capital transactions cannot be effectively separated from current transactions, there would be a strong tendency to extend controls to current transactions as well. Indeed, there would be considerable independent pressure to do that as improved world telecommunications, transportation, and information flows increase international competition further.

But this paper is supposed to address the question of reform, not piecemeal retrogression. There is a normative component to reform, not merely a projection of likely trends. So I turn now to a different possible evolution of international monetary arrangements, which attempts to deal with what I have identified as the intrinsic problems with present arrangements which render them not stable in the long run. To fix the time frame, let us go forward 25 years, to the year 2010. That is far enough ahead so that many changes from now are plausible. Developments that are completely unrealistic in the next five or ten years can be contemplated. But it is not so far ahead that we cannot really contemplate it at all. Many of us will still be around and functioning at that time, and it is only as far ahead as the year 1960 is behind us, and no doubt that is still a fresh memory to most of

us. I propose first to sketch a set of arrangements which I believe will deal with the problems in the present setup. If this proposed scheme is agreeable, we can then ask what interim steps will be useful to get from here to there.

IV. A Monetary Scheme for the Year 2010

Before sketching the main features of the scheme, it is perhaps worth saying a word about the state of modern industrial economies in the year 2010. Populations and labor forces will of course be larger than they are today, but the labor force engaged in manufacturing production in today's OECD countries will probably not have changed much, and may actually have declined. Manufacturing is likely to go the way that agriculture has already gone, with a declining share of the labor force able to produce all of the goods that the rest of society needs. Real incomes per capita will be over 50 percent higher than they are today. The world will be very electronic. Thus not only will large-scale financial transactions be able to be made virtually instantaneously to any part of the world—we are close to that situation today—but even retail transactions in financial services and in goods will take place electronically. That is, householders will be able to purchase information about taxation, investments, retirement possibilities, or education by consulting electronic catalogues and information sources in their own home. Even goods will be able to be purchased by inspecting them on a television screen, placing the order electronically and having them delivered in a relatively short period of time. With higher real incomes and lower relative prices for long-distance transportation, much more travel will take place than occurs today. Reliable, high-speed, and low-cost communications over the globe will permit management control of production locations in many places. Lower transportation costs (relative to the price of other goods and services) will encourage trade. Less reliance on labor forces combined with these other factors will result in higher substitution rates in manufacturing production among locations, so real movements in exchange rates can be highly disruptive of production in any particular location. Yet financial factors, not international trade, will dominate exchange rate determination in the short run. In view of the greater sensitivity of production to changes in real exchange rates, governments must reduce arbitrary movements in the real exchange rates in order to maintain an open trading system. With widespread information and low transactions costs, an adjustable peg system of exchange rates that results in discretionary movements in market exchange rates is not likely to be tenable—indeed, did not prove to be tenable even under the technological conditions prevailing in the 1960s.

Taken together, these considerations lead me to conclude that we will need a system of credibly fixed exchange rates by that time if we are to preserve an open trading and financial system. Exchange rates can be most credibly fixed if they are eliminated altogether, that is, if international transactions take place with a single currency. But a single currency is possible only if there is in effect a single monetary policy, and a single authority issuing the currency and directing the monetary policy. How can independent states accomplish that? They need to turn over the determination of monetary policy to a supernational body, but one which is responsible to the governments of

the independent states collectively. There is some precedent for this in the origins of the U.S. Federal Reserve System, which blended quite separate regions of the country and banks subject to diverse state banking jurisdictions into a single system, paralleling the increasingly national financial market. Similarly, we will need a world monetary system that parallels the increasingly global financial market. It will probably not be possible, even within the time scale envisaged here, to have a truly global Bank of Issue. But that will not be necessary either, and it may be possible to have a Bank of Issue which serves a more limited group of democratic countries, and which can serve as the core of an international system. More will be said about the membership in this core below.

The Monetary Authority

The tasks, the instruments, and the decision-making structure of the Bank of Issue could look something like the following:

The governing board would be made up of representatives of national governments, presumably finance ministers, who would vote according to the share of the national GNP in the total gross product of the community of nations participating in the monetary authority. These weights could be altered at five-year intervals to make allowance for different growth rates. If national membership in the monetary authority became so large that representatives from every country would make a committee unmanageable, the managing committee could be constituted on a representative basis, much as the International Monetary Fund is today.

The task of the monetary authority would be to stabilize the macroeconomic situation and to avoid or mitigate liquidity crises through a lender of last resort function, just as national central banks do today. The debate on the relative weights to be attached to output as opposed to price stabilization could continue just as they do at present, without prejudice.

The Bank of Issue would accomplish its tasks by engaging in open market operations in which it issued the new currency for the securities of member countries. It could also engage in rediscount operations, whereby it extended claims against itself in exchange for acceptable paper at the initiative of banks within the system, subject to its own acquiescence in those initiatives.

The Bank of Issue need not engage in detailed regulation of the banks throughout the system covered by the new currency. That could be left in the hands of national regulators. However, it would probably want to issue guidelines—minimum standards—to be followed by national regulators, and to maintain enough surveillance over banks to be sure of itself when it was called upon to act as a lender of last resort.

In the first instance, open market operations by the Bank of Issue could be distributed among the securities of national governments in proportion to their voting weight (i.e., their GNP share), but over time this limitation would probably cease to be necessary as financial markets evolved and securities issued by many national governments became virtually perfect

substitutes one for another. In any case, the Bank of Issue's holdings of national government securities could be altered from GNP shares via the rediscounting facility, as needed.

Seigniorage in this system would automatically be distributed to national governments as their securities were purchased by the Bank of Issue, thereby giving them the purchasing power to buy goods and services. In addition, the Bank of Issue would run profits from its interest earnings, and those could be distributed from time to time to national governments on the basis of their voting shares.

The currency of the Bank of Issue could be practically anything, an evolution from the Canadian dollar, the Swedish krona, the ECU, or the SDR. Most natural would be an evolution from the present U.S. dollar, making use of the extensive dollar-based worldwide markets. But if that were not politically acceptable, it could be a synthetic unit which the public would have to get used to, as it had to get used to the metric system when that replaced numerous national systems. The key point is that monetary control—the issuance of currency and of reserve credit—would be in the hands of the new Bank of Issue, not in the hands of any national government, no matter what the historical origin of the new currency happened to be.

National Economic Policy

The peoples of the industrial democracies have placed high expectations on their national governments for economic management. Here governments are being asked to pass monetary policy to a supernational agency, the actions of which they can influence but not determine, taken one by one. Would national governments be giving up all of their macroeconomic control? The answer to this question is no, since they could still pursue fiscal policy at the national level. What they would be giving up is monetary financing of budget deficits beyond their prorated allocation from jointly agreed open market operations. In particular, they could not engage in inflationary finance to reduce the real value of outstanding debt at the national level, although the requisite majority could do so at the international level. To finance budget deficits, therefore, it would be necessary to go to the capital market. But the regime we have in mind would no doubt involve a very high degree of capital mobility among participants, especially since all securities would be denominated in a single, widely used currency. Of course, the influence of fiscal actions on national aggregate demand would be limited by leakages abroad through demand for imports, and at the outer limits by the extent to which individual governments could borrow in the capital market. Governments could also use their fiscal powers to attract internationally mobile firms via tax holidays or through covering the expenses of a portion of new investments. These practices have already emerged as a new form of fiscal action both within countries (e.g., industrial development bonds issued by the individual states within the United States) and between countries. With internationally mobile capital, these practices may indeed succeed in generating local employment in "depressed" areas without necessarily resulting in a misallocation of resources (see Cooper, 1974). Nonetheless, if these practices became too competitive among nations, they might want to

put some collectively agreed limits on them, and even allow special differentiation under some circumstances, e.g., when unemployment rates were higher than some agreed norm.

One old-fashioned policy instrument for encouraging investment and employment is the use of tariffs to discriminate against goods from abroad. It would be logical if free trade accompanied this single currency regime. That would also be consistent with the collaborative political spirit that would be required to establish the single currency regime. Free trade would insure one market in goods as well as in financial instruments. But the scheme would be quite workable also with modest tariffs, at or below the levels that now generally prevail among OECD countries. Higher tariffs in the presence of a free flow of capital run the risk of leading to a gross misallocation of capital, even from the viewpoint of the tariff-imposing country, as tariffs draw capital and labor into what are by definition relatively inefficient industries. But the exact nature of the commercial regime is beyond the scope of this paper.

How the Regime Would Work

Governments could determine the balance between their expenditures and taxes as they do now, but beyond their prorated share of the Bank of Issue's open market purchases and profits they would have to borrow on the capital market to cover any budget deficits. Market access would be determined by a market assessment of the probability of repayment, which would assuredly be high within a plausible range of budgetary behavior. Both receipts and expenditures would be made in the common currency, as would the borrowing. Each country could set its own course independently, with no need for formal coordination of fiscal policy. Financial markets would "coordinate" to some extent, via interest rates, since if all governments decided to borrow heavily at once, in a period in which private demands for credit were also high, interest rates would rise and that would induce greater caution in borrowing. But the larger countries would certainly find it useful to exchange information on intentions with respect to future actions, so that each of them could take the actions of others into account. This exchange would over time no doubt evolve into an iterative process which was hardly distinguishable from coordination, although in the end each country would be free to act as it saw fit.

Monetary policy would be set for the community as a whole by a board of governors, who in practice would probably be finance ministers. No single country would be in control. A weighted majority of the governors would decide both the principles to govern monetary policy (e.g., how much weight to give to monetary magnitudes as opposed to other variables in framing monetary policy) and with respect to actual operations. The governors in turn would be accountable to legislatures. The Bank of Issue would have a certain autonomy by virtue of not being beholden to any single legislative or executive authority. Thus it could not be manipulated for particular electoral reasons. On the other hand, its actions would be determined by a majority of officials who would be individually accountable to legislatures or executives,

so that if a (weighted) majority of them desired a shift in policy, it would occur.

Balance of payments adjustment within this regime would be as easy, or as difficult, as it is between regions of the United States or any other large country today. The adjustment would be automatic, except insofar as it was cushioned by capital inflows induced by fiscal actions. Automatic balance of payments adjustment sometimes leads to unemployment, as following a shift in demand away from the products of a particular region or country. Fiscal policy could be used to cushion such unemployment. In addition, my guess is that the present industrial democracies will have considerable net immigration by early in the next century, and the distribution of that flow of migrants would provide considerable flexibility to the labor force in the region as a whole.

This one-currency regime is much too radical to envisage in the near future. But it is not too radical to envisage 25 years from now, and indeed some such scheme, or its functional equivalent, will be necessary to avoid retrogression into greater reliance on barriers to international trade and financial transactions. Moreover, it is useful to have a "vision," MITI-style, to provide guidance for the steps that may be feasible in the near future. Thus some idea of where we would like to get to provides a sense of direction for the next steps.

V. Next Steps for Getting from Here to There

If the objective of a single currency is thought to be desirable, compared with the likely alternatives, are there steps we should be taking now to work toward that objective? The idea is so far from being politically feasible at present—in its call for a real pooling of monetary sovereignty—that it will require many years of consideration before people become accustomed to the idea. But the economic effect can be gradually approximated by giving greater weight to exchange rates in framing national monetary policy. Many countries—all those with fixed or semi-fixed rates—of course already do this. This injunction therefore applies mainly to the United States, Canada, Japan, the United Kingdom, and the EMS countries taken as a group. If monetary policy were governed in such a way as to limit wide swings in key exchange rates, this would tend also to reduce fluctuations in real exchange rates. This result could be accomplished by adopting one or another of the formal schemes that have been proposed from time to time, such as the target zone (Williamson, 1983), whereby countries undertake to confine market movements of the exchange rate within a specified band centered on a target rate, which target can if necessary be altered from time to time. The European monetary system is a variant of such a scheme, with central rates being subject to periodic renegotiation as they become questionable. Seven changes in central rates have been made in the period since 1979, and generally the changes have been sufficiently small so that market exchange rates were not immediately affected, or were affected only modestly.

It may not be possible to reach international agreement on a formal scheme for exchange rate management. But the process of official discussion of such schemes, each particular one of which is subject to defects under some circumstances, will apprise officials of the possibilities for accomplishing the principal objective, viz., to reduce undue fluctuations in real exchange rates. Thus launching a move toward "reform" of exchange rate arrangements may fail in the sense that no formal scheme is agreed on, but still succeed in its underlying purpose of establishing a more or less shared view of what exchange rates should be at a given time and a consensus to work toward keeping market rates within the neighborhood of the consensus rates.

This approach runs from monetary policy to exchange rates. But it does not rule out elements of an alternative approach, espoused especially by McKinnon (1984), running from exchange rates to monetary policy. If a country's real exchange rate is rising for reasons that are not associated with a clear change in economic fundamentals, that can be taken as prima facie evidence that the country's monetary policy is too tight relative to that of its trading partners. The opposite interpretation can be made for the countries whose real exchange rates are falling. The former country should ease and the latter countries should tighten their monetary policies, on this line of argument. While McKinnon's proposal is excessively monetaristic in its details—he would consolidate the money supplies of the United States, Japan, and West Germany, and have the consolidated money supply grow at a specified rate—the spirit is compatible with the target zone proposals and with the line of thought developed here, that monetary policy should be so managed to limit movements in real exchange rates.

N countries targeting N-1 exchange rates leaves a degree of freedom, which can be used to determine the overall degree of monetary ease or tightness for the community of countries in question. Under the gold standard, this degree of freedom was used to tie currencies to a particular commodity, gold. Many academic proposals over the years would have retained that principle, but enlarged the list of commodities to some bundle or even to an index number of commodity prices (for a summary, see Cooper, 1982). McKinnon uses the degree of freedom by introducing a collective monetary rule, governing the growth of the joint money supply. A dollar-centered system has all countries other than the United States target an exchange rate, leaving it to the United States to determine monetary policy for the world. It was resistance to this last arrangement that contributed to the breakdown of the early 1970s and led to the introduction of floating exchange rates. What is necessary is some consultation among major countries on the overall "tone" of monetary policy. This is a politically difficult step and cannot be taken overtly any time soon, since each nation has its formal system of decision-making and channels of responsibilities for determining monetary policy. However, the same result can be accomplished informally, centered around discussion of exchange rate management, for which there seems to be a widespread desire, especially in business circles.

The previous section suggested that the choice of a currency for a one-currency regime is open and in a sense is arbitrary. It could be anything that is

agreed upon, since money is above all a social convention. In fact the choice would be a politically charged issue, with strong if irrational objections to the choice of any national currency. If national currencies are ruled out, that leaves the ECU and SDR in today's world. The ECU might meet the same objections in the United States and Japan as the U.S. dollar would meet in Europe. That in turn leaves only the SDR, which is now a weighted average of five leading national currencies in value. We must distinguish between the SDR as a liability of the IMF, and the SDR as a unit of account. The new Bank of Issue could not issue IMF SDRs unless the Bank were the IMF itself (more will be said about this below). But the Bank could use the SDR as its unit of account, and issue its own liabilities in that unit, whether they be currency notes or reserve bank credit.

The future of the SDR as a currency would be immeasurably enhanced if private parties could transact in SDRs; indeed, that would be a necessary condition. It would also greatly facilitate the use of the SDR as a central bank currency, since the modus operandi of central banks in most cases is through private markets, and they need a medium which can be used in private markets. Thus the IMF-SDR would be enhanced if some mechanism could be found to make this possible. The IMF Articles would have to be amended to make the IMF-SDR directly holdable by private parties, including commercial banks. But Kenen (1983) has made an ingenuous proposal, an extension and elaboration of one made earlier by Coats (1982), which would accomplish much the same result without formally amending the Articles. This is not an urgent step, but it should be done if the role of SDR is to be strengthened. Also, it would be desirable to issue more IMF-SDRs to keep that asset alive and in use. We will want it sometime in the future.

A key question concerning the new Bank of Issue is what countries should participate in its management, use its currency, and forswear monetary policy. We have come to think of the international monetary system, centered on the IMF with its 146 members, as a global system, albeit excluding most communist countries and Switzerland. That was certainly the conception at Bretton Woods, even though most of the negotiation had been between the Americans and the British. That was also the spirit of the times at Bretton Woods, when the wartime allies placed their hopes for a better world in the United Nations Organization and its functional satellites.

But there is serious question about whether one world money is either necessary or desirable. And it is certainly not feasible, even within our generous 25 year time frame. It is not feasible for two reasons. First, it is highly doubtful if the American public, to take just one example, could ever accept countries with oppressive autocratic regimes voting on the monetary policy that would affect monetary conditions in the United States. I believe that the same reservations would obtain in other democratic societies. For such a bold step to work at all, it presupposes a certain convergence of political values as reflected in the nature of political decision-making, and the basic confidence to which that gives rise.

Second, countries with different values, circumstances, and systems of governance are bound to introduce into negotiations leading toward a Bank of Issue elements which are of greater interest to them, thus broadening the

agenda for negotiation and rendering impossible an already difficult negotiation. For both reasons the proposal should be undertaken in the first instance by the United States, Japan, and the members of the European Community. This group represents the core of the monetary system at present and for some time to come. Other democracies would be free to join if they wished, and if they were willing to undertake the commitments involved, but no one should be obliged to join. Very likely many countries would find it attractive in the early stages not to join, but nonetheless to peg their currencies to the SDR or whatever was the unit of account of the Bank of Issue. They would retain the monetary freedom, however, which members had given up. Some countries would be reluctant to give up the seigniorage from monetary issue, which can be consequential where currency still bears a high ratio to GNP (see Fischer, 1982).

In short, there would be an inner club accepting higher responsibilities, but open to additional members who met the requirements, and of value even to nonmembers by providing a stable monetary environment against which to frame their economic policies. But this arrangement would mark a formal break with the universalism that governs the de jure if not the de facto structure of the Bretton Woods system today.

VI. Conclusions

This paper addresses the question of the need for reform of existing international monetary arrangements by asking whether they are stable—that is, whether they are likely to survive over a considerable period of time, such as a couple of decades. My answer is negative. Dissatisfaction with both the very short-run and year-to-year movements in real exchange rates, combined with technological developments which will lead to further integration of the world economy, will force an alteration of existing arrangements. Unless that alteration is carefully managed, it will take the form of defensive, insulating measures involving controls over international transactions, both trade and finance. That would be politically divisive and economically costly.

I have put forward a radical alternative scheme for the next century: the creation of a common currency for all of the industrial democracies with a common monetary policy and a joint Bank of Issue to determine that monetary policy. Individual countries would be free to determine their fiscal policy actions, but those would be constrained by the need to borrow in the international capital market. Free trade is a natural but not entirely necessary complement to these macroeconomic arrangements.

This proposal is far too radical for the near future, but it could provide a "vision" or goal which can guide interim steps in improving international monetary arrangements, and by which we can judge the evolution of national economic policy.

In the meantime, we should design exchange rate arrangements and national economic management so as to reduce the variability of real exchange rates and to move toward some consensus on equilibrium values for exchange rates, necessarily to be altered from time to time. In addition, we will want eventually to move away from a dollar-based system, so we should breathe

some life into the SDR by providing for a new allocation of SDRs plus making efforts to give the SDR an existence in the world of private finance. The SDR is perhaps the most suitable of several possible choices for the new, common currency.

By focusing on longer-run monetary arrangements, this paper has not addressed some issues that are usually thought of in connection with reforming the monetary system. In particular, it has not addressed foreign aid, external debt, or the substitution account, and the related question of multiple reserve currencies. We may some day want something that might be called a substitution account, but that should derive from the details of other, more basic arrangements that are being put in place. That issue can therefore be deferred until the right moment.

External debt is a serious, immediate issue. Growth in the world economy and maintenance of open markets are preconditions for managing the problem successfully. Given the highly diverse circumstances of the debtor countries—including the largest debtor, which is not Brazil, but the United States, which will borrow almost as much in 1984 from the rest of the world as Brazil's total external debt—and the politically charged atmosphere surrounding external debt, there is no practical alternative to a case-by-case approach for dealing with it. We need net new lending to cover at least a part of the interest that is due on outstanding debts, and that is entirely appropriate insofar as nominal interest rates carry an inflation premium. In addition, debts will have to be rescheduled from time to time, in conjunction with national stabilization programs. These arrangements against the background of a suitably buoyant world economy will probably be enough to get the monetary system through to the longer run which has been dealt with here.

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Discussion

Lord Eric Roll*

I am delighted to take part in the first session of this conference which brings us together on the fortieth anniversary of Bretton Woods. Looking at the program one realizes that all the subjects taken together form a seamless garment and it is really very difficult to know what end to begin with. In fact, I was tempted when I first saw the program to suggest to Frank Morris that this particular session should be held right at the end. By that time we would have heard a number of specific analyses of aspects of the international monetary system and be a little clearer, perhaps, not so much about the need for reform but what that reform might be precisely, and therefore, in what particular respects the present system is unsatisfactory.

Dick Cooper has provided us with an extremely interesting paper with which I find myself in agreement to a considerable extent. I just want to make a few general comments on the subject as such as well as on his paper. I thought that the question: "Is there a need for reform?" would probably get a very resounding positive answer. And certainly Dick Cooper's paper clearly indicates his belief that reform is necessary; just as St. Augustine's prayer to the Lord to give him chastity was very clear. But like St. Augustine, Dick Cooper also says, "Not yet oh Lord, not yet." In fact he's prepared to wait 25 years for it. I'm sure that I personally cannot wait 25 years!

A great deal of material has been published in recent years which I think gives us a better insight into the history of Bretton Woods; and we shall hear a lot more about that this evening from Ed Bernstein who is particularly qualified as he was one of the principal actors in that event. But if one reads, for example, in the recent volumes of Keynes's collected works about the origin of the plans, the interchanges with Harry White, the account of the negotiations and discussions at Bretton Woods, one gets I think a very clear idea of what was going on at the time and this will enable us, and I shall refer to it briefly in a moment, to form a better judgment of what is similar or dissimilar today to the situation at Bretton Woods 40 years ago.

I said that I thought the case for a need for reform was clear. One speaks often nowadays of a breakdown of Bretton Woods and Dick Cooper was quite right in defining that concept more closely by speaking of the breakdown of the exchange rate system. Nevertheless, I think that the breakdown of the exchange rate system, which was so much at the heart of at least the financial arrangements under Bretton Woods, probably justifies one in speaking of a breakdown of Bretton Woods. I don't think anyone who looks at the way in which we have managed the floating rate system, perhaps managed is the wrong word, but the way in which the floating rate system has served us, can be particularly proud of it as an improvement on the Bretton

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Woods system, flawed though that System was, as Dick Cooper points out in his paper. I believe that President Truman is credited with the saying, "If it ain't broke, don't fix it," but nobody can say that this particular exchange rate system isn't broke. Therefore perhaps one should try to fix it. (I subsequently learned that the phrase was used by Burt Lance.)

The Chairman in his introductory remarks has himself pointed out the difficulty of relating exchange rates to any other fundamental in the economic system. I haven't had time to do it but I wish somebody would, for example, look at the six-month Eurodollar deposit rate and the six-month Eurosterling deposit rate over the last two years and correlate their fluctuations with other variables, for example with the actual or expected inflation rates, or the actual or expected growth rates. I am quite sure you will find no significant relationship whatsoever between any of these magnitudes. These so-called signals that the market is supposed to be getting aren't always getting through; and "overshooting" is something markets are particularly prone to. It reminds me of the story about a man who had some marital problems and went to see the doctor. The doctor said to him, "You know what you do, you take a ten mile walk every day for the next seven days and at the end give me a call." So at the end of the week the man called him up and the doctor said, "How are you getting on with your wife now?" "How would I know," said the man, "I am 70 miles from home." That's an example of overshooting of the kind which we can get in the exchange rate system also.

In a way we are bemused by the phrase Bretton Woods. Perhaps meeting in this environment will finally exorcise that incubus, because I think this constant reference to Bretton Woods, much as I sympathize with people like Sir Robert Muldoon and Dick Cooper who are asking for a new Bretton Woods, does tend to conceal the differences in the situation which our founding fathers faced and the situation which we have today.

Of course, there are similarities which Dick Cooper pointed out and which can also be found in Bob Roosa's paper on the exchange rate system. For example, there was a great deal of exchange rate instability before the war; the founding fathers were very much influenced by the experience of the 1930s. There was a fair amount of indebtedness, although not anything like the magnitude we are facing today and not relating particularly to the less-developed countries. There were actual restrictions on the free flow of trade and the free flow of money and even more threats of greater departures from liberalism. All this, I think, had an enormous influence on those who came to formulate the Bretton Woods system 40 years ago.

Nevertheless, there are quite substantial differences in the situation today and to these I want very briefly to refer. First of all there is an enormous difference in the intellectual climate. If you read Keynes, if you read any of the source material available on the ideas of Harry White and others in the U.S. Treasury and read their exchanges before and during the actual course of the negotiations here you do find tremendous argument, due to substantial differences of view on practical issues, but you do not find these differences on what I might call the intellectual foundation of what today we call macroeconomic policy. This is not the case now. I wish it were but I

don't see any signs of a great convergence of ideas on what macroeconomic policy really should be. That I think is a most important difference. I believe if you could have put Harry White and Keynes in the same room to talk in general terms, not about the system they were trying to negotiate at the time (and I stress the word "negotiate"), but about the objectives and broadly speaking the means of macroeconomic policy, you would not have found the sort of substantial difference which you undoubtedly would today if you got people in similar positions into the same room.

That is the first point. The second point of course is the factual situation. At Bretton Woods the preoccupations of the founding fathers were almost entirely concerned with what we call the advanced industrialized countries of the world. I think the question of the raw material producing countries, (today we would call them the third world, less-developed countries, etc.) were very much in the background. They were going to be taken care of to some extent by the World Bank, though it took many years before the World Bank actually started to devote itself to the problems of the reconstruction of the less developed countries: in the early years, as you know, it dealt almost entirely with the industrialized countries of the world. The ITO and commodity agreements were going to take care of the less-developed countries. Well, it is hardly an attitude that we can have today on the less-developed countries. Thirdly, I would say, and it may seem paradoxical, the fact that these negotiations took place during the war was in a sense helpful because the war-time machinery, the way in which economic and financial policy was handled during the war, although no doubt it posed quite important problems from day to day, was set. Here was a piece of machinery that was running its own way and, therefore, it was possible for people even though they were actively concerned in current affairs to isolate themselves for a period and work on the future. Today, the firefighting requirements that fall upon people, for example like our friend Paul Volcker, I think are a very important inhibiting factor in getting together a group of people who would be able to think about the future no doubt with the aid of academics, semi-academics and others but essentially people who are involved in current affairs and therefore can properly judge feasibilities and practicalities. And that is a very important inhibiting factor.

One last point on the question of the dissimilarities, remember this: the paper that was worked out here 40 years ago was signed by 44 countries. I think it is no great exaggeration to say that it was essentially the work of two, with the assistance of one or two others, notably Canada, particularly because Louis Rasminsky played an important part in it. The essential power source for getting this whole plan across was an Anglo-American agreement. Of course there were 44 countries present, many of them representing governments in exile and they could not, and were not completely ignored. But the essential negotiation was between Britain and the United States. Now that, as Dick Cooper recognizes in his scenario for 25 years hence, will still be a very important factor though for different reasons. Certainly, if you were to follow some suggestions and actually try to organize a conference now, the mind boggles as to how you would do that. Would the members of the IMF agree to be represented at such a conference, for example, by those who

presently constitute the IMF's executive boards? This is a very moot question indeed. It may seem a practical problem, but it is one of the utmost importance. It is perfectly clear that the United States and the United Kingdom today could not organize and "run" such a conference; but that is certainly what was the case 40 years ago. Since then power in the world has become very much more diffused and that in itself creates an entirely new situation.

Finally, a word about Dick's long-term vision. I haven't dealt with the initial portions of his paper because in everything I've said I hope you will recognize a very considerable agreement with his analysis and diagnosis of the present situation. But as for the future I can't wait 25 years for the outcome and I wonder if the economy can wait 25 years. He has produced a scenario of the surrounding circumstances of technology which I think is by no means exaggerated. Indeed, I think many of the things he forecasts to be a reality in 25 years will be fully in operation 5 years from now, not 25. Nevertheless 25 years to get to where you want us to get, with a Central Bank with limited membership, seems to me to be a very distant dream—one which we certainly cannot hope to realize in the next two or three years but one, on the other hand, for which we cannot afford to wait 25 years.

Therefore what is left? Well I'm afraid here I begin to falter and do not know exactly where the answer should come from. Once you start with the idea of a full-fledged system of the kind he has outlined or even something less ambitious, the practical difficulties which I have only alluded to become enormous. But if you abandon the ambitious scheme, you then get caught in this terrible dilemma which we are constantly encountering. There has to be, as some argue, as a prerequisite to a new exchange rate system let alone a whole new international monetary system, a greater convergence and harmonization of economic policies at least between the major countries. Or can one help bring such convergence about by instituting a somewhat more rigorous exchange rate system than the one we have today. I myself tend toward the latter view and would like to see a more positive exchange rate policy by the major countries perhaps on the lines of Bob Roosa's proposals and including British membership in the EMS.

If you are forced back onto a step-by-step approach, doing a little cobbling up here and there, a little repair work here and there, you will constantly be faced with this dilemma. When the House of Lords recently debated whether we should join the European monetary system, the government's reply was "Yes, we must join, but not yet." St. Augustine all over again.

Discussion

Ariel Buira*

Professor Cooper has prepared a very lucid paper which centers on one of the most important problems faced by the international monetary system today: the choice of an exchange rate regime and the issue of exchange rate instability. The paper clearly shows the difficulties inherent in a flexible exchange rate system in which rates can be pushed beyond long-run equilibrium levels by market expectations, a process that can affect inflation and introduce an element of instability in national economies.

There can be no question that exchange rate variability increases the uncertainties associated with international trade, weakens the relation between sales and profit, and raises the costs of shifting resources between different sectors in response to changes in relative prices, thereby tending to introduce an antitrade bias that reduces the volume of trade and distorts trade patterns.

Surprisingly, however, the large majority of empirical studies are unable to establish a significant link between measured exchange rate variability and the volume of international trade, whether on an aggregated or a bilateral basis. This, of course, does not prove that a causal link does not exist. It may be that measures of variability are inadequate measures of uncertainty, that other factors obscure its impact, or that technical problems undermine the significance of these statistical tests. As the paper rightly points out, this exchange system gives rise to a tendency to exchange rate manipulation by national authorities for macroeconomic policy purposes. Moreover, ample evidence of exchange rate misalignments among major currencies leading to a rise in protectionism is provided by balance of payments statistics of some of the major trading nations. Although IMF surveillance should prevent such practices, such surveillance over major countries has not gotten off the ground, indeed, I would say, has no teeth.

A further anomaly of the system, is that international liquidity is to a considerable extent the result of U.S. policies. Dr. Cooper suggests that this is a weakness of the system that will make for instability in the long run, simply because of the expected decline in the relative position of the United States in the world economy. This long-run threat to stability leads him to a bold proposal for a monetary system for the year 2010, one in which the problems of excessive exchange rate variability are avoided. His solution is a common currency issued by a common central bank for the major industrial countries, i.e., a supranational monetary authority directing monetary policy for these countries.

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Objections to such a scheme would appear to be largely political, in view of the different needs of economies arising from their being at different stages of the economic or political cycle. More pointedly, since different policy objectives and differing preferences between unemployment and inflation among the various countries are bound to exist in adopting a common currency and therefore a common monetary policy, countries would be giving up an instrument of policy. In a sense it would be like going back to the gold standard, since monetary policy would be exogenously determined. Would the benefits of so doing clearly offset their loss? Should a dynamic economy with low inflation, unemployment and a strong external position, say Japan, whose potential GDP grows more than twice as fast as Europe's sacrifice the possibility of having its own monetary policy to join a monetary area with Europe?

My impression is that the possibilities of reaching agreement on such an arrangement are rather small since the political costs would be easier to visualize than the rather tenuous economic benefits. Couldn't the main benefits be attained through other less formal arrangements such as increased policy coordination and convergence, and exchange market intervention?

While focusing his analysis on a long-term solution to the issue of exchange rate variability, Dr. Cooper has left aside a number of major problems on the current international monetary scene. It is the privilege of academia to look at the issues free from the pressures of the day. It is, however, an opportunity denied to many of us either by our daily responsibilities or by the pressing problems faced by our countries. I don't believe we can wait 25 years before addressing the problems of the international monetary system.

So I shall have to call your attention to other issues, to my mind more significant to the world economy today. For reasons of time I shall have to be very selective and limit myself to this brief comment on Dr. Cooper's proposal and on three other topics.

I. Surveillance by the IMF and Asymmetry in Adjustment

A fundamental responsibility of the IMF and one essential to the functioning of the international monetary system is to scrutinize and promote the consistency of member countries' exchange rates and related policies with orderly and cooperative external adjustments. The exercise of this surveillance function has focused on: 1) the need for a balanced macroeconomic policy approach in which monetary, fiscal and exchange rate policies combine to counter internal and external imbalances; 2) issues concerning the appropriate scale of intervention to counteract disorderly conditions in exchange markets; 3) assuring that exchange rate policy is not used to secure inappropriate competitive advantage; 4) the promotion of resistance to protectionist pressures and recently, 5) the improvement of information and analysis in the field of external debt. In practice, however, serious flaws have become apparent in the implementation of surveillance by the IMF.

As is well known, the economic policies of the industrial countries, especially in the largest among them, have far-reaching effects on the evolution of the international economy given the key position they occupy in the

system as a whole. Therefore, surveillance by the Fund should focus primarily on these countries. However, a review of the poor economic performance of the world economy since the seventies and of the reasons behind such performance suggests that the Fund has been unable to perform that function efficiently.

Among industrial nations, the economic policy response to economic difficulties has too often been based on unbalanced policy approaches placing undue reliance on monetary restraint measures without regard to the stance of fiscal policy, to the solution of structural difficulties, or to the impact of such measures on the rest of the world. The adverse effects of this approach are well-known: unprecedentedly high interest rates in the international financial markets leading to stagnation or slow growth, as well as volatility and misalignments of the major currencies and the growth of protectionism.

These factors, together with the oil shocks, have had strong adverse effects on the non-oil developing nations. In recent years, these countries registered a very large increase in their payments disequilibria, generated by a combination of domestic and external factors.[1] Their difficulties have been substantially accentuated by the marked asymmetry that has characterized the international adjustment process, i.e., the burden of adjustment has come to rest on deficit developing nations, with little corresponding action on the part of the surplus countries. Nevertheless, the growth of total output of the group has decelerated dramatically and, as a result of the high levels of external indebtedness, fears have arisen about the creditworthiness of the major borrowers and the stability of the international financial system.

The lack of political willingness on the part of some of the major industrial countries to follow policies that are consistent with the requirements of the international economy has constituted a major factor behind the poor performance of the world economy in recent years. In general, the IMF has been unable to exert signficant influence on the stance of members' economic policies, except in those cases when these countries have requested access to its resources. Thus, the IMF has focused its attention and has been able to exert effective pressure only on the users of its resources, i.e., developing countries with balance of payments deficits. In the process, a basic asymmetry has been introduced in the Fund's surveillance function and the international adjustment process has become seriously biased.

The major biases are: a) the current account imbalances of major reserve currency countries have not been subject to the same discipline as deficits of other countries; b) the existence of structural balance of payments deficits and surpluses, as well as their interconnection, has in practice been largely ignored; and c) the existence of a "natural" tendency to adjust by deficit nations, and the absence of effective surveillance on the surplus countries, has placed the burden of adjustment on deficit countries. As a result, the deficit

[1]According to estimates of the IMF, of the $66 billion increase in the aggregate current account deficit of the non-oil LDCs from 1978 to 1981, more than 90 percent may be explained by the combined effect of the rise in net interest payments, the deterioration of the group's non-oil terms of trade and the adverse change in the group's oil trade balance. See IMF, World Economic Outlook, Occasional Paper 21, Washington, D.C. 1983.

nations have been faced with shorter periods and harder adjustments and the world economy with a lower level of activity and trade than would otherwise be necessary.

A reformed international monetary system should include an effective, symmetrical and equitable adjustment process. In supervising the exchange rate and related policies, the IMF must give symmetrical treatment to all countries, surplus and deficit, and ensure that countries with surpluses and those with reserve currencies accept an equitable part of the burden of adjustment. In order to ensure effective application of these principles, the Fund should be given greater means of exerting pressures over major countries.

Moreover, the Fund's surveillance must provide guidance for the design of national economic policies, especially within the industrial world, so that they contribute to the achievement of the objectives of the international economy as a whole. Such objectives could be set on the basis of the periodical diagnosis of the international economic situation by the IMF Interim Committee. In this process, surveillance by the Fund should adopt a dynamic perspective, taking into account both the current situation and prospects, and the requirements for world economic growth with stability. In exercising its surveillance function, the Fund would give proper consideration to structural difficulties and the high degree of interdependence of national economies.

II. The Changing Nature of the Adjustment Process

Over the last decade, substantial changes have taken place in the world economic environment. (In particular, the international economy has registered a reduction in the rate of growth of world trade, the increasing emergence of structural disequilibria, and an unprecedented level of interdependence among national economies). At the same time, the developing nations have become a more important economic and political force in the world scene. The structure created at Bretton Woods in 1945, despite partial reforms, has failed to respond fully to such changes. As a result, the difficulties in the world economy have been aggravated.

Economic disequilibria during the 1950s and 1960s were traditionally the result of excessively expansionary domestic policies. The typical case was that of an ambitious development program financed through a growing public sector deficit. Economic adjustment of such disequilibria obviously had to center on the control of demand and the reestablishment of fiscal discipline. The causes and the characteristics of economic imbalances, however, have shown a substantial evolution during the last decade, changing to a considerable extent the nature and the requirements of the international adjustment process and giving rise to new problems.

Firstly, the economic environment has been plagued by the emergence of structural difficulties often closely related to huge changes in the relative prices of traded goods, including energy, and by record interest rate levels in the international financial markets. Secondly, the pace of world economic expansion and the growth of world trade have declined substantially, a situa-

tion that will likely persist in the medium term. Finally, the conduct of economic policy has faced the constraints imposed upon it by an unprecedented level of world economic integration.

The above-mentioned factors have significant implications for economic adjustment. In the fifties and sixties where the traditional adjustment programs were developed, they often entailed no more than slower growth of domestic consumption, since mild demand dampening measures at times coupled with a devaluation were enough to switch resources to exports while keeping the economy at near full employment. This is no longer the case. World trade is too depressed. The protracted recession recently ended and the modest growth of world trade give rise to significant difficulties in the implementation of economic adjustment. In addition, the structural nature of numerous economic problems makes the traditional approaches to the process of adjustment incomplete. Macroeconomic adjustment is not enough, since it does not by itself ensure the resumption of growth or the needed adaptation of sectoral policies and the reallocation of resources toward tradeables.

For the most heavily indebted developing countries, accounting for the largest share of GNP of the developing world, after several years of declining income, it is not merely preferable to restore equilibrium through a combination of policies aimed not only at reducing or eliminating excess demand, but necessary to stimulate production and investment in certain strategic sectors so as to restore economic growth. Structural changes must be supported by policies that go beyond mere demand management leading to the diversification and strengthening of the economy, even if they may not immediately reduce payments imbalances. Exclusive reliance on policies that concentrate on restraining demand run the risk of affecting adversely the sources of economic growth and becoming politically unsustainable. The social and political constraints faced by adjustment programs are no less real or binding than the technical ones.

Moreover, a substantial drop in LDCs' imports, frequently associated with sole reliance on demand restraint measures, has adverse effects on the rest of the world. This is of special relevance at present, since numerous developing nations[2]—including those with a significant role in world trade—are undertaking sharply deflationary adjustment programs that generate a substantial decrease in developing countries' imports. Since LDCs account for about one-third of world imports, a decrease of developing nations' imports ranging from say 5 percent to 10 percent, ceteris paribus, would contract world trade by 1.5 percent to 3 percent hindering the recovery of the international economy. It is evident, thus, that the implementation of adjustment measures in LDCs must give appropriate consideration to world economic integration. This calls for the adoption of policies leading to the required structural adjustment of their economies consistent with the maintenance of international trade flows.

The prospects for growth and external adjustment on the part of LDCs depend substantially on the evolution of economic growth in the industrial

[2]Argentina, Brazil, Mexico, Nigeria, India, etc.

countries. As a result of a combination of factors, however, the pace of expansion in the developed world over the medium term is likely to remain slower than during earlier periods. On the other hand, the structural nature of the economic adjustment needs faced by most developing countries calls for larger amounts of longer-term finance if their growth prospects are not to be seriously impaired. Consequently, the financial requirements of structural adjustment in LDCs must be placed within the framework of the international adjustment process and recognized as a problem of the international community.

The achievement of an efficient process of international adjustment requires the existence of an adequate operational framework. In fact, many of the costs involved in economic adjustment in recent years may be associated with the malfunctioning of existing arrangements. Thus, a growing need to modify them has emerged so as to adapt their operation to present needs and developments in the near future. The resources available to international financial institutions for the financing of payments disequilibria occupy a central role in this process.

III. The External Debt Problem

Almost two years after the Mexican debt crisis the problem of external debt needs no introduction. The basic elements are well-known. The expansionary fiscal policies followed by numerous developing countries to sustain growth in an adverse external environment and the overvaluation of their exchange rates leading to growing current account deficits were the major domestic factors that led to the rapid accumulation of debt. On the external side, the large expansion in the supply of funds in the international financial markets following the oil crisis of 1973 and the decline in demand for funds in industrial countries favored an aggressive expansion in bank lending to those middle-income countries that had a good growth record and favorable prospects.

Efforts by the major debtor countries, the IMF, the BIS and the monetary authorities of industrial countries have permitted considerable achievements in controlling the short-term impact of the crisis on the international financial system. Nevertheless the problem, far from being solved, has introduced an element of fragility in international economic relations which is likely to remain with us for a number of years.

Most Latin American countries have undertaken balance of payments adjustment programs with the support of the IMF. Although most of them managed to obtain unprecedentedly large trade surpluses in 1983, these were inadequate to allow them to meet their debt service payments. Trade surpluses in all cases reflected a sharp reduction in imports between 1981–83 (Brazil 30 percent, Argentina 52 percent, Mexico 66 percent) rather than an expansion of exports, with the consequent sharp recessionary impact. This is partly because of the trade barriers their exports face and partly because many countries in the region followed protectionist, import substitution industrialization strategies for protracted periods and have yet to develop a diversified and competitive export industry.

As a result, in 1983 the resource balance between net capital inflows and payments of interest turned negative to the tune of over $17 billion for Latin America. This is not merely an obvious case of an international misallocation of resources but is unhelpful to the solution of the underlying problem.[3]

In the short run, efforts aimed at fiscal and balance of payments adjustment must necessarily result in heavy import reductions. But this will not be sufficient to strengthen the debt servicing capacity of these economies. For that purpose, it will be necessary to undertake a process of structural adjustment over the next few years aimed at generating export growth. This may require in some cases a review of development patterns and objectives for the medium and long-term and a reorientation of the economy's commercial policy, industrial structure and policies, agricultural policies, domestic prices, institutional arrangements and fiscal incentives to favor exports.

It is obvious that such a process of structural adjustment will be made all the harder if a substantial proportion of domestic savings, otherwise available for new investment, have to be transferred abroad to service external debt. The only long-term solution is for these economies to grow out of the debt problem. In the meantime much can be done to facilitate this process by lowering the debt service burden on debtor countries. This covers two aspects: amortization and interest payments.

Amortization payments on a substantial proportion of the external debt of developing countries fall due in the next few years, partly as a result of recent rescheduling agreements. Therefore, if no additional measures are taken, the bunching of maturities could give rise to a new crisis in the near term as grace periods come to an end.

Debt restructuring exercises will have to play a fundamental role, but frequent restructurings are costly and create uncertainty. To be really useful and not merely postpone the problem, they must allow time for structural changes to take place. Debt restructurings will have to go well beyond the maturities of a year or two, spreading them over the next 10 to 15 years as a minimum.

Interest rates should also be abated to the greatest possible extent. To a considerable degree the debt problem is a result of current interest rates, which are unprecedentedly high in real terms. For instance, at a real rate of interest of 3 percent a country whose external debt equals 50 percent of its GNP would devote 1.5 percent of GNP to interest payments and if exports amount to 10 percent of GNP, 15 percent of export proceeds would be needed to service debt. This is not difficult to achieve since in many cases a current account deficit of say 2.5 percent of GNP can be considered appropriate and be sustained by a growing economy without difficulty.

However, when as today the real rate of interest rises to 8 percent or 9 percent (12.5 percent prime rate -5 percent inflation $+1.5$ percent of spreads and other fees) interest payments excluding amortization can easily exceed 4 percent of GNP or 40 percent of export proceeds.

[3]Moreover, it imposes a heavy economic and social burden on the debtor country populations, a cost that they are increasingly reluctant to bear. How long can countries half of whose population is under 21 and whose labor force grows at over 3 percent annually maintain social and political stability without growth?

It is therefore essential that fiscal and monetary authorities of industrial countries adopt policies conducive to the decline of interest rates and that commercial banks adopt cooperative attitudes that may contribute to the reduction of interest payments of developing countries. But there is an obvious danger that this will not happen. Indeed, as likely as not, interest rates will increase further in the coming months with consequences that may be far-reaching.

As I look to the future, I can not conclude without expressing an additional concern, that the current financial crisis has led to the neglect of the future external sources of development finance. At a time when capital markets will not be able to play the leading role of the past decade, international financial institutions and government agencies must have an enlarged participation in channeling long-term funds to developing countries. These should promote adjustment giving greater attention to the correction of structural imbalances and ensure an adequate supply of funds for balance of payments and development financing. This, however, is one of the major problems on the international economic agenda since it is crucial to the sustained recovery and growth not only of the developing countries, but of the world economy over the next decade.

Though it is apparent that the international monetary system has serious shortcomings, the main obstacles to reform are of political rather than a technical nature.

Discussion

Anthony M. Solomon*

The theme of this conference—do we need a new Bretton Woods?—reflects a deep and widespread desire to reestablish an international economic and financial order whose stability is better appreciated in hindsight than it was at the time. It is certainly an understandable desire and one that I share to a great extent. Still, I think we all recognize that we can't simply restore the old arrangements. The pressing concerns of today are not the same as those faced by the Bretton Woods participants. And answers to the problems that Bretton Woods could not solve and that led eventually to its breakdown are no more at hand now than they were in the past.

The Bretton Woods arrangements—the creation of the IMF and the World Bank and the establishment of an adjustable parity system of exchange rates—were part of the solution to the problems of the time: how to reconstruct the war-devastated economies of Europe and Japan, to promote world trade and to guarantee against a return to the competitive devaluations and protectionism of the 1930s. They were not the only parts of the solution. Other important elements—Marshall Plan assistance and the establishment of GATT, for example—lay outside of those arrangements. But the Bretton Woods structure was critical.

International financial stability—exchange rate stability, in particular—was taken for granted then to be an essential prerequisite for world economic recovery. After all, the memory of the exchange rate anarchy of the 1930s and the associated collapse of world trade was still vivid. League of Nations figures record that international trade, measured by the import values for 75 countries, dropped from almost $3 billion per month in January 1929 to less than $1 billion in January 1933. Even after trade recovered from this low, it did not rise any faster than domestic production, and then only for France and the United States among the major nations. For Britain, Canada, Japan, Germany and Italy trade lagged well behind. In the process, any orderly structure for international commerce was destroyed. Exchange controls, bilateral clearing and payments arrangements, discriminatory tariffs and competitive devaluations abounded.

The entire experience was an economic trauma beyond anything we have seen in more recent times. The Bretton Woods participants faced a set of problems for which an order of stable exchange rates was an unquestioned part of the prescription. That made it easier to mobilize the spirit of international cooperation to achieve reforms.

Judged against the long-term strategic goals that the postwar reforms set for themselves, we should view Bretton Woods as a success. Europe and Japan recovered strongly from the war and world trade grew rapidly. The

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Depression with its competitive devaluations and protectionism did not return.

Still, we know today, with the benefit of hindsight, that the system had serious structural difficulties. In brief, the very success of the world economy, to which the Bretton Woods arrangements contributed, changed the conditions that made the fixed rate system work relatively smoothly and created problems for the management of such a system that have no clear solution to this day.

The most important change was the relative decline of the economic and financial position of the United States from its status of unquestioned dominance. World GNP grew from $700 billion in 1950 to $3.2 trillion in 1970. While U.S. GNP also grew rapidly, its share dropped from about 40 percent of the 1950 world total to 30 percent in 1970.

The international financial system was similarly transformed. In 1950 the United States held fully half of the world's international reserves. By 1970 it held only 16 percent and only 11 percent by August 1971. As reserves in Europe and the rest of the developed world were rebuilt from virtually nothing, the perceived "dollar shortage" was transformed to a "dollar overhang."

With these fundamentals so much against the dollar, the final weakness of the Bretton Woods system—the inability to handle capital flows—was glaringly exposed. The capital controls supposed to prevent runs on currencies proved entirely ineffective, in large part because economic and financial growth itself had put into private hands vast resources that could be marshalled for speculation against exchange rates. The effective run on the U.S. official reserve position finally forced an end to the Bretton Woods system.

We cannot turn back the clock. Problems that led to the breakdown of the Bretton Woods system persist. The problems stemming from the dollar's role as the principal reserve asset are, at least in principle, no longer so severe. The SDR offers a potential alternative over time. But the problem of capital flows is now even more severe. The sheer size of international financial markets, their greater integration with national financial markets and the more aggressive and innovative management of money make the chances of a fixed rate system working pretty low.

Yet the consequences of living with floating rates have created an understandable desire to see a reestablishment of stability. Exchange rate swings are often perceived to be inconsistent with changes in economic fundamentals, leading to unnecessary adjustment costs, including higher rates of unemployment and bankruptcies, and creating a general environment of uncertainty that lowers investment and trade.

Dick Cooper offers a radical answer to this dilemma, namely, the abandonment of national currencies and the establishment of a world money and world central bank. This proposal represents his vision of the ideal future arrangements for the monetary system. He also discusses some more pragmatic reforms of the present exchange rate system, which he paints as stepping stones on the way to his ideal system. I want to make some comments on both his ideal system of a world central bank and on his proposals for the transition.

Cooper sees the establishment of one global currency as a solution to anticipated future problems that will arise from basic forces now at work. These basic forces are, first, the continuing decline of the relative share of the United States in the world economy. This, presumably, undermines the dominant role of the dollar in the international system. The second basic force is the continuing adoption of telecommunications and other technologies that will aggravate the problems of volatile capital flows, and even goods flows, across national borders. The resulting swings in exchange rates will be greater in the future and will create a higher order of disruption. In his assessment, by the next generation these forces will make the present system of floating rates and dollar-based international finance incompatible with independent national monetary policies and free trade. No one can know the future, so it is possible to object that the basic forces will not carry disruption so far. But I am inclined to agree that those forces are at work and point in that direction.

Where I take issue with Cooper's ideal is in the nature of the adjustment process. If I understand him correctly, adjustment in a one-money world will be essentially similar to that under a gold standard. The rate of growth of world money will be fixed from the point of view of individual countries. We have to ask what will happen when fiscal policies are not coordinated—for experience teaches us that will certainly be the case at times. A nation following relatively expansive fiscal policies can postpone the day of reckoning by borrowing, but eventually it will reach a limit. Yet if domestic wages and prices are not sufficiently flexible—and nothing in Cooper's argument says they will be necessarily more flexible in the future than they are today—adjustment will be forced by reductions in output and employment, as in the gold standard. Clearly, the world central bank cannot run monetary policy to accommodate the most expansionary of national fiscal policies without creating global inflation.

This does not compare favorably with adjustment under a floating rate system. Changes in exchange rates can introduce a degree of price flexibility that is missing in domestic product and factor markets and can dampen the swings in output and employment that result during adjustment. For example, a country that must adjust back from too rapid an expansion can receive the trade balance benefits of a depreciating currency, which will moderate the effects of domestic recession. This is the strong point of the floating rate system, when it works well, that must be balanced against the problems caused by overshooting. Adjustment is likely to be an even more difficult business in Cooper's ideal system.

On the question of what steps can be taken to promote the transition to an ideal system, Cooper argues for two broad reforms: enhancing the role of the SDR, his candidate for world money, and giving greater weight to exchange rates in framing national monetary policies. I am basically sympathetic to both of these proposals, although with some important qualifications.

For promoting the SDR, Cooper stresses taking steps to privatize its use. I think there is a role for this and I have said so in the past. I also viewed the U.S. proposal for establishment of a substitution account as not just a prac-

tical measure to address the problem of reserve diversification in the late 1970s but also as a step promoting an expanded role for the SDR.

I also think there is a case for giving greater weight to exchange rates in monetary policy, but only if the mix of monetary and fiscal policies is appropriately balanced. Otherwise the flexibility of monetary policies to react to exchange rate developments can be seriously limited.

In fact, I think that a lot of what is perceived as exchange rate problems under floating reflects a lack of policy coordination that would have undesirable symptoms under any exchange rate system. Take the behavior of the dollar over the past two years, for example. Many view this as a striking example of the kind of currency misalignment that reform of the exchange rate system would avoid. But how much responsibility for the current dollar problem can we lay on the workings of the floating rate regime?

To the extent that the strength of the dollar reflects the U.S. fiscal-monetary policy mix, in particular unprecedentedly high federal deficits, it represents more a policy failure than a weakness of the exchange rate system. Under a par value system, this policy mix would have also led to disturbing consequences. Since the dollar would have been nominally fixed, the trade deficit would not have been so large. With less competition from the traded goods sector, domestic inflationary pressures would have been higher. To offset these greater pressures, higher interest rates would have been needed, leading to even greater private capital inflows. The greater surplus in the official settlements balance of the United States and the greater associated deficits in other countries would have created strains on the system as our trading partners tried to cope with massive reserve outflows.

The solution to current exchange rate problems does not lie in returning to fixed parities. Although it may be true that exchange rates have been too flexible under our current system, the Bretton Woods arrangements broke down because exchange rates were too rigid. A move toward some middle ground, such as pursuit of target zones, would be a more pragmatic approach, but only if the policy mix is first put right.

Clearly, under a floating rate regime, whether heavily or lightly managed, a stable anchor is essential to pin long-term expectations about exchange rates. The most effective way of providing that anchor is through reducing policy uncertainty. If our policy mix and high real interest rates are largely responsible for the overvalued dollar, what could be a more effective way to restore a sustainable structure of exchange rates than a credible and specific plan to change the policy mix? Since a monetary accommodation of our huge federal deficits is ultimately going to be inflationary and would only add to uncertainty that already appears excessive, the action must come from the fiscal side. A credible plan to reduce our federal deficit substantially can do more at this time to lower real interest rates and eliminate the overvaluation of the dollar than a reform of the exchange rate system that imposes greater coordination on national monetary policies only.

The experience of recent years shows that the major countries have not been very successful at consistently coordinating their macroeconomic policies. This has led some people to support reform of the exchange rate system as a way to bring about that coordination. The idea is that once a

commitment to a fixed rate system is made, improved coordination, of fiscal as well as monetary policies, must follow if the system is to be made to work. I am afraid that this puts the cart before the horse. The absence of coordination in national economic policies is not due to a lack of institutional arrangements to help it along. IMF surveillance, annual economic summit meetings, committees of the OECD and regular meetings of central bankers at the BIS are all part of the existing institutional arrangements for coordinating policies. The difficulties of getting policies to mesh reflects basically the underlying differences in goals on the part of national authorities, not an absence of mechanisms or institutions. So I am skeptical that greater coordination, particularly for fiscal policies, can sneak in, so to speak, through the back door of exchange rate reform.

So far, I have raised some skeptical points about what international reform of the exchange rate system could achieve today. But international financial system reform covers more than just the exchange rate system and we do face another pressing concern that is essentially both structural and international in character. The international debt problem is one area where a critical review of existing financial mechanisms and arrangements seems to be in order. I am willing to go farther than Dick Cooper in supporting more general initiatives here. The case-by-case approach that has been followed so far has proved to be a very trying one and is getting a bit frayed around the edges. If there is one area where we may need reform now, this appears to be it.

The events of the last four years—and an assessment of the experience of the last decade—seem to point to one important lesson: the traditional way commercial banks have provided international lending to LDCs may not be the best way of financing either their long-term development programs or cyclical but prolonged balance of payments difficulties. The current vulnerability of the major debtors was greatly compounded by the way they were financed in 1979–82: most of the borrowing was short term, on a floating-rate basis and concentrated in dollars. In the course of only three years, countries that appeared to be financially sound suddenly faced grave and deteriorating payments difficulties.

An evaluation and rethinking of the existing mechanisms of international borrowing and lending have begun. I hope a concrete and constructive revamping of the financial system will be the final outcome. The immediate concern is to reduce the vulnerability of debtor countries to interest rate increases during their adjustment programs. But we must also look to the longer term and put in place a structure of official and private capital flows that will be more diversified, more flexible and less subject to serious abrupt contractions. The experience of the early 1980s will be doubly damaging and painful if it is allowed to repeat in the future.

The major lesson that I draw from the experience of Bretton Woods is not that it tried to be universal in the scope of its exchange rate system and failed, but that it was pragmatic in the spirit of its reform and succeeded. It was pragmatic because it channeled the energies for reform to solving the pressing problems of its time. Dick Cooper has taken a more comprehensive approach to the problem of reform but it too leads to some practical in-

itiatives for the exchange rate system in which I find much merit. But I would stress that the problem of the fiscal-monetary policy mix must be addressed first before we can realistically go ahead with exchange rate reforms. And I would like to see the energies for cooperation and reform focused now on the principal international problem currently before us, the management and restructuring of LDC finances.

General Discussion

Richard Cooper pointed out that the United States is not alone in having an inappropriate policy mix. While noting that a reduction in projected U.S. budget deficits is necessary, Cooper indicated that fiscal policy in many key countries—notably Japan, West Germany and the United Kingdom—has been contractionary. Furthermore, even if the U.S. tax cuts of the early 1980s had been more modest, large real exchange rate changes would still have resulted because of the tightness of U.S. monetary policy.

Anthony Solomon asserted that the dollar's strength is largely attributable to the high real U.S. interest rates induced by large current and projected U.S. budget deficits. He doubted that contractionary fiscal policies abroad contributed much toward the dollar's strength.

Max Corden argued that there was a fundamental paradox in Cooper's proposal for a complete monetary union among a group of countries. Cooper believes, according to Corden, that sticky prices allow nations to influence real exchange rates, and consequently real output and employment, in the short run using monetary policy. If national monetary policy is this powerful, though, won't countries be unwilling to concede this power to some supranational monetary authority? That is, a complete monetary union could evolve only in a world where "money doesn't really matter for real things."

Cooper responded that a monetary policy change in one country generates an external disturbance to another country. As these disturbances proliferate, countries might resort to financial controls to smooth domestic economic activity. Thus, a need exists now for a system to induce governments to coordinate monetary policies.

International Liquidity: Are the Supply and Composition Appropriate?

John Williamson*

I. Introduction

The conference whose fortieth anniversary we are here to commemorate omitted to create a fiduciary reserve asset as desired by Keynes, but instead gave its blessing to the gold exchange standard inherited from the interwar years. The members of the Fund subsequently repaired the omission of Bretton Woods by creating the Special Drawing Right (SDR), and then allowed the gold exchange standard to lapse. But this has not led the world into a system even remotely resembling the well-ordered vision of which Keynes dreamed. The question posed to me today is whether the arrangements that have evolved instead—which some of us have referred to as a "non-system"—serve the world well.

The paper is organized as follows. The next section deals with semantic and measurement problems, regarding "international liquidity" and the notion of "appropriateness." This is followed by a sketch of the evolution of reserve arrangements and of perceptions of the issues involved from the time of Bretton Woods to the present day. Section IV discusses the current adequacy of reserve supply, and Section V the appropriateness of the present composition of reserves. The final section considers proposals for change.

II. Concepts and Measurement

The term "international liquidity" has for some years been used as a synonym for "international reserves," rather than defined in functional terms as a measure of a country's ability to finance a payments deficit and avoid resort to adjustment measures. Despite my own former sympathy for the functional approach (Williamson 1973, pp. 687–88), I shall abide by conventional practice.

"International reserves" were defined by the Ossola Report as "those assets of [a country's] monetary authorities that can be used, directly or through assured convertibility into other assets, to support its rate of exchange when its external payments are in deficit" (Group of Ten 1965, p. 21). This definition suggests that liquid foreign exchange holdings of central banks, SDRs, and reserve positions in the Fund should certainly be included in reserves. European Currency Units (ECUs) held by members of the European Monetary System (EMS) are more ambiguous, since they can be used only for financing deficits incurred with other members of the EMS. The traditional reserve asset, gold, is an even more doubtful candidate.

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Gold is not in practice used in intervention to support exchange rates in times of deficit. It is not routinely exchanged into currencies for that purpose, as SDRs are, perhaps because its enormous price fluctuations would expose to criticism central bankers who sold before a price rise (or bought before a price fall). To the extent that "assured convertibility into other assets" implies conversion at an assured rate (and this was considered the essence of convertibility in the 1920s), it clearly does not qualify as a reserve asset by the traditional definition. The IMF has recognized the dubious nature of gold's claim to continued classification as a reserve asset by creating a concept of total liquid reserves, rather inelegantly labeled "total reserves minus gold," which excludes gold altogether; and this is the concept on which most calculations of reserve adequacy are now based.

On the other hand, it seems paradoxical to many that the traditional reserve asset, still held by central banks in large volume,[1] should be excluded from the measure of reserves. The volatility of the gold price undoubtedly detracts from its liquidity. The fear of depressing the price against themselves may act as an added deterrent to substantial sales by large holders. On the other hand, gold can be used as collateral rather than sold outright. The fact is that gold is an element of national wealth held by central banks that can be—and occasionally is—mobilized to meet an external crisis.

This is perhaps a topic where an empirical study could hope to clarify whether gold still merits classification as a reserve asset. There are, after all, a number of estimates of the demand for reserves which have found a significant explanatory role for most of the variables that theory would suggest to be relevant (see, for example, Edwards 1983, Frenkel 1983, von Furstenberg 1982, and Section II.1 of Williamson 1973 for a survey of an earlier generation of such studies). Similarly, it has proved possible to detect a systematic effect of reserve levels on adjustment policies. If such studies yield markedly better results for nongold reserves than for total reserves including gold, as I would conjecture, we will surely be able to conclude that the time for completing the statistical demonetization of gold has arrived. Until then, the value that is placed on gold holdings in measuring reserves is uncomfortably arbitrary.

ECUs also present a major problem of measurement. They are created by member countries of the EMS depositing 20 percent of their holdings of both gold and dollars in the European Monetary Cooperation Fund (EMCF) in exchange for an equivalent quantity of ECUs that may then be used in settling intra-EMS interventions. However, ECUs are created not by a permanent deposit with the EMCF, but by a series of three-month swaps. Each swap is unwound with no impact on the net worth of the central banks involved, irrespective of whether or not they have drawn on their ECU balances. The sole role of the gold and dollars deposited in the EMCF is to determine entitlements to receive ECUs. Under these circumstances the most appropriate way to measure reserves is to adjust the published reserve statistics to show the gold and dollar holdings nominally deposited with the EMCF as if they remained in national possession, and not to include the holdings of

[1]Gold holdings are, however, highly concentrated; six countries account for over two-thirds of the total.

ECUs. This adjustment has sometimes been made by the IMF in its *Annual Report.*

Even this expedient is not entirely satisfactory. Since intra-EMS imbalances are financed by swaps, the transfer of ECUs, and lending by the EMCF, reserves as measured above underestimate the sums available to members of the EMS for certain purposes. A suitable adjustment can be made where the reserves/imports ratio is being used to appraise reserve adequacy, however, by combining the measure of reserves proposed above with a measure of trade that excludes intra-EMS trade.

The problem with measuring foreign exchange reserves is quite different from that of measuring the value of gold and ECU holdings. There is no question that liquid foreign exchange holdings qualify as reserve assets, and no doubt about their appropriate valuation. The problems arise, rather, because a number of countries have for some years engaged in window-dressing designed to conceal either the accumulation or loss of foreign exchange reserves. The main underreporters are the capital-surplus oil exporters, while the countries that exaggerate their currency reserves are usually those that wish they had more than they do. Several instances of such over-reporting have recently come to light, as detailed in Williamson 1984 (pp. 17–18). In that study I concluded that the reserves of the capital-importing developing countries were almost certainly exaggerated by at least SDR 10 billion (almost 10 percent) in mid-1983, and perhaps by much more.

In order to address the topic assigned to me, it is important not just to clarify what is understood by international liquidity but also what is meant by "appropriate." When they are being theoretically self-conscious, most economists claim to employ the concept of Pareto optimality in reaching such judgments. In the context of international relations it is natural to think of countries as the individual agents, and so one set of arrangements is judged Pareto preferable to another if at least one country can be made better off without worsening the position of any other. I suspect that this is pretty much the standard that the international community of sovereign states does in fact employ in seeking international agreements—which is why there have not been many such agreements of substance for some years.

In practice, applied economists escape from the hopeless indeterminacy of the Pareto criterion by asking whether there is a "general" gain, interpreted as a gain by some that outweighs the losses of others. The weighing of those gains and losses is customarily done by a simple monetary test, evaluating a dollar equally no matter to whom it accrues, which is semi-rationalized by Scitovsky's compensation principle. Those of us with egalitarian value systems are uneasy about this, and try to insist that at least some greater weight should be attached to changes in the income of the poor in evaluating whether a change is desirable. Hence in gauging whether present arrangements are appropriate I shall ask whether there would be a general gain in moving to a feasible alternative, and in particular whether there is reason to think that the developing countries would gain by the change.

III. Historical Background

As is well known, Keynes failed to persuade the U.S. Treasury of the virtues of his visionary proposal for creating a new international reserve asset (bancor) and endowing countries with large overdraft rights in an International Clearing Union. Instead, the White Plan for retaining the gold exchange standard and supplementing it with a modest Stabilization Fund provided the basis of the Bretton Woods system.

A gold exchange standard, like a simple gold standard, is supposed to ensure that the monetary expansion each country can afford (given the obligation of maintaining a fixed exchange rate), and therefore the level of world nominal income, will be governed by the available gold stock. The reserve center can to some extent finance its deficits by liability financing, thus supplementing the world monetary base provided by the gold stock with a certain sum of reserve currency, but this process must be limited if the gold exchange standard is to survive. Supplementation of gold by a reserve currency permits a larger nominal income to be based on a given gold stock, but an increase in the stock of gold is still expected ultimately to generate a proportionate increase in nominal income (what I once termed the "international quantity theory," see Williamson 1973).

In fact economic policy in the postwar years was not conducted even approximately in accord with these rules of the gold exchange standard. This was the height of the Keynesian Era, when countries aimed at "full employment" or "internal balance," and treated reserves as a buffer stock which enabled them to combine their dominant (domestic) objective with temporary departures from external balance. The rate of inflation was (especially for the United States) whatever was judged (or misjudged) to be internally optimal, as reflected in the internal balance target pursued, rather than anything dictated by the supply of gold.

Robert Triffin, who in 1947 pioneered the buffer-stock as opposed to monetary-base theory of reserves, was also the first to recognize its implications for the nonviability of the Bretton Woods system. For a time the reserve center can sidestep the threat posed by a growth of gold stocks less than the growth in the demand for reserves by issuing its own liabilities, but eventually this will inevitably undermine the credibility of the commitment to gold convertibility. Hence the Triffin Dilemma: either the United States would correct its payments deficit and confront the world with a liquidity squeeze that would imperil real growth, or the deficit would continue and undermine confidence in the dollar price of gold. This analysis inspired the negotiations that led in 1969 to creation of the SDR, thus repairing the great omission of Bretton Woods.

By 1969, however, the world was no longer on a gold exchange standard. To prevent a confidence crisis developing until a reserve asset to supplement gold had been created, countries had increasingly refrained from exercising their rights to convert dollars into gold. After introduction of a two-tier gold market in 1968, it was generally understood that any major exercise of the ostensible option of converting dollars into gold would precipitate a closing of the gold window. The new U.S. administration indicated its sympathy for

"benign neglect." The world was on a *de facto* dollar standard.

Under a full-fledged dollar standard with permanently fixed exchange rates, the pace of world monetary expansion would be determined by the decisions of the Federal Reserve Board. But in fact exchange rates could change under the Bretton Woods system, and thus one cannot take it for granted that the other countries were reduced to monetary dependence on the United States. Indeed, the United States came to view the key feature of the *de facto* dollar standard as something quite different, namely, the nth currency role of the dollar which allowed other countries to choose their exchange rates and hence their balance of payments outcomes. The U.S. balance of payments deficit was viewed as the residual which allowed other countries to build up the reserves they wished to hold for buffer-stock purposes.

In retrospect it seems difficult to doubt that both views had an element of truth. The U.S. monetary expansion of the early 1970s was transmitted abroad by the attempt to preserve the system of pegged exchange rates, as under a dollar standard. But other countries did have the ability to adjust their balance of payments position in ways other than by playing the gold standard rules of the game, and those policy instruments were used in the attempt to combine internal balance with a desired rate of reserve accumulation.

Both views recognized that the United States occupied a highly asymmetrical position in the system, and both sides found the asymmetries on which they focused their attention irksome. It is a matter of history that the party which finally ended the fiction of the gold exchange standard was the United States, and a matter of speculation as to whether the Europeans would have chosen to break away from the *de facto* dollar standard had the formal gold exchange standard been terminated less provocatively.

The closing of the gold window in 1971 set in train a series of negotiations in the Committee of Twenty which it was hoped would establish a new monetary order free of the asymmetries that had been perceived to be so irksome in the past. The Europeans wanted asset settlement to complement the SDR agreement, so as to make the rate of SDR creation the basic determinant of world reserve growth (and therefore, according to the monetary-base view of reserves, of world monetary growth). The United States wanted a reserve indicator system, to remedy the asymmetry in exchange rate determination. For some reason that I could never understand these two ideas were perceived to be in conflict, while the necessity of limited exchange rate flexibility in permitting managed crisis-free adjustment was not acknowledged. Increasing monetary nationalism, plus the intellectual fashion for ascribing miraculous stabilizing powers to steady growth of some domestic monetary aggregate, ensured that the negotiations ended in abject failure (Williamson 1982a). The alternative that emerged was generalized floating and a multiple reserve currency system.

From the standpoint of the monetary-base view of reserves, the crucial characteristic of floating is that it devolves the determination of monetary policy to individual nations: the reserve stock no longer has any role in gov-

erning the growth of nominal income. According to the buffer-stock view of reserves, the move to floating is a good deal less basic: it merely reduces the constraints on countries being able to achieve the reserve stock they desire. (It need not necessarily reduce the desired level of reserves: as Harrod (1965) once argued and Black (1983) has recently shown formally, it is conceivable that countries would be moved to hold larger reserves under floating because of the greater uncertainty.)

But the move to generalized floating was only one of two developments that transformed thinking about the reserve system in the 1970s. The other was the emergence of an international capital market. By the mid-1970s, most countries, with the exception of the least developed, were able to satisfy their liquidity needs from the liability side of the balance sheet, so that the external constraint on policy shifted from liquidity to creditworthiness. The increase in the supply of dollar reserves ceased to bear any relationship to any concept of the U.S. balance of payments. Reserve supply became endogenous.

The consequences of these developments were important. There is fairly general agreement that they have served to erode what remained of the monetary-base theory of the demand for reserves.[2] For a decade or so they permitted the world economy to expand with less concern for external constraints than in any previous historical period, despite the coincidence of the OPEC surplus and its counterpart, abnormally large deficits in the rest of the world. Paradoxically, the countries most limited by the external constraint were not the middle income countries that built up the proportionately largest net debtor positions (although Peru and Turkey both confronted the creditworthiness constraint relatively early), but industrial countries (notably Britain and Italy, and subsequently France). The explanation is presumably that the industrial countries contracted foreign debt denominated in their own currencies rather than in foreign exchange, so that a withdrawal of funds brought the external constraint into play as soon as asset holders started to doubt the determination to resist partial expropriation through inflation. The overt repudiation needed to expropriate creditors when debt is denominated in someone else's currency is a far more traumatic—and therefore less likely—step, so what we now call the Debt Crisis did not break until 1982. In that year most nonindustrial countries, with the exception of the capital-surplus oil exporters, discovered that they had reached the creditworthiness constraint. Since then they have reverted to being liquidity constrained.

The preceding account has not attached much importance to the distinction between reserve centers and other countries. The greater is capital mobility in general, the less significant is the ability to attract short-term deposits of foreign monetary authorities. A much more critical distinction is that between those countries that borrow predominantly in their own currency and those that borrow principally in foreign exchange. The former have the option of writing down the real value of their foreign debt through internal inflation—as a result of which the markets give them *less* latitude to contract foreign debt. One cannot, for example, assume that the United

[2]Compare the arguments in successive conference volumes: IMF (1970), Mundell and Polak (1977), and Dreyer, Haberler, and Willett (1982).

States will be able to run a current account deficit at the rate now in prospect for the decade or more that it would take to reach the sort of debt/GNP ratios at which the Latin debtor countries got into trouble.

IV. The Adequacy of Reserve Supply

While the monetary-base view of reserves may have had some residual validity in the pegged-rate Bretton Woods system,[3] there can surely be no doubt that under current circumstances—with exchange rates flexible even when not formally floating and the major countries integrated into a world-wide capital market—it is the buffer-stock view of reserves that should guide assessments of reserve adequacy. It has also been argued that reserve supply is endogenous and that the level of reserves is demand-determined so far as the industrial countries are concerned. What are the implications for assessing the adequacy of reserve supply?

A first implication is that it is necessary to analyze separately the positions of the industrial countries (plus the capital-surplus oil exporters) and the capital-importing developing countries. For the former group, which has just over two-thirds of IMF quotas, one can assume that countries will be holding more or less the reserves they desire. There will be times when buffer stocks will be run down to less than the levels countries would prefer, and when they will not be replenished rapidly by going out and buying foreign exchange with domestic currency in the foreign exchange market, because this would accentuate the exchange rate fluctuations that reserves are held to mitigate. And there will be times when buffer stocks rise to levels in excess of perceived needs. But it is in the nature of buffer stocks that over some (possibly wide) range such fluctuations will simply be accepted rather than prompting a policy change. And the opportunities countries have to manage their buffer stocks without jeopardizing other objectives are—except in stabilization crises—good. Hence one can assume that these countries hold as many reserves as they need or desire.

There is an important corollary. If these countries receive additional reserves, e.g., as the result of an SDR allocation, they will not be prompted to seek a proportionate increase in their money supplies (as the monetary-base view of reserves would imply). They will simply be less inclined to induce foreign borrowing, more inclined to reduce domestic interest rates to encourage foreign lending, less inclined to intervene to buy foreign exchange, and more inclined to intervene in support of their own currency. While a reduction in domestic interest rates implies some monetary expansion, any change in intervention policy will tend to work in the opposite direction, and the net effect is in any event likely to be modest. The primary effect of an SDR allocation will be to diminish the volume of currency reserves. This point is important because much of the hostility to substantial SDR allocations seems to stem from a lingering belief that this involves injecting large quantities of "high-powered money" into the world economy, and is therefore bound to

[3]But Triffin's historical study (1964) cast doubt on the exogeneity of the money stock, and therefore on the monetary-base theory of reserves, even under the classical gold standard.

be inflationary—a belief that depends on the monetary-base view of reserves, and that is utterly unfounded in today's world.

Since mid-1982 the situation of the capital-importing developing countries has been very different.[4] They are now back in the typical Bretton Woods situation of having pegged exchange rates and limited borrowing ability. The debt crisis that has afflicted so many of these countries is, almost by definition, a manifestation of a reserve shortage. This is not to claim that the debt crisis was *caused* by a global reserve shortage, but simply to observe that it could occur only when the countries involved exhausted their reserves. The fact that this could happen implies that reserves are not demand-determined, and therefore that the type of analysis used to assess the need for the first SDR allocation—as presented in IMF (1970)—is appropriate.

My recent assessment of the case for a new SDR allocation (Williamson 1984) recognizes, and indeed tries to exploit, the differences in the situation of those two groups of countries. It may be of interest to review the approach I adopted in endeavoring to quantify the desirable size of a new allocation.

A first question I asked concerned the size of allocations that would be needed to provide through the SDR system for a growth of reserves related to the growth in trade. I adopted the estimate of 3 percent trend GNP growth of the OECD, and applied to it the Bergsten-Cline (1983, p. 74, n. 26) equation relating OECD growth and trade growth, to estimate a 4 percent trend growth in the volume of world trade. To that I applied von Furstenberg's (1982, p. 88) estimate of an income elasticity of the real demand for reserves of 0.65 to get a growth in the real demand for reserves of 2.5 percent, or SDR 9 billion, per year.

A second approach sought to estimate the reserve shortfall of the developing countries, as of mid-1983. For this purpose I adopted the traditional rule of thumb that under Bretton Woods conditions (a pegged exchange rate and limited capital mobility) the minimum safe reserves/imports ratio is 25 percent, or three months worth of imports. One inevitably feels uneasy about resting so much on a rule of thumb, but this particular one has been hallowed by time and recent developments have not suggested that it has ceased to be useful. The reserve shortfall of the capital-importing developing countries was estimated as the difference between published reserves and what would have been needed to achieve a 25 percent reserves/imports ratio, *plus* the exaggeration of published reserves referred to above (estimated as at least SDR 10 billion).

The question arose as to whether the resulting SDR 21 billion shortfall constituted the appropriate level of total SDR allocation, or whether it should be multiplied by three (since the capital-importing developing countries have about one-third of IMF quotas). An allocation of 21 billion would imply that the countries with a reserve shortage would have only one-third of their shortage remedied by allocation, and would have to earn the remaining two-thirds. According to the traditional theory in which reserves are not demand-determined, this would be appropriate: the other countries would

[4]Indeed, the least-developed countries never achieved the level of creditworthiness needed to make their reserves demand-determined, even in the 1970s.

receive more reserves than they desired to hold, and would therefore allow the reserve-deficit countries to earn the extra reserves they need. Creating three times as many reserves as needed would instead result in excessive global reserves and the threat of competitive payments policies to dispose of the excess. With demand-determined reserves, matters are less clear: in the limit the creditworthy countries might simply neutralize their allocations by cutting back their borrowing from the Euromarkets, and the reserve-deficit countries might find it no easier than without an SDR allocation to earn the two-thirds of their reserve shortages that they did not receive via allocation. Despite some sympathy for the second viewpoint, I opted for the more traditional interpretation—on the ground that any biases in my calculations should be in a conservative direction.

An easier question concerns the allowance to be made for inflation in translating growth in real reserve demand into the desirable rate of SDR allocation. The last thing that SDR-creation policy should do is to underpin expectations of continuing inflation. Accordingly, I made no allowance for future inflation in determining the desirable rate of SDR allocation. In this instance principle and conservatism argued the same way.

There is also the question of gold. Despite a desire to give my calculations a conservative bias, I could not persuade myself that gold holdings should be taken into account as a part of reserves in calculating the existing reserve level.

The final question relates to timing. The earliest feasible date for a new allocation is presumably January 1985. My calculation of reserve shortfall was made for mid-1983, the latest date for which reasonably comprehensive data were available. I suggested a figure of SDR 34 billion as the desirable size of an allocation in January 1985, consisting of SDR 21 billion to make good the estimated shortfall plus 18 months' growth at SDR 9 billion per year. This procedure might be criticized as making no allowance for growth in reserve supply from other sources in the 18-month interval between mid-1983 and the end of 1984. In fact reserves grew by no less than SDR 21 billion, or 6 percent, in the first six months of this period. This increase was distributed: SDR 12 billion to the industrial countries, SDR 4 billion to the oil exporters, and SDR 5 billion to the non-oil developing countries (of which almost SDR 2 billion was accounted for by China). If this rate of growth is extrapolated to the beginning of 1985, it would suggest that 60 percent of the forecast capital-importing developing country reserve shortfall (15 out of: 21 plus a third of 13.5) will have been satisfied from alternative sources. The projected reserve shortfall to be made good by an SDR allocation would then be SDR 10 billion rather than SDR 34 billion—a number that looks distinctly closer to the realm of the politically possible.

Perhaps this approach can be used to rationalize a pruning back of the large numbers that emerged from my study to something politically acceptable. But, while I should have made some allowance for reserve accumulation from alternative sources in the period between the date used to estimate a reserve shortfall and the date planned for allocation, full discounting may be excessive. This is because reserve supply is elastic, so that one expects a reserve shortfall to be eliminated over time by one means or another, whether

or not there is an SDR allocation. If countries knew that they could expect an allocation at the beginning of 1985, they would tend to build up fewer reserves through 1984 than they have been doing recently. What needs to be asked is whether the world economy will function better if that reserve shortfall is made good through an expansion of reserve currency holdings or through an SDR allocation.

A requirement that the debtor countries push adjustment far enough to replenish their reserves through payments surpluses—in addition to curbing the buildup of debt and servicing existing debt—would imply the need for other countries to accept further curbs on their exports, and/or absorb yet more imports from the debtor countries, and/or pressure their banks into yet larger involuntary lending. It seems clear that, at the margin, such an obligation would be found irksome, and that the industrial countries also should therefore prefer to see reserve replenishment accomplished via SDR allocation. Furthermore, a buildup of currency holdings would take the form predominantly of dollars, and would therefore tend to accentuate the overvaluation of the dollar. Indeed, considerations of exchange rate management—or rather the lack of it since the initial declines of the yen and DM in 1979–81—would suggest that the reserves of the industrial countries may also be on the low side. It would be interesting to know whether the reduction in intervention has in part been caused by a desire to avoid a further depletion of reserves.

V. The Composition of Reserves

In my 1973 survey article, I argued that three issues had emerged as fundamental in the design of a new reserve asset: "The prevention of instability due to the confidence problem, the control of the volume of liquidity in the interest of stabilization, and the size and distribution of the resource benefits (or costs)..." (Williamson 1973, p. 717). These are surely all important issues in judging whether reserve composition is appropriate. I would now add two other issues: the question of "backing," which I was inclined to dismiss in 1973, and the question of usability. The present section evaluates the appropriateness of present reserve composition in terms of these five criteria.

Backing

In one of the best-known passages of his assessment of the Rio Agreement to create the SDR, Fritz Machlup (1968, pp. 66–68) wrote of how the myth of "backing" had been scuttled:

> The notion of backing is associated with the notion of debt money. The issuer of the debts... which circulate as money is supposed to hold good assets against the circulating liabilities, and the quality of the assets is believed to be a necessary condition of the moneyness (that is, acceptability) of the liabilities. Since the assets "behind" the debt-money are ordinarily debts of some financially respectable and creditworthy persons, corporations, or countries, the theoretical link between the quality of the ultimate debtors (backers), the quality of the

> assets (backing), and the acceptability of the immediate debt (money) seems to be established. This venerable myth has long enjoyed wide currency, especially in banking circles.
>
> Practically all the plans and schemes for the creation of new international liquidity had incorporated these notions. There was to be a central legal debtor—the IMF, BIS, or a new international institution—and the certificates of deposit liabilities of this legal debtor (or drawing rights against this legal debtor) were to be backed by the currencies or securities of the debtor's debtors—the financially responsible countries.
>
> The new facility established by the Rio Agreement dispenses with the central legal debtor of the special drawing rights and, of course, with the debtor's debtors. By implication, it disposes of the old myth of backing. In so doing, the officials of the Fund and of the negotiating governments showed a courage far greater than the academic economists have had. Not that any reputable economist of our time has believed the old myth; but they were convinced that all bankers and other practical men of the world of finance believed in the myth and could not possibly be "enlightened." Thus, the academic economists had not dared to recommend schemes that would do away with the trappings of backing. Now the forward-looking experts of the Fund and the negotiating governments have proved that their reputation for backwardness in economic thinking had been undeserved. (I propose that they be granted honorary doctor's degrees by the great universities.)
>
> All that matters for the acceptability of anything as a medium of exchange is the expectation that others will accept it. If over a hundred central banks or national monetary authorities including those of the major trading nations of the world agree to accept SDRs from one another in exchange for convertible currencies, this is all that is needed to establish the moneyness of the SDRs in inter-central-bank transactions. Money needs takers, not backers; the takers accept it, not because of any backing, but only because they count on others accepting it from them.
>
> The myth of backing is dead. It was buried in Rio de Janeiro on September 29, 1967.

There is no doubt that what money needs is takers rather than backers; the doubt is whether a formal agreement to take, even if subscribed to by all the leading monetary authorities, will carry complete conviction in the absence of obligations that provide reassurance under a worst-case scenario.

The willingness to stand behind a country's own currency is not in serious doubt. Gold is an asset with "intrinsic" value. In both cases potential holders may have concerns about fluctuations in value, and this may give rise to confidence problems. But a concern that in *extremis* there might be no one with "real wealth" who recognized an obligation to service or accept the assets is unique to the reserve assets provided by the Fund. I have frequently encountered reservations about a rapid expansion in the role of the SDR which make sense on no basis except such a concern. The debate on creation of a Substitution Account in 1979–80 suggested a preoccupation with such issues (Gowa forthcoming 1984). And surely history shows too many cases of

international undertakings having been disregarded to justify labeling such concerns irrational. Machlup's obituary notice for the principle of backing was, I fear, premature.

Usability

The purpose of holding reserves is to enable a country, if it so wishes, to support its rate of exchange when its external payments are in deficit. Since such support is nowadays provided through intervention in the foreign exchange market, the most usable reserve assets are currencies, which can be used directly for that purpose. Both Fund-related assets and gold have first to be converted into currencies before they can be used in intervention. (The great uncertainty about the price at which the latter conversion can be effected is the basic reason for questioning whether gold still functions as a reserve asset. See Section II.)

It has recently been argued that the inability to use the SDR as an intervention medium impedes its acceptance as a reserve asset (Kenen in von Furstenberg 1983, pp. 342–43). Perhaps more important, the lack of a wide and deep private market in SDRs seriously compromises the suitability of the SDR as a currency peg, since even if a country's effective exchange rate would be more or less stabilized by pegging to the SDR, this macroeconomic advantage can be realized only by depriving a country's traders and borrowers of any stable link to a currency in which their international contracts can be expressed (Williamson 1982b). Until the SDR becomes an asset that is widely used by the private sector and transferable between the private and official sectors, it seems certain to remain confined to a peripheral role in the international monetary system.

Confidence

The developments of the past decade have profoundly changed the nature of the confidence problem. On the one hand, the adoption of generalized floating has changed the consequences of reserve shifting in a way that received theory teaches should be stabilizing: a shift out of an asset causes its value to depreciate, and therefore (under regressive expectations) reduces the attractiveness of a further shift, instead of eroding the ability of the issuer to sustain its commitment to maintain the price. On the other hand, the move to a multiple reserve currency system has further multiplied the number of assets among which shifts are possible in response to changes in confidence.

Evaluation of the second development depends upon whether received theory is correct in arguing that reserve shifts are relatively innocuous under floating. If central bankers determine the portfolio composition of their reserves by maximizing expected yields under rational expectations, they will act as classical stabilizing speculators, and the advent of a multiple reserve currency system need occasion no alarm. If, however, they are prone to jump on bandwagons, the multiplication of reserve assets will tend to generate additional instability as confidence waxes and waves.

In a forthcoming paper, Bergsten and Williamson (1984) attempt to discriminate between these two hypotheses using IMF data on reserve composition. Publication of the results has been delayed pending revised and updated data, but the calculations made two years ago indicated that central banks tended to destabilize exchange rates, and to lose money in the process, as a result of their portfolio decisions. (Note that these conclusions relate to reserve switching behavior, not to intervention.) Central banks did tend to lean against the wind, but they leaned harder when the wind started to blow (i.e., when the rate was still moving toward equilibrium) than when it had blown for a long time (i.e., when the rate was moving away from equilibrium), so that the net effect of their switching was to push rates away from their trend values. It should be added that the quantitative impact of these switches in destabilizing exchange rates does not appear to have been very large, according to the results of two of the large econometric models.

Control of Liquidity

A major advantage claimed for introduction of the SDR was that it would give the international community the power to control the volume of liquidity, or at least to remedy a shortage of reserves, in the cause of stabilizing the world economy. The failure to exploit this potential during the last two years (especially since inflation had started to subside), when the need was clearer and more urgent than at any time since invention of the SDR, must cast doubt on whether the existence of this legal power means very much. An economic instrument can be of value only if its political masters are susceptible to rational economic arguments in determining how it should be wielded.

The volume of reserves held by the industrial countries is essentially demand-determined. The part of the reserve stock in elastic supply, which accommodates changes in demand, is the reserve currency element. The fact that supply is elastic means that it cannot be an active element in determining countries' policies, either as a useful discipline or mechanism of coordination, or as a disruptive pressure for excessive inflation or deflation. (This does not mean that the macroeconomic policies of the leading countries cannot exert such pressures—or produce reserve changes as a byproduct).

At one time fears were expressed that fluctuations in the gold price might induce variations in the value of gold reserves that would motivate competitive payments policies. For example, if many countries simultaneously found that the value of their reserves had increased because of a rise in the gold price, they might be tempted into simultaneous pursuit of excessively expansionary policies in an attempt to reduce reserves toward their target levels. I am aware of no evidence which suggests that countries have in fact modified their policies in the light of changes in the gold price—which is, of course, consistent with the view that gold is no longer a reserve asset.

Seigniorage

The question of seigniorage is that of who gets the real resources that are

released to the issuers of money, or in this instance the issuers of reserves.

Seigniorage arises to the extent that a country is able to finance its net debt (or net creditor) position vis-à-vis the rest of the world more cheaply than would otherwise be possible by virtue of its ability to issue a reserve currency, borrow from the Fund, or receive SDR allocations. Since currency reserves, and now Fund-related assets, pay competitive interest rates, the reduction in borrowing costs that these possibilities permit is modest (though positive) for the industrial countries.

The situation is very different so far as the developing countries, and especially the less creditworthy ones, are concerned. In order to build up a buffer stock of currency reserves of prudent size for precautionary purposes, these countries have to borrow from the international capital market at substantially higher rates than they earn on their reserve holdings. The receipt of SDRs to satisfy the normal demand for reserves-to-hold would be a significant benefit. That benefit is being realized on only a modest scale today: in mid-1983 capital-importing developing countries had received net cumulative SDR allocations of SDR 6.7 billion, while their published nongold reserves were SDR 100.2 billion. Even allowing for considerable exaggeration of published reserves, the developing countries were clearly substantial net creditors on monetary account. This is offensive to those with an egalitarian welfare function.

The offense is compounded by the way in which the developing countries were discouraged from diversifying their reserves into gold back in the days of the Bretton Woods system, and then received in compensation for their nonparticipation in the capital gains from the rise in gold price merely the profits on one-sixth of the Fund's holding of gold. But that is a sad story that has little to do with today's monetary system.

It should also be remarked that the continued hoarding of about 1 billion ounces of gold by the world's monetary authorities has a real cost. Gold is a commodity with nonnegligible industrial, artistic, and dental uses, which are currently severely curtailed by the high price of gold. That price could be reduced for many years by release of the gold that formerly played a monetary role.

VI. Policy Proposals

The preceding discussion has brought to light a number of areas where international action on reserve arrangements might serve to improve the functioning of the global economy. The present section focuses on those areas and sketches appropriate policy initiatives.

SDR Allocation

As noted above, there has been a failure to use the mechanism of SDR allocation in order to remedy the reserve shortage currently afflicting the capital-importing developing countries. More generally, the SDR system has not in fact been exploited to allow the less creditworthy countries to gain adequate precautionary balances, or reserves-to-hold, without first borrowing

(or exporting real resources).

The immediate problem of reserve shortage could be addressed by a substantial SDR allocation, as urged in my recent study (Williamson 1984). This would also go a modest way toward alleviating the more general complaint.

Three objections seem to underlie opposition to this course of action. The first is that it might be inflationary. Much of the feeling along these lines seems to be based on the old monetary-base view of reserves, which I have already argued to be utterly misleading in present circumstances. Even the buffer-stock view of reserves recognizes that SDR allocation could be inflationary if it occurred on such a scale as to present countries with excess reserves which they would go out and compete to spend. But the scale of allocation proposed in my study was calculated precisely with a view to ensuring that it did not give rise to excess reserves.

A second objection is that an allocation might undermine the incentive of the debtor countries to take the action that is needed to resolve the debt crisis, which is of course resolute pursuit of the adjustment policies on which almost all of them have now embarked. The numbers suggest that this is not very likely: even the large allocation proposed in my study would yield the largest debtor, Brazil, only SDR 552 million, a modest sum compared to the entitlement to draw SDR 1.4 billion during 1984 under the Fund's high-conditionality facilities, not to mention its recent $6.5 billion bank loan.

The final objection is that SDR allocations are just another way of providing aid. This is of course precisely what the developing countries have long wished them to be—this is the idea of the link proposal. I long favored the link, on the grounds that I favor more aid and that the link is a technically efficient way of giving effect to a political consensus in favor of more aid. It is clear, however, that there is no political consensus in the major industrial countries in favor of more aid to all low-income IMF member countries, irrespective of the use they make of the resources or of the record of the government in question. No proposal that is perceived to involve aid for Kampuchea is going to be politically salable in the North. Moreover, if Machlup was premature in announcing the burial of the myth of backing, there is after all a serious technical objection to the link.

But the SDR scheme as originally conceived was not intended to be a vehicle for providing aid. It would indeed be more accurate to regard it as an instrument for avoiding "reverse aid"—a transfer of resources from poor to rich—occurring in the process of the developing countries building up prudent levels of precautionary balances. Since the developing countries are large net creditors on monetary account, the reserve system currently involves substantial reverse aid. An SDR allocation would involve aid only in the sense of reducing the reverse aid inherent in current arrangements.

The reasoning used to establish that conclusion is, however, fairly subtle. A Congressman asked to acquiesce in U.S. approval of an SDR allocation is more likely to focus on the fact that this would permit Kampuchea (and South Africa) to obtain dollars—unconditionally and for an indefinite period—which the U.S. Treasury or Fed would in effect have to borrow. On average these countries may well be lending more to the U.S. Treasury (because, for example, they hold reserves in Treasury bills), but this

is not evident in the accounting, and it need not always be true.

In the hope of alleviating such concerns, I suggested in my study the possible reconstitution of the reconstitution provision. It is true that for the vast majority of countries this would be cosmetic, since it would influence reserve composition rather than induce countries to hold more reserves than they otherwise would have done. It nevertheless seemed to me that, by making the nature of the services provided by the SDR more transparent, it might help to allay some genuine concerns.

But the reconstitution provision fell into disfavor at least in part because it was a clumsy arrangement. It prevented use of a country's whole SDR stock to finance deficits for anything beyond a rather limited period (perhaps three years). On the other hand, by allowing countries to use 70 percent of their allocations permanently, it was not a particularly effective instrument for providing reassurance that countries would not be able to gain a permanent resource transfer by running down their SDR holdings. Another problem arose on policing the reconstitution provision. Countries would delay reconstituting until the end of a five-year averaging period approached: in principle a country could always plan to buy up enough SDRs in the last week (or day) of the period to raise its average holding to the critical level. But then at the last moment it might have insufficient reserves, and plead force majeure; or there might not be enough available SDRs in the system to allow all countries to reconstitute simultaneously.

In my study I endeavored to mitigate these problems by suggesting lengthening the averaging period over which reconstitution applied, raising the necessary minimum holding level, and introducing guidelines as to when countries ought to reconstitute. It has subsequently been suggested to me that there may be a much better way of meeting the concerns that my proposal to reintroduce reconstitution was designed to allay. This would involve the imposition of a penal interest rate on use of the SDR beyond some level. If the interest charge on use of the SDR were *higher* rather than lower than the interest rate at which countries were normally able to borrow, they would clearly choose to use their SDRs only in difficult situations, i.e., when precautionary reserves *ought* to be used. There would be no possibility of gaining a permanent transfer of real resources from an SDR allocation, and this fact would be reassuringly obvious to everyone.

One should allow a reasonable level of SDR use at the interest rate paid to holders,[5] especially if the proposal discussed below were to be introduced, so that the SDR became a transactions medium. In order to avoid penal interest rates being charged on SDRs that have already been allocated and perhaps spent, it would no doubt be appropriate to ensure that the tranche of normal-interest SDRs was at least as large as the existing stock at the time the new arrangements were adopted. Beyond that, interest charges might rise in a graduated way with the extent and duration of SDR use, on lines that recall proposals made for implementing a reserve indicator system in the Committee of Twenty—not to mention Keynes's proposals for charges on the use of bancor overdraft rights.

[5]It would not be appropriate to raise the interest rate presently paid to SDR holders: rather, excess income of the SDR Department might be paid into the Trust Fund.

There has never been any evidence that U.S. policy (or the U.S. Congress) was motivated by a desire to maximize the seigniorage benefits to the United States of the reserve role of the dollar, and so it is not axiomatic that the United States would reject a proposal that sought to eliminate the reverse aid inherent in present reserve arrangements—provided it were clear that there were no possibility of going any further than this. Since the developing countries would prefer to go further, they may be reluctant to endorse such ideas. But they surely need to question the wisdom of a strategy of demanding the unattainable, at the cost of precluding the considerable benefits they would reap through the provision of the bulk of their reserves-to-hold through the SDR system. For SDRs would still be able to satisfy precautionary needs, and they could prudently be allocated on a far larger scale than now seems likely, under a system incorporating penal interest rates on use beyond some modest level.

An SDR Clearinghouse

Another problem to which attention was drawn above is the limited usability of the SDR. Peter Kenen (in von Furstenberg 1983) has proposed a plan that would resolve this problem without requiring an amendment of the IMF's Articles. This would involve the Fund creating a clearinghouse entitled to hold SDR claims on the Fund itself and to accept SDR accounts from commerical banks. The clearinghouse would clear transactions among commercial banks and would permit transfers of SDRs between the official and private sectors, thus allowing the SDR to be used in intervention. The establishment of such a clearinghouse (or equivalent facilities in some other institutional form) would seem to be an essential precondition for evolution of the SDR as an active working instrument of international finance. An initiative of this type is overdue.

A Substitution Account

It might at some stage be worthwhile reviving the proposal to create a substitution account in order to provide some protection against reserve shifting. (The only other reforms of the reserve system that could hope to accomplish this, mandatory rules on reserve composition or a shift to a single reserve asset, are quite unrealistic.) In my view this will become a possibility only if and when the United States comes to accept the propriety of the former issuer of a reserve currency accepting a straightforward SDR liability, thus avoiding the complications and ambiguities that killed the last proposals for substitution in 1980.

Gold Demonetization

A test was suggested in Section 2 to determine whether the time has arrived for the statistical demonetization of gold. That test should be performed and its results should be accepted.

Complete demonetization of gold would require central banks to sell off their gold stocks in the private market. This appears highly desirable, in order

to eliminate the residual fear that fluctuations in the gold price might generate macroeconomic instability and in order to contribute to microeconomic efficiency, but somewhat improbable.

VII. Concluding Comments

The preceding suggestions for policy initiatives have an obvious omission: there is no proposal designed to try to ensure discipline on global monetary expansion. This is not because I see no value in such discipline, but because rejection of the monetary-base view of reserves implies that reserve policy is not the way to accomplish such control. Mutual agreement among a group of leading countries designed to manage their exchange rates and to target consistently their rates of domestic credit expansion, as urged by McKinnon (1984), is the only feasible proposal to that end.

Even the initiatives that I would strongly urge, for a substantial SDR allocation, the introduction of penal interest rates on SDR use beyond a certain point, and the establishment of an SDR clearinghouse, may not find immediate welcome in an age that has come to treat muddling through as a positive virtue. One cannot help reflecting how much more open to innovation based on rational analysis the world was in 1944 than it is today.

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Discussion

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John Williamson has given us a wide-ranging and stimulating paper in a field in which he is a well-established expert and where his own thoughts, as those of all of us, appear to be evolving. I find myself mostly in agreement, but there are some doubts and questions. I shall pass over the issues of the concept and measurement of liquidity and go straight to a number of central issues. As in John Williamson's paper, the focus of my comments will be on the role of SDRs, and especially whether their supply should be increased and—more generally—whether an increase in their supply matters. I shall first deal with SDRs and the industrial countries and then with the developing countries.

International Liquidity and the Industrial Countries

In various parts of his paper John Williamson makes two crucial points. The first is that, because of the existence of a well-functioning world capital market, international liquidity in the hands of the industrial countries is now endogenous, and there is no need to "create it" centrally. He says that it is "demand-determined," but I would prefer to describe it as demand-and-supply determined—i.e., market-determined. If more SDRs were created, market forces would lead to adjustments such that total liquidity may not change at all, or not much. This view has, in effect, been accepted by the Fund in the regular discussions of the "reserve adequacy" issue in the *Annual Reports.* I have set it out in some detail in my own discussion of these matters in von Furstenberg (1983).

The logic of this view is that the natural tendency for the supply and composition of international liquidity is to be "adequate," in the same way as the supply of anything else in a market is "adequate." Of course there may be distortions, lack of information, and so on. If one accepts this view, then much of the classic discussion of the liquidity problem is no longer practically relevant.

The second point he makes is that the supply of liquidity need no longer affect world inflation or deflation. Thus, if liquidity were increased, this need not be inflationary through domestic monetary repercussions.

In the case of a fixed exchange rate system there would be some tendency for the domestic money supply to expand when there is reserve ease, and the reverse when there is a reserves shortage. Only in special cases would there be a firm, rigid link. But once exchange rates can readily alter, there need be no connection at all between reserves and the money supply. A coun-

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try that has excess reserves will still wish to increase its imports, but it can bring this about by appreciation of the exchange rate combined with appropriate increase in absorption such as to keep demand for domestic goods and services constant. There need be no rise in domestic employment, nor a rise in the domestic price level.

It follows that, in a world of floating or flexible exchange rates, each country can determine its own rates of money supply growth and price inflation. Of course, interest rates will still be related, and through the terms of trade (affected by aggregate demand policies in different countries) real wages, and hence employment, may depend on foreign conditions, so that monetary insulation does not mean real insulation.

I also sought to stress this insulation theme in my paper mentioned above, and it is a second reason why the discussions of the sixties and early seventies seem barely relevant now. Even if the centralized creation of reserves succeeded in changing total international liquidity, this need not have any effects on world inflation or deflation.

SDRs and the Debt Crisis

Turning to the developing countries, the immediate problem is the liquidity crisis involving a limited but very important group of countries. It is widely agreed that, somehow or other, they ought to be provided with more liquidity. From the point of view of the international system, it would be highly desirable if these countries obtained assured extra drawing rights at below market rates of interest (which is what SDRs are). Of course, in the short run there would be costs for the taxpayers in the industrial countries. These drawing rights are available unconditionally, but if conditional loans are required in addition, then conditionality will remain. But the pressure to adjust will be moderated to the extent that the net result is for more funds in total to be provided. It seems reasonable to conclude that—provided a significant increase in net funds available to the debtor countries results (i.e., provided there is not a fully offsetting reduction in other sources of funds and the SDR increase is large enough)—a general increase in SDRs would have a favorable effect on the debt situation.

The provisos are really most important. As John Williamson has pointed out, the magnitudes generally contemplated for a new issue of SDRs are small in relation to the debt problem. I draw attention to the figures he has cited for Brazil. The problem is clearly not going to be solved, or even significantly eased, by the method of a general issue of SDRs.

There is another, rather obvious, point. It is a rather clumsy way—cracking an admittedly large nut with a very broad sledgehammer—to try and improve the liquidity of a small group of countries by increasing the supply of SDRs to everyone, including the industrial countries who would get the great bulk of a new issue and yet do not need it. John Williamson and I agree that a large issue of SDRs to industrial countries would lead to various adjustments such that finally their reserves might not increase much at all, a reduction in foreign exchange reserves at least partially offsetting the increased SDRs. Furthermore, we agree that an increase in reserves need not be inflationary.

Hence there would not really be any harm in a large issue of SDRs to industrial countries. But it is most unlikely that a general issue would be large enough to make a significant difference to the indebted developing countries (through the SDRs issued directly to them). The reason is that decision-makers in the industrial countries *do* believe that a large world-wide increase would be inflationary.

I conclude then that SDRs are, more or less, irrelevant to this immediate debt crisis problem.[1]

International Liquidity and the Developing Countries in the Longer Run

Having already concluded that SDRs are irrelevant for the industrial countries as well as being relatively unimportant for the debt crisis, there remains one question: are SDRs relevant for those developing countries not involved in the present crisis, and are they likely to be relevant in the longer run for the current-debtor developing countries once the crisis has passed or been resolved in some way?

I think it is a theme of Professor Williamson's paper and of his other recent paper—Williamson (1984)—that this is where the relevance really lies. We have a group of countries that are not perceived to be creditworthy by the private market, and yet they need owned reserves that grow with their trade. They cannot obtain them in the market by borrowing.

In theory they could obtain extra reserves with current account surpluses. There appears to be no problem in the next few years about the willingness of the United States to run the current account deficit that would need to correspond to the required surpluses of the developing countries. The U.S. budget deficit is ready made for helping to solve any world "liquidity shortage." The problem is, of course, that the generation by developing countries of the required surpluses would involve an expansion of exports and reduction of imports that is hardly possible and would, if brought about, involve great sacrifices. Is it then not better to issue developing countries (and, perhaps as a by-product, industrial countries as well) with a steady flow of new SDRs?

This seems to me a convincing argument for regular SDR allocations. But its implications should be noted. If the countries *were* thought creditworthy by the market, they could always borrow when they were in need. When they use their SDRs they are automatically allowed to borrow, but also have to pay an interest rate, namely the usual rate on SDRs. But if the view that they are not creditworthy were correct, one could not be sure that they would actually be willing or able to pay the interest on the SDRs they used. The risk has to be carried somewhere, presumably by the IMF and its members. When SDRs are accepted in payment, governments are willing to lend to certain countries even when the private market is not. If the private market were willing to lend, there would be no need for SDRs. That is the situation that applies to industrial countries and, until a few years ago, also to the now-indebted developing countries. On the other hand, in the situation

[1]John Williamson told me afterwards that he agrees with this conclusion.

envisaged, an issue of SDRs implies certain risks.[2]

It may be that the private market is overreacting, so that it ought to be willing to lend the modest amounts which the use of SDRs allows countries to borrow automatically. There may thus be an information or lack of judgment problem in the market. That seems to be the central issue or implication. Alternatively, the argument is simply that the provision of SDRs includes an element of aid. It makes it possible for countries to have assured borrowing rights at interest rates that do not fully allow for perceived risks.

Other Matters

Finally, let me turn to a few specific points in John Williamson's paper.

Does it matter whether gold stocks are "reserves"? In the case of the countries that hold most of the gold, reserves are endogenous anyway and, as discussed earlier, the policy issue of optimal reserves creation does not arise. But relatively little gold is held by official authorities in those countries where there *is* a liquidity problem and thus where the policy issue arises.

Another point. John Williamson makes the interesting observation that reserve center countries may have more difficulty borrowing than nonreserve center countries, other things equal, because there is always the risk that they will inflate away their debts, something that countries which borrow in terms of foreign currency cannot do. He suggests that this consideration will reduce the willingness of the non-U.S. world to continually finance U.S. deficits. My comment is that the inflationary expectations will be embodied in the interest rate, and there will always be some nominal interest rate that will compensate for these expectations. If U.S. monetary policy sought to avoid a rise in the U.S. nominal interest rate some current depreciation of the dollar (given expected depreciation associated with expected inflation relative to other countries) would be needed to bring about the desired expected real return to foreign holders of dollar balances.

I think John Williamson may have in mind a situation where the United States seeks both to avoid a rise in nominal interest rates and a depreciation of the dollar sufficient to maintain the required flow of funds into the United States.

Finally, I must refer to the argument that there has been "reverse aid" because the developing countries are creditors on monetary account. Presumably the argument is that they are borrowing funds at high interest rates and then lending them back at low rates. It seems to me that they have been "buying" liquidity. The funds that they lend are (one hopes) in safer hands, and more liquid, than the funds their now-unhappy creditors have lent to them. They have been paying for an expected service, rather than giving aid.

It used to be said once that developing countries were getting aid to the

[2]It was pointed out to me at the conference that the Fund is a preferred lender, and it is very unlikely that countries would fail to pay full interest on the SDRs they used. Clearly, the larger the SDR allocation and thus the more SDRs are used for covering payments deficits in emergencies, the more likely it would become that a country would have difficulties in paying interest. If the country is also a borrower in the private market, then the existence of a preferred lender will increase the risks for the private lenders.

extent that they had current account deficits, and so were net borrowers, i.e., sellers of financial assets in return for receiving current real resources. We now see clearly that this was a market transaction and not aid. If the buyers of the financial assets find out later that these assets were not worth as much as they thought, and were possibly even completely worthless, they may have given aid by accident, but it was certainly not intended aid.

I feel we should confine the term aid to cases where goods or financial assets are clearly sold to developing countries below market prices or bought from them above market prices, the extreme case of pure aid being where the "sale" is at zero price.

Of course, this is only a semantic issue. One can readily agree that an increase in well-directed aid, for example through IDA or through a special issue of SDRs to particular countries, would be highly desirable, irrespective of whether there is now "reverse aid" or not.[3]

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[3]John Williamson pointed out to me that the implication of my argument is that the international income distribution that results from market outcomes provides the base line, so that "aid" is any transfer that redistributes incomes away from that base line. That is a correct interpretation. We both agree that there is no particular virtue in the base line income distribution. Furthermore, the market outcome will be influenced by various distortions.

General Discussion

John Williamson responded that an SDR allocation would not necessarily be irrelevant simply because the reserve gains made by the debt-burdened developing countries would be small. Furthermore, an SDR allocation could provide a net social gain to the world economy by providing liquidity to the capital-importing developing countries at a much lower interest rate than they now pay.

Richard Cooper suggested that the dilemma surrounding an SDR allocation might be clarified by distinguishing between "owned" versus "borrowed" reserves. Cooper noted that developing countries are able to borrow reserves in the world capital market in "normal" times. However, such reserves tend to dry up in "troubled" times, when they are needed most. In the present crisis, an allocation of SDRs—an owned reserve—would make up partly for the unavailability of borrowed reserves to the debtor countries. This allocation would also alleviate the need for these countries to transfer more real resources abroad to service their external debt. Williamson added that since these countries' gross external debts exceed their reserves, all their reserves should be classified as borrowed.

Scott Pardee questioned how the United States would react to a major currency crisis since its reserves are comprised predominantly of gold and SDRs, neither of which the United States has shown any inclination to use. Williamson rejoined that an SDR increase could improve the U.S. reserves position. However, any such improvement would be of marginal benefit compared with the probable severity of a currency crisis. To forestall such a crisis, Williamson emphasized instead the need for improved international coordination of monetary policies.

Henry Fowler asserted that no single compelling *new* reason for an SDR issue has come to light. Yet an old reason still exists. Regular and modest SDR creations would encourage the SDR's use as the primary international reserve medium, as contemplated in the second IMF amendment. Williamson agreed that this was a viable reason for such issues. He added that if the vast external debt incurred by certain developing countries had been denominated in SDRs rather than dollars, the local currency costs of servicing and repaying these debts would not have risen so sharply.

International Emergency Lending Facilities — Are They Adequate?

Pedro-Pablo Kuczynski*

Preamble on Latin American Debt

The central issue in the international financial system today is Latin American debt. That is why my remarks on international emergency lending facilities focus particularly on this special subject.

The table below makes clear why the problem is concentrated in Latin America:

Table 1
External Debt of Latin America and Other Developing Countries[1]
(in billions U.S. Dollars)

	Latin America	Others
Total outstanding external debt, incl. short-term, end 1983	345	383
Owed to commercial banks	232	130
Official lenders and bondholders	113	253
Merchandise exports, f.o.b. 1983	98	270
Ratios (in percent)		
1. Debt to exports	352	142
2. Floating rate debt to total debt	67	34
3. 1984 interest payments as percent of exports	46	16
4. Estimated proportion of debt denominated in U.S. $	79	57

[1]All other developing countries excluding centrally planned economies and Kuwait, Libya, Qatar, Saudi Arabia and the United Arab Emirates.

Source: Author's estimates derived from debt data of Bank for International Settlements, *Annual Reports*, and *Maturity Distribution of International Bank Lending*, and export data from IMF, *International Financial Statistics*.

First, the ratio of debt to exports in the case of Latin America is about 3.5 to 1 or more than double the ratio for the rest of the developing world. Only the Philippines has a ratio similar to that of the main Latin American

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debtor countries. While there are exceptions in Latin America—Colombia and Trinidad and Tobago have low external debts—the magnitudes for Latin America are dominated by Argentina, Brazil, and Mexico, which account for about 70 percent of the gross national product of the region.

Second, the proportion of debt owed to commercial banks and the proportion at floating rates is about 70 percent for Latin America and only 40 percent for the other developing countries as a group. Rising interest rates are obviously painful with such a high proportion of floating rate debt.

Third, as a result of the above, in 1983 Latin America paid out in interest the equivalent of approximately 40 percent of its merchandise export earnings; in 1984, assuming that the prime and Euro rates continue at their early May levels, that proportion would rise to 46 percent. For the other developing countries, the average is 16 percent. Finally, about 80 percent of the external debt of Latin America is dollar-denominated whereas I estimate the proportion for the others to be about 60 percent.

Latin America is a relatively high-income area in comparison with other developing countries but, given the large national markets of Argentina, Brazil, and Mexico, with relatively low exports as a proportion to GNP. The external debt is high in relation to exports and it has grown very rapidly, mainly at floating interest rates from commercial banks. While sweeping comparisons can be misleading, the rest of the developing world does not have the same problem. In the case of Eastern Europe, the debt-to-export ratios are much lower and the proportion of the debt owed to commercial banks is minor. African countries have a development and a commodity problem; Eastern European countries have had a productivity problem; most Latin American countries have too much debt and not enough exports.

Much of the discussion of the debt problem has so far focussed on the international banking system. Not enough emphasis has been placed on the setback for the debtor countries. Per capita income of most Latin American countries will not grow in the 1980s. While the debtors ultimately have the human and natural resources to overcome the problem in time, the question is what the cost will be in the interim.

The mechanism set up by the International Monetary Fund after the Mexico crisis in August of 1982 has worked reasonably well but we do not yet know what the outcome will be. There are major uncertainties, both on the political and economic side.

At the start of the crisis three elements were identified as necessary to overcome it: a renewal of growth in the world economy, especially in the United States and the other OECD countries; adjustment by the debtors; and additional resource flows.

As to growth, it is not yet clear whether the growth today in the industrialized countries has the same pulling power for developing country exports as in the past. There are structural reasons such as the relative decline of smokestack industries which mean that the industrialized economies are using fewer basic materials per unit of output, such as copper and steel. Another reason is the relatively high dollar which has kept dollar-denominated commodity prices lower than otherwise. Thus, the terms of

trade of developing countries today are still 15–20 percent below their level in 1980. It is true that the U.S. economy is absorbing a large growth in imports but these are not primarily commodity imports of the type that account for 80 percent of Latin American merchandise exports.

As for austerity, not every country has followed it, but the performance for Latin America as a whole is nevertheless eloquent: merchandise imports fell 45 percent in dollars between 1981 and 1983; the current account deficit of the region fell from U.S. $38 billion to U.S. $18 billion in the same period. Per capita income fell 13 percent and is by now 15 percent lower than it was in 1980. There is therefore no question about the extent of adjustment, only about its distribution.

Table 2
Latin America and Caribbean Countries[1]: Estimated Net Resource Transfer from International Commercial Banks, 1978–1984
(in billions of current U.S. dollars)

	1978	1979	1980	1981	1982	Est. 1983	Proj. 1984[5]
1. Net lending by banks[2]	20	27	29	31	13	7	11
2. a. Interest paid by countries to banks[3]	−14	−21	−29	−34	−31	−31	−34
b. less: interest received on net reserves held by debtor countries at banks[4]	2	4	4	4	3	2	2
c. net interest paid to banks (2a—2b)	−12	−18	−25	−30	−28	−28	−32
3. Net resource transfer (1—2c)	8	9	7	2	−15	−21	−21

[1]Excluding offshore banking centers as recipients of lending.
[2]Estimates by author based on Bank for International Settlements, 1982/1983 and prior *Annual Reports*, with author's adjustments for banks not included. Includes short-term debt movements.
[3]Based on outstanding debt at mid-year, estimated from same source as 2. Interest calculated at LIBOR plus 1.25 percent, which is probably an underestimate.
[4]Based on International Monetary Fund, *International Financial Statistics,* reserves less gold and IMF positions, adjusted for estimated cash; reserves thus defined assumed to yield London Eurodollar six-month deposit rate. This is probably an overestimate of interest received from banks, because part of reserves are held in other instruments such as Treasury bills, etc.
[5]Assumes U.S. prime and also LIBOR interest rates remain in 1984 at the average levels at the end of March 1984.
General Note: These estimates should be interpreted with care, although the general trend of the net resource transfer is probably a reasonable approximation.

As for resource flows, Table 2 on estimated resource transfers is clear enough: Latin America is now transferring to the commercial banks systematically more than it receives from them, a sharp reversal of the trend which prevailed until 1980. It is equally clear, of course, that the pace of lending in the late 1970s could not possibly be sustained over time, as the Latin American assets of major international commercial banks, especially in the United States, were rising by 20–25 percent a year compared to a 10 percent annual growth in their capital.

Interest rates have made the crucial difference between the scenarios of a year ago and the outlook today. William Cline in his excellent monograph assumed as one scenario that the average interest applicable to the external debt of Latin America would in 1984 be about 2 percent lower than in 1983. Similar assumptions were made by others. In fact the average interest is 2 percent higher: that 4 percent difference would cost Latin America U.S. $10 billion in 1984. This worrisome short-term outlook stems from the fact that real interest rates are particularly high for commodity exporters. Although Carlos Diaz-Alejandro disagrees with me, the "purchasing power" interest rate for Latin American countries on their debt to commercial banks is about 18 percent, namely the nominal rate of about 14–15 percent multiplied by the decline in the terms of trade since the peak period of borrowing which I have taken to be around 1980. While the inflation-adjusted real interest rate is about 10 percent, the purchasing power-adjusted interest rate is in effect much higher, hence the problem. Each percentage point increase in nominal interest rates on an annual basis represents 0.3 percent of the GNP of Brazil and 0.5 percent of the GNP of Mexico. As long as rates remain at their present extremely high levels, the prospect for an orderly workout of the debt of the principal Latin American economies will recede dramatically, even if the U.S. economy is pulling in manufactured imports at record levels.

Emergency lending can stem a temporary problem. However, a much more comprehensive approach is needed to help solve the long-term problem. An emergency facility does not really address that problem. At present interest is added upon interest and austerity programs are becoming politically difficult to defend because they tend to be viewed increasingly as a way of paying for an inflated interest bill.

Introduction and Summary

Can we be sure that the fire brigade can cope with a very large fire?

In this paper I will try to look at the question of whether existing institutional arrangements, whether formal (primarily the International Monetary Fund and cooperation through the Bank for International Settlements) or not (such as emergency lending by major central banks and nonmarket lending by consortia of commercial banks), are likely to be adequate to cope with possible crises in international payments.

I think that there is little doubt that in the present world setting existing organizations and arrangements are adequate to cope with temporary payments disruptions among industrialized countries. The only exception might be a sudden loss of confidence in the U.S. dollar, but even then, past

experience suggests that the network of treasuries and central banks can substantially mitigate the initial disruptions which would be part of such a crisis. Another possible problem might be a "third oil crisis" but few expect it now—which might be a sign that we should perhaps worry about it more than we have.

I will therefore concentrate on whether present international lending facilities are adequate to meet a crisis brought on by prolonged nonpayment of interest by major developing country debtors, and a much more complex question, whether such facilities can keep these countries from defaulting on current obligations and at the same time avoid socially catastrophic income declines.

In a sense, the way we ask the question already begs it: we are already in a crisis, with major interest payments arrears by some large debtor countries and a sharp reduction in incomes in Latin America—an estimated 12.5 percent decline in real per capita income for the region as a whole between 1980 and 1983.[1] On the other hand, emergency lending is supposed to take care of temporary problems: if we could distinguish with confidence between "temporary" as opposed to "fundamental" disequilibria, a task for which the last 40 years do not necessarily help us much beyond the work of the fathers of Bretton Woods,[2] it seems that the Latin American (and Philippines) debt problem is increasingly a long-term one, which needs rather basic internal and international solutions rather than emergency lending.

The first part of this paper will dwell on the nature of the debt-related problem of developing countries—particularly of Latin America. At the risk of adding to the already voluminous literature on the subject, I will then take a look at some of the requirements for a gradual unraveling of the problem. Finally, I will try to relate this background to the main question of this paper.

In fairness to those who would prefer to stop reading here, my thesis is that the problems of the over-indebted countries of Latin America, with the possible exception of Venezuela and the addition of the Philippines and a few other middle-income developing countries, are not manageable without the combination of a significant reduction in international interest rates, an improvement in commodity prices (themselves held back by high interest rates and a strong dollar) and in export markets, continued capital inflows, and intensified efforts at financial austerity and structural reform (especially in state enterprises) on the part of debtors. The only new element in this list is the need to reduce the burden of interest: rather than going down, as some students had assumed in 1983,[3] it is going up to even more unmanageable levels. The problem is therefore not so much emergency lending, as was successfully attempted in the last minute in the case of Argentina at the end of March 1984, but a coherent package of measures prepared well ahead of time

[1]U.N. Economic Commission for Latin America, *Balance Preliminar de la Economia Latinoamerican durante 1983*, Santiago de Chile, December 1983.

[2]See Ragnar Nurkse's famous piece, *Conditions for International Monetary Equilibrium,* Princeton Essays in International Finance No. 4, 1945.

[3]See, for example, the base case projection of William R. Cline in his *International Debt and the Stability of the World Economy,* Washington, D.C.: Institute for International Economics, September 1983.

in order to cut the interest burden and maintain capital inflows. Otherwise, austerity programs will become politically and economically unbearable, as they will be viewed by people and politicians as simply devices to pay an inflated interest bill.[4]

Three additional points are worth mentioning. First, the significant progress made by Mexico in its financial program has lulled many lenders and observers into believing that the debt problem was short-lived. They have not sufficiently taken into account the special factors in the case of Mexico: the dramatic internal economic adjustment, including a major reduction of real wages made possible by a historically strong political system, and the close links between Mexican exports and economic activity in the United States. Second, whatever action plan and lending facilities may be developed have to start from the premise that neither taxpayers in the industrialized countries nor bank stockholders are willing to make major contributions; even a major effort at persuasion is unlikely to elicit substantial government funds. Third, since we are already in a crisis, going from one payment deadline to the next, whatever action plans are developed must be practical and of the type that can be implemented quite quickly.

The Short-Term Outlook for Debtor Countries and the Level of Dollar Interest Rates

It goes almost without saying that problems and prospects of the debtor countries differ from country to country. All of the East Asian countries, except for the Philippines, are clearly outside the problem category. In the Western Hemisphere, Colombia, and Trinidad and Tobago have been able to maintain their credit standing, thanks to conservative external borrowing policies in the past among other reasons. Venezuela has to refinance its short-term external debt; with that, it has a manageable external position. Of the heavily indebted economies shown in the appendix table, Mexico has made the most progress so far, at the cost of a major decline in per capita income and a drastic reduction of industrial production. If it can continue its fiscal austerity program and combine it with some stimulus to the economy and to employment, it has the best chance of working its way out of the present predicament.

In looking at prospects for the most indebted countries, most of which are middle-income semi-industrialized economies, perhaps the first point to emphasize is the apparent truism that the sooner they can resume effective economic growth, the better. The longer high unemployment and declining per capita incomes continue, the less the chance of recovery—as popular resentment against austerity programs builds up and is fanned by political opinion—and the greater the chance of social and political upheavals. As it is, even cautiously optimistic analysts[5] foresee that it will take until 1987 or

[4]See Appendix Table 1 for an estimate of the interest paid in 1983 as a proportion of merchandise export earnings. Kuczynski, "Latin American Debt: Act Two," *Foreign Affairs,* Fall 1983.

[5]See, for example, Cline, *International Debt. . .* Also Ronald Leven and David L. Roberts, "Latin America's Prospects for Recovery," *Quarterly Review,* Federal Reserve Bank of New York, Autumn 1983.

1988 for regional per capita income to recover to its 1980 level. Since we are now down more or less to the 1976 level, such a projection implies strong growth in the period 1985-88, by no means a certainty.

Second,[6] it is clear that the U.S. economic recovery has not so far been accompanied by an equivalent recovery elsewhere in the industrialized world. As a result, the recovery in the growth of world trade is still slow, although accelerating, and the growth of the industrialized world is so far barely at the level envisaged a year ago by a number of observers as the minimum for major debtors to be able to meet the interest on their external debts.[7] In any case, the nature of the link between the growth of developing country exports and the GNP growth in the industrialized world is by no means entirely clear. In the 1970s, slow growth in the industrialized economies was accompanied by rapid growth in the more advanced developing countries—largely because of world inflation and a cheap dollar, which helped to sustain commodity prices, and because of large-scale bank lending to these higher-income developing countries. Unfortunately, while some commodity prices have rebounded from the depths of 1982, others—particularly minerals—are still extremely depressed, so that the terms of trade of a number of developing countries are about 15 percent (in dollar terms) below the peak levels of 1980. For producers of metals and tropical agriculture products, the shortfall is larger.

Third, perhaps the most important feature of the last months has been the extent of belt-tightening and austerity in a number of countries. Mexico has been the most visibly successful, and its efforts have been aided, as noted, by the close links of Mexican trade and services to the United States, and have therefore benefited from the economic recovery there. The adjustment effort in other countries has been very large also. In part, of course, it has been the unavoidable result of the lack of international loans and the shortage of foreign currency. The current account deficit of Latin America has fallen from U.S. $38 billion in 1981 to my estimate of U.S. $18 billion in 1983, mainly as a result of the squeeze in imports. At the same time regional income per person has declined sharply.

The size and suddenness of the adjustment give rise to questions about whether it is sustainable for very long from a political point of view, particularly considering that the bulk of the adjustment probably falls on urban lower-income groups. The fact that, given the lack of resources, there is no alternative to belt-tightening does not mean that austerity will necessarily be accepted or that the economic managers who are implementing it will be kept on.

The fourth factor to ponder in the short-term outlook is the severe scarcity of new capital flows to major debtor countries. While the external financing needs of Latin America have for now shrunk sharply, the availability of external finance has fallen even more. Earlier in 1983,[8] I estimated that net commercial bank loans—after repayment or refinancing of amortization—to

[6]The pages that follow are part of my contribution to a series of essays on Mexico and the Debt Problem to be published later this year by the Stanford University Press.

[7]See Kuczynski, "Latin American Debt: Act Two."

[8]Ibid.

Latin American countries for 1983 would be on the order of U.S. $8-10 billion, compared to about U.S. $25 billion annually in the period 1979-1981, an admittedly unsustainable rate. It now appears that actual net new disbursed lending in 1983 was closer to U.S. $7 billion or so because trade financing was cut and disbursements on major loans accompanying restructuring, especially in the cases of Argentina and Brazil, were delayed for several months when those countries were unable to meet various targets in the stabilization programs agreed to with the IMF.

Finally, the continuation of the present high level of international dollar interest rates puts a major obstacle in the way of recovery in the heavily indebted countries:

- most obviously, by dampening growth prospects in industrialized countries, particularly in capital goods and in a number of depressed industries which need capital to restructure themselves. The fact that these industries are usually heavy importers of commodities is an additional consideration.
- high interest rates, and the associated exchange rate imbalances to which they have contributed, are greatly intensifying protectionist pressures against important exports which come in part from heavily indebted nations. On top of traditionally protected products such as shoes and textiles, cut flowers, specialty steels and the pending copper imports quota case in the United States come to mind.
- needless to say, high interest rates constitute a very heavy burden for highly indebted countries. With relatively low commodity prices and limited capital inflows, it is not an exaggeration to say that present interest service burdens are, as long as these variables remain unchanged, unmanageable. So far, the major focus of debt rearrangements has been on the postponement of principal, while little has been done to reduce the interest burden.

Before we turn to this crucial question, it may be well to look at the impact upon GDP and the balance of interest payments on the external debt. The model recently described by two Federal Reserve economists[9] assumes that average interest rates payable by Latin American countries on their total external debt would trend down from about 12 percent to 10 percent by 1984. They estimate that if such a decline does not take place, the growth of GDP would be reduced by .5 percent annually over the projection period 1984-87. If this estimate is roughly correct, it means that Latin America's prospects for recovery would be substantially diminished as long as dollar interest rates (because about 80 percent of the external debt is in dollars) continue at their present relatively high levels. The corollary of these high interest rates is an expensive dollar; while this helps to attract imports into the U.S. economy, thus stimulating exports from Latin America, this beneficial effect is offset by the lack of competitiveness, at present exchange rates, of Latin American ex-

[9]Leven and Roberts, "Latin America's Prospects..."

ports in Europe and Japan, given the traditional relationship between Latin American currencies and the U.S. dollar. Moreover, the possibility that the average interest rate on Latin America's external debt would be about 13 percent in 1984, based on the U.S. prime and LIBOR (London interbank offer rates) rates at the end of March 1984, would lead to an adverse shift in the current account balance of the region of almost U.S. $8 billion in 1984 in comparison with the forecasts made in 1983 by the various observers already cited. That amounts to about 40 percent of the 1983 current account deficit. This explains in part the strains experienced by a number of countries, Argentina being the most recently publicized.

A final less obvious aspect has to do with the real burden of interest in economies with weak or declining terms of international trade. "Real" interest rates are usually measured as nominal rates adjusted downward for inflation, on the theory that on average interest payers' income will go up with inflation, thus decreasing the effective burden of their payment obligation, and vice-versa for interest income recipients. Today, it is often said that real interest rates for borrowers are not that high, once inflation is taken into account and the adjustment is made to a net-of-income-tax cost basis for a borrower. This is true enough for domestic U.S. borrowers with sufficient income to reduce the net after-tax cash effect of interest paid. But it is certainly not true for international borrowers. And this is so especially when the inflation adjustment which matters to such borrowers is not just the negative effect of domestic prices in industrialized economies upon the cost of their imports but especially the overall terms of their international trade, including the purchasing power of their exports.

In the case of Latin America and much of the developing world export prices have fallen since 1980—with some recovery in 1983—so that "real" interest rates are probably in a range around 17 to 18 percent[10] instead of the 6 or 7 percent "real" level estimated after adjusting for the U.S. inflation rate.

Since interest payments on the external debt in the case of Latin America in 1983 absorbed about 41 percent of merchandise export earnings, the major more or less predictable source of foreign exchange, and absorbed higher percentages in the cases of Argentina, Brazil, Chile and Mexico, a reduction in the burden of interest over time is crucial to recovery.

The size of the import reductions which have taken place in 1982-83—ranging between 20 and 60 percent for the larger Latin American economies—and the heavy burden of interest payments have fostered a need on the part of economic planners to make rather heroic assumptions. Whereas a few years ago, in the growth period of the sixties and seventies, careful model-building and lengthy discussions took place about small differences in prospective growth rates, the present financial squeeze means that policymakers think nothing of assuming major cuts in per capita income and consumption. While it is healthy to have moved away from the loose spending and planning stimulated by the relatively easy external bank financing of the seventies and early eighties, the present attitude is at the other extreme and is unlikely to be sustainable for long.

[10]This represents 13 percent multiplied by the decline in dollar terms of trade, in this case using a 1980 base.

Resource Flows and the Elements of Recovery

The present conundrum of high interest charges and reduced loan inflows has led since 1982 to a sharp resource transfer from Latin America to commercial banks, in comparison with positive flows from banks to debtors in earlier years.

The focus on resource transfer (essentially cash flow) can be criticized as one-sided, since it is the whole of the balance of payments that matters, rather than just one segment of it, and since it is true that banks as a whole are still increasing their net lending and exposure, albeit at a much lower pace than the breakneck one of 1979-81. However, the net flows from countries to the commercial banks have become the second largest item in the balance of payments, after the merchandise trade account, and—other things being equal—cannot be financed without a very large surplus in the latter, an unsustainable proposition if countries are to resume growth and import again at a more normal rate. Moreover, in a setting where the foreign exchange reserves are low (except for Venezuela, Colombia and Trinidad and Tobago), it is understandable that Treasury and central bank officials of debtor countries are focusing primarily on net foreign exchange cash flows rather than on the growth of the stock of debt outstanding.

To reinforce the above point, it is fairly clear that in the absence of offsetting capital flows, the negative transfer since 1982 is sustainable only so long as a large enough trade surplus can be maintained to finance the outflows. That is the reason many observers focus on the need for heavily indebted nations to maintain large trade surpluses. However, the emergence of such surpluses in 1983[11] is not a reliable sign of their continuation in the future, because they were achieved primarily as a result of massive import cuts, which were in turn both cause and effect of fairly drastic income and production declines. It is of course widely recognized that the approximately 40 percent decline in imports between 1981 and 1983—more than 50 percent in the case of Mexico—has brought them to a level which is unsustainable if economies are to grow again.

The difficulties of resuming orderly income and production growth should not obscure the continued need for financial discipline on the part of debtors. Several countries, notably Brazil, Chile, Ecuador, Peru, and especially Mexico, among others, have already made drastic adjustments. In general, there is still room for major sustained action in improving the finances of state enterprises—if that is indeed achievable for long—, in reducing subsidies, especially in energy prices—and in maintaining realistic exchange rate policies. Nevertheless, it is well to recall the words of the most recent annual report of the U.S. Council of Economic Advisers: "By far the greatest share of the burden [of adjustment] was borne by the debtors themselves. . . . Calls for solutions to the debt problem through adjustment by the debtor countries must acknowledge the fact that an enormous amount of adjustment is already taking place."[12]

[11]See Morgan Guaranty Trust Company, *World Financial Markets,* September 1983, p. 5.

[12]*Economic Report of the President,* Annual Report of the Council of Economic Advisers, U.S. Government Printing Office, February 1984, pp. 78-79.

Renewed growth will inevitably require rapid recovery of imports. For that to be feasible, a combination of three elements is necessary: a decline in market interest rates (in order to diminish the magnitude of the negative net transfer to banks), a sustained improvement in the access of developing country exports to the markets of industrialized countries as well as a strengthening in commodity prices (the latter in turn depends partly on the same decline in interest rates, at least for several major interest-sensitive commodities), and new resource flows. These requirements are well highlighted in the projections cited above and others, although few observers so far have paid enough attention to the increasing protectionism of several industrialized countries, a significant obstacle.

The projections for economic recovery may well come to pass, especially in the longer run. But for the transition period 1983-84, the probability looks quite uncertain, especially if domestic and international U.S. dollar interest rates continue at the levels of the end of 1983 for any length of time; more problematic still would be a continuation of the uptrend in U.S. interest rates which has occurred beginning in the second half of 1983. The "transition" could then stretch into 1985 and perhaps even beyond. The pace of interest rate increases of the spring of 1984 could—I almost say "would"—swiftly undo the careful progress made so far, if the increases continue.

Because refinancing arrangements have so far operated reasonably well, and because there is no simple and practical alternative to them, a feeling of optimism has arisen on the side of the lenders. This has been reinforced by Mexico's success in implementing a drastic stabilization program. Moreover, for Latin America as a whole, the social and economic sacrifices of stabilization programs have been surprisingly well accepted, so far. However, part of that acceptance probably stems from the rapid economic growth which preceded the period of adjustment. As that memory recedes, social stability may become difficult to maintain, unless renewed economic growth comes quickly. It is not safe for international policymakers to assume that a region of 370 million mostly urban inhabitants can calmly continue to withstand income declines such as those of the last three years for long, particularly when past population growth creates today a rapid increase in the labor force of almost 3 percent per year and there are high expectations in the predominantly young population.

Since progress has been made both by lenders and borrowers in coping with a very difficult problem, the initiatives of the governments of the industrialized countries, other than in supporting an expanded role for the International Monetary Fund, have been relatively mild. With some exceptions, primarily in the U.S. government role in the Mexico rescue package in the autumn of 1982, and most recently in the March 1984 emergency loan to permit Argentina to service part of its interest arrears, it has been business as usual.

The supply of long-term official finance has been limited. The net transfer of resources from the World Bank and the Interamerican Development Bank has been increasing, but at a modest rate in the light of needs. In 1983, for Latin America as a whole, the transfer from both multilateral banks

combined was about U.S. $1.4 billion, equivalent to 7 percent of the current account deficit of the region. The World Bank in particular has been hamstrung by the lack of support from donor governments for the International Development Association, its concessional loan window for the poorest countries of Africa and Asia. Lack of resources for IDA draws away World Bank lending for Latin America. Many initiatives for additional lending have been discussed, notably to increase the flow of export credits from industrialized countries but they have so far remained on paper. Other than the increase in the quotas of the International Monetary Fund, important as it is, contingency planning appears to have been quite limited. If recovery does not take place as planned, mechanisms to foster additional resource flows and face emergencies will need to be put in place quickly. So far, such plans do not appear to exist, at least in a systematic fashion.

Lowering the Interest Burden

The problem of recovery is thus a long drawn-out one and it is therefore best tackled through fundamental measures rather than last-minute emergency loan packages. That does not mean, however, that action can be postponed. The rise in interest rates poses an urgent and immediate problem. Even though U.S. domestic economists have for some time foreseen such a rise, its implications for heavily indebted developing countries have not really been factored into the debt refinancings and the IMF programs and bank loan packages which accompany them. The room for maneuver is simply too limited.

In designing a comprehensive approach, we must recognize two realities of today:

a. Taxpayers in the United States, Europe, and Japan will simply not foot the bill.
b. Neither will bank stockholders. Their shares are already in many cases selling at a substantial discount below book value, especially in the United States, and in comparison with alternative investments.

There is, of course, some give in these positions, but it is probably quite limited. Sweeping schemes to refund debt at much lower rates for long maturities are therefore quite unlikely to get off the ground for now. Moreover, even if they were doable, one can question whether they are even desirable, since they would tend to reward imprudence in borrowing, and would create demands for similar treatment by many debtors, from the governments of some high-income countries to individual U.S. voters from the sometimes heavily indebted middle-class.

But these sweeping proposals do address themselves to a key issue: the heavy interest burden. Some way has to be found to reduce it during the present period of high interest rates. The difficulty is to reconcile this objective with the maintenance of net lending by commercial banks. In the end, it is conceivable that there is room for a significant reduction in interest charges, because the main motivation for the type of maintenance nonmarket lending being done today is not profitability but is an attempt to ensure the recovery of the interest on what has already been lent in the past. However, in order to

be feasible, a reduction of interest charges below "market" levels has to be acceptable to bank supervisory and accounting authorities, so that they do not declare loans on which negotiated interest rate reductions take place—within predefined parameters—as nonperforming or substandard, as they would have to at present. The practice is already well accepted in the United States in the case of domestic reschedulings, as long as the borrower is not in danger of going bankrupt. Whether the same could occur for international loans, without additional legislation in various countries, is not entirely clear.

Choices exist, at least in theory, on whether to capitalize the deferred interest, and postpone it to the end of the refinancing period, or whether to simply reduce it. The former maintains the original earning asset of the banks, and thus would be preferable because it would make continued net lending less difficult. On the other hand, it would by definition continue to increase the exposure of the lenders, although without the problems of organizing large syndicates for nonmarket loans. In either case, depending on the size of the reduction of interest, lenders would get a more secure asset since the chances would be improved of collecting the remaining interest and leaving some margin to begin amortizing principal.

Several additional points should be made:

a. Such arrangements would need to be done under some kind of systematic pattern, with the IMF providing the balance of payments information and analysis to justify a given amount of interest relief. An IMF program would be a key ingredient for lenders to have some assurance that the relief would not simply be misdirected into unrealistic domestic monetary expansion.
b. Since interest rates are not predictable, arrangements would have to be for one period—say one year—at a time, subject to annual reassessment.
c. Negotiations would be bilateral, under the aegis of the IMF, rather than global.

How much relief is needed? The case varies from country to country. Purely as an illustration, reductions in spreads and base rates down to the CD rate—as a proxy for the cost of money—would in the coming 12 months reduce the interest burden of Latin American countries and the Philippines by about U.S. $8 billion, a very substantial contribution indeed, equivalent to more than a third of the current account deficit of the group of countries. Undoubtedly, there would be an equivalent cash flow loss to the lenders. Since that reduction, however, is from a level of receipts which the lenders can probably not obtain without more strain and crises—which would further adversely affect the value of their stock and could well impair their ability to raise funds competitively—there is at least a basis for arguing that lenders would be no worse off and quite possibly better off. They would have more secure assets, although less profitable ones in the short term.

Is there a need for a special emergency lending facility, perhaps within the IMF, beyond such a scheme? We are constrained by the great difficulties of raising the money. It would be unrealistic to do so in 1984. The existence of such a facility might also indirectly encourage borrowers to defer payments

beyond the already reduced levels and might lead lenders to let up on the efforts they are making for an orderly workout of individual country problems. Of course, if interest rates continue upward and no concerted effort is made to reduce the interest burden, at least temporarily, emergency facilities of one kind or another would undoubtedly become urgently needed. The sums involved, however, might by then have become unmanageably large.

The most effective way of establishing new emergency facilities would be through the IMF, since this would provide confidence that emergency lending would be used with care. However, it is also clear that such lending would have to be outside of the normal quota mechanism of the Fund, in the same way as the Oil Facility of the last decade.

How to fund an emergency facility is a matter of much discussion. Clearly, given the fiscal and political constraints in major industrialized economies, it would be very difficult to obtain additional budgetary funds. The simplest alternative would be IMF borrowing in the capital markets. However, this has been opposed by a number of major countries. One of the arguments has been that a world central bank should not be a borrower in the capital markets. This subject merits detailed discussion. It can perhaps be said here that the Fund is not a world central bank which can create money, and that in any case central banks do "borrow" through their open market operations. In practical terms the issue is whether such borrowing should be a limited short-term undertaking, in order to cope with a special situation, as it should be at this stage or whether it would be the start of a totally new and permanent mechanism, a far more complex undertaking.

There is no simple solution to the debt problem. As countries work towards a new set of policies—encouraging productive investment and efficiency—it is fundamental for lenders and for the international financial community, including the governments of the major industrialized market economies, to focus on the most immediate problem of the heavily indebted developing countries: the high and rising burden of interest payments at a time of limited capital inflows and still lagging export earnings. Otherwise, there is a risk, even a high risk, that the progress made so far towards an orderly workout of the debt problem would be set back significantly.

Appendix Table 1
Estimated Debt Burden of Some Major Developing Countries
(amounts in U.S. $ billion)

	Total External Debt, Including Undisbursed, at End 1982	Estimated 1983 F.O.B. Merchandise Exports	Ratio of Debt to Exports	Estimated Interest Due 1983 as % of Exports
Argentina	39	9	4.3	50
Brazil	86	22	3.9	46
Chile	17	4	4.2	50
Mexico	86	21	4.1	48
Venezuela	33	15	2.2	27
Total Latin America[1]	330	98	3.4	41
Algeria	15	12	1.3	14
Indonesia	22	21	1.1	19
Korea	37	24	1.5	18
Philippines	21	5	4.2	48
Nigeria	11	12	0.9	11
Total Other LDCs[2]	350	270	1.3	15

[1]Including Caribbean and other countries not listed.
[2]All other developing countries except centrally planned economies and Kuwait, Libya, Qatar, and the United Arab Emirates.
Source: *Foreign Affairs,* Fall 1983, *Latin American Debt: Act Two,* by the author. Derived by the author from Bank for International Settlements, *Maturity Distribution of International Bank Lending* (July 1983); Morgan Guaranty Trust Co., *World Financial Markets* (June 1983); International Monetary Fund, *International Financial Statistics,* various issues; and World Bank, various *Annual Reports.*
Note: These are estimates, subject to error, and should be used with care.

Discussion

Charles P. Kindleberger*

Pedro-Pablo Kuczynski limits his discussion to Latin America and the Philippines on the ground that existing arrangements among industrialized countries are adequate—except possibly for a sudden loss of confidence in the dollar—and that the East Asian debt problem, apart from the Philippines, is not serious. This perhaps glides over the troubles of Africa, Eastern Europe—especially Poland which has been in unrecognized default for years—and a potential problem in France with $40 billions of foreign debts, $30 billions of gold, but a psychological incapacity to sell the latter to bring down the former, plus a probable economic incapacity if major sales of gold by France were to knock the price down drastically. Even so, let us stick to Latin America.

The argument in brief is that the debt problem of Latin America, a few countries apart, is unmanageable without some combination of reduced interest rates, improved commodity prices and exports, continued capital inflows and increased Latin austerity. The last has political limits which Brazilian and Argentine renegotiations in the last year have approached and threatened to exceed. While Mexico adopted a stiff enough program, it is not clear how long into the future it can be sustained politically. Increased export prices and export values depend on revival in Europe, Japan, and the United States. Kuczynski's timing led him to underestimate recovery in Europe and Japan; whether he is right that the U.S. recovery will be sustained is a subject on which I have no confident opinion, although I note the view that it may be topping off here because of deficits, high interest rates and a strong dollar. The present interest in protection in the industrial countries is something to worry about. It is probably countercyclical and will decline in Europe and Japan, perhaps intensify in the United States. The restrictions on U.S. imports of steel from Argentina and Brazil are not a good omen.

Continued capital flows into Latin America are not discussed at length. The IMF has been acting as a whipping boy, pushing the money market banks to continue lending. The money market banks in turn have been leaning on the regionals. The regionals seem to be a weak link in the chain. Britain was pushed off the gold standard in 1931 not by withdrawals by France and the United States, but by conversions into gold of Belgium, Holland, Switzerland—the same countries that later switched their dollars into gold overnight, this time followed by France. In the summer of 1971, again, it was the smaller countries, not Germany, Japan, or Britain, that applied the *coup de grace* to dollar convertibility. "Responsible" big banks can be held in line. The little ones feel no compulsion to defend the system when they are so small—the typical free-rider attitude.

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This leaves the reduction in interest rates, on which Dr. Kuczynski spends most of his time. The approach is an indirect, not a direct answer to the question—whether "Emergency Lending Facilities Are Adequate." On the whole, he chooses not to discuss this question on the ground that taxpayers in the industrialized countries are unwilling to make major contributions—which I interpret to mean that there is no possibility of further enlarging the IMF through the legislative process, even though contributions to the IMF lie outside the regular budget and are not paid for by taxes. The other part of this statement is that bank stockholders are unwilling to make a major contribution either. I should have thought the positions of taxpayers and bank stockholders were altogether different. The former can choose through the legislative process not to help. The latter may be called upon to contribute through default on the part of one or more debtor, and would certainly be affected by Kuczynski's proposal for an interest-rate reduction. The argument that bank stockholders won't assist because their shares are in many cases already below book value is not very compelling. If loans to the three major debtors were marked to market, book values would decline drastically. In any event they are locked in and as a group have little choice. A reduction of interest rates might be nominally at stockholder's expense, but could ultimately maintain the value of their shares above levels to which default would bring them.

It is not clear to me that all the bank loans to these countries were contracted on a floating-rate basis. Floating rates help the debtor, of course, so long as interest rates are falling, but are particularly painful now when they are rising. I am impressed by Henry Kaufman's criticism of the innovation of floating rates of the last two decades that it encouraged loose lending by banks because it eliminated the interest-rate risk—or rather eliminated it for the lender and assigned it to the debtor. This left the banks with only one major risk, the one they now face, of borrower default. No doubt the borrowers should have been more circumspect in borrowing at floating rates and taking on the added risk of an adverse movement of interest rates, which they now have to shoulder. But as I shall presently argue, one should perhaps adopt asymmetric standards for developing countries in finance as is done in trade, and I agree with Kuczynski that this may well be done by interest rate reduction.

"Purely by way of illustration" the paper suggests a reduction of interest rates, including spreads and base rates, to the CD rate which is taken to be the cost of money. This would eliminate the banks' profits on rolled-over loans, but in a period of rising interest rates it would not greatly help some of the borrowers on maturing old loans with fixed low rates, if there be any. I should like to refine Mr. Kuczynski's suggestion by adding the asymmetry that rolled-over loans for separate debtors, after IMF approval implying stern programs of austerity kept within the limits of political feasibility, be fixed in interest against increases, but flexible should interest rates decline. Such asymmetry is not entirely new in banking. Richard Sayers' history of the Bank of England records the troubles of the William Deacon's Bank in January 1929 when the Bank came to the rescue but Montagu Norman laid down the condition that the bank was not allowed to raise its dividend even

though other banks were doing so, but was required to reduce it should any other bank take that action. The purpose, of course, was to hide the bank's condition from the world. The days of bank secrecy on the subject of bad loans, however, seem long forgotten.

Mr. Kuczynski does not mention the dollar exchange rate, except as the possible cause of a crisis in the event of industrial countries' expectations turning negative. I should like to add to his list of conditions that are necessary for the world to inch its way back from the precipice of default—i.e., reduced interest rates, improved commodity prices and exports, continued capital inflows, and increased austerity—a decline of the dollar from its present overvalued position. The matter is subject to some controversy, but I take the position along with many others that reduced interest rates in general depend on the government deficit, and a reduction in U.S. interest rates would slow down the capital inflow, perhaps lead to some returns, and bring down the dollar. It is a consummation devoutly to be wished for many other reasons as well. If the reduction in interest rates were limited to those on rolled-over Latin loans, separately negotiated, however, without a general reduction leading to a decline in the dollar, one important element in the puzzle would be missing.

Finally, let me return to the question posed by the title of Mr. Kuczynski's paper: "Are international emergency lending facilities adequate?" One aspect of adequacy is amounts. Kuczynski thinks those under the control of the IMF cannot be increased, and he is probably right. I worry further that the IMF moves so slowly in decision-making. The swap network can be put into effect in hours; the IMF takes weeks to make its decisions. For small sums, bridging loans can be marshalled—the $100 million for Hungary in the summer of 1982 from the Bank for International Settlements, $300 million of the $500 million for Argentina scraped up from Latin American countries. The U.S. Treasury in August 1982 dug up $1 billion to buy Mexican oil in advance, and the Federal Reserve Bank of New York in 1983 made a $1 billion bridging loan for Brazil. These look *ad hoc*, and some of them threaten to bring rescue operations to forestall a worldwide crisis into the political arena, as happened with loans to Austria, Germany, and Britain in May, June, and August 1931 respectively. But I take comfort in the words of Sir Robert Peel writing to Parliament about the Bank Bill on June 4, 1844:

> My Confidence is unshaken that we have taken all the Precautions which legislation can prudently take against the Recurrence of a pecuniary Crisis. It may occur in spite of our Precautions; and if it may be necessary to assume a grave Responsibility, I dare say Men will be found willing to assume such a Responsibility.

Planning and rules are necessary up to a point; beyond that we must rely on "Men."

General Discussion

Barend de Vries drew attention to the country-by-country approach that appears to have been taken toward coping with the debt crisis. In many developing countries—such as India, Indonesia and South Korea—this approach includes both short-term and medium-term economic strategies. In these countries, long-term capital inflows are limited to priority projects. Most Latin American nations have neglected the development of medium-term strategies; only Colombia has demonstrated a willingness to adjust foreign capital inflows to a medium-term plan. Colombia is one of the few Latin American countries with no apparent debt problem. Accordingly, medium-term economic strategies deserve greater attention in designing a long-run solution to the debt problem.

David Holland added that the commercial banking system should also focus on a medium-term strategy as a precondition to designing international emergency lending measures. Without some structure, banks will bounce from one crisis to another.

Andre de Lattre rejoined that the IMF has outlined a medium-term strategy for the capital-importing developing countries. While one could judge the IMF's assumptions as too optimistic, its strategy does have meaning.

Robert Solomon commented on the economics of capping. According to Solomon, the typical interest rate capping scheme is fully equivalent to the alternative of increasing loans to the debtor countries. Capping involves adding interest payments beyond some ceiling to the principal on the loans. This would likely lower the debtors' ratios of current interest payments to export earnings, providing some semblance of improved creditworthiness.

Arthur Meehan raised two issues. First, in Far Eastern countries one often finds that capital markets are not free. He suspected that certain Latin American nations' debt problems might be quickly resolved if their capital markets were opened up. He suggested that this might be a less extreme solution for the debt problem than interest rate capping. Second, if capping was adopted, commercial banks—the likely losers under such a program—might reduce their lending.

Pedro-Pablo Kuczynski agreed that Latin American capital markets should be opened, especially to direct foreign investment. During the past 20 years, Latin American governments have adhered to the philosophy that loans from abroad are good but direct investments of foreigners are bad—for reasons of sovereignty. If direct foreign investment had been a larger component of these capital inflows in the late 1970s, the debt problem would likely have been significantly smaller; when economic activity declined in the debtor countries, dividend remittances to foreigners on such investments would have fallen. Instead, these countries face larger interest payments, as U.S. interest rates and the foreign exchange value of the dollar rise.

Kuczynski stressed that interest rate capping would address the immediate debt problem. He estimated that Mexico and Brazil will be devoting roughly 60 percent of their export earnings to debt service in 1984. A reduction in that burden would help such countries to meet future interest payments.

Exchange Rate Arrangements in the Eighties

Robert V. Roosa*

Literally dozens of international conferences have been convened already in the decade of the eighties to deplore "the failure of Bretton Woods" and to call for bold new reforms. It seems to me a calumny, though, to attribute failure to either of the Bretton Woods institutions, or to any of the supplemental facilities added to their scope over the past 40 years. The only trace of failure is to be found in that one segment of the international financial system that has been assigned to me for this symposium—exchange rate arrangements. And I am going to suggest that even the system of par value exchange rates envisaged here on Mt. Washington in 1944, and broadly realized across the world by 1958, only broke down in the early seventies because it had already by that time successfully promoted a remarkable diversity of growth in the incomes and trade of the principal participating countries. What is more, an increasing number of participants in the international markets for money and goods, after living with the resulting nonsystem of floating exchange rates for over a decade, are beginning to yearn for the comparative orderliness and stability which their idealized memories associate with "the days of Bretton Woods."

My own view is that for the rest of the eighties, and no doubt for even longer, the preoccupation of most of the world, so far as exchange rate matters are concerned, will be in finding ways back to the objectives—though not to the machinery—that were envisioned here four decades ago for the exchange rate mechanism. As some of you know, I have since 1974 been arguing for, and trying year after year to develop in an acceptable form, a concept of "target zones" for the exchange rates of some of the leading countries. Regardless of whether my successive efforts have yet produced a usable result, they do bring into focus many of the same objectives for the exchange rate system that underlay the original Bretton Woods formulation.

That formulation centered operationally, of course, on the gold-dollar system—the system which did break down. Yet I think it is helpful, en route to whatever may evolve in the years ahead, to review the way that system worked before the breakdown, to identify not only the causes of the breakdown but also the elements of strength in the system that disappeared with the breakdown, and to suggest ways in which some of those constructive elements might be restored within the context of a worldwide system of flexible exchange rates.

Consequently, as a preface to where I hope we might be going, I will take a look back at where we have been both under the gold-dollar standard

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and under floating. After that I will sort out some of the characteristics of the gold-dollar system that look more attractive now, after the experience with floating. I will then turn to the centerpiece, my own view of the potentials in a "target zone" approach for the exchange rate environment of the eighties and beyond. In doing that, I will suggest the scope there may be for recovering some of those attributes of the old system for which I sense nostalgia beginning to grow.

I. The Gold-Dollar System in the Quarter Century after Bretton Woods

As the recovering nations of the early postwar years approached a prospective era of open trade supported by freely convertible currencies, the image that many of us thought we saw over the horizon was a reconstituting of the disciplines and guidance which earlier incarnations of the gold standard had provided for all countries. The newly created International Monetary Fund (IMF), once a few transition years were completed, would preside over a par value system of currency relations among countries hinged to a gold standard that was defined in terms of ready exchangeability between gold and the U.S. dollar at a fixed price. Within this framework, each country might develop in its own way, but the obligation to maintain its currency's gold-related par value would always keep it responsive to the needs for order in the system as a whole.

This was not expected to be a world of static states, in which exchange rates were never changed. But it was hoped that a surging postwar expansion would be surrounded by a network of moderating constraints exerted across the exchanges, first, by the efforts of each country to reach a stage of viability within the world economy that would permit it to set a par value for its currency, and thereafter, by the actions taken to maintain that par value for an indefinitely long period of time.

It is important to remember, when caricatures of the old Bretton Woods approach to these matters are the subject of classroom ridicule, that the founders recognized from the start that countries inherently differ in resource potential as well as in performance, and that there would have to be variations among them in real growth. But the founders did believe that so long as each country was subject to the balance of payments discipline exerted through the fixed currency relationship, the domestic price levels and the external trade of all countries would adjust moderately up or down to maintain an orderly equilibrium among them. Once determined, exchange rates in this setting became parameters; the variables consisted of domestic policies affecting the prices, interest rates, production, employment, and short-term capital flows of each country. Gains or losses of foreign exchange reserves (notionally convertible into gold at a stable price) signaled a need for corrective domestic policies to restore the reserves to normal size, and to keep the actual exchange rate in the market from bumping against the ceiling or the bottom of the narrow band around parity permitted by IMF regulations.

In practice, however, this neatly elegant theoretical construction proved to be asymmetrical. There was no leverage available to impel strong countries to appreciate their currencies and risk curtailment of export-led booms, with

the result that only four parity increases occurred over the whole quarter-century. The number of reductions exceeded 100. To be sure, for countries whose reserves were falling toward minimal operating levels, drawing rights facilities were available at the Fund—either to help hold to a given parity or to support resumed expansion following a parity reduction. But neither increases in those availabilities of reserves through Fund quota increases, nor an imaginative enlargement of Fund lending capabilities beyond the original four-tranche conception, proved sufficient to withstand the buffets which struck the very heart of the system—the fixed dollar price for gold.

This is no place to recapitulate the many strands of that story. But it is important to recognize three major developments which would have made the continuance of a par value system unsustainable even if the United States had moved sooner, and further, than it did in adjusting its gold price in 1971. These same conditions permeate the "flexible disarray" that characterizes the current state of the world's currency markets, and I stress them because of their significance for any attempt to restore order in the present confusion—whether that be through trying to work toward "target zones," or any other approach.

First, as countries continued on their differing growth paths over the postwar years, the composition and pace of their economic growth differed so widely as to make unsustainable a simple model of adjustment that presumed an organic impetus toward equilibrium in the flows of goods and services among the leading countries. Second, with offshore markets able to create dollars, reliance upon dollars generated within the United States to provide the world with a controlled supply of reserve currency (as a sort of governor of worldwide purchasing power) became impossible. And third, capital flows among nations, and among national currencies in the newly emerging extraterritorial markets, became at times so large as to overwhelm the influence of goods and services transactions upon the market exchange rates of the major countries.

(1) *Widening differences among countries in economic performance.* Various attempts were made to shape new structures around the emerging forces in an effort to maintain order in the economic relations among countries. Such initiatives centered on the leading countries whose performance could provide a dominating influence toward stability in the world system as a whole. Creation of the OECD at the beginning of the sixties was aimed at assuring the kind of communication and systematic interchange of critical diagnoses among those countries which might help them to identify unstabilizing developments among themselves, and then to provide a consultative facility for working out common approaches toward limiting distortions or disruptions. Formation of WP-3 and the Group of 10 followed in close order to reinforce such objectives. But endemic differences still seemed to keep some countries tending persistently toward surplus, while others ran more or less continuing deficits in their international accounts. To try to develop guidelines for correction of these disparate tendencies, under the aegis of the IMF, the financial officials of member countries toward the end of the sixties were trying to define criteria for judging the appropriate size and behavior of the reserve assets of the leading countries. These criteria, once established,

were to lead to agreed reaction patterns for restoring a balanced viability among these countries. But events overtook such efforts before they could come to fruition.

(2) *Expanding dollar supplies outside the United States.* The pressures causing some currencies persistently to strengthen, and others to weaken, in response to their differences in economic performance, were exacerbated by the unusual dependence on the dollar. For from the early sixties onward there was virtually no control over the worldwide supply and use of dollars. The "dollar shortage" of the fifties was becoming the "dollar glut" of the sixties. It appeared impossible for the United States to maintain effective control over the supply of dollars at home and abroad simply by following the old rules of the gold standard game—i.e., by maintaining a surplus in its external current accounts. The urgent needs for capital expansion around the world attracted the expertise of rapidly developing multinational companies, many of them based in the United States, and all of them drawing on additional dollars to finance their desired growth. Capital outflows from the United States, spurred by direct investment from within and substantial borrowings from without, began to flood the world with an apparent excess of dollar liquidity—despite the absorption of liquidity that might have been expected from the large current account surplus of the United States. Central banks abroad found themselves with what became an "overhang" of dollars in their foreign exchange reserves.

One improvisation after another was attempted in order to preserve or restore confidence in the credibility of the dollar as a reliable standard of value and medium of exchange capable of assuring stability in the payments relations throughout an expanding world. A "gold pool" among leading central banks, initiation of a "ring of swaps" between the dollar and a dozen or more other currencies, creation of U.S. dollar obligations denominated in foreign currencies, the introduction of an Interest Equalization Tax and other measures to deter capital outflows—all these were part of an effort to sustain the dollar while also building a network of closer joint involvement with other countries in maintaining currency arrangements that could serve the best interests of all.

But this combination of improvisations could not cope with, and indeed may have contributed to, the enormous expansion in markets for U.S. dollars offshore, and the new networks of interbank relations that made possible the creation of additional supplies of dollars outside the United States and beyond the control of the Federal Reserve. The "offshore" currency markets soon became securities markets and, spurred by the U.S. effort to maintain control over capital exports from the United States, markets in Eurodollar securities (where the interest would not be subject to U.S. withholding taxes) flourished.

(3) *Trade and services transactions dwarfed by other currency movements.* Though at first extraterritorial markets in other currencies were discouraged by the central banks responsible for those currencies, the pressures of market demand persisted and eventually won out. The D-mark and yen, in particular, joined the vestigal remnants of the pound sterling and the French franc in meeting some of the currency needs of an expanding interdependent

world. In these circumstances, many other central banks found it feasible to increase the diversification of their reserve assets, adding sizable amounts of such leading currencies as D-marks and yen to the gold that they held as inner reserves and the dollars that they used as active reserves. Central bank diversification was paralleled by growing speculative and precautionary interests on the part of banks and businesses throughout the world as they shifted their own working balances between dollars and other currencies.

In time, flows of all forms of capital among nations and currencies reached a scale much larger than that characteristic of the payments flows for transactions in goods and services. By 1971 the resulting aggravation of swings into and out of dollars, for capital as well as "normal" transactions purposes, made it impossible to maintain fixed parity relationships between other leading currencies and the dollar.

The result was the attempt in 1971 to restore new credibility to the dollar by moving its par value from $35 to $42 for an ounce of gold. But by March of 1973 that too had become unsustainable and any remaining pretense of gold-dollar convertibility had to be suspended. In the decade following, the world has tested the theories of floating exchange rates that many economists had once advanced as an assured means of attaining order and stability in the international payments system.

II. The Search for Stability under a Floating Rate System

With the same elegance of analytical formulation that had characterized the earlier case for the gold standard, proponents of flexible exchange rates had argued that countries could pursue their domestic policies independently while any balance of payments adjustment would be handled by freely moving exchange rates. Instead of serving as parameters, exchange rates were to become the principal variable in the adjustment process. After an initial "break-in" period, exchange rate changes would establish a balance between a country's trade and capital accounts, and fluctuations would occur only marginally around the purchasing power relation between that country and the outside world with which it traded. But in reality, those same large and growing capital flows which had already precipitated the breakdown of the fixed rate system were now free to play havoc with both nominal and real exchange rates.

As capital started moving between centers increasingly on the basis of the expectations of market participants, the resulting exchange rate gyrations often far surpassed any movement of the underlying fundamentals in trade and prices. Under the fixed rate system capital flows were expected to play a subsidiary role, tending to reinforce an already impending exchange rate adjustment brought about by comparative price changes and shifts in trade. But under conditions of floating, capital flows have more and more become the prime determinants of exchange rates, thereby imposing on the curent account the burden not only of adjusting for changes in relative prices or trading potentials but also of overcompensating for excesses induced by capital flows.

With exchange rates "overshooting" continually against a traditional purchasing power parity standard, and official exchange market intervention only intermittent, it is no wonder that the possibility of countries making moderate adjustments in response to balance of payments discipline seems obsolete. The only remaining discipline now sets in after flexibility has permitted exchange rates to be driven to untenable levels, and a correction gets underway which may "overshoot" in the opposite direction.

That is why, after just a few months of all-out floating in early 1973, an urge for some kind of managed influence on exchange rate behavior permeated the new system. Some of the facilities that had been developed initially to help fortify the dollar became essential in the new environment. Individual central banks, hoping to minimize the wideswinging oscillations of their currencies, began to intervene more and more heavily from time to time in the trading markets for their own currencies. The swap facilities, initiated between the dollar and a number of other currencies in the sixties to finance central bank intervention directed at checking rate movements that gave promise of early reversal, came increasingly into play. Floating rates proved susceptible, on an even larger scale, to the same precautionary or speculative movements from one currency to another that had brought down the gold-dollar system.

Efforts to move market exchange rates back into line with approximations of purchasing power parity, through central bank intervention, have generally been frustrated by the continuing force of those currency and capital flows which may bear no relationship to the comparative price levels, nor even to the comparative productive advantages, of individual countries. Yet a longing for some degree of stability, even if not fixed-rate convertibility, in exchange rate relationships remains profound. And central banks, often despite the indifference or disparagement of the United States, have continued to support their currencies through intervention in magnitudes of multibillions during the "floating decade" (1973–1983).

Several countries of the European Economic Community, consistent with their aim for closer economic integration, tried a common approach toward their currencies. Commitments to a narrow band of permitted exchange rate variation, these countries felt, could help restore some degree of that foreign exchange discipline on domestic policies which seemed to disappear under a floating rate regime. A "snake" of linked relations between this group of currencies and the dollar became transformed by the late seventies into a parity "grid" in the form of the European Monetary System (EMS). The EMS then began moving toward eventual wider use of a common currency, the European Currency Unit (ECU). The EMS encouraged both the opening of balances denominated in ECUs on the books of member country banks and the issuance of interest bearing bonds denominated in ECUs.

While official use of ECUs has not thus far been significant, partly because of some official resistance in West Germany, the spectacular growth of the private market for ECUs is stark evidence of a felt need for some approximation of that degree of relative currency stability which fostered an unprecedented growth of trade, and of real capital movements, among countries in the two halcyon decades of the fifties and sixties. Maintaining the

market rate for each currency close to a declared par value within the EMS and encouragement of a new common currency clearly represent an attempt to recover for these countries some elements of the discipline they had accepted and respected during the heyday of a gold-dollar system operating within a framework of IMF rules.

For most of the developing countries of the world, of course, principal dependence still has to be placed on the capability of the leading countries to create a climate of stability for the world as a whole. Each of the developing countries, under the umbrella of potential IMF assistance, has to work out its own approach toward a stabilizing external influence, usually by tying its currency to one of the leading currencies. The dollar is still the currency of choice for most such countries, not only because of the convenience it offers as the most widely used transactions currency but also because no other currency has yet emerged to a position of sufficient stability in its own right for its use to have an overpowering attraction for countries seeking an anchor for their own currencies. The disciplines of the exchanges continue to be felt in the developing countries mainly through the loss or gain of their reserves. As corrective measures are introduced to restore depleted reserves, borrowing from the IMF can ease the transition period and action programs can be reinforced by IMF surveillance.

Until the last year or two, the central banks of the leading countries have actively discouraged other countries from relying on their currencies as anchors within the system. And indeed the risks to which the extensive external use of a country's currency might expose it in its own domestic economy and capital markets could at times be quite unsettling. Such risks present an understandable deterrent to a country moving into a key currency role, despite the presumed advantages which others often attributed to that kind of role during the years of dollar hegemony. Nonetheless it does appear that the forces of evolutionary development may inexorably be leading the D-mark (as a representative of the EMS) and the yen (serving the world's second largest industrial country) to take a place alongside the dollar as key currencies. The world economy appears destined to expand beyond the scale that any one currency or any one national capital market could expect adequately to serve. The strength of the economic potential behind these three key currencies, if meaningfully harnessed together, might conceivably be great enough to provide a common center of stability for the international monetary system.[1]

III. Renewable Characteristics of the Gold-Dollar System

Recurring emphasis on a perceived need for management of floating rates reflects the nostalgia for some of the characteristic aspects of the gold-dollar system which I mentioned in beginning these remarks. These characteristics broadly fall into four categories. First, there was the limiting

[1]I have attempted a more extensive description and analysis of dollar, D-mark, yen behavior during the years of floating, as well as a brief outline of a possible approach toward the use of target zones, in R.V. Roosa, *Economic Instability and Flexible Exchange Rates*, Singapore: Institute of Southeast Asian Studies, 1983.

of day-to-day or week-to-week fluctuations in exchange rates within a narrow range, avoiding the wide hourly or daily oscillations of recent years. Second, there was a general reliance on the existence of a known benchmark against which banks and businesses could measure obligations in other currencies over time, with reasonable assurance that values expressed in benchmark terms would have reliable continuity. Third, there was an assurance that most leading currencies would remain relatively stable for periods of several years at a time, with adjustments only occurring when underlying change in a given economy had become so great in relation to the rest of the world that a mutation in its exchange rate was appropriate; and the adjusted rate was then likely to remain virtually unchanged for another relatively long period. And fourth, there was a prevailing presumption that the "discipline of the exchanges" would be a major influence on the domestic economic policies of the leading countries, thereby creating a climate of viability for the world trading system so that the gains from an optimal international division of labor could be more nearly realized.

These were the kinds of conditions under a gold-dollar system that helped assure the firms buying or selling goods or services, as well as those making longer term commitments of an investment nature, that business calculations could be made in terms of exchange rate relations that would be relatively neutral, so far as the business decision was concerned, over considerable periods of time. Yet the gold-dollar standard as it formerly existed contained other inherent features whose consequences would destroy the system again if an attempt were made to restore it in the environment of the 1980s.

For the fulfilling of the four objectives just mentioned remained possible under the gold-dollar standard only so long as there was a fixed buying and selling price for gold in terms of dollars, and central banks believed that their holdings of dollars could be exchanged for gold on demand. When such conditions prevailed, countries could set parities for their own currencies in terms of gold or dollars, and market forces would keep the price of each currency within a narrow margin around its parity—so long as central banks were prepared to defend those margins by acquiring or selling reserves of dollars. Yet an attempt in today's world to meet any one of these essential conditions of the gold-dollar standard would almost immediately self-destruct.

Given the highly volatile public market for gold that has existed for more than a decade, a fixed price would probably have to be set well above any previous peak. Otherwise, there would be an immediate run on U.S. reserves, and the capacity to maintain the fixed price would be exhausted. Yet the alternative of a price of, say, one thousand dollars per ounce would provide a possible basis for the valuation of existing central bank reserves of gold so high as to generate a spontaneous burst of liquidity and portend a runaway inflation. Moreover, it must surely be doubtful that the United States would accept an obligation to buy gold at so high a price. Were it to do so, the buy and sell condition of the dollar's gold relationship would either be severed, or the creation of new dollars to acquire gold would in itself become an engine of inflation.

With the stabilizing influence of the basic gold-dollar relationship jeopardized, there could be no prospect for the kinds of pressures for balance of payments discipline that other countries would only feel if they were trying to maintain fixed par values for their currencies. And the three kinds of forces which brought down the golddollar standard at the beginning of the seventies would give the coup de grâce to any effort to achieve stability in exchange rates. The very measures traditionally relied upon to maintain reserves and support the exchange rate, though strengthening a country's current account, might well backfire as a related decline in domestic interest rates led to an offsetting outflow of capital.

What this means, in short, is that any search for those useful influences still attributed to the gold-dollar standard will have to be resolved, if at all, in some other way. Is it conceivable that a proxy could be found for the old standard—an approach that could approximate conditions conducive to the four objectives associated historically with the gold-dollar system, while bypassing its inherent contradictions in a modern environment? Would such an approach be practicable? Might it contain other pitfalls?

IV. The Potentials of a "Target Zone" Approach

At first glance, the notion of substituting some kind of orderly relationship among a few leading currencies for the old gold-dollar linkage would seem to point toward reliance on the SDR, particularly since it has been defined in terms of only five major currencies. But as will appear shortly, the intricacies of establishing a workable convergence of exchange rate performance among countries are so complex and challenging that an initial attempt, if there is to be any hope for its success, should be limited to three currencies. Concentration on the United States, West Germany, and Japan would seem logically indicated by their leading positions in production, trade, and capital movements, and by the emerging preference for the D-mark and the yen alongside the dollar in world commerce. Conversely, sterling and the French franc can be left aside, at least for a time, because of the apparent reluctance of the United Kingdom and France to encourage further worldwide use of their currencies.

There is good reason to urge that any attempt to implement target zones for the exchange rate relations among the three should be initiated in a manner compatible with IMF procedures and policies. Indeed, the effort here to outline both the potentials and the problems in a target zone approach is in part an offspring of a much more ambitious undertaking considered by the IMF itself, early in the floating rate era, when its staff developed "Guidelines for the Management of Floating Exchange Rates,"[2] which included a concept of target zones for the exchange rates of all Article VIII countries (that is, countries undertaking to maintain a fixed par value for their currencies). That came to naught at the time, no doubt partly because the Fund, necessarily careful to avoid singling out particular member countries for lead

[2]IMF, "Guidelines for the Management of Floating Exchange Rates," *Selected Decisions of Executive Directors*, Washington, D.C., 1974, pp. 21–30.

roles, became bogged down in trying to devise criteria that could fit a large number of countries and currencies, and still exert a meaningful, positive influence on the system as a whole. The objectives of the IMF initiative were, in any event, nearly identical with the four renewable characteristics of the gold-dollar standard already mentioned here.

This outline of an approach toward the use of target zones can best proceed in three stages: first, the procedures and criteria for determining what the agreed target zones might be; second, the methods which the three countries might use to reach, or to remain within, the target zones; and third, the extent to which the design and implementation of target zones for the exchange rates of the three currencies could be expected to replicate those four characteristics of the old standard that so much of the trading and financial world would now like to restore.

(1) *Determining the target zones.* If a beginning is to be made, the three governments would have to accept the concept of seeking order in the markets for their currencies, and to accept a consequent need for regularized negotiating procedures focused explicitly on their exchange rates. Once initiated, the negotiations would undoubtedly require various substrata of specialized representatives to develop data and analyses for many relevant sectors of the three countries' interrelations. But the major elements of diagnosis and decision would have to represent the highest levels of policy-making responsibility. And it would have to be clear from the start that there are no simple touchstones for determining appropriate target zones,[3] that, indeed, the outlining of target zones, however wide the agreed circumference might be, implies an approach toward harmonizing the domestic and the external economic performance of each country with the other two, while also taking into account the uses made of each currency in transactions among other countries and through the offshore markets.

What this means, in effect, is that these three countries would accept responsibility for bringing their national economies, and their currencies, into a pattern of compatibility that can perform for the world of the eighties and nineties what the United States did alone, and much less self-consciously, in the fifties and sixties. Senior officials would have to make judgments resting on an array of assumptions or projections (for several years ahead) as to the probable directions and magnitudes of change for each of the three countries, not only in domestic production and prices, but also in their external trade (both goods and services), and in their inflows and outflows of capital, vis-à-vis the rest of the world as well as with each other. They will have to work out, through a searching appraisal of these probable prospects, and their interrelations, some very rough boundaries of the zones in which the three-sided exchange rate relationships should fall. To do so would presume that the various forecasts have some likelihood of fitting together, and that these three countries are determined to try to so manage their affairs that their currencies can have a reasonably stable relationship with each other.

[3]For a possible approach to setting target zones, see John Williamson, "The Exchange Rate System," Washington, D.C., Institute for International Economics, September 1983.

This kind of consultation, and negotiation, would go far beyond the informal exchange of information and the proffering of advice that now occurs in the OECD or in other international bodies, or even in bilateral trade negotiations. The complex considerations would resemble those faced by the IMF in its most difficult appraisals of the prospects of particular members as it works out adjustment programs with them. Perhaps partly for that reason an IMF official might usefully attend the actual negotiations as an observer or catalyst, thereby bringing into the three-sided consultation both a cautionary consideration of the position of other countries and a realistic recognition of the limitations of any attempt to project the forces affecting exchange rate behavior. Realism might compel the three countries initially to focus only on the direction of change that should occur in the exchange rates among the three currencies, in order to come closer to an equilibrating balance.[4] Moreover, in reaching a decision on direction, the countries would have to consider many of the same factors that would be relevant to the much more demanding task of defining target zones. Consequently to proceed in this less ambitious way at the start would be a useful way of "breaking in," providing experience not only in the appraising of forces to be considered but also in the implementing of agreed decisions.

(2) *Implementing target zones.* Having determined, at least directionally, where the market exchange rates of the three currencies ought to go, the authorities in the three countries will have to develop agreed, appropriate methods for edging market rates in the desired direction. In principle, the methods should be consistent with the same principles of open trade and free capital movements that the intended exchange rate stability is presumably meant to support. Thus, to the extent that mutual diagnosis by the three countries has identified, among the causes of their exchange rate maladjustment, such things as export subsidies or tariffs, or capital controls, or discriminatory taxation, one early action plan can be centered on the reduction or removal of such obstacles.

There are also positive approaches to be tried, such as changing the posture of monetary policy[5] in one or more countries, or changing domestic tax and spending programs, or borrowing or retiring debt in each other's capital markets, or using other market-oriented methods for influencing domestic growth, or prices, or exports, or imports. And there would also be a place for joint intervention in the currency markets, to reinforce or emphasize a directional change, once underway, or to smooth out short-lived aberrations that might otherwise give rise to disruptive speculation or to a cumulative run in the wrong direction.

To be sure, many of the suggestions for action are no different from measures that might well be tried, or urged, in the floating rate environment in any event. The difference, in a target zone framework, is that the three

[4]The United States' program for strengthening the dollar in the autumn of 1978 was initiated because there was widespread agreement that the dollar was so undervalued that a change in direction was essential, for the United States and for the world economy.

[5]See, for example, Ronald I. McKinnon, "Currency Substitution and Instability in the World Dollar Standard," *American Economic Review*, June 1982.

countries would undertake a regularized commitment to consult, to negotiate, and, within practicable limits, to act, as part of a common effort to achieve balanced stability. The appraisal of obstacles, or of possible positive action, would occur against the frame of reference provided by agreed objectives. That is, the three countries would be engaged in working out reference points to use in developing policies of economic cooperation or harmonization. The relevant facts, and the gauging of impacts or interacting results, would be brought out in an atmosphere of continuous familiarity with the basic elements of each country's situation, and might even at times escape the glare of publicity or political posturing during the course of the continuing negotiations.

Once agreed, courses of action would take on a greater credibility as coherent parts of a package program. An intangible but implicit pressure for public acceptance and understanding could develop, in contrast with the fragmented, exaggerated, and often emotional reactions so common today when these or other countries bargain over trade concessions, or complain about interest rates, or dumping. Acceptance of the need for agreed action, on the part of officials within governments, and by the public outside, can surely be enhanced when it results from an established process of systematic consultation and negotiation. Even so, of course, there can be no guaranty of stability in the exchange rate relations among the three countries; but there is a good chance that rate variations among their currencies would be decisively reduced. What then, about the consequences for the world monetary system as a whole?

(3) *Replicating useful characteristics of the gold-dollar system.* Once the three countries, under the aegis of the IMF, have accepted the constraints and obligations of a mutual approach to target zones, in order to reduce the burden of exchange rate uncertainties on their own economies, there will also be derived benefits to the rest of the world. For the three dominant currencies within the SDR will then be in a much stronger position "to collaborate with the Fund to promote exchange stability, to maintain orderly exchange arrangements with other members, and to avoid competitive exchange alternations."[6] An approach back toward the four renewable characteristics of the old gold-dollar standard would then become possible.

(a) *Moderating short-term fluctuations.* The guidelines suggested by the IMF staff as early as 1974 provided that "a member with a floating exchange rate should intervene on the foreign exchange market as necessary to prevent or moderate sharp and disruptive fluctuations from day to day and from week to week in the exchange value of its currency."[7] That would be a Pyrrhic effort for most other countries so long as capricious swings in rate relations between the dollar and other major currencies could whipsaw the deliberate attempts by any other country to smooth its own rate oscillations. But once a target zone system were in operation, even in a preliminary stage, facilities for joint intervention by the three currencies would necessarily be

[6]IMF Articles, Article IV, Section 4(a).

[7]IMF, "Guidelines...", p. 24.

activated, and in their own interest the three countries would routinely act to reverse short-lived aberrations. And by pegging on any one of the three, or on the SDR, other countries could benefit directly from the smoothing operations of the three and could expect to cope with aberrant fluctuations of their own currencies more effectively through direct action on their own account.

(b) *Establishing a durable benchmark.* In the floating rate environment of the last decade, any international yardstick that might have been chosen for setting values over time has the elasticity of a rubber band, even after providing for an inflation adjustment, because the exchange rates of all currencies have been swinging widely. To be sure, if the proposed target zones were being implemented, the contrast would not be complete. The setting of target zones would not involve tightly drawn margins around inflexible par values for the three currencies, in the manner of the gold-dollar standard. Indeed variations of as much as 10 percent from top to bottom might be visualized for some time after the three countries reached the stage of setting (at least notionally) some loosely defined upper and lower limits in relation to each other; and no par or center values need be set or implied.

However, the likelihood that movements within the target zones might tend to offset each other, and that these currencies in combination would account for roughly three-fourths of the presently formulated valuation of the SDR, points strongly toward the probability that a three-country target zone effort would make the SDR the closest approximation to an internationally usable standard of value in the tradition of the gold-dollar system.

(c) *Avoiding mutations in exchange rates.* Under the gold-dollar system, as administered by the IMF, decisive one-time adjustments in exchange rates were, or were supposed to be, limited to conditions of sustained structural change in the economic position of the adjusting country. Even though rate adjustments came rather frequently as the performance paths of countries began to diverge more widely during the sixties, the general understanding was that underlying economic changes, once established, were the basis for moving the par value. The ability to rely on that rationale for any impending exchange rate changes, often enabled banks and businesses to hedge against impending exchange rate adjustments as they observed decisive structural changes occurring within a country, or in a country's foreign trade, or in its price behavior. Under floating rates that kind of an approach to projecting possible rate adjustments, at least among the dozen or more leading countries and currencies, has been much less reliable. The easy readiness with which huge sums can flow into or out of a currency in response to apprehension of political unrest, or expectations of changing interest rates, or even of exchange rates, has pushed fundamental analysis into a secondary role.

Once a target zone procedure became operational, however, the possibility would increase for a drift back toward a comfortable reliance on economic fundamentals in the determining of exchange rates. For the combined weight of the three countries, taking action in unison on the basis of jointly determined appraisals, could effectively limit the scope for cumulative "bandwagon effects" to run up (or down) any of these three currencies. And as familiarity grew, both among the three governments in implementing their

judgments and among the currency users of the world in distributing their currency holdings, the marketplace itself might well become a powerful reinforcement for the efforts of the three sets of officials. These efforts would aim to hold ordinary exchange rate fluctuations within a bounded zone, and to limit more definitive rate changes to conditions which all three recognize as evidence of impending or realized structural change.

To be sure, the further extension of this comparative stability among the three currencies to the exchange rates of other countries would resemble a "trickle down" theory, and might consequently contribute only marginally toward rate stability outside the dollar, D-mark, yen relationship. However, a relatively stable central core of the monetary system must almost inevitably promote some improvement over the conditions of the early eighties.

(d) *Strengthening the "discipline of the exchanges."* For the three target zone countries, adherence to the new arrangements would in fact institutionalize and articulate the discipline of the exchanges. These countries would literally be putting into effect among themselves all of the conditions outlined in the 1974 "Guidelines" of the IMF. The very process of considering together all the factors capable of influencing their own interrelations and then of setting target zones "within the range of reasonable estimates of the medium term norm"[8] for their exchange rates, will impel a shaping of domestic policy to sustain a viable international position for each of the three.

To be sure, even under the conditons of floating in the early eighties, all traces of the discipline of the exchanges will not have been lost. So far as weak currencies are concerned, their exchange rate behavior will always exert some influence on their domestic policies under any international currency system. If exchange rates fall so far as to make the prices of needed imports prohibitive, or if reserves and borrowing power fall so low as to leave no means of paying for imports, whatever their price, then something will happen. Reaching those extremes may, however, be cataclysmic for the domestic political and economic system of the affected countries, and cause incredible human misery.

The aim should be to find ways to utilize the discipline of the exchanges instead as an early warning system, understood and put to use while orderly correction is still feasible. The enhanced prestige of the IMF and its SDR, under a three-country target zone system, should strengthen the power of the IMF, through its surveillance of all member countries, to press for early domestic action that can avert disastrously wide swings in exchange rates, and thereby help countries to avoid the kind of collapse that would require drastic corrective action and a prolonged period of painful adjustment.

In Conclusion

The case for some orderly management of exchange rates, without impairing the fundamentals of an open system of trade and payments, has become greater as existing rates have remained persistently over- or under-

[8]Ibid., p.24.

valued. Alongside that growing need there has been a growing nostalgia for the old gold-dollar standard. Paradoxically, at the same time, much of the responsibility for the disruptive distortions that have emerged under the floating rate system has been attributed by many observers to a maverick performance of the United States, with its high interest rates and its overvalued dollar.

One way to move toward some of the useful characteristics of the old standard, and to bring the United States into a more harmonious codetermination of objectives and actions, would be to initiate a systematic program among the United States, West Germany, and Japan for establishing target zones for the exchange relations among their currencies. Such a program should be developed under the watchful eye of the IMF, and in accord with the guidelines for target zones once proposed for adoption by the IMF.

A three-way target zone system, in addition to all of the advantages in comparative stability and improved viability that it would bring to the three countries and their currencies, could also contribute to a strenthening and stabilizing of the SDR as a centerpiece in the world's monetary sytem. In turn, as the three countries responded more explicitly to an advance recognition of the policies implied by the discipline of the exchanges, the IMF's position would be enhanced for using its surveillance over its other members similarly—that is, to signal needs for adaptive change that could, in effect, anticipate and precede the otherwise harsher impact that would be felt when disciplines were exerted through the exchanges in the extreme form that works with punitive (if not actually crippling) effect.

At the least, a target zone system, understood and faithfully carried through by the three countries, could help to lessen the day-to-day swings that now so often add uncertainty to the exchanges, and could help to provide for the three countries and the world at large a moderately durable benchmark for the measurement of values across frontiers and over time. Some semblance of the old gold-dollar standard, but without its inherent instability, might indeed be attainable if the three countries were, with the blessing of the IMF, committed to the pursuit of target zones.

Discussion

Jacob A. Frenkel*

Robert Roosa's paper "Exchange Rate Arrangements in the Eighties" represents an eloquent and a well-reasoned case for the "target zones" approach to the exchange rate system. Roosa's paper starts with the premise that the current regime of floating exchange rates failed, and that it is desirable to develop a system that possesses some of the attractive features of the gold-dollar system which was part of the original Bretton Woods arrangement. Roosa recognizes that a formal restoration of the exchange rate arrangement of Bretton Woods is entirely impractical and, therefore, he recommends the adoption of target zones as the primary system linking the currencies of the United States, West Germany and Japan.

I have found Roosa's interpretation of the operation of the gold-dollar system during the quarter century after its introduction in Bretton Woods very illuminating. Of special usefulness was his emphasis on some of the logical difficulties that were responsible for the collapse (or the evolution) of that system. Since I believe that a good medical school needs to have a good department of pathology, I sympathize with Roosa's methodology of conducting a postmortem analysis on the old system prior to the introduction of his new alternative. The study of the historical record is presumably motivated by the famous assertion that "those who do not remember the past are condemned to repeat it." Unfortunately, when applying this dictum to the study of institutions and societies one may frequently observe that "the past is not what it used to be." Furthermore, and in contrast with many of the experimental sciences, when forecasts of the impact of institutional and legal systems on the behavior of individuals and societies are made on the basis of past experience one may frequently observe that also "the future is not what it used to be." This inherent difference between social and physical sciences reflects the impact of experience and memories on behavior. It renders the study of past records somewhat less productive than one would have liked since once we go through an experience (as individuals or as a society) we cannot ignore it any more and start all over again. For such cases Lewis Carroll's phrase "all the King's horses and all the King's men couldn't put Humpty Dumpty together again" is clearly applicable. Therefore, I share Roosa's judgment that the restoration of the gold-dollar system à la Bretton Woods is out of the question. My subsequent remarks deal with (i) the characteristics of the present system of flexible exchange rates, (ii) the proposed restoration of exchange rate rules, (iii) the question of who should join the target zones and (iv) the question of reform.

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The Characteristics of Flexible Exchange Rates

The presumption that the flexible exchange rate system failed is typically based on the observations that during the past decade exchange rates have been highly volatile, that changes in exchange rates have been unpredictable and have not been closely linked to differentials between national inflation rates. Indeed, charts portraying changes in bilateral exchange rates among the major currencies resemble an electrocardiogram of a patient who has just suffered a heart attack. Furthermore, if data from forward markets for foreign exchange provide measures of the market's prediction of future changes in exchange rates, then a comparison between actual and predicted changes reveals that most of the changes in exchange rates have been unpredicted. The forward market has accounted for only about 5 percent of the actual variability of exchange rates. Since these changes in exchange rates have not reflected exactly inflationary differentials, they have resulted in large changes in *real* exchange rates.

Granting these facts, my main point is that they should not have come as a surprise but rather that they are intrinsic characteristics of flexible exchange rate regimes. Events in the foreign exchange markets, as in other asset markets, are frequently dominated by changes in information. It follows that periods that are dominated by "news" are likely to be periods during which exchange rates, which are highly sensitive to expectations concerning the future course of events, exhibit large fluctuations. Since by definition the "news" cannot be predicted on the basis of past information, it is evident that, by and large, fluctuations in exchange rates are unpredictable. Further, since the prices of goods comprising the aggregate price index are less sensitive to expectations, it follows that during periods dominated by news which alter expectations, exchange rate developments will in general not mirror the course of inflationary differentials. Once we adopt a flexible exchange rate regime, we should expect to get these characteristics, as it were, these come with the territory.

Should They Be Fixed?

The volatility and unpredictability of exchange rates have stimulated many plans for the restoration of some form of "orderly" conduct for them. A popular intervention rule has been the PPP rule (Purchasing Power Parity rule) by which exchange rates adjust so as to exactly match inflationary differentials.

There are, however, at least four difficulties with a PPP rule. First, there are intrinsic differences between the characteristics of exchange rates and the prices of national outputs. These differences, which result from the much stronger dependence of exchange rates (and other asset prices) on expectations, suggest a more relevant yardstick; exchange rate volatility should be assessed by comparison with variability in the prices of other assets like securities rather than variability in the prices of national outputs. The evidence shows that the variability of exchange rates has been about half that of the stock market indices. Of course, this does not mean that the volatility

of either exchange rates or stock market indices has been acceptable, but rather that exchange rate volatility cannot be condemned as excessive by pointing to the fact that exchange rates have moved more than national output price levels.

Second, the prices of national outputs do not adjust fully to shocks in the short run, and thus intervention in the foreign exchange market to ensure purchasing power parity would be a mistake. When commodity prices are slow to adjust to current and expected economic conditions, it may be desirable to allow for "excessive" adjustment in some other prices.

Third, continuous changes in real economic conditions require adjustment in the relative prices of different national outputs. Under these circumstances, what seem to be divergences from purchasing power parities may really reflect equilibrating changes.

Fourth, if there is short-run stickiness of domestic goods prices in terms of national moneys, then rapid exchange rate adjustments, which are capable of changing the relative prices of different national outputs, are a desirable response to changing real economic conditions. An intervention rule that links changes in exchange rates rigidly to changes in domestic and foreign prices in accord with purchasing power parity ignores the occasional need for equilibrating changes in relative prices.

Thus, while it might be tempting to "solve" the problem of divergences from PPP by adopting a rigid PPP rule, I believe this to be a mistaken policy course. The key point to realize is that the volatility of exchange rates is not the likely source of the difficulties but rather a *manifestation* of the prevailing package of macroeconomic policies. Fixing or manipulating the rates without introducing a significant change into the conduct of policies may not improve matters at all. It may amount to breaking the thermometer of a patient suffering from high fever instead of providing him with proper medication. The absence of the thermometer will only confuse matters and will reduce the information essential for policymaking. If volatile events and macropolicies are not allowed to be reflected in the foreign exchange market, they are likely to be transferred to and reflected in other markets (such as labor markets) where they cannot be dealt with in as efficient a manner.

The preceding argument ignored, however, one of the important characteristics of the gold-dollar system which Roosa's target zones attempt to promote, i.e., the characteristic of the "discipline of the exchange." Accordingly, it could be argued that the obligation to peg the rate or to follow a predetermined intervention rule would alter fundamentally the conduct of policy by introducing discipline. Experience seems to suggest, however, that national governments are unlikely to adjust the conduct of domestic policies so as to be disciplined by the exchange rate regime. Rather, it is more reasonable to assume that the exchange rate regime is more likely to adjust to whatever discipline national governments choose to have. It may be noted in passing that this is indeed one of the more potent arguments against the restoration of the gold standard. If governments were willing to follow policies consistent with the maintenance of a gold standard, then the gold standard itself would not be necessary; if however, governments are not willing to follow such policies, then the introduction of the gold standard *per se*

will not restore stability since, before long, the standard will have to be abandoned.

One of the intriguing puzzles concerning the choice among alternative exchange rate regimes is the remaining wide division of opinions about the best choice. It seems that over the years neither the evolution of events nor the developments of economic theory have succeeded in narrowing the gap between extreme views and in bringing about a convergence of opinions in both academic and policy circles. As a matter of fact, Roosa's own proposals for target zones have been the subject of considerable discussions and analysis and yet many disagreements remain. My interpretation of the lack of convergence is that the participants in the debate have not shared the presumption concerning the relevant alternative to the system which they promote. Thus, extreme promoters of fixed rates believe that the relevant choice is between a "good fix" and a "bad flex;" on the other hand extreme promoters of flexible rates believe that the relevant choice is between "bad fix" and a "good flex." As is obvious, if these are the alternative choices the outcomes are self-evident—for who would not prefer a "good fix" over a "bad flex?" And, by the same token, who would not prefer a "good flex" over a "bad fix?" In reality, however, the choices are much more complex and much less trivial since they may involve comparisons between a "good fix" and a "good flex" or, even more frequently, between a "bad fix" and a "bad flex." When these are the choices, one may expect lack of unanimity. Reasonable people may also differ in their assessments of which "good" system is more likely to gravitate towards its "bad" counterpart. Furthermore, the likelihood that a given "good" system would deteriorate and be transformed into its "bad" counterpart depends on the circumstances and, therefore, it is not unreasonable that some economies would be wise to choose greater fixity of rates while some other economies would be equally wise to choose greater flexibility.

Who Should Join the Target Zones and Are the Zones Sustainable?

According to Roosa's proposal the key members of the proposed target zones arrangement would be the United States, West Germany and Japan. The United Kingdom and France are left out on the argument that they have not shown great interest in seeing their currencies being used worldwide. Roosa brings persuasive arguments in support of his proposals, and I find them by and large congenial. My main concern, however, is not with the details concerning the precise number of currencies etc., but rather with the link between this proposal and the key criteria that economic theory provides for the choice of memberships in monetary unions and currency areas.

As is well known, the literature on optimal currency areas highlights several criteria according to which prospective members should be chosen. These criteria include (i) the degree of openness of the economy, (ii) the size of the economy, (iii) the degree of commodity diversification, (iv) the degree of inflation rates among prospective members, (v) the degree of capital mobility, (vi) the degree of other prevailing forms of integration (like custom unions), (vii) the degree of similarities of tax structures and other fiscal

characteristics, and (viii) the degree of similarities of external and domestic monetary and real shocks. A central question is how do Roosa's members of the target zones measure up to this set of characteristics.

Suppose the target zones are established. Is it likely that the member countries will be willing to adjust their prevailing package of macroeconomic policies so as to conform with the rules of game? Until recently intervention in the foreign exchange market was believed to be effective even if its monetary consequences were sterilized. Thus, a commitment to an exchange rate arrangement did not need to imply a drastic obligation concerning the conduct of monetary policy. Recent evidence (from the Federal Reserve Intervention Studies) raises significant doubts on this presumption. The evidence suggests that the exchange rate effects of sterilized intervention are much weaker and much less reliable than the corresponding results of nonsterilized intervention. In view of these findings it is relevant to ask whether it is realistic to presume that these countries are likely to harmonize their monetary policies. Put differently, even if such harmonization was desirable from the viewpoint of the world, is it likely to be adopted? In dealing with this question it is instructive to recall John Stuart Mill's analysis in his *Principles of Political Economy* more than a century ago. There, he concluded regretfully that:

> So much barbarism, however, still remains in the transactions of the most civilized nations, that almost all independent countries choose to assert their nationality by having, to their own inconvenience and that of their neighbors, a peculiar currency of their own.

In predicting the future course of events, Mill believed that eventually the international monetary system would evolve into a unified currency area, a process that would be brought about by, what he termed, "the progress of political improvement."

Mill's prediction has been clearly refuted by the actual trend of events. This outcome may be regrettable, but it is clearly typical of government policies. As a general rule, governments tend to discount the future heavily, since their time horizon is relatively short. Consequently, faced with a conflict between internal and external targets, elected officials (who wish to be reelected) will typically sacrifice external obligations to domestic goals by renouncing previous commitments to the international rules of the game.

Is it likely that the current political realities will undergo a significant change in the near future? I believe not. Even though it is usually agreed that the international monetary system faces a fundamental conflict and that it is in the self-interest of all countries viewed as an *aggregate* to preserve a viable international monetary system, it is also clear that each and every *individual* country has the incentive to minimize the weight given to international considerations in the design of domestic policies. Unfortunately, Adam Smith's "invisible hand" cannot be relied upon to bring individual behavior in line with the global optimum since the world economy is not composed of atomistic units but rather of oligopolies. In such a world the "invisible hand" yields to the "visible fist" and the "free market" solution maybe suboptimal from the world's society viewpoint. A repetitive breakdown of rules could be

very costly from the global viewpoint. Therefore, it is extremely important that the monetary system does not depend in critical ways on harmonized policies, since such harmonization may not be sustainable.

Should We Reform or "If It Ain't Broke Don't Fix It"

Much of the discussion in Roosa's paper and in other papers in this conference evolved around the need for a reform of the way in which the international monetary system operates. A central feature of any operational monetary system must be a formal resolution of the so-called (n-1) problem. We have n currencies and only n-1 independent exchange rates. We thus have one degree of freedom and its disposal must be explicitly specified. It takes two to tango and it takes one for intervention. The original Bretton Woods system allocated the degree of freedom to the United States which obliged itself to peg the price of gold at $35 an ounce; the other n-1 countries then committed themselves to peg their currency to the U.S. dollar. A design of the international monetary system is not complete unless it provides a resolution of this (n-1) problem. Therefore, my question is how does the target zones system deal with the extra degree of freedom?

In contrast with fixed parities, the target zones are moving. As they move how do we escape from the inherent difficulty of having the private sector speculate against governments? In the absence of an anchor what ensures credibility? How exactly are conflicts being resolved? These are critical questions that need precise resolution prior to implementation. I believe that the central difficulties with the current regime do *not* rest with the exchange rate policies but rather with the overall mix of the uncoordinated macroeconomic policies. It is unlikely, therefore, that the introduction of exchange rate targets can do any good unless they are accompanied by drastic changes in the way in which macropolicies are being designed. Placing excessive weight on the role of exchange rates may divert attention from the more central role that global macroeconomic policies play in the interdependent world economy.

A reform of the international monetary system should be viewed as a constitutional change that occurs once in a lifetime. It ought to be viewed as the "step of last resort." It ought to be thought of as the last bullet which should be used properly and which, once being fired, had better not miss. The success of a new monetary arrangement depends on the adoption of a consistent set of policy tools, and on a reasonable understanding of the implications of each course of action. It might be very costly to experiment with a new system just to learn how it works. In these matters the cost of delaying the adoption of a new international monetary arrangement until its full implications are understood is likely to be small relative to the cost of a premature implementation. The target zones proposal has many attractions. But since it is novel, prudence is clearly called for. More discussions and critical evaluations can be highly desirable. In view of this it may be a good place to conclude with a quote from John Maynard Keynes's remarks in his closing speech at the original Bretton Woods Conference exactly 40 years ago.

Speaking on the desirability of critical evaluations of the proposed system Keynes said:

> I am greatly encouraged, I confess, by the critical, skeptical and even carping spirit in which our proceedings have been watched and welcomed in the outside world. How much better that our projects should *begin* in disillusion than that they should *end* in it.

General Discussion

Otmar Emminger agreed with Roosa that governments need to "orient their policies more than at present toward exchange rate movements" and that key currency countries have a special responsibility in supporting the international monetary system. However, while sharing the belief that the exchange rate system employed should strengthen discipline, he doubted that target zones would provide the desired discipline.

Emminger believes that problems would arise in implementing a target zone system. First, governments would have to agree on initial values for the respective exchange rates, which would be a difficult task. For example, most countries would claim that the dollar is currently overvalued; yet other initial values for the dollar would require massive, coordinated foreign exchange market intervention to defend these target values. Second, the only chance for European governments partially to uncouple their interest rates from the U.S. interest rate is to maintain flexible exchange rates vis-à-vis the dollar. Third, given the enormous volume of international capital flows, governments would be unable to maintain target zones without frequent and extensive exchange market intervention.

William Poole added that exchange market intervention as a policy often becomes counterproductive. Once a government starts intervening regularly the market begins speculating about what the monetary authorities will do. If intervention is initially ineffective, political pressure descends on the central bank to preserve its credibility. Consequently, intervention is stepped up. Other measures—such as capital controls—also surface.

Robert Roosa responded that exchange market intervention would be an essential but minor aspect of a target zone system. Instead, a target zone system would encourage "mutual acceptance of a joint responsibility" for exchange rates prevailing among a group of participating countries. These countries would exchange ideas and design domestic economic policies taking into account their external commitments. Nevertheless, intervention can be effective in alleviating "disorderly" exchange market conditions, especially when it is coordinated among central banks.

Noting the experience of the EMS, Jean-Jacques Rey agreed with Roosa that a target zone system would encourage mutual acceptance of exchange rates among participating countries. The EMS induces member countries to meet periodically to agree on exchange rates among their currencies and to discuss policy alternatives to maintain these values. While "expectations" greatly influence exchange rates, expectations are formed taking into consideration the attitude of authorities toward their exchange rates. Consequently, expectations have generally reinforced the attainment of exchange rate stability within the EMS.

Jacob Frenkel rejoined that he also wants actively to address the problem of exchange rate misalignments, but he sees poor macroeconomic policies rather than a poor exchange rate system as the source of these misalignments. If macroeconomic policies were modified and coordinated first, a flexible exchange rate system would deliver the right thing.

The European Monetary System: Tombstone or Cornerstone?

Robert Triffin*

The interested layman will get the gist of this overlong and overtechnical paper by looking merely at its Synopsis, Summary and Conclusions, and whatever other passages are of interest to him, skipping the documentary verbiage designed for skeptical experts.

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Synopsis

The breakdown of the Bretton Woods international monetary system has been followed by floating exchange rates. This led initially to a huge depreciation of a previously overvalued dollar vis-à-vis its major rival currencies on the exchange market: the D-mark, the Swiss franc, and the yen. The partial, but spectacular, recovery of the dollar since 1979 is *not* due to any improvement of the U.S. balance of payments on current account, but to enormous inflows of speculative capital, due mostly to fears of a third world war and to exceedingly high U.S. interest rates, related themselves to the unprecedented fiscal deficits triggered by sharp increases of military expenditures. These capital movements are unacceptable and unsustainable in the long- or even medium-run for the rest of the world, and the renewed overvaluation—undercompetitiveness—of the dollar is increasingly unbearable for U.S. firms exposed to foreign competition at home and abroad. Trade deficits of about $110 billion this year, according to official estimates, are as absurd for the most industrialized country of the world as their financing by capital imports from poorer and less capitalized countries.

The restoration of a viable world monetary order continues to demand the fundamental reforms agreed upon after 10 years of continuous debates and negotiations in the International Monetary Fund (IMF), the Group of Ten, the Committee of Twenty, etc., but bizarrely put on ice by the Second Amendment to the IMF Articles of Agreement. No agreement is yet in sight, however, on the major reform proposed by the negotiators, i.e., the replacement of *national* reserve currencies—primarily the dollar—by a reformed SDR *(Special Drawing Rights)* as the main instrument for *international* settlements and reserve accumulation by central banks, commercial banks, etc.

Pending such a distant agreement, the countries other than the United States are desperately trying to minimize the impact of the present world monetary disorder upon their national economies. They seek to stabilize their exchange rates vis-à-vis their main trading partners through regional agreements, making them less dependent on the fluctuations of the dollar. The *European Monetary System* (EMS) has been partially successful in this respect. It is still very far from its ultimate objective of full Monetary and Economic Union but has nevertheless succeeded in preserving, or restoring fairly rapidly, stable competitive *real* exchange rates between its member currencies through appropriate realignments of *nominal* exchange rates, offsetting persistent differences in national rates of inflation.

The keystone of this system, the ECU has begun to compete spectacularly with the Eurodollar and other Eurocurrencies for the denomination of international contracts, particularly in the Eurobond market and in the lending and borrowing transactions of commercial banks. This role is likely to increase further if and when the dollar begins to depreciate, as is regarded highly probable and desirable, both in the United States and abroad, to correct its present overvaluation.

The parallel appreciation of the stronger EMS currencies will, however, increase exchange rate tensions between them and the weaker EMS currencies, and require the strengthening of the system initially envisaged after two years of operation, but not yet implemented in practice. If this is finally achieved, the EMS success should inspire a renewed drive for a reformed world monetary order in which regional cooperation could proceed much further than is feasible worldwide between more developed and less developed countries, and between Communist and non-Communist countries . The IMF could then devote its limited time and capabilities to tackling the balance of payments problems between such regions rather than between their member countries.

The World Monetary System (or Scandal?): 1969–1983

The following three tables, derived from the *International Financial Statistics* of the International Monetary Fund, summarize the crucial defects of the present world monetary system:

1. Its *inflationary proclivities:*

Table A
1983 Indices of World Inflation (1969 = 100)

Year Averages		Percent	
Consumer Prices	:	435	
Money	:	539	
End of Year Estimates			
International Reserves other than gold	:	883	
of which: Foreign Exchange	:	900	
International Reserves, including gold	:	947	
Euro-Currency Liabilities	:	2,000	
Gold Price ($381.50 per ounce)	:	1,090	(with a peak of more than 2,400 percent, at $850 per ounce on January 21, 1980)

2. The *distorted investment pattern* of its major assets component (foreign exchange), whose main creditors are the poorest and least capitalized countries of the Third World, and the major debtor the United States.

Table B
Foreign Exchange Assets and Liabilities
($ billions)

	End of 1969	1970–83 Changes	End of 1983	End of 1983 in %
I Assets of:	33	+263	297	100
United States	3	+3	6	2
Other Industrial Countries:	17	+117	134	45
Nonindustrial Countries.	13	+143	156	53
Oil Exporting	3	+62	65	22
Other	11	+81	92	31
II Liabilities (−) of	−33	−263	−297	−100
United States	−18	−179	−197	−66
Other Industrial Countries:	−16	−84	−100	−34
III Net Assets, or Liabilities (−)	x	x	x	x
Debtors: United States	−15	−176	−191	−100
Creditors:	+15	+176	+191	+100
Other Industrial Countries:	+2	+33	+35	+18
Nonindustrial Countries:	+13	+143	+156	+82
Oil Exporting	+3	+62	+64	+34
Other	+11	+81	+92	+48

3. The fantastic increase of the abnormal *current account deficits* of the United States, financed by equally *abnormal capital inflows;* and the abrupt curtailment of U.S. banks' capital exports in 1983.

Table C
U.S. Balance of Payments and Capital Flows: Yearly Averages
($ billions)

	with capital flows adjusted for valuation and coverage				with capital flows unadjusted		
	1950–69	1970–78	1979–82	1982	1982	1983	Official Forecasts 1984
I Earnings on Past Investments	+4	+13	+30	+27	+27	+24	
II Other Current Transactions:	−2	−13	−32	−39	−39	−64	
Merchandise	+4	−8	−29	−36	−36	−61	−110
Other	−2	−5	−3	−3	−3	−4	
Current-Account (I+II)	+2	−	−2	−11	−11	−41	−80
I Valuation and Coverage Adjustments	−1	+1	−6	−18	n.a.	n.a.	
II Net Capital Flows[1]	+1	+1	−8	−29	−11	−41	−80
A. Foreign Aid	+1	+3	+5	+6	+6	+5	
B. Other:	−	−2	−13	−34	−17	−46	
1. Official Reserves	−1	−17	−1	−4	+2	−5	
2. U.S. Banks and Treasury Securities	−1	+7	+26	+38	+38	−35	
3. Other:	+2	+8	−38	−68	−57	−6	
(excldg. Discrepancy)	(+2)	(+10)	(−7)	(−27)	(−15)	(+1)	
(Stat. Discrepancy)	−	(−1)	(−30)	(−41)	(−41)	(−7)	
ASSETS	+5	+33	+97	+117	+118	+49	
A. Foreign Aid	+1	+3	+5	+6	+6	+5	
B. Other:	+4	+30	+92	+112	+112	+44	
1. Official Reserves	−	−	+4	+4	+5	+2	
2. Bank Claims	+1	+13	+68	+109	+109	+25	
3. Other	+4	+16	+20	−1	−2	+18	
LIABILITIES (−)	−4	−32	−105	−146	−129	−90	
1. To Official Inst.	−1	−17	−5	−8	−3	−6	
2. U.S. Banks & Treasury Securities	−1	−6	−42	−71	−71	−60	
3. Other:	−2	−8	−57	−67	−55	−24	
(excldg. Discrepancy)	(−1)	(−7)	(−27)	(−25)	(−13)	(−17)	
(Stat. Discrepancy)	(−1)	(−1)	(−30)	(−41)	(−41)	(−7)	

[1]Capital exports shown as +, and imports as −

I. Shortcomings and Unviability of the Dollar-Anchored World Monetary System

1. *Introductory Remarks*

The economic disaster of the last decade is summarized by economists in the word *"stagflation"* which suggests that it began with "stagnation" *followed* by inflation. The word *"infession"* would be less misleading, since inflation *came first* and was followed not by mere stagnation, but by *recession.*

The roots of this inflation lie outside the monetary field: in the unprecedented growth of material production which threatens to deplete world resources in some economic sectors—particularly energy, and more specially oil reserves—and can be met only at increasing production and investment costs. Future historians will probably describe this phenomenon as a short parenthesis in world history:

a) initiated only two centuries ago by the *industrial revolution* which helped meet the most basic needs of man for food, shelter, health, etc;
b) sustained later by the *advertising revolution* which created needs, previously unperceived, for a more comfortable life;
c) accelerated in the 1950s and 1960s by the success of the *Keynesian revolution* in minimizing the cyclical *recessions* which previously slowed down periodically the pace of growth; and,
d) last but not least, compounded by the *armament explosion* which threatens us today with a nuclear suicide.

These sectorial inflationary pressures were met by national monetary policies in either of the two following manners, or a combination of both:

a) In most countries, by far, they transmitted these inflationary pressures to the economy in general, by *permissive,* or *accommodating* policies, increasing money supply sufficiently to finance the contagion of price and wage increases from the affected sectors to the others.
b) In a small core of countries—particularly the United States and Western Europe—they tried to preserve the overall stability of prices and wages by increasing the money supply only moderately, and often setting thereby price and wage increases in the affected sectors by price and wage contraction—at the risk of unemployment—in the other sectors of the economy.

The inevitable result of these divergent policies was steep declines in the exchange rates of the countries with accommodating policies vis-à-vis the currencies of the countries following anti-inflationary policies. Measured in the latter countries' currencies, however, world prices rose only moderately in the 1960s: by 4 percent yearly on the average for consumers' prices, and only about 1 percent or less for export and import unit prices. But their growth rose to about 6 percent a year on all three of these measurements in the following three years (1970–72), i.e., well before the first explosion of oil prices at the end of 1973; and to between 10 and 12.5 percent a year in the

next 11 years (1973–83) of floating exchange rates.[1]

As distinct from *national* inflations and recessions, *worldwide* inflations and recessions are primarily linked, in my opinion, to the breakdown of the world monetary system. The deep and prolonged world recession of the 1930s followed the collapse, in September 1931, of the world key-currency of the times: the pound sterling. The recession of the 1970s followed similarly the suspension, 40 years later nearly to the day, in August 1971, of the convertibility of the successor key-currency: the U.S. dollar. But it is accompanied this time by a world inflation, largely due to the explosion of foreign exchange reserves by 744 percent between 1969 and 1982—in sharp contrast with their 25 percent decline from 1928 to 1937—and to the concomitant explosion of the international private capital market, practically paralyzed after 1929.

2. *Inflationary Explosion of World Reserves*

Table 1 summarizes the evolution of gross and net international monetary reserves from the end of 1969 to the end of 1983, measured at constant gold prices (35 per ounce) and dollars equal to SDRs in the first two columns, and at $ market gold prices and $-SDR exchange rates in the third column.

[1]Calculated from the estimates of *International Financial Statistics (Yearbook* 1983 and March 1984).

Table 1
Sources of International Monetary Reserves: 1969–1983
(SDR or $ billions)

	End of 1969	End of 1983		Changes over Years 1970–1983			
				Total	Transactions	Impact of Gold Price and Exchange Rate Fluctuations	
	(a)[1]	(b)[1]	(c)[2]	(d=c−a=e+f)	(e=b−a)	Total (f=g+h)	SDR Gold Price (g)	$–SDR Exchange Rate
GROSS RESERVES	79	373	748	669	294	375	342	34
I World Gold	41	40	435	394	−1	395	376	20
II Credit Reserves	38	333	313	275	295	−20	−34	14
A. Foreign Exchange	33	283	297	263	250	13	x	13
B. Concerted Reserve Creation	4	50	17	12	45	−33	−34	1
1. SDR Allocations	x	21	22	22	21	1	x	1
2. Net IMF Credit	4	28	−6	−10	24	−34	−34	–
a) *Reserve Positions in* IMF	7	39	41	34	32	2	x	2
b) *minus* acquired through gold and SDR transfers to IMF	−2	−11	−47	−44	−8	−36	−34	−2
NET RESERVES[3]	40	39	398	358	−2	359	342	18
I World Gold	41	40	435	394	−1	395	376	20
II *minus* Unallotted IMF Profits[4]	−1	−1	−37	−37	−1	−36	−34	−2
A. on Credit Transactions	−1	−1	−1	−1	−1	–	x	–
B. on Gold Holdings	x	x	−36	−36	x	−36	−34	−2
A. Gross IMF Lending (−)[5]	−5	−30	−31	−26	−25	−1	x	−1
B. Net IMF Credit	4	28	−6	−10	24	−34	−34	–

[1]*Measured in SDRs = dollars, at constant gold price of $35 per ounce.*
[2]Measured in dollars, at market gold prices and $–SDR exchange rates.
[3]*Net* foreign exchange and SDR assets and liabilities equal 0 by definition.
[4]*Including, after 1980, minor accounting adjustments for member's short-term borrowings under enlarged access policy, and for borrowed reserves held in* suspense.
[5]Including in 1969, gold deposits and investments of the IMF in the United States ($1,019 million) and in the United Kingdom ($40 million).
Source: Calculated from *International Financial Statistics, Yearbook 1983*, pp. 25–53, and March 1984, pp. 28–43.

a) The evolution of *gross reserves*, shown in the top half of the table, suggests the following observations:
   i) First and foremost, the *inflationary explosion of credit reserves* (i.e., of reserves other than gold), by $275 billion from $38 billion to $313 billion (line II). Credit transactions increased world reserves more than seven times as much in this short span of 14 years as in all previous years and centuries since Adam and Eve. This represents an average increase of 16.3 percent per year, far in excess of the *IFS* estimate (in its 1983 *Yearbook*, p. 87) of the 3.5 percent average increase of world Gross Domestic Product at constant prices over the years 1970–1981,[2] but approximately equal to the obviously inflationary 15.2 percent yearly increase of money and quasimoney over this period (1983 *IFS* Yearbook, p. 65).[3]

      This credit reserve explosion is due nearly entirely (96 percent) to the accumulation of *"foreign exchange"* reserves (see line IIA) in a few *national* currencies—primarily U.S. dollars—as *international* reserves. Its other component part, *concerted credit creation* (line IIB) increased only slightly, cumulative allocations of *Special Drawing Rights* (line IIB1) being relatively small and nearly half of them offset by the decline of *Net IMF Credits* (line IIB2), i.e., the increase of *Reserve Positions in the Fund* (line IIB2, a) other than those acquired by the transfer to the IMF of previously accumulated gold and SDR holdings (line IIB2, b).
   ii) Foreign exchange holdings also account for nearly 85 percent ($250 billion) of the increase of gross reserves including gold, measured at constant gold prices and $-SDR exchange rates ($290 billion), and concerted reserve creation for only 15 percent ($45 billion).
   iii) The near decoupling of gross reserves (including gold), measured in dollars at fluctuating market prices and exchange rates, reflects obviously a total failure of official policies, which had repeatedly proclaimed, until defeated by events, the intangibility of the $35 per ounce price of the U.S. dollar on which the world system had been anchored at Bretton Woods.

b) The bottom half of Table 1 shows the evolution of world *net* reserves, i.e., of the gross assets recorded at the top of the table *minus* reserve liabilities: foreign exchange liabilities, "contingent" liabilities for SDR allocations, and reserve liabilities to the IMF. For the world as a whole, *net* liabilities for foreign exchange and SDR allocations are zero by definition, as pointed out in footnote (3). Net world reserves are equal to official world gold holdings (line I), *minus* the profits of

[2]1982 estimates are not yet published.

[3]Gold is excluded from these calculations because the enormous increase at $ market prices is due exclusively to price increases and reflected nearly exclusively in "bookkeeping profits" sterilized until now by central banks, rather than in increases in the monetary issues of reserve money.

the IMF on its credit transactions and on its own gold holdings (first lines A and B under II), equal themselves to the difference between net IMF credits (last IIB line = line IIB2 of the top half of the Table) and gross borrowings from the Fund (penultimate line IIA).

The $358 billion increase in net reserves, shown in the 4th column of the first line is due more than entirely to the impact of the market fluctuations of SDR gold prices ($342 billion) and $-SDR exchange rates ($18 billion), whose stability had been previously proclaimed by the authorities as the two "unshakable pillars" of any reformed Bretton Woods system. Measured at stable gold prices and $-SDR exchange rates, net reserves show indeed a slight decline over this period, in sharp contrast with their huge increase when measured at market gold prices and exchange rates.

3. *Distorted Pattern of the Regional Distribution of International Reserves*

A second characteristic of the present system (or nonsystem?) of world reserve creation is also the exact opposite of the proclaimed goal of our official authorities and of plain common sense. Economic logic as well as human concerns would require capital flows to move from the richer and more capitalized countries toward the poorer and less capitalized countries, in order to accelerate their development and to enable them to finance levels of consumption indispensable to the very survival of their people. This objective is indeed untiringly reaffirmed in pious United Nations resolutions, but in the sector most susceptible of being oriented by responsible officials, i.e., the creation and investment of international monetary reserves, the present system leads to the opposite result: the financing of the richer and more heavily capitalized countries by poorer, capital-short countries.

This comes out clearly from the estimates summarized in Table 2.[4]

[4]The net reserve estimates on line III differ from those shown in Table 1 by the amount of IMF gold holdings, unassignable regionally.

Table 2
Sources and Regional Distribution of Net International Monetary Reserves:1969–1983
(SDR or $ billions)

	End of 1969	End of 1983		Changes over Years 1970–1983				
				Total	Transactions	Impact of Gold Price and Exchange Rate Fluctuations		
	(a)[1]	(b)[1]	(c)[2]	(d=c−a=e+f)	(e=b−a)	Total (f=g+h)	Gold Price (g)	$–SDR Exchange Rate (h)
I. Countries Gold	39	36	396	357	−2	359	342	19
United States	12	9	100	89	−3	91	87	5
Other Industrial Countries	21	22	235	214	1	213	202	11
Nonindustrial Countries:	6	6	60	55	–	55	52	3
Oil Exporting	1	1	16	15	–	15	14	1
Other	4	4	44	40	–	41	39	2
II. Credit Reserves	2	2	2	1	1	–	x	–
United States	−14	−171	−180	−166	−158	−8	x	−8
Other Industrial Countries	2	45	47	45	43	2	x	2
Nonindustrial Countries:	13	129	135	122	116	6	x	6
Oil Exporting	3	73	76	73	70	4	x	4
Other	10	56	59	49	46	3	x	3
A. Foreign Exchange	x	x	x	x	x	x	x	x
United States	−15	−182	−191	−176	−167	−9	x	−9
Other Industrial Countries:	2	33	35	33	31	2	x	2
Nonindustrial Countries:	13	149	156	143	136	7	x	7
Oil Exporting	3	62	65	62	59	3	x	3
Other	11	87	92	81	77	4	x	4
B. Concerted Reserves	2	2	2	1	1	–	x	–
United States	1	11	11	10	9	1	x	1
Other Industrial Countries	1	12	13	12	11	1	x	1
Nonindustrial Countries:	–	−20	−21	−21	−20	−1	x	−1
Oil Exporting	–	11	11	11	11	–	x	1
Other	−1	−31	−33	−32	−31	−2	x	−2

[1]Measured in SDRs = dollars at constant gold price of $35 per ounce.
[2]Measured in dollars at market gold prices and $–SDR exchange rates.
Source: Calculated from *International Financial Statistics, Yearbook 1983*, pp. 25–53; and March 1984, pp. 28–43; and *Federal Reserve Bulletin* for U.S. foreign-exchange liabilities.

Table 2 (continued)
Sources and Regional Distribution of Net International Monetary Reserves:1969–1983
(SDR or $ billions)

	End of 1969	End of 1983		Changes over Years 1970–1983				
				Total	Transactions	Impact of Gold Price and Exchange Rate Fluctuations		
	(a)[1]	(b)[1]	(c)[2]	(d = c − a = e + f)	(e = b − a)	Total (f = g + h)	Gold Price (g)	$–SDR Exchange Rate (h)
III Total Net Reserves	40	39	398	358	−2	360	342	19
United States	−2	−162	−79	−77	−160	83	87	−4
Other Industrial Countries	23	66	282	259	43	216	202	13
Nonindustrial Countries:	19	134	195	177	116	61	52	9
Oil Exporting	4	74	92	87	71	18	14	4
Other	15	60	103	88	46	43	39	5

[1]Measured in SDRs = dollars at constant gold price of $35 per ounce.
[2]Measured in dollars at market gold prices and $–SDR exchange rates.
Source: Calculated from *International Financial Statistics, Yearbook 1983,* pp. 25–53; and March 1984, pp. 28–43; and *Federal Reserve Bulletin* for U.S. foreign-exchange liabilities.

a) *Measured at constant gold prices and $-SDR exchange rates,* the United States emerges, at the end of 1983, as a net reserve *debtor* of $162 billion and other countries as net reserve *creditors* of $200 billion, the $38 billion difference between world claims and debts being accounted for by countries' gold reserves ($36 billion) and an insignificant amount of net reserve claims on the IMF. (See lines III, I and IIB of the third column, and for transaction changes from the end of 1969 to the end of 1983, the same lines of the fifth column.) This is, once again, due entirely to the constellation of foreign exchange accounts, in which the rest of the world had accumulated net claims of $182 billion on the United States, as against $15 billion in 1969. (See line IIA of the same columns.)

It should also be noted that the relatively richer industrial countries were the smallest net creditors, the largest being the nonindustrial, non-oil exporting countries of the Third World.

As for the countries' gold reserves of $36 billion, practically unchanged in volume over this period, nearly 85 percent of them were held by the industrial countries (25 percent by the United States and 59 percent by the other industrial countries) and only 15 percent by the nonindustrial countries.

b) *Fluctuations of exchange rates, and particularly of gold prices* mostly benefited the United States and the other industrial countries: they reduced by $83 billion—from $162 billion to $79 billion—the net reserve debt of the United States, and increased by $216 billion—from $66 billion to $282 billion—the net reserve claims of the other industrial countries. All in all, 83 percent of the $360 billion of net reserve increases—due entirely to these fluctuations—accrued to the industrial countries, and only 17 percent to the nonindustrial countries.

c) As mentioned, *concerted credit creation* had only an insignificant impact on net reserves. Appendix Tables A1 and A2 provide more information in this respect. Note that the industrial countries received two-thirds ($15 billion) of total SDR allocations ($22.4 billion), and the nonindustrial countries only one-third ($7.3 billion), but that the IMF increased its lending to the nonindustrial countries from only $1 billion in 1969 to $31 billion in 1983, while its loans of $4 billion to the industrial countries were repaid practically in their entirety.

4. *Impact upon U.S. Reserves*

The impact of this method (?) of reserve creation upon the net reserves of the United States *made*, of course, *impossible* as I had predicted to the U.S. Congress in 1959, *the preservation of the gold convertibility of the dollar* at $35 per ounce and of its parity with the SDR. Net U.S. reserves fell dramatically from *plus* $23 billion at the end of 1949 to *minus* $24 billion at the end of June 1971, and the convertibility of the dollar, at a fixed price or exchange rate, into gold or any foreign currency was "temporarily" suspended on August 15, 1971.

The evolution of world reserves, measured at $ market prices and exchange rates, has been practically determined ever since, as already noted above, by the wild fluctuations of the $-SDR exchange rate, but particularly of the price of gold. A peak of $850 per ounce (more than *24 times* its theoretical par of $35 per ounce) was briefly reached on January 21, 1980 and followed by a *decline of nearly two-thirds* to less than $300 per ounce in mid 1982, with considerable up and down movements, bringing it, for example, to $456.90 at the end of 1982 and $381.50 at the end of 1983.

Bizarrely at first view—and certainly unforeseen by me in my 1959 forecast to the U.S. Congress—this did not slow down the accumulation of dollars by foreign central banks. Their foreign exchange claims on the United States rose indeed by 10 times as much—from $18 billion in 1969 to $191 billion in 1983—in 14 years as in all preceding years. Being able to settle their deficits in dollars, the U.S. monetary authorities retained only an insignificant portion of these inflows in foreign exchange reserves. (See the U.S. lines in the "Foreign Exchange" columns of Appendix Table A2.)

They were, instead, "recycled" abroad by commercial banks. To understand this process, turn to Table 3, which summarizes the evolution of the U.S. international investment position over the years 1949–82.[5] As indicated in the footnotes to Appendix Table A4, these estimates must be taken with several bags, rather than grains, of salt. Their broad order of magnitude remains, however, highly significant.

[5]These estimates differ slightly from those of Table 2 above and of Appendix Tables A3 and A4, because they do not include the foreign exchange liabilities of foreign branches of U.S. banks to official institutions.

Table 3
The International Investment Position of the United States: 1949–1982
($ billions)

	End of Year				Average Yearly Flows				Year
	1949	1969	1978	1982	1950-69	1970-82	1970-78	1979-82	1982
I. LIABILITIES (−)	−20	−103	−387	−804	−4	−54	−32	−104	−146
A. Money Market to:	−7	−49	−263	−450	−2	−31	−24	−47	−80
1. Official Institutions	−3	−19	−176	−195	−1	−14	−17	−5	−8
2. Other	−4	−30	−87	−255	−1	−17	−6	−42	−72
B. Other	−13	−54	−124	−354	−2	−23	−8	−57	−67
1. excluding Statistical Discrepancy	−8	−51	−112	−221	−2	−13	−7	−27	−25
a) Direct Investments	−3	−12	−42	−102	−	−7	−3	−15	−11
b) Portfolio Investments	−3	−32	−54	−93	−2	−5	−2	−10	−18
c) of U.S. Nonbanking Concerns	−3	−7	−16	−26	−	−2	−1	−2	+4
2. Statistical Discrepancy	−5	−3	−12	−133	−	−10	−1	−30	−41
II. ASSETS	54	159	448	834	+5	+52	+33	+97	+117
A. Excluding Foreign Aid	43	128	394	760	+4	+49	+30	+92	+112
1. Money Market:	27	30	150	436	−	+31	+13	+72	+113
a) Official Reserves	26	17	19	34	−	+1	−	+4	+4
b) Bank Claims	1	13	131	402	+1	+30	+13	+68	+109
2. Other	16	98	244	324	+4	+17	+16	+20	−1
1) Direct Investments	11	71	163	221	+3	+12	+10	+15	−5
2) Portfolio Investments	4	19	53	75	+1	+4	+4	+5	+12
3) of U.S. Nonbanking Concerns	1	8	28	27	−	+2	+2	−	−9
B. Foreign Aid	11	31	54	74	+1	+3	+3	+5	+6
III. NET ASSETS	+34	+56	+61	+30	+1	−2	+1	−8	−29
A. Excluding Foreign Aid	+23	+25	+7	−44	−	−5	−2	−13	−34
1. Money Market	+21	−19	−113	−14	−2	−	−10	+25	+34
a) Official Reserves	+23	−2	−157	−161	−1	−12	−17	−1	−4
b) Other	−2	−17	+44	+147	−1	+13	+7	+26	+38
2. Other	+2	+44	+120	−30	+2	−6	+8	−38	−68
a) excluding Statistical Discrepancy	+7	+47	+132	+103	+2	+4	+10	−7	−27

Table 3 (continued)
The International Investment Position of the United States: 1949–1982
($ billions)

	End of Year				Average Yearly Flows				Year
	1949	1969	1978	1982	1950-69	1970-82	1970-78	1979-82	1982
1) Direct Investments	+8	+59	+120	+119	+3	+5	+7	–	−16
2) *Portfolio Investments*	+1	−13	–	18	−1	–	+2	−4	−6
3) of U.S. Nonbanking Concerns	−2	+1	+12	+2	–	–	+1	−3	−5
b) Statistical Discrepancy	−5	−3	−12	−133	–	−10	−1	−30	−41
B. Foreign Aid	+11	+31	+54	+74	+1	+3	+3	+5	+6

Sources: See Appendix Table A4

Net Assets (line III) are relatively minor thoughout, and far less significant than *gross* assets and liabilities, except that their minor size shows that the United States is not using foreign capital inflows to finance domestic consumption and investments. It "recycles" them nearly entirely abroad, thus financing the mounting balance of payments deficits of industrial as well as of Third World countries. The acceptance of the dollar by foreign countries as the major so-called "parallel currency" of the world enables it to play the role of "world banker," just as the previous acceptance of sterling in the same role enabled the United Kingdom to be the main "world banker" of the XIXth century and of the early interwar period, until the collapse of the pound in 1931.

The table begins with liabilities (line I) rather than assets, because their enormous and persistent increase is primarily due to this world currency role of the dollar, and is the major explanation of the ability of the United States to increase its assets abroad approximately on the same scale, by about $52 billion a year in the 1970–82 period, with a peak of $117 billion in 1982 (line II).

Lines IIA and IIIA exclude foreign aid assets, held mostly on the countries of the Third World, more akin in fact to "grants" than to real assets, and unusable to support the dollar rate on the exchange markets of the world vis-à-vis its main rival currencies, such as the mark, the Swiss franc and the yen.

The breakdown of assets and liabilities between "money market" (line 1) and "other" (line 2) stresses the difference between the transactions of financial intermediaries (mainly central and commercial banks, and the U.S. Treasury) and those of the "customers" financed by them. Money market assets are the sum of official monetary reserves and commercial banks' claims on foreigners. Money market liabilities are the sum of foreign official assets in the United States and of the U.S. Treasury securities and the other liabilities reported by U.S. banks. To facilitate reconciliation with standard estimates of the U.S. balance of payments, however, I have included under these money market liabilities the small amounts of "contingent" liabilities arising from SDR allocations, and of Treasury securities and bank claims held by nonbanks as well as banks. "Other" (than money market) assets and liabilities (on line 2) are the total of all other foreign assets and liabilities. They used to be mostly the sum of direct and portfolio investments, and of relatively small amounts of assets and liabilities reported by nonbanking concerns and of errors and omissions. These errors and omissions, however,—now relabelled "statistical discrepancy"—rose by $121 billion in the last four years to a cumulative total of $133 billion. It is generally agreed that they are in fact unrecorded inflows of speculative capital, but a minor portion of them—which I have not hazarded to guesstimate—might be deducted as due instead to unrecorded current account receipts.

One may derive from these Table 3 estimates a number of observations highly relevant both analytically and politically:

a) Note first the striking contrast between the 1950–69 and the 1970–78 capital inflows and outflows. The increases of liabilities over the years 1950–69 were relatively modest in size, averaging less than $5 billion a

year. Yet, their persistence was regarded as sufficiently worrisome both by the United States and by other countries to induce them to launch ambitious negotiations aiming at fundamental reforms of the "gold-exchange standard," or rather *"gold-convertible dollar standard,"* enshrined in the Bretton Woods Agreement. The abortion of these negotiations inexorably led to the 1971 collapse of the system.

b) These inflows and outflows were dramatically magnified—more than 10 times—over the following years:
   1) Capital inflows (the liabilities on line I) totaled more than $700 billion from 1970 through 1982, their yearly average rising from $32 billion in 1970–78 to $104 billion in 1979–82, and reaching a peak of $146 billion in 1982 alone;
   2) The bulk of these inflows were recycled abroad (see the assets' increases on line II), mostly by commercial banks whose foreign claims rose from a paltry $13 billion at the end of 1969 to more than $400 billion at the end of 1982, at an annual rate rising from $13 billion over the years 1970–78 to $68 billion in the following four years, including again a peak of nearly $110 billion in 1982 alone (line IIA 1, b).

c) The breakdown of these global capital movements between "money market" transactions (line 1) and "other" transactions (line 2) exhibits some sharp contrasts which explain the dramatic reversal of the dollar exchange rate from an *overdepreciation* until the end of the 1970s to an *overappreciation* in the following four years (see Section 5 below):
   1) "Other" (than financial intermediaries) net capital transactions, i.e., direct and portfolio investments, other nonbank capital transactions, and errors and omissions, switched from net *outflows* of $76 billion in 1970–78 to net *inflows* of $150 billion in 1979–82, average *outflows* of $8 billion a year being followed by average *inflows* of $38 billion, peaking to $68 billion in 1982 (line IIIA2).[6]
   2) This switch in customers' transactions, from outflows to inflows, was accompanied and partly financed by an opposite switch in money market net transactions from average *inflows* of $10 billion a year to average *outflows* of $25 billion, including peak outflows of $34 billion in 1982 (line IIIA, 1). Foreign countries' net assets in the U.S. money market, which had *risen* by $94 billion, from $19 billion at the end of 1969 to $113 billion at the end of 1978, have *dropped* precipitously since then by $99 billion to only $14 billion at the end of 1982. The continuation of this trend would require that the U.S. monetary authorities and com-

[6]These $38 billion and $68 billion capital inflow estimates would be reduced only moderately to about $30 billion and $50 billion respectively if one follows the suggestion of the Morgan Guaranty *World Financial Markets* (February 1984, p. 3) to attribute to the overestimation of the U.S. current account deficit, rather than to unrecorded capital inflows, one-fifth of the huge asymmetry in the published current account transactions for the world as a whole shown in the 1983 *Balance of Payments Statistics* of the IMF, volume 34 Yearbook, Part 2 p. xii.

mercial banks increase year after year their net lending to the rest of the world, and that other countries accept an annual increase in their net debt to the U.S. money market in order to finance their other, unrequited capital exports to it.

5. *Disequilibrating Impact of the "Dollar Exchange Standard" upon Nominal and Real Exchange Rates.*

a) The "gold convertible dollar-exchange standard" enshrined in the Bretton Woods system and the "inconvertible paper-dollar standard" which succeeded it both preserved the ability of the United States to escape very largely the balance of payments discipline normally imposed upon countries incurring persistent deficits on overall (current and capital) account. The gradual depletion of international monetary reserves entailed by such deficits forces these countries to accept, sooner or later, a readjustment of their "nominal" exchange rates, restoring the competitiveness of their currency in world trade.

Foreign deficits do not, however, impose such a readjustment on a country whose *national currency* is accepted by foreigners as a parallel *world currency*. The United States experienced *net* reserve losses of $25 billion between 1949 and 1969, (the first two columns of Table 3, line III A1,a) by increasing its reserve liabilities by $16 billion (line IA1) and losing only $9 billion of its gross reserve assets (line IIA1,a).

The growing overvaluation of a stable dollar rate finally led to its depreciation, and even overdepreciation, over the following years, its rate vis-à-vis the German mark, for instance, falling by 57 percent (from 4.00 to 1.7315 marks per $) between the inception of floating rates in September 1969 and the end of 1979. This was, however, followed by a spectacular 62 percent appreciation to an obviously overvalued rate of 2.8113 marks per $ in the closing days of January 1984 (still 30 percent below its 1969 rate).[7]

b) This renewed overvaluation of the dollar—estimated, or "guesstimated" at 32 percent in the January 1984 *Report of the Council of Economic Advisers*—emerges clearly from an even cursory examination of the U.S. balance of payment and capital investment estimates summarized in Table 4.

[7]These enormous fluctuations are, of course, drastically curtailed when attention is centered on a so-called "effective rate," averaging the dollar rate vis-à-vis a large number of currencies, including those of all the industrial or OECD countries, or those of an even larger number of countries including many less developed countries. This is of little relevance, however, to exchange market transactors interested only in the choice between the dollar and the few currencies able to appreciate in relation to it.

Table 4
Changes in $ Exchange Rates (in %) and in U.S. Foreign Income and Capital Accounts: 1950–1983 (average yearly flows, in $ billions)

	1950–82	1950–69	1970–82	1970–78	1979–82	Year 1982	Year 1983
I. $ Fluctuations (in %) vis-à-vis:							
German mark	−43	−5	−41	−54	+30	+5	+15
Swiss franc	−54	−	−54	−63	+23	+11	+11
Japanese yen	−35	−	−35	−46	+21	+7	−1
Gold	−98	−	−98	−85	−51	+20	+17
II. Income Accounts Balance[1]	+5	+6	+4	+5	+3	−5	−34
A. Earnings on Past Investments	+9	+4	+18	+13	+30	+27	+24
B. Other Current Transactions[1]	−4	+2	−14	−8	−27	−32	−58
III. Economic and Military Grants (−)	−4	−4	−5	−5	−5	−6	−7
IV. Valuation and Coverage Adjustments to Capital Accounts	−1	−1	−1	+1	−6	−18	n.a.
V. Adjusted Capital Accounts Balance[2] = II − (III + IV) = A + B	−	+1	−2	+1	−8	−29	−41
A. Foreign Aid Assets	+2	+1	+3	+3	+5	+6	+5
B. Other Net Assets	−2	−	−5	−2	−13	−34	−46
1. Money Market	−1	−2	−	−10	+25	+34	−40
2. Other	−1	+2	−6	+8	−38	−68	−6

[1]Including exports financed by economic *and military* grants.
[2]1983 estimates do not include valuation and coverage adjustments, not yet reported.
Source: See Appendix Tables A3 and A4

The huge fluctuations of the $ exchange rates vis-à-vis its main rival currencies, recorded under line I, obviously bear little or no relationship to the minor fluctuations of the U.S. *income accounts* balance, recorded on line II.[8] They are, instead, closely related to the huge fluctuations of the adjusted net capital accounts recorded on line VB2, i.e., excluding foreign aid and the money market financing of clients' capital transactions by financial intermediaries.

Three successive phases mark the 33 years covered by these estimates:

1) The dollar remained relatively stable over the 20 years from the end of 1949 to the closing months of 1969, the net yearly average of capital exports of banks' clients (line VB2) being approximately financed by the $ accumulation of financial intermediaries (line VB1). Yet, this continued accumulation, totaling $40 billion over the period as a whole, was regarded as excessive by foreign creditor countries, moving them to cease their unquestioned support of the dollar on the exchange market. Floating rates were adopted by more and more countries, and became the norm, rather than the exception, in March 1973.
2) The huge depreciation of the dollar in the following years is explained by the quadrupling of the yearly average of net capital exports from the United States, which passed from $2 billion to $8 billion (2nd and 4th columns of line VB2).
3) Its spectacular recovery over the years 1979–82 is due to the reversal of these movements. Capital *outflows* totaling $74 billion ($8 billion a year) were followed by *inflows* totaling $150 billion ($38 billion a year), including peak inflows of $68 billion in 1982.

   These outflows and inflows were largely financed—or even overfinanced at first—by opposite inflows and outflows of money market transactions, reducing in part the overappreciation of the dollar exchange rate.

c) Contrary to most economists' forecasts—including my own—this overappreciation continued, even more steeply, throughout 1983, reaching a peak in the first months of 1984. The impact of this overappreciation—undercompetitiveness—has been enormous. The current account balance of the United States, as usually measured by the *Survey of Current Business*, deteriorated from *minus* $11 billion in 1982 to *minus* $41 billion in 1983 and is officially forecast to reach *minus* $80 billion this year. The merchandise balance moved from *minus* $36 billion in 1982 to *minus* $61 billion last year and is officially forecast at *minus* $110 billion this year (see Synopsis Table C above). This is clearly untenable for U.S. firms exposed to foreign competition at home as well as abroad. It is unleashing enormous pressures for protectionist restrictions, mostly resisted so far by the Administration. Such measures might reduce imports, but not exports,

[8]Nor to those of the current account balance as usually defined, i.e., excluding exports financed by economic and military grants.

which would decline even further, on the contrary, as a result of foreign retaliation.

All policymakers thus pray for substantial declines in the dollar rate vis-à-vis the German mark, the yen, the Swiss franc, etc., essential to restore U.S. competitiveness in world trade. But when and how? Barring massive official interventions in the exchange market (on a scale hardly to be expected from either the United States or foreign countries), the only possible answer lies in a reversal of the speculative capital flows which still push the dollar upward under today's floating exchange rate system.

The likelihood and timing of such a reversal obviously depend on an abatement of the capital flows' root causes. What are they?

1) The one most frequently mentioned, and deplored, is the high level of interest rates flowing from record fiscal deficits and low savings in the United States, combined with the reluctance of the Federal Reserve to finance the former through inflationary levels of money creation.
2) As, or more, important are the fears of a third world war unleashed by the Iranian revolution and other political and military crises in the Middle East, Poland, and Central America. These fears have moved huge amounts of refugee capital from European havens to the United States.
3) A third cause is the initial confidence in President Reagan's proclaimed determination to combat inflation, and in his ability to do so more successfully than other countries. Capital will continue, of course, to move out of scores of inflationary countries, but need not for that reason move only toward the United States. A few other countries, such as Germany and Switzerland, may recover their traditional attractiveness in this respect, in view of both the current success of their anti-inflationary policies and, most of all, the unanimously forecast appreciation of their currencies vis-à-vis the dollar.

I would conclude that the two most durable factors in the continuing appreciation of the dollar on the exchange market are the fears of a third world war and the interest rate differentials between the United States and other major money markets. Nevertheless, net capital outflows from an increasing number of weaker countries are bound to dry up, in view of the near-exhaustion of the previously accumulated reserves and borrowing capacity of these countries. Even in those countries still able to sustain outflows, they contribute to stagflation (a) because of excessive rates of currency depreciation and consequent price increases, and (b) because investments in the United States compete with domestic investments, thereby reducing economic activity and employment at home. Some economists and policymakers therefore advocate capital controls. But their successful implementation would require joint action by several major countries, and the idea meets with obvious opposition from influential financial circles, and widespread skepticism about their feasibility.

If I were forced to hazard a reluctant guess, two reasons would incline me to foresee that the generally desired depreciation of a vastly overvalued dollar may not be too far off.

The first reason is the drying up of the OPEC surpluses which contributed so hugely to the flood of foreign capital to the United States following the two explosions of oil prices. These surpluses dropped from $65 billion in 1981 to $18 billion in 1982, and switched into rising deficits last year, mainly because of lower oil prices and the curtailment of production, aimed at avoiding even steeper price declines.

The second reason is the continued likelihood of a banking crisis. U.S. bank claims abroad totaled more than $400 billion at the end of 1982, and were still rising in 1983, although at a sharply reduced annual rate of only $25 billion compared to more than $109 billion in 1982. A substantial portion of these claims is held in countries such as Mexico, Brazil, Argentina, and a large number of others whose liquidity, if not solvency, raises increasing concern today. The exposure of other countries' banks to debtors' default— open or concealed in various ways—is also disquieting, although in a lesser degree.

Renewed exchange crises of serious magnitude thus loom on the horizon and might strengthen the incipient, but spectacular, interest now shown by the market for ECU investments as an important adjunct and alternative to dollar investments. This brings me to the second part of my paper: the prospects for the ECU in the European and in the world monetary system of tomorrow.

II. An ECU-Anchored European Monetary Area as Harbinger of a Decentralized World Monetary System

1. *Introductory Remarks*

The creation of the *European Monetary System (EMS)* was prompted by two very different, but converging, objectives:

1. in the short run, the desire to make the national economies of the member countries of the European Community less dependent on the vagaries of an unstable paper dollar;
2. in the longer run, the desire to progress toward a full economic, monetary, and therefore political union of the Community.

Three successive sessions of the *European Council* of the Heads of State or Governments—at Copenhagen, on April 7th and 8th, at Bremen, on July 6th and 7th, and at Brussels, on December 4th and 5th—defined the broad lines of the initial system put into operation on March 13, 1979. Its later evolution, however, was referred to only very briefly in Annex 5 to the "Conclusions of the Presidency of the European Council" at Bremen,[9] and the paragraph A14 of the "Resolution of the European Council" at Brussels,[10] foreseeing the creation, within two years, of a *European*

[9]"Not later than two years after the start of the scheme, the existing arrangements and institutions will be consolidated in a European Monetary Fund."

[10]"We remain firmly resolved to consolidate, not later than two years after the start of the scheme, into a final system the provisions and procedures thus created. The system will entail the creation of a European Monetary Fund...as well as the full utilization of the ECU as a reserve asset and a means of settlement."

Monetary Fund. The implementation of this decision was, moreover, relegated to "an opportune moment" by the European Council held at Luxembourg in December 1980.

This might confirm the pessimism of those who regard the European monetary system as a "tombstone" rather than a "cornerstone." History teaches us, however that the most crucial reforms of the *international* monetary systems as well as of *national* monetary systems, have already been determined, with very rare exceptions, by the private sector of the economy rather than by the governments and their bureaucracies.

On the national level, for instance, the replacement of gold and silver moneys by fiduciary money cannot be credited—or debited?—to official initiatives, such as the French "assignats," soon bound to bankruptcy, but to the spectacular development of currency notes and bank deposits in the XIXth century. By 1913 these constituted about 85 percent of world money supplies, but it took another 35 years for the French and Italian monetary authorities, for instance, to include checking deposits in their official monetary statistics.

As for the international monetary system, the *gold standard* originated in England from a 1696 law aiming to consolidate the *silver standard*, but at an official rate overvaluing gold in relation to silver and making silver, therefore, more attractive as a commodity than as circulating money. Similarly, the collapse of the Bretton Woods *gold exchange standard* was certainly not intended by the authorities. When they belatedly resigned themselves to debate reforming a system whose breakdown had become unavoidable, they repeatedly proclaimed that they would examine all possible reforms, except two: fluctuating exchange rates and any change in the price of gold. They unanimously regarded the stability of exchange rates and of the price of gold—at *$35 per ounce*—as the two unshakable pillars of any international monetary system, present or future! Any comments would be superfluous and unkind.

I shall therefore turn to market developments as a better guide to the forecasting of an uncertain future, and to any policy that may reverse the disastrous course of events in which we have all been engulfed for more than a decade already.

2. *Spectacular Growth of ECU Transactions in the Private Market*

The first years of the 1980s decade have witnessed a spectacular growth in the private use of the ECU, overtaking and stimulating the slower progress of the official authorities toward its development, not only as a unit of account, but as a full "parallel" currency in international settlements, investments, and working balances, outside as well as within the European Community.

Currency speculators will of course continue to prefer a basket of their own making, centered on the currency, or currencies, which they expect to appreciate, and excluding those which they expect to depreciate. Exchange gains or losses may be largely offset, however, or more than offset, by interest rate differentials. There were no exchange rate realignments, for instance, in

the second half of 1983, and the slight appreciation of the mark on the market (0.3 percent) was far more than offset by interest rate differentials of about 4 percent a year between one month ECU and one month mark deposits.

Even more important, of course, is the fact that speculators trusting their own judgment or that of their advisers lost heavily on their dollar investments over the years 1971–78, and on their Swiss franc or German mark investments in the following years.

Dollar investments have certainly proved far more remunerative than ECU investments over the last few years, but the opposite seems probable in the near future, since the forecast depreciation of an overvalued dollar far exceeds in percentage terms any chances of further appreciation, except in the event of a third world war. The ECU should, therefore, be far more attractive to all risk-averters, and particularly to company treasurers whose exchange losses expose them to far greater criticism from their boards and shareholders than their failure to maximize exchange gains.

This explains the fast growing use of the ECU in the Eurobond and Euromoney markets.

ECU flotations on the Eurobond market have grown from a mere 224 million in 1981 to more than 2,600 million in 1983 and a yearly rate of 3,600 million in the first quarter of this year. They totaled about 4.7 billion by the end of 1983 and 5.6 billion in March 1984. The ECU share in public market flotations is still extremely modest, but has risen more than 14 times over three years, passing from 0.3 percent in 1980 to 4.8 percent in the first quarter of 1984, and from 8th to 3rd place, immediately after the dollar (80 percent) and only insignificantly below the German mark (4.8 percent).[11]

[11]See Tables 5 and 6; and the monthly articles of Pierre Guimbretiere in *Eurépargne* (Luxembourg) 1984.

Table 5
ECU Bond Issues: 1981 – March 1984

	World Total	Within EEC						Outside EEC				
		Total	Institutions	Countries				Total	Canada	U.S.	Japan	Other[2]
				Total	Italy	France	Other[1]					
Number of Issues:												
Period: 1981	6	5	3	2	2	–	–	1	1	–	–	–
1982	*17*	*13*	*3*	*10*	*3*	*7*	–	*4*	*1*	*1*	–	*2*
1983	36	25	7	18	1	9	8	11	1	1	2	7
1984 January–March	16	8	3	5	–	2	3	8	1	3	1	3
Yearly rate	(64)	(32)	(12)	(20)	–	(8)	(12)	(32)	(4)	(12)	(4)	(12)
Cumulative, end of: 1981	6	5	3	2	2	–	–	1	1	–	–	–
1982	23	18	6	12	5	7	–	5	2	1	–	2
1983	59	43	13	30	6	16	8	16	3	2	2	9
March 1984	75	51	16	35	6	18	11	24	4	5	3	12
Amounts (ECU millions)												
Period: 1981	244	204	139	65	65	–	–	40	40	–	–	–
1982	1,810	1,690	150	1,540	1,240	300	–	120	50	15	–	55
1983	2,607	2,042	550	1,492	600	587	305	565	50	40	80	395
1984 January–March	906	545	210	335	–	110	225	361	85	96	40	140
Yearly rate	(3,624)	(2,180)	(840)	(1,340)	–	(440)	(900)	(1,444)	(340)	(384)	(160)	(560)
Cumulative, end of: 1981	*244*	*204*	*139*	*65*	*65*	–	–	*40*	*40*	–	–	–
1982	2,054	1,894	289	1,605	1,305	300	–	160	90	15	–	55
1983	4,661	3,936	839	3,097	1,905	887	305	725	140	55	80	450
March 1984	5,567	4,481	1,049	3,432	1,905	997	530	1,086	225	151	120	590

[1]The Netherlands, United Kingdom, Ireland, Denmark, Belgium, Germany.
[2]World Bank, Council of Europe, Sweden, Australia, South Africa.
Source: *ECU Newsletter*, No. 1–8, February 1982–March 1984, Istituto Bancario San Paolo di Torino.

Table 6
Currency Denomination of Euro-bond Issues (%)

Year	SDR	ECU[1]	U.S. Dollar	Deutsch-mark	British Pound	Other Currencies
1980	0.2	0.3	68.5	15.0	4.1	11.9
1981	1.4	1.0	84.9	4.0	1.6	7.1
1982	0	3.8	85.1	5.0	1.4	4.6
1983	0	4.2	79.2	7.9	4.0	4.7
Jan.-March 1984	0	4.8	80.3	4.8	7.0	3.0

[1]Former equivalent "Unit of Account" in 1980.
Source: *World Financial Markets*, March 1984, p. 11

Bank and savings deposits in ECU are fast growing in number (several thousands) and amount, and bank loans denominated in ECU were estimated to total about 10 billion ECUs at the end of 1983. A bank syndicate has just announced that the setting-up of a company to issue travelers checks in ECU is now at hand. A number of multinational firms have also started to use the ECU for the denomination of their internal accounts and external contracts. International insurance, airline, and shipping firms are particularly attracted by the use of the ECU in their operations.

ECU settlements were initially handicapped by the fact that actual drawings by the payer could take place only in national currencies that had to be reconverted into ECU by the payee, unnecessarily entailing a double series of exchange costs on the transaction. A number of major banks have now overcome this handicap by opening mutual settlement accounts for the clearing of ECU transactions among themselves and for correspondent banks.

A further major step is expected to be taken within a few months with the organization of a broader clearing structure, under the prestigious and impartial aegis of the Bank for International Settlements acting as agent for a larger number of clearing banks.[12]

3. *Prospective Evolution of the EMS towards Economic and Monetary Union*

The ultimate fulfillment of repeated summit meetings' promises of an *Economic and Monetary Union* of the European Community countries can only be deemed a distant hope at best. As long as member countries fail to harmonize their inflation rates, exchange rate realignments will remain unavoidable between the stronger and the weaker currencies, as the only way to preserve the minimum goals of free trade for manufacturers and of a still imperfect common market for agriculture within the customs union of the

[12]See particularly the papers on the private use of the ECU, in a debate that took place in Paris, June 10, 1983, under the sponsorship of the "Groupement pour la Coopération Monétaire Européene," and the address by A.L. Swings on "ECU and SDR Banking Practices, Yesterday, Today and Tomorrow" at the Conference on Composite Currencies, Financing, Accounting and Invoicing, London, 26-27 April, 1983.

Community.

Progress toward a fuller use of the ECU in the Eurocurrency market, in which European banks now hold the equivalent of about $850 billion to $900 billion (thousand million) of assets and liabilities in currencies other than their national currencies, should however elicit enthusiastic support from all sides of the political spectrum. The anti-European nationalists obdurately oppose, of course, the substitution of the ECU for their national currency in *domestic* transactions, but would be delighted to see it replace foreign currencies, such as the dollar, the Swiss franc, the mark, etc., in *international* accounts and transactions.

The economic arguments for the further development of a European Monetary System anchored on the ECU rather than on the wildly fluctuating paper dollar are even more incontrovertible. Since you might deem me to be biased in this respect, let me quote from a recent lecture of Professor Henry C. Wallich, member of the Board of Governors of the Federal Reserve System:[13]

> As an example of monetary-policy cooperation, this [the EMS] is at least a partial success story and, unfortunately, one of the not many that I have been able to refer to in this paper....
>
> In a world in which exchange-rate movements have become extremely large, movements within the EMS have remained small relative to fluctuations of outside currencies. While outside currencies have over- and undershot purchasing-power-parity levels by wide margins, relative purchasing-power parity has been very roughly maintained in the EMS. And while outside currencies have often experienced sharp reversals, movements within the EMS have generally been in the direction of better adjustment, and without reversals except for some recent small revaluations of previously devalued currencies....
>
> While the EMS currencies have not enjoyed the complete stability that some expected of the system, they have had the relative stability of a moderately predictable jumping peg, with respect to each other. Contrasted with the wide moves against outside currencies and among those outside currencies, there may have been benefits from this form of "stability."

The eight exchange rate realignments that have intervened so far between member currencies have all been agreed to jointly, as is made *operationally* imperative and unavoidable by the fact that any currency appreciation or depreciation is expressed in relation to the ECU basket, i.e., to a weighted *average* of all the member currencies of the system. None can appreciate, therefore, or depreciate, in terms of this average, without simultaneous depreciation, or appreciation, of some other. Moreover, these realignment agreements have not merely endorsed—as used to be the case in the IMF—the initial request of the country wishing for a change in its own exchange rate. They have often been modified and influenced by the views of the partner countries desirous to minimize—or, occasionally enlarge—the scope of these realignments.

[13] "Institutional Cooperation in the World Economy," University of Chicago, May 5th, 1983.

A greater contrast could hardly be imagined between these concerted readjustments, on the one hand, and on the other the erratic, daily, fluctuations of the dollar—and other nonmember currencies—most often prompted by speculative capital movements; and in which offsetting or aggravating official interventions by the authorities, if any, rarely reflect joint Community decisions. This is bound to be a major political argument favoring a further strengthening of the present EMS.

Tables 7 and 8 document Governor Wallich's observations about the comparative fluctuations of "nominal" and "real" exchange rates, within and outside the EMS. Table 7 shows that fluctuations of members' currencies vis-à-vis the ECU have been a mere fraction of the corresponding fluctuations of nonmember currencies. The first two lines of Table 8 show that "nominal" exchange rate fluctuations within the EMS have largely offset divergencies in inflation rates, thus preserving a remarkable stability between "real" (competitive) exchange rates, or restoring it for the Belgian franc and the Italian lira. (The franc entered the system in March 1979 at an obviously overvalued or undercompetitive rate, and the lira at an undervalued or overcompetitive one.)

Table 7
Cumulative Exchange Rate Appreciation (+) or Depreciation (−) vis-à-vis the ECU since March 13, 1979 (in percent)

	1979		1981		1982		1983	
	Sept. 24	Nov. 30	March 23	Oct. 5	Feb. 22	June 14	March 21	May 18
SDR	−2.59	−3.82	+6.75	+11.15	+15.56	+18.42	+21.81	+23.72
U.S. Dollar	−4.21	−5.35	+11.42	+23.80	+30.82	+38.15	+45.02	+46.92
Japanese Yen	−10.14	−20.79	+11.42	+12.98	+17.31	+15.37	+26.66	+31.91
German Mark	+1.01	+1.15	−1.35	+4.18	+3.82	+7.58	+13.34	+11.99
French Franc	−0.97	−0.83	−3.29	−6.09	−6.41	−12.33	−14.64	−15.66
Italian Lira	−0.97	−0.83	−9.09	−11.72	−12.03	−14.97	−17.21	−18.19
Belgian-Luxembourg Franc	−0.97	−0.83	−3.29	−3.19	−11.72	−12.26	−11.06	−12.12
Netherlands Guilder	−0.97	−0.83	−3.29	+2.14	+1.79	+5.47	+9.01	+7.71
Danish Krone	−3.80	−8.25	−10.52	−10.43	−13.41	−13.94	−11.91	−12.96
Irish Punt	−0.97	−0.83	−3.29	−3.19	−3.51	−4.11	−7.59	−8.69
U.K. Pound	+2.07	+2.21	+22.34	+10.34	+19.07	+18.34	+5.30	+12.97
Swiss Franc	+2.27	−1.24	−1.79	+9.50	+17.34	+12.66	+17.74	+20.62

Table 8
Cumulative Changes in Nominal Exchange Rates, Consumer Prices, and Real Exchange Rates vis-à-vis EMS Competitors[1]

	France	The Netherlands	Denmark	Germany	Belgium	Italy	Switzerland	Japan	United Kingdom	United States
I. Competitiveness Changes										
A. Under EMS-: to 1st quarter 1983										
1. Nominal Exchange Rates	−10.4	+9.9	−15.2	+18.7	−11.7	−13.8	+20.5	+24.6	+10.9	+44.6
2. Inflation Rates	+11.7	−11.1	+14.2	−20.3	−4.4	+44.9	−14.1	−16.2	+9.7	−1.4
3. Real Exchange Rates	+0.1	−2.3	−3.2	−5.3	−15.6	+25.0	+3.4	+4.4	+21.6	+42.7
B. Before EMS: 1970 to 1st quarter 1979 Real Exchange Rates	−4.0	+17.6	+6.7	+8.0	+9.4	−27.1	+39.4	+33.8	−16.5	−36.8
II. Changes in Real Exchange Rates Under EMS										
1979: 3rd quarter	+1.0	−2.8	+3.4	−1.6	−2.4	+5.3	−0.7	−10.3	+15.9	+0.5
4th quarter	+2.0	−3.2	+0.9	−2.1	−3.4	+6.6	−3.5	−19.6	+10.8	−0.7
1981: 1st quarter	+7.0	−5.2	−0.8	−7.3	−5.5	+18.0	−7.6	+6.1	+45.9	+19.8
4th quarter	+6.2	−3.5	+0.6	−8.1	−7.5	+15.0	+4.2	+4.0	+34.7	+32.6
1982: 1st quarter	+6.4	−3.8	−2.0	−7.5	−11.8	+17.1	+5.8	+3.0	+38.3	+37.6
2nd quarter	+6.1	−2.1	−2.2	−5.7	−14.2	+16.6	+2.4	+0.7	+39.0	+41.2
1983: 1st quarter	+0.1	−2.3	−3.2	−5.3	−15.6	+25.0	+3.4	+4.4	+21.6	+42.7

[1]Lines IA 1 and 2 show changes in *nominal effective* exchange rates and in consumer prices measured in national currencies, in relation to corresponding EMS weighted averages. All other estimates (arrived at by multiplying indices of relative exchange rates by indices of relative consumer prices) reflect the changes in *real* exchange rates, after exchange rate adjustments, *plus* signs indicating relative price increases *(decreased competitiveness)* and *minus* signs relative price declines *(increased competitiveness)*. Line IB shows changes from 1970 to the first quarter of 1979, and all other lines changes from the first quarter of 1979 (initiation of EMS) to the quarters in which central rates of EMS currencies were realigned.

However, this "partial success story"—to quote again from Governor Wallich—is to be explained in part by the strength of the dollar vis-à-vis the mark throughout most of the EMS years. This has eased the exchange rate tensions between the stronger and weaker currencies within the Community. The expected strengthening of the mark vis-à-vis the dollar will accentuate these tensions and make the functioning of the EMS more difficult, as well as more necessary than ever.

The Commission of the European Communities is keenly aware of this problem and has proposed to the Council a variety of measures to be gradually implemented in the very near future:

a) Using the ECU in preference to national currencies in the accounting and financial transactions of the Communities, including their resort to the capital market.
b) Granting the ECU a uniform "foreign currency" status, thus enlarging its use in all member states for the denomination of private capital movements, which are today still contracted predominantly in dollars, Eurodollars, and a few other Eurocurrencies. This would require, particularly, a change in German regulations, which still improperly apply to the ECU a legal prohibition against "indexation clauses," in spite of the fact that it has developed into a real currency, and is no longer a mere "unit of account" justifying this initial interpretation of the German law.
c) Privileged access to the ECU market for residents of countries with exchange control legislation.
d) Promulgation of a document defining a uniform ECU status throughout the Community, stating clearly the rules which users have to follow and protecting the ECU trademark.[14]

The progress of the EMS towards its proximate objective of making the ECU the major "parallel" currency of the Community countries in their external transactions—and its ultimate objective of enlarging ECU use to a growing category of domestic transactions—will still have to overcome the understandable concern of central banks, particularly the Bundesbank and the Nederlandsche Bank, about two interrelated dangers. These are the inconvertibility of the ECU into third currencies, and the danger of inflationary abuses of its issues by the FECOM (European Monetary Cooperation Fund), or the European Monetary Fund (best rechristened the "European Federal Bank")—initially expected to replace the FECOM in March 1981, but later postponed sine die by the European Council of Ministers.

4. *Convertibility of the ECU*

Frequent misapprehensions in some circles should first be dispelled by emphasizing that the ECU has remained, since its inception, fully convertible for the settlement of deficits outside as well as within the Community. Outside deficits are settled nearly exclusively in dollars, and entail a reduction *pari passu*:

[14]See the editorial of F.X. Ortoli in the *ECU Newsletter* of the Istituto Bancario San Paolo di Torino, May 1983.

—of the 20 percent of gold and dollar reserves held with the FECOM;
—of the 80 percent of gold and dollar reserves held outside the FECOM.

The external convertibility of these two types of reserve assets is therefore *legally* identical, and the so-called "pooling" ("mise en commun") of reserves held with the FECOM does *not* allow any country to draw down the reserve assets of any other country. The depletion of a deficit country's reserves may force it eventually to devalue its currency if it does not adopt in time the measures necessary to readjust its balance of payments, but other countries' reserves are totally unaffected by this.

While this *automatic* convertibility does not apply to the ECUs issued to finance member countries' market interventions, such issues have remained nil or minimal so far. (See last column of Table 9.) Nor should they grow excessively if the rules suggested below are implemented. The FECOM's ECU 54 billion gold and dollar assets should enable it to meet also the same 20 percent of ECU creditors' conceivable external deficits.

What is true is that the legal convertibility of ECU reserves into dollars does not guarantee the stability of the dollar exchange rate vis-a-vis the ECU, any more than vis-à-vis the national currency of any member country. The appreciation or depreciation of dollar rates will be determined for the ECU basket as well as for its component currencies by the factors amply discussed above in the first section of this paper. A further strengthening, rather than weakening, of the EMS joint policies and institutional arsenal would obviously enable member countries to combat more effectively the $ exchange rate fluctuations, up and down, which member countries deem detrimental to their interest, and in any case to preserve a greater stability of the intra-Community exchange rates far more important to them than the $ rate.

5. *Safeguards against Inflationary ECU Issues*

The danger of *inflationary ECU issues* is undoubtedly real: they have doubled indeed over five years, passing from 26 billion to nearly 53 billion, (first and fourth lines of first column of Table 9).

The first and most urgent reform obviously called for is to eliminate what has been the overwhelming cause, i.e., the automatic increases or decreases in ECU issues flowing automatically and haphazardly today from wild fluctuations in the contractual rate at which gold "swaps" are converted into ECUs. These account for 92 percent of the global increase just mentioned. The rise of the contractual conversion rate of gold in ECUs (identical to or lagging slightly behind its market prices) from the initial 165 ECU per ounce to 451 resulted in a 25 billion increase in the ECU counterpart of FECOM gold assets, which were nearly unchanged in volume.

Note also that this cumulative increase of 25 billion was subject to enormous variations, up and down:

—a 24 billion expansion (171 percent) from 14 billion initially to a first peak of 38 billion in January 1981;
—a subsequent 10 billion decline (27 percent) to a low of 28 billion in July 1982;

Table 9
ECU Issues and Counterpart Assets
(ECU Billions)

I. At end of:	Total (a=b+c)	Gold (b)	Credits		
			Total (c=d+e)	To United States (d)	To Member Countries (e)
A. At Current Rates					
April 1979[1]	26	14	12	12	0
January 1981	51	38	13	11	2
July 1982	40	28	12	10	2
April 1984	53	39	14	13	1
B. At Initial Rates					
April 1979[1]	26	14	12	12	0
January 1981	27	14	12	11	2
July 1982	23	14	9	7	2
April 1984	24	14	10	8	1
II. Value changes, from	+27	+25	+2	+1	+1
April 1979 to January 1981	+25	+24	+1	−1	+2
January 1981 to July 1982	−11	−10	−	−1	−
July 1982 to April 1984	+13	+11	+2	+2	−1
A. Volume Changes, from	−2	−	−2	−4	+2
April 1979 to January 1981	+1	−	+1	−1	+2
January 1981 to July 1982	−3	−	−3	−3	−
July 1982 to April 1984	−	−	−	−	−
B. Price Changes,[2] from	+28	+25	+3	+3	×
April 1959 to January 1981	+24	+24	−	−	×
January 1981 to July 1982	−7	−10	+3	+3	×
July 1982 to April 1984	+13	+11	+2	+2	×

[1]April 1979 estimates include UK gold and dollar deposits, made only in July, at the April gold and dollar conversion rates of other deposits.
[2]Price changes (i.e., changes in gold and dollar rates vis-à-vis the ECU) are obviously nil for credits to member countries denominated in ECUs.

—a renewed 13 billion expansion (47 percent) to 41 billion in October 1983;

—a decline of 2 billion (5 percent) to 39 billion in April 1984.

Such absurd fluctuations in ECU issues should be avoided through the "sterilization" of bookkeeping gold profits and losses in special, "frozen" accounts on which drawings would be authorized only as an alternative to borrowings from the FECOM, and under the same conditions, or for the repayment of such borrowings.

The adoption of this first measure is indispensable to enable the monetary authorities of the Community to adjust ECU issues to the financing requirements of potential, noninflationary growth in the volume of trade and production. To guard against possible abuses, a *presumptive ceiling* of x percent per year should be imposed by the European Council. Issues exceeding this ceiling might occasionally prove justifiable in exceptional circumstances ("force majeure," or "act of God"), such as the past explosions of oil prices, but would require qualified voting majorities of 2/3, 3/4, or even more, depending on their amplitude.

The *global* definition of this ceiling would impose *operationally* upon the authorities an explicit choice between the financing of credits to member countries and external investments—only dollars today—which are the counterpart of ECU issues. This would be both economically desirable and politically feasible, since balance of payments surpluses increasing the issue of ECUs against deposits of dollars—and other agreed-on currencies?—should normally reduce member countries' credit needs, while on the contrary these needs would normally increase—and be more compelling politically—when external deficits decrease the amount of ECUs issued in exchange for foreign currencies.

Opponents of the EMS constantly reiterate their fears and warnings about the likelihood of excessive credits to its more lax member countries, imposing additional inflationary pressures on the others. This has certainly not been the case in its first five years of operations. Credits to members (last column of Table 9) have remained extremely moderate, and often nil because promptly repaid by debtors. They accounted, at the end of April 1984, for only 2.5 percent of total ECU issues, while credits to the United States accounted for 24 percent (10 times more) and gold holdings of 73 percent. The ceiling proposed above should therefore be politically acceptable to all member countries, and eliminate all fears, unjustified *in the past*, of *future* abuses of its credit facilities.

As long as countries fail to harmonize their domestic policies sufficiently to avoid persistent divergences in their inflation rates, these divergences will continue to be sanctioned by periodic realignments of exchange rates. Any country—whether in surplus or in deficit—deeming such a realignment preferable to excessive credit extensions should receive the benefit of the doubt whenever its central rate clearly appears commercially overcompetitive or undercompetitive.

On the other hand, the countries opposed to such a realignment should also receive the benefit of the doubt whenever the strength or weakness of a

currency on the exchange market is due primarily to speculative capital movements. One should explore in this case the possibility of avoiding unnecessary and disequilibrating exchange rate realignments through a variety of measures aiming to deter such speculation—bullish as well as bearish—notably through a better coordination of interest rates, and even possibly through an "interest equalization tax," as the United States did in 1963.

This exploration should take fully into account the *geographic constellation* of these capital movements, largely due today—as amply demonstrated above—to enormous, undesirable and disequilibrating capital movements between the United States and the rest of the world, including the European Community. A more effective coordination of Community countries' policies regarding national interventions on the dollar exchange market and negotiations with the United States about exchange rates, interest rates, etc. is particularly necessary in this respect.

Within the Community, deficit countries should moreover consult their partners concerning their resort to international credit, including their borrowings on the market and from foreign official agencies as well as from the FECOM. Similarly, the surplus countries should submit to the examination of the Community the manner in which they finance their surpluses by the extension of credits—particularly their central bank's accumulation of foreign exchange—to their EC partners, the United States, and other countries. The "imported inflation" of which they have a right to complain may indeed often be due to an excessive financing of countries other than their Community partners!

III. Summary and Conclusions

1. The acceptance of the dollar as the main "parallel currency" of the world in international payments and reserve accumulation, official and private, is the main explanation of:

a) the forced suspension of its convertibility in August 1971, 40 years, nearly to the day, after the suspension of convertibility of the main previous "parallel currency," the pound sterling, in September 1931;

b) the worldwide monetary inflation resulting from the fantastic accumulation of international dollar reserves by foreign central banks and commercial banks;

c) the ability of U.S. banks to increase their foreign lending from about $1 billion a year in 1950–69, to an annual average of $68 billion in 1979–82, peaking to $109 billion in 1982, to a total cumulative level of more than $400 billion, which belatedly raises growing concern about the liquidity, if not solvency, of the borrowing countries.

Further inflows of foreign capital into the U.S. money market have been triggered additionally in recent years by fears of a third world war and by the rise of real as well as nominal interest rates prompted by unprecedented fiscal deficits and low saving rates in the United States. This has depleted the *net*

reserves of foreign countries in the U.S. money market from $113 billion at the end of 1978 to only $14 billion at the end of 1982, while provoking at the same time a switch from a previously undervalued dollar to a vastly overvalued (undercompetitive) dollar vis-à-vis its main rival currencies in world trade and finance.

These capital movements and exchange rate fluctuations bear little or no relationship to balance of payments disequilibria on current account between the United States and the rest of the world. The huge deterioration of the U.S. merchandise account—officially expected to close with a *deficit* of about $70 billion in 1983 and $110 billion this year—is obviously unbearable to the U.S. firms exposed to foreign competition at home as well as abroad. It can be corrected only by drastic protectionist measures and/or a sharp depreciation of the overvalued dollar.

2. Dangerous exchange rate and bank crises thus loom on the horizon. They should accelerate the spectacular development of the incipient ECU as an alternative "parallel currency" for the countries of the European Community and many others.

In the private market, the ECU has moved rapidly from 8th to 3rd place in public Eurobond flotations, and is used increasingly today not only as a unit of account, but as a real currency in transfers and payments.

The official authorities of the Community are now seeking to encourage this development of the ECU system, in order to protect, as far as possible, economic stability and growth from the disastrous impact of huge fluctuations in U.S. exchange rates and interest rates. They have unfortunately made little or no progress so far toward the promised elimination of the excessive divergences between national inflation rates, which is an indispensable prerequisite to the achievement of their ultimate objective of full economic and monetary union. As long as they do not succeed in this ambitious and politically difficult task, exchange rate realignments will remain unavoidable.

Yet, even as it now functions, the EMS is a remarkable "success story." All exchange rate realignments between participating currencies have been effected relatively smoothly and by unanimous agreement, after quick but meaningful consultations. They have, moreover, been limited to a fraction of dollar fluctuations imposed by the capital market, with little or no effective consultations between the authorities of the Community and of the United States. Finally and mostly, they have preserved or restored "real" exchange rates (competitiveness), by compensating for national inflation divergences that proved politically unavoidable.

A fuller acceptance of the ECU by the monetary authorities of all member countries will still require, however, fundamental changes of policies and institutions, guaranteeing the ECU against inflationary abuses of its issue power, and against the erratic impact imposed upon it, under present rules of operation, by the instability of speculative gold prices on the private market.

This acceptance should make politically feasible the implementation of other fundamental reforms of EMS, foreseen at the 1978 meeting of the European Council at Bremen, including the gradual conversion of the *FECOM* into a *European Monetary Fund,* better relabeled *Federal Reserve Bank of Europe.*

3. Forward-looking statesmen are already well aware of the need to move in this direction as rapidly as possible. But even politicians, concerned with their reelection, will accept it if and when excessive procrastination threatens the very survival of the Common Market itself. They know that public opinion will not accept the demise of an experiment whose success is as fantastic as obvious. Economically, it has helped bring the GNP per capita of most European countries from a mere fraction of that of the United States to approximate equality with it. Politically, it has removed from the horizon what was the nightmare of my generation, and of that of my parents and grandparents: the specter of a devastating Franco-German war. As Jean Monnet used to say, politics is not merely "the art of the possible." It is also "the art of making possible tomorrow what seems impossible today!"

Statistical Appendix

Note on Recalculation of the *International Financial Statistics* Tables on International Reserves

I *ASSETS,* measured in SDRs, with gold at 35 per ounce and the $ equal to the SDR, are taken from the latest *IFS* source available, i.e.:

a) the March 1984 issue of *IFS* for the 1978–1983 estimates;
b) the 1983 *IFS Yearbook* for the 1969 and 1972 estimates;
c) the 1979 *IFS Yearbook* for the 1949 estimates.

These estimates are modified in my tables:

1. In order to include a) *under gold,* b) at *35 per ounce,* the gold holdings (initially negative) of European institutions (only the FECOM and the Bank for International Settlements today, but also the European Fund in 1969)[15] whose ownership is retained by the depositing countries under quarterly swap arrangements. These are included in the main *IFS* tables as *foreign exchange,* rather than gold, and at *market prices,* rather than at 35 per ounce.
   This entails the following corrections:
   a) The inclusion under countries' "*gold*" of the difference between the *IFS* estimates of world gold and of IMF gold, valued at 35 per ounce (on lines 001 and 992 of the first bottom paragraph of p. 42 of the March 1984 *IFS,* and of the corresponding lines of the 1979 and 1983 *Yearbooks*). In my regional breakdown, this difference is included under "Industrial countries other than the United States."
   b) The deduction from *All Countries' Total Reserves* (line 010 of *IFS*) of the "revaluation" of European gold holdings, i.e., of the excess of their measurement at market prices over their measurement at 35 per ounce (lines 977 and 993 of the second and first bottom paragraphs, respectively, on p. 42 of the March 1984 *IFS*).
   c) The deduction from reported *Foreign Exchange* assets of industrial countries other than the United States (lines 110 *minus* 111) and of all countries (line 010), of these European institutions' gold, valued at market price (lines 997 and 993 of the second bottom paragraph of p. 42 of the March 1984 *IFS*).
2. In the regional breakdown of my tables, the addition discrepancy between the "All Countries" totals (line 010) and the sum of regional tables (lines 110, 999, and 201) are ascribed, on the advice of the Director of the IMF research department, to the "non-oil developing countries."
3. The regional breakdown of countries' gold is calculated residually by deducting from the "Total Reserves" of each regional group its "Total Reserves *minus* Gold," after the corrections mentioned above.

II *LIABILITIES,* measured in SDRs = dollars, are calculated as follows, for all countries and for regional groups:

1. *Concerted internationally* (the sum of):
   a) *SDR allocations* as reported in column (39) of the Fund Accounts (on p. 20 of the March 1984 *IFS,* and the corresponding column of the *Yearbooks* for earlier years);

[15]No longer reported but last shown on p. 7 of the July 1975 *IFS.*

b) *Liabilities to IMF* are reported "Use of Fund Credit" (on p. 28 of the March *IFS,* etc.) *plus* for 1969 the gold deposits and investments of the IMF with the United States (1,019 million) and the United Kingdom (40 million).

2. *Foreign Exchange:*
   a) The "*All countries*" total, as recalculated (see I, 1, c above) is debited exclusively to the industrial countries, under the assumption that holdings on nonindustrial countries are nil or insignificant.
   b) The *United States* is debited for the sum of:
      1) "Selected liabilities to foreign official institutions," reported on line 1 of Table 3.15 of the latest *Federal Reserve Bulletin*, converted from dollars into SDRs;
      2) "Liabilities of foreign branches of U.S. banks to official institutions," reported on line 60 of Table 3.14 of the same *Bulletin*, and similarly converted into SDRs.
   c) The difference between a) and b) above is debited to industrial countries other than the United States.
      Note that this procedure probably leads to a slight underestimation of U.S. liabilities, and a corresponding overestimation of other industrial countries' liabilities. My "guesstimated" U.S. liabilities are substantially lower than the "Eurodollar liabilities" estimates of the IMF, some of which are created by non-U.S. banks.

III *NET RESERVES* other than gold are equal to the gold transfers of countries to the IMF (valued at 35 per ounce) *minus* the undistributed IMF profits and, after 1980, minor accounting adjustments for "members' short-term borrowings under enlarged access policy," and for "borrowed reserves held in suspense." Again, I am indebted to Dr. William C. Hood, Director of the IMF research department, for this clarification.

IV *CORRESPONDING DOLLAR ESTIMATES*, at market gold prices and exchange rates are:

1. For *credit reserves:* SDR estimates, multiplied by the $-SDR exchange rate (penultimate line of bottom paragraph of p. 42 of March 1984 *IFS*).
2. For *gold reserves:* SDR estimates, multiplied by the market dollar price of an ounce of gold (first line of bottom paragraph of p. 42 of the March 1984 *IFS*) and divided by the 35 price used for SDR measurements.

Table A1
Gross and Net International Monetary Reserves: 1949–1983
(SDR and $ billions)

MEASURED IN SDRs[1]	End of Year	1949	1969	1972	1978	1979	1980	1981	1982	1983
I ASSETS		45.5	78.7	147.3	282.0	273.9	315.3	341.4	328.9	373.2
A. Credit Reserves		12.6	40.2	111.3	245.4	237.6	278.7	304.9	292.5	336.9
1. Concerted:		1.7	6.7	15.0	22.9	24.2	28.6	37.7	43.2	53.5
a) SDR Holdings		x	x	8.7	8.1	12.5	11.8	16.4	17.7	14.4
b) Res. Pos. in IMF		1.7	6.7	6.3	14.8	11.8	16.8	21.3	25.5	39.1
2. Foreign Exchange		10.9	33.5	96.3	222.5	213.4	250.1	267.1	249.3	283.3
3. Gold		33.0	38.5	35.9	36.6	36.3	36.6	36.6	36.4	36.3
II LIABILITIES (-)		−11.1	−38.6	−106.7	−242.1	−234.7	−275.9	−301.9	−290.1	−334.7
1. Concerted		−0.2	−5.1	−10.4	−19.6	−21.4	−25.9	−34.8	−40.7	−51.3
a) SDR Allocations		x	x	−9.3	−9.3	−13.3	−17.4	−21.4	−21.4	−21.4
b) to IMF		−0.2	−5.1	−1.1	−10.3	−8.0	−8.5	−13.4	−19.3	−29.9
2. Foreign Exchange		−10.9	−33.5	−96.3	−222.5	−213.4	−250.1	−267.1	−249.3	−283.3
III NET RESERVES		+34.4	+40.2	+40.5	+40.0	+39.3	+39.4	+39.5	+38.9	+38.5
A. Credit Reserves		+1.5	+1.7	+4.6	+3.4	+2.9	+2.8	+2.9	+2.5	+2.2
1. Concerted		+1.5	+1.7	+4.6	+3.4	+2.9	+2.8	+2.9	+2.5	+2.2
a) SDRs		x	x	−0.6	−1.2	−0.9	−5.6	−5.0	−3.7	−7.0
b) on IMF		+1.5	+1.7	+5.2	+4.6	+3.8	+8.3	+8.0	+6.1	+9.2
2. Foreign Exchange		x	x	x	x	x	x	x	x	x
B. Gold		+33.0	+38.5	+35.9	+36.6	+36.3	+36.6	+36.6	+36.4	+36.3

[1]at $ = SDR, and gold at 35 per ounce.

Table A1 (continued)
Gross and Net International Monetary Reserves: 1949–1983
(SDR and $ billions)

MEASURED IN DOLLARS[2] (End of Year)	1949	1969	1972	1978	1979	1980	1981	1982	1983
I ASSETS	45.3	79.0	187.5	556.3	844.6	971.8	770.2	797.9	748.4
A. Credit Reserves	12.6	40.2	120.9	319.7	313.0	355.5	354.9	322.7	352.7
1. Concerted	1.7	6.7	16.3	29.9	31.9	36.5	43.9	47.7	56.0
a) SDR Holdings	x	x	9.4	10.6	16.4	15.1	19.1	19.6	15.1
b) Res. Pos. in IMF	1.7	6.7	6.9	19.3	15.5	21.5	24.8	28.1	41.0
2. Foreign Exchange	10.9	33.5	104.6	289.8	281.1	318.9	310.9	275.0	296.6
3. Gold	32.7	38.7	66.6	236.5	531.6	616.4	415.3	475.2	395.7
II LIABILITIES (–)	–11.1	–38.6	–115.9	–315.3	–309.2	–351.9	–351.5	–320.0	–350.4
1. Concerted	–0.2	–5.1	–11.3	–25.5	–28.1	–33.0	–40.5	–44.9	–53.7
a) SDR Allocations	x	x	–10.1	–12.1	–17.6	–22.2	–24.9	–23.6	–22.4
b) to IMF	–0.2	–5.1	–1.2	–13.4	–10.5	–10.8	–15.6	–21.3	–31.3
2. Foreign Exchange	–10.9	–33.5	–104.6	–289.8	–281.1	–318.9	–310.9	–275.0	–296.6
III NET RESERVES	+34.2	+40.4	+71.6	+240.9	+535.4	+619.9	+418.8	+477.9	+398.0
A. Credit Reserves	+1.5	+1.7	+5.0	+4.4	+3.8	+3.5	+3.4	+2.7	+2.3
1. Concerted	+1.5	+1.7	+5.0	+4.4	+3.8	+3.5	+3.4	+2.7	+2.3
a) SDRs	x	x	–0.7	–1.6	–1.1	–7.1	–5.8	–4.1	–7.3
b) on IMF		+1.7	+5.7	+5.9	+5.0	+10.6	+9.3	+6.8	+9.6
2. Foreign Exchange	x	x	x	x	x	x	x	x	x
B. Gold	+32.7	+38.7	+66.6	+236.5	+531.6	+616.4	+415.3	+475.2	+395.7
Memo: a) U.S. dollars per SDR	1.000	1.000	1.0857	1.3028	1.3173	1.2754	1.1640	1.1031	1.0470
b) U.S. dollars per ounce of gold	34.71	35.20	64.90	226.00	512.00	589.50	397.50	456.90	381.50
c) U.S. dollars per ounce of gold divided by 35	0.9917	1.0057	1.8543	6.4571	14.6283	16.8429	11.3571	13.543	10.900

[2]at market exchange rates and gold prices.

Sources: a) of SDR estimates: latest *International Financial Statistics* (March 1984); and *Yearbook* (1979 and 1983), corrected as shown in separate Note. b) of dollar estimates: for Credit Reserves: SDR estimates x U.S. dollars per SDR (memo a); for Gold: SDR estimates x U.S. dollars per ounce, divided by 35 (memo c).

Table A2
Composition and Regional Distribution of International Monetary Reserves
($ billions, at market prices and exchange rates)

	End of 1969							End of 1983						
	Industrial Countries			Nonindustrial Countries			All Countries	All Countries	Industrial Countries			Nonindustrial Countries		
	United States	Others	Total	Total	Oil Exptg.	Other			United States	Other	Total	Total	Oil Exptg.	Other
I ASSETS	17.0	42.0	59.0	20.0	4.1	15.8	79.0	748.4	123.1	391.5	514.6	233.8	94.1	139.7
A. Other than Gold	5.1	20.9	26.0	14.3	2.8	11.4	40.2	352.7	22.6	156.7	179.3	173.4	78.0	95.4
1. Concerted	2.3	3.6	5.9	0.8	0.2	0.6	6.7	56.0	16.3	22.5	38.8	17.3	13.4	3.8
a) SDR Holdings	x	x	x	x	x	x	x	15.1	5.0	7.0	12.1	3.0	1.6	1.4
b) Reserve Position in IMF	2.3	3.6	5.9	0.8	0.2	0.6	6.7	41.0	11.3	15.4	26.8	14.2	11.8	2.4
2. Foreign Exchange	2.8	17.3	20.1	13.4	2.7	10.8	33.5	296.6	6.3	134.2	140.5	156.2	64.5	91.6
B. Gold	11.9	21.1	33.0	5.7	1.3	4.4	38.7	395.7	100.5	234.8	335.3	60.4	16.1	44.3
II LIABILITIES (−)	−18.9	−18.4	−37.3	−1.3	−0.1	−1.1	−38.6	−350.4	−202.1	−109.6	−311.8	−38.6	−2.0	−36.6
1. Concerted	−1.0	−2.8	−3.8	−1.3	−0.1	−1.1	−5.1	−53.7	−5.1	−10.0	−15.1	−38.6	−2.0	−36.6
a) SDR Allocations	x	x	x	x	x	x	x	−22.4	−5.1	−10.0	−15.1	−7.3	−1.6	−5.8
b) Debt to IMF	−1.0	−2.8	−3.8	−1.3	−0.1	−1.1	−5.1	−31.3	–	–	–	−31.3	−0.4	−30.8
2. Foreign Exchange	−17.9	−15.6	−33.5	–	–	–	−33.5	−296.6	−197.0	−99.6	−296.6	–	–	–
III NET RESERVES: I + II	−1.8	+23.5	+21.7	+18.7	+4.0	+14.7	+40.4	+398.0	−79.0	+281.8	+202.8	+195.2	+92.0	+103.1
A. Other than Gold	−13.8	+2.4	−11.3	+13.0	+2.7	+10.3	+1.7	+2.3	−179.5	+47.0	+132.5	+134.8	+76.0	+58.8
1. Concerted	+1.3	+0.8	+2.1	−0.4	+0.1	−0.5	+1.7	+2.3	+11.2	+12.5	+23.7	−21.3	+11.4	−32.8
a) SDR Accounts	x	x	x	x	x	x	x	−7.3	−0.1	−3.0	−3.0	−4.3	–	−4.4
b) IMF Accounts	+1.3	+0.8	+2.1	−0.4	+0.1	−0.5	+1.7	+9.6	+11.3	+15.4	+26.8	−17.1	+11.4	−28.4
2. Foreign Exchange	−15.1	+1.6	−13.4	+13.4	+2.7	+10.8	x	x	−190.7	+34.5	−156.2	$156.2	+64.5	+91.6
B. Gold	+11.9	+21.1	+33.0	+5.7	+1.3	+4.4	+38.7	+395.7	+100.5	+234.8	+335.3	+60.4	+16.1	+44.3

Source: *International Financial Statistics,* Yearbook, 1983 for end of 1969; and March 1984 for end of 1983, with corrections explained in separate *Note.*

Table A3
U.S. Balance of Payments and Capital Flows: 1950–1983
($ billions)

	Average Yearly Flows					Year	Year
	1950–59	1960–69	1970–82	1970–78	1979–82	1982	1983
A. Net Earnings on Past Investments	2.1	4.9	18.3	13.0	30.4	27.3	23.6
B. Other Current Transactions	2.2	2.1	−14.2	−8.5	−27.0	−32.5	−50.8
1. Merchandise	2.9	4.1	−14.9	−8.5	−29.4	−36.4	−60.6
2. Military[1]	0.1	−0.9	0.3	0.8	0.7	0.8	0.7
3. Other services	−0.2	−0.1	2.4	1.0	5.4	5.7	4.3
4. Pensions and Remittances	−0.6	−1.0	−1.9	−1.8	−2.4	−2.6	−2.6
I. Income Accounts[2] = *Unadjusted Capital Accounts*	4.3	7.0	4.2	4.5	3.4	−5.2	−34.6
A. Foreign Aid	6.2	5.3	8.3	7.5	10.1	11.8	11.1
1. Economic and Military Grants	4.4	3.6	5.0	4.9	5.2	6.1	6.2
2. Net Assets	1.8	1.6	3.3	2.7	4.9	5.7	4.9
B. Other Capital	−1.9	1.7	−4.1	−3.0	−6.7	−16.9	−45.7
II. Adjustments to Capital Accounts	−4.2	−4.9	−6.1	−3.9	−11.1	−23.8	n.a.
A. Deduct Grants	−4.4	−3.6	−5.0	−4.9	−5.2	−6.1	−6.2
B. Valuation and Coverage	0.2	−1.3	−1.1	1.0	−5.9	−17.7	n.a.
1. Foreign Aid	−1.3	−0.2	–	–	–	−0.2	n.a.
2. Other Capital	1.5	−1.1	−1.1	1.0	−5.9	−17.5	n.a.
III. Capital Accounts, Adjusted (except 1983) = I+II	0.1	2.1	−1.9	0.6	−7.7	−28.9	−45.7
A. Foreign Aid	0.5	1.5	3.3	2.6	4.9	5.5	4.9
B. Other Capital[3]	−0.4	0.6	−5.3	−2.0	−12.6	−34.4	−45.7
1. Statistical Discrepancy	−0.3	0.6	−10.1	−1.2	−30.1	−41.4	−7.1
2. Other	−0.1	–	4.8	−0.8	17.6	−7.0	−38.6
[1]Including transfers of goods and services under military grants programs	2.4	1.8	1.6	2.0	0.6	0.6	0.7
[2]*Income Accounts* (line I) =	4.3	7.0	4.2	4.5	3.4	−5.2	−34.6
a) Reported Current Account	−0.1	3.3	−0.8	−0.4	−1.8	−11.2	−40.8
b) Plus Goods & Services financed by economic & military grants	4.4	3.6	5.0	4.9	5.2	6.1	6.2
[3]Including "contingent" liability for cumulative SDR allocations converted into $	x	x	−0.4	−0.3	−0.6	+0.3	−0.8

Sources: *Survey of Current Business*, June and August 1983; plus for early years rough estimates derived from *Historical Statistics of the United States* and *Annual Report of the Council of Economic Advisers*.

Table A4
U.S. International Investment Position: 1949–1982
($ billions)

	End of Year					Total Flows					Average Yearly Flows					
	1949	1959	1969	1978	1982	1950-59	1960-69	1970-82	1970-78	1979-82	1950-59	1960-69	1970-82	1970-78	1979-82	Year 1982
I. Excluding Foreign Aid																
A. Liabilities (−)[1]	−20	−48	−103	−387	−804	−28	−55	−701	−284	−417	−3	−6	−54	−32	−104	−146
1. Money Market[1]	−7	−20	−49	−263	−450	−13	−30	−401	−213	−187	−1	−3	−31	−24	−47	−80
a) to Official Institutions[1]	−3	−11	−19	−176	−195	−8	−9	−175	−157	−19	−1	−1	−14	−17	−5	−8
b) Other: Treasury Securities and Bank Liabilities	−4	−9	−30	−87	−255	−5	−21	−255	−57	−169	−1	−2	−17	−6	−42	−72
2. Other[2]	−13	−28	−54	−124	−354	−15	−26	−300	−71	−230	−2	−3	−23	−8	−57	−67
B. Assets[3]	43	66	128	394	760	23	+61	+633	+266	+367	+2	+6	+49	+30	+92	+112
1. Money Market[3]	27	25	30	150	436	−2	+5	+406	+120	+287	—	+1	+31	+13	+72	+113
a) Official Reserves[3]	26	22	17	19	34	−5	−5	+17	+2	+15	−1	−1	+1	—	+4	+4
b) Bank Claims	1	4	13	131	402	−2	+9	+389	+118	+272	—	+1	+30	+13	+68	+109
2. Other	16	41	98	244	324	+26	+56	+226	+147	+80	+3	+6	+17	+16	+20	−1
C. Net Assets (=A+B)[1,2,3]	+23	+19	+25	+7	−44	−4	+6	−68	−18	−50	—	+1	−5	−2	−13	−34
1. Money Market[1,3]	+21	+6	−19	−113	−14	−15	−25	+6	−94	+99	−2	−3	—	−10	+25	+34
a) Official Reserves[1,3]	+23	+11	−2	−157	−161	−12	−13	−159	−155	−3	−1	−1	−12	−17	−1	−4
b) Other	−2	−5	−17	+44	+147	−3	−12	+164	+61	+103	—	−1	+13	+7	+26	+38
2. Other[2]	+2	+13	+44	+120	−30	+11	+31	−74	+76	−150	+1	+3	−6	+8	−38	−68
II. Foreign Aid Assets[4]	11	16	31	54	74	+5	+15	+43	+24	+20	+1	+2	+3	+3	+5	+6
III. Total Net Assets (=IC+II)[1,2,3]	+34	+35	+56	+61	+30	+1	+21	−25	+6	−31	—	+2	−2	+1	−8	−29
1. Reported in Survey Tables	+39	+43	+58	+76	+169	+4	+15	+110	+18	+92	—	+2	+9	+2	+23	+12
2. Minus	−5	−8	−3	−15	−138	−3	+6	−135	+12	−123	—	+1	−10	−1	−31	−41
a) Statistical Discrepancy	−5	−8	−3	−12	−133	−3	+6	−130	−9	−121	—	+1	−10	−1	−30	−41
b) "Contingent" SDR liabilities, converted into $	x	x	x	−3	−5	x	x	−5	−3	−2	x	x	—	—	−1	—

[1]To facilitate reconciliation with Table A3 (U.S. Balance of Payments and Capital Flows: 1950–1982), "contingent" SDR liabilities are added to money market liabilities to official institutions.

[2]"Other" liabilities include the "statistical discrepancy" which the *Survey of Current Business* repeatedly considers "as probably in large part accounted for by unrecorded capital inflows," but nevertheless excludes *totally* from the capital accounts reported in its tables, thus implying that they belong entirely to the current account balance. Readers of my table may wish to assign a portion of these liabilities to the current, rather than to the other capital, account.

The Morgan Guaranty *World Financial Markets* (February 1984, p. 3) suggests that this be done for *one-fifth* of the huge asymmetry in published current account transactions for the world as a whole. Using for this purpose the latest *Balance of Payments Statistics* of the IMF, (volume 34 *Yearbook* Part 2, p. xii), the $38 billion and $68 billion net capital inflows shown in the last two columns of line IC2 would be moderately reduced to about $30 billion and $50 billion respectively.

My cumulative estimate of $5 billion at the end of 1949 is obviously a *rough guesstimate,* but is only an insignificant fraction of the $138 billion estimate at the end of 1982, $121 billion of which comes from the *Survey's* estimate for the years 1979–1982.

[3]The gross and net asset estimates for the years 1978 and 1982 would be raised by $109 billion if gold holdings were included at market prices rather than at $42.20 per ounce, but such an estimate would be equally unrealistic, since substantial sales would depress considerably the current market price.

[4]Foreign aid assets, mostly on LDCs, are of little relevance to the dollar's strength on the exchange market, and are generally more akin to "grants" than to real "assets."

Sources: see Table A3.

Discussion

Robert Solomon*

I am honored and very pleased to be participating in this commemoration of the important meeting that occurred here 40 years ago. That meeting immortalized the name of this small place because of its lasting effects.

This is a time for memories, even nostalgia, as we review what has happened over the four decades. I suspect that most of us who are here today were unaware of the Bretton Woods conference in July 1944. Either we were too young or, like me, we were involved in World War II, perhaps even preoccupied with staying alive. But our well-being has been affected by what happened here.

Those who met here in 1944 were determined to make the postwar world a better place economically than the world my generation grew up in. Despite all the monetary crises, misalignments, liquidity explosions, bouts of inflation, stagflation, and recession, and despite the many problems still crying for solution, especially in the developing world, there is no doubt that the period since the end of World War II has witnessed an enormous increase in prosperity and much more economic cooperation than ever before. It has also witnessed an increase in international economic and financial interdependence far beyond the dreams of the founding fathers of the Bretton Woods institutions. The lessons of the 1930s may not have been learned perfectly, but they were learned. For that, we pay homage to those who met here 40 years ago.

What did they accomplish? They established two institutions that are an integral part of the international landscape and that have made numerous contributions to the economic welfare of the world. And they acted on the idea that international economic and monetary arrangements are not God-given and immutable. Rather they are subject to improvement and reform.

Did they bequeath us an international monetary system? That is a question about which people may differ, depending in part on how they define the word system. I shall avoid semantic hair-splitting. But I do want to make the point, with all due respect to those who labored here 40 years ago, that there were basic flaws in the monetary arrangements that emerged from the Bretton Woods conference. The breakdown of those arrangements in the 1970s was not just the result of human perversity or failure to live up to the rules that were established here.

The flaws pertained to both the balance of payments adjustment process and the provisions for international liquidity.

Regarding balance of payments adjustment, there were really no rules or guidance to Fund members. Countries could alter their exchange rates only in the event of "fundamental disequilibrium." But what were the criteria for

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actions to restore equilibrium? Keynes had proposed a set of rules, but they were not accepted by the American side. The implicit criterion was that countries in deficit, other than the United States, had to restrict aggregate demand when their reserves ran low. Often this involved a crisis, as in the case of the United Kingdom and France in the 1950s, Italy in 1963, Britain again and again in the mid 1960s, France in 1968–69, and finally, the United States in 1971. It is commonplace to observe that these arrangements were asymmetrical. Countries in surplus were under little pressure to adjust. The scarce currency clause was designed to prevent this asymmetry, but it did not work. As a result, misalignments developed and persisted under the old system too. Remember that the Smithsonian agreement produced a "realignment" of exchange rates.

Regarding international liquidity, the Bretton Woods Agreement made no provision for the regular increase in reserves required by a growing world economy. Whether the designers of the Agreement anticipated that the dollar would play a major role as a *source* of reserve growth, I do not know. But that is what happened. It was Robert Triffin's brilliant insight that the system was unstable—expressed in the well-known Triffin dilemma. And as Robert also pointed out, the supply of new reserves was haphazard, depending on the vagaries of gold production (or that part of it that found its way into official reserves) and changes in the U.S. balance of payments. The agreement to establish Special Drawing Rights was designed to correct this flaw in the Bretton Woods arrangements. To be more precise, SDRs were a necessary, but not a sufficient, condition for dealing with the unstable supply of world reserves. But the SDR agreement came too late and nothing was done to correct the other flaw—that in the adjustment process.

It is not a mark of disrespect to the founding fathers to point out that the Bretton Woods Agreement was flawed. We who followed had the chance to improve it. It was we who failed, though sporadic attempts at reform were made over the years.

I have already mentioned the SDR, a significant reform accomplished in the 1960s, thanks in no small part to the efforts of former Secretary of the Treasury Henry Fowler, who is here with us today.

In the late 1960s, there was much discussion in official circles, as well as in the academic community, of introducing greater flexibility into the exchange rate regime. The IMF carried out a study and published a report that was noncommittal. American officials, at least those in the Treasury, were nervous about discussing the subject in public. And a number of Europeans were opposed on the grounds that a reform that facilitated upward movements of their currencies would take the United States off the hook of a weak balance of payments. The basic problem was that what was needed was not only more flexible exchange rates but a correction of the misalignment that existed. The dollar was overvalued. Thus the exchange rate reform got nowhere.

In the Committee of Twenty, in 1972–74, another opportunity arose to reform the system, adapting it to the conditions of the last quarter of the century and correcting the shortcomings of the original Bretton Woods agreement. It is perhaps ironical, but explicable, that in 1972 the United States put

forward a detailed proposal for strengthening the adjustment process, a proposal strikingly similar to the one formulated by Keynes in the early 1940s. The principal author of the American proposal was Paul Volcker. The principal opponents were some of our friends in Europe, who, like the Americans 30 years earlier, thought that their countries would be eternally in balance of payments surplus.

Whether the Committee of Twenty could have succeeded in establishing a workable and improved system, we shall never know. Its efforts were overtaken by events—namely, the quadrupling of the price of oil in late 1973. That put an end to longer-term planning and concentrated the minds of policymakers onto current problems. The oil-price explosion also put an end to the notion that floating exchange rates were a temporary aberration, which in turn led to the revision of the IMF Articles of Agreement, especially Article IV dealing with exchange rates.

The next effort at reform occurred in Europe, with the establishment of the European Monetary System (EMS). As Robert Triffin has stressed, that was a reform that succeeded. The present occasion demands that a few words be said about Robert himself.

Robert Triffin was always in the forefront, as he is today, of those who regard institutions as perfectable. Robert is a natural-born reformer. While at the Federal Reserve Board, he helped to establish central banks in Latin America. He was a, if not *the*, father of the European Payments Union, which had so much to do with freeing up trade in Europe in the early postwar years. He put forward proposals for creating a new reserve asset. He produced several books that will always be part of the essential body of work on international monetary affairs. And, at Yale, he helped to nurture and turn out a generation of students of international monetary economics who are now prominent in the profession.

As you have just heard, Robert is not happy with the operation of present international monetary arrangements. Nor am I, though perhaps for different reasons. What I find missing in Robert's presentation is a discussion of the *process* by which the increase in international reserves has caused world inflation under existing arrangements. He speaks of the ability of the United States to settle its deficits in dollars. Yet whether or not other countries acquire dollars depends on whether or not their central banks choose to intervene.

Robert also states that the present system of world reserve creation leads to "the financing of the richer and more heavily capitalized countries by poorer, capital-short countries." This conclusion is based on net reserve positions at the end of 1982, which show the United States as a net reserve debtor to the extent of $149 billion, while developing countries were net reserve creditors to the extent of $133 billion, (of which oil exporters account for almost 60 percent). It does not follow that capital has not been flowing from the richer to the poorer countries. The debt crisis of the past two years tells us that.

As is evident elsewhere in Robert's paper, the United States has been a heavy lender to developing countries. Its nonreserve claims far exceed its

reserve liabilities. It has provided capital to poorer countries. But the United States is also a bank to the rest of the world, as Emile Despres, Charles Kindleberger, and Walter Salant were at pains to point out to us back in the 1960s. A bank will inevitably have liabilities that are more liquid than its assets. Robert recognizes this, of course, but he does not accept the reserve-currency role of the dollar with satisfaction. I have never been a dollar chauvinist. But until someone has the wit and will to replace with a workable scheme the arrangements under which the United States now assumes the role of world financial intermediary, we have to expect Robert Triffin's carefully constructed tables to continue to show what they do.

In the second part of his paper, devoted to the EMS, Robert focuses on the private market development of the ECU, telling us that crucial reforms are determined mainly by the private sector. To support this thesis, he reminds us that the members of the Group of Ten, when discussing reform of the system in the 1960s, "unanimously regarded the stability of exchange rates and of the price of gold—at $35 per ounce—as the two unshakable pillars of any international monetary system, present or future! " I hope that Robert has his tongue in his cheek when he reminds us of this. He appears to take this declaration too seriously. As Robert undoubtedly knows, it was American officials who insisted on these strictures, and for understandable reasons. A banker cannot let doubt be cast on the future value of his or her liabilities. We used to talk in the 1960s—thanks to the late Fritz Machlup—of three elements of the system: adjustment, liquidity, and confidence. It was to preserve confidence that the Americans insisted on the two unshakable pillars.

Robert presents us with an interesting account of the growing use of the ECU and advises the EMS officials to stop monetizing increases in the price of gold. I find this treatment of the ECU to be noncontroversial.

Robert also brings out the "success story" of the EMS in maintaining stability of real exchange rates among its members while exchange rates with outside currencies, notably the yen and the dollar, have fluctuated wildly. It would be of interest to know what costs, if any, have been associated with this benefit of exchange rate stability. Have there been costs to some members of the EMS in the form of lower employment and real income?

Depending on the answer to this question, we have every reason to join Robert Triffin in blessing the EMS and wishing it well. It seems to be a reform that is working.

General Discussion

Robert Triffin stated that observers, on the whole, have been surprised at the success of anti-inflationary policies within the EMS. But he has come across little support for the view that employment and income have been lower in the EMS countries than in the absence of the system.

Lord Eric Roll posed two questions to Triffin. First, why has Great Britain not yet entered the EMS? Second, has the EMS induced greater policy convergence among member countries than would have been attained without it?

On the first question, Triffin remarked that Great Britain did not enter the EMS initially because such an action was expected to make it more difficult for the pound sterling to depreciate. In fact, the pound sterling appreciated relative to EMS currencies over recent years. He conjectured that British industry might have been happier with EMS membership; yet opposition to EMS membership still exists in Britain.

On the second question, Triffin expressed no doubt that the existence of the EMS has augmented policy convergence among member countries. He added that opportunities for regional coordination among policymakers exist even where wider international economic cooperation is not feasible. This is not to suggest that regional and international coordination are substitutes; rather they are complements. Cooperation among national governments should be pushed as far as is humanly possible.

Capital Movements—The Tail That Wags the Dog

Henry C. Wallich*

Capital movements are small; exports and imports are large. Nevertheless, capital movements dominate the American balance of payments. Some of the implications, exemplified by the high level of the dollar in the face of a large current-account deficit, will be explored in this paper.

By "dominate" I mean, in a very broad sense, that the dollar exchange rate which keeps international payments in balance is primarily determined by the capital account. The evidence for this generalization is partly systematic, partly admittedly casual. For systematic evidence covering the postwar years, I refer to a paper by Klaus Friedrich and myself,[1] covering the period since 1950, and to work by Arthur Bloomfield covering most of the period from 1919 to 1939.[2] During both periods, the evidence predominantly indicates that a cyclical expansion in the United States, relative to the rest of the world, strengthens the U.S. balance of payments by increasing *ex ante* desires to move funds into the United States, and in conditions of floating exchange rates causes the dollar to appreciate. Naturally, these are broad tendencies rather than tight relationships. For the post World War II period, the case is particularly clear for the cyclical expansions (with respect to the rest of the world) of 1960–61, 1963–65, and 1975–77.

A similar impression is conveyed by simulations with macro models. Simulations with the Federal Reserve Board's multi-country and MPS models show that the fiscal expansion that has occurred in the United States since 1982 was likely to lead to a rise in the dollar as indeed happened. A caveat, in both cases, however, is intuitively appealing: in the long run, fiscal expansion and the resulting current account deficit may lead to a decline in the dollar.

Finally, there is the evidence before our eyes today: in the face of a huge current account deficit, the dollar has risen significantly and so far has remained high. A simple and straightforward analysis of this phenomenon might run as follows. First, the U.S. current account deficit, projected at more than $80 billion for 1984, reflects a $100 billion negative swing in the non-oil trade deficit, offset by a $20 billion positive swing in oil. Of the $100 billion, perhaps one-quarter can be attributed to the cyclical expansion of the

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[1]H.C. Wallich and K. Friedrich, "Cyclical Patterns in the U.S. Balance of Payments," *Economies et Societes*, Tome XVI, No. 405, Avril-Mai 1982, pp. 481–502.

[2]Arthur I. Bloomfield, "The Mechanism of Adjustment of the American Balance o Payments," *Quarterly Journal of Economics*, Vol. LVII, No. 3 (May 1943), pp. 333–377 *Capital Imports and the American Balance of Payments 1934–39* (Chicago: The University o Chicago Press, 1950.)

American economy relative to the rest of the world. This expansion, in turn, is in some degree the result of the fiscal policies pursued, mainly the large budget deficits. Of the rest of the current account deficit, some 10 to 15 percent may be attributed to the particular problems encountered by developing countries, especially Mexico, and the resulting weakness of U.S. exports to those countries. The rest, at least one-half of the total current account deficit, may be attributed to the rise of the dollar through the end of 1983.

Had the dollar not risen, there would still have been a substantial current account deficit, and this deficit would have had to be financed by capital inflows. But the rise in the dollar indicates that the deficit was overfinanced. In other words, the rest of the world's demand for dollars exceeded basic U.S. current account financing requirements. *Ex ante*, the desired inflow of capital into the United States, at an unchanged dollar level, was larger than the actual current account deficit allowed it to be *ex post*. Thus, demand and supply of dollar assets had to clear at a higher dollar level, part of the adjustment occurring subsequently through a higher current account deficit and part, presumably, through a reduction in the desired capital flow into the dollar.

The principal uncertainty about the present situation is whether and how long this strong demand for dollars will continue. If the excess demand function for dollars, at given exchange and interest rates and given the safe-haven advantages of the United States, should shift downward gradually, to the point where a more moderate current account deficit can be financed, the dollar also would drop moderately. If excess demand for dollar assets should become negative, the dollar would have to fall sufficiently to permit a surplus in the current account.

The questions here raised about the driving forces in the American balance of payments echo an old debate about the international transfer mechanism. Typically, the question examined was how an international capital transfer that for one reason or another had to take place would be effectuated in real terms. Under the fixed rate regime, it then was argued that the transfer would cause deflation in the country originating the transfer, whether on account of an international loan or reparations payments, while the opposite would occur in the recipient country. This would lead to a current account surplus in the first and a deficit in the second country, generating a real transfer. The capital movement was the driving force in this analysis.

Alternatively, it was sometimes argued that current account deficits arose in particular countries, for whatever reason, which then were financed with a loan or bond issue. The question whether the contractionary and expansionary effects of the financial transfer were of a magnitude sufficient to bring about the transfer, and whether the mechanism did not have undesirable side effects on employment and prices, could be set aside in this second formulation. Empirically, presumably either mechanism could be at work in a given situation—the capital account driving the current account, or the current account driving the capital account.

The Structure of the U.S. Balance of Payments

The thesis of the dominance of the capital account requires a brief look at the structure of the U.S. balance of payments. It consists of a current account, with its multiple subclassifications of a functional, commodity, and geographic kind, and the capital account. The latter distinguishes principally direct investment, portfolio investment, banking flows, and government transactions, differentiating between domestic and foreign residents. The gross flows generally far exceed the net flows in each category, i.e., there are sizable inflows and outflows in each category which, however, summed across all categories, must equal the balance of the current account, with sign inverted. When weighing the relative influences of the capital and the current account on the net balance of payments and the value of the dollar, it is important to bear in mind that for both the gross movements generally are much larger than the net. Their respective influences on the net balance of payments and the rate of the dollar must be viewed in terms of their gross magnitudes.

Since there are capital flows in both directions, in and out, it is clear that no particular category of transactions can be viewed as having a particular function in offsetting a current account imbalance, positive or negative. It is the totality of the transactions that either must adjust to the current account or, with a lag and with the help of exchange rate and income movements, cause the current account to adjust. Nevertheless, it is not impossible to distinguish at least in degree two categories of transactions: those that serve primarily to adjust to and finance the current account, and others that lead a life more of their own. The latter sometimes are exaggeratedly referred to as "autonomous." These at times may go in the wrong direction. In other words, they may add to the imbalance created by the current account, thus increasing rather than diminishing the financing job. Direct investment, for instance, although undoubtedly responsive to changing rates of return, probably has some degree of "autonomy" within the totality of capital movements. So, of course, do government transactions.

Banking transactions sometimes have been viewed as behaving autonomously. Large banking outflows during 1982 and the first quarter of 1983 have been viewed as adding to the financing needs of the U.S. balance of payments. In this light, they seem to be part of the problem rather than of the solution. There can be little doubt that some banking transactions have an autonomous character, for instance, a bank's decision to participate in a major LDC syndication, or a large takeover loan. For the most part, however, international operations of banks, both on the lending and the funding side, reflect interest rates. These, of course, reflect demand for credit in the U.S. and Euro markets interacting with the supply of deposits. If banks in the United States export capital, it is likely to be because the volume of nonbank capital flowing to the United States, reflecting portfolio adjustments, has exceeded the financing needs of the current account deficit plus other "autonomous" items. Some countervailing flows thus need to develop. Interest rates in the United States and abroad will move to levels which make it

profitable for the banks to initiate such movements.[3]

Bank flows have a further peculiarity. Since banks take only very limited exchange positions, foreign lending and borrowing by banks in the United States take place almost entirely in U.S. dollars. Their international flows are flows out of and into the geographic United States, but not out of and into the U.S. dollar area. That area includes, of course, the "Euro" dollar market in whatever continent or offshore island it happens to appear. Bank transactions recorded as balance of payments transactions, therefore, do not necessarily give rise to foreign exchange transactions. They may stay entirely within the dollar area and may remain without effect on the exchange rate of the dollar.

Exchange rate transactions that have an effect on the dollar rate may, of course, occur as a further consequence of lending and borrowing by banks in the United States. The nonbank borrower of dollars may not want dollars. He may, therefore, convert into other currencies, accepting the exchange risk or passing it on to whoever supplies forward cover. If he is a resident of another country, such conversion for business use seems quite likely. On the other hand, residents of foreign countries, especially large corporations, may conduct some part of their worldwide business in dollars. They may, for instance, keep part of their liquid assets in dollars, the dollar being an important trade and investment currency. They may adjust their portfolio of liquid assets and liabilities so as to maintain a constant dollar component, or perhaps a constant national-currency component, in the latter case allowing variations in the portfolio to occur principally in its dollar component. In such cases, capital movements out of the continental United States may involve no exchange transactions and no direct pressure on the dollar.

Of course, such transactions in dollars will have interest rate effects. These, in turn, may cause other market participants to alter the exchange composition of their portfolios. Lending by banks in the United States to their London branches, and further lending in dollars by these branches drives down the Eurodollar interest rate relative to interest rates on assets denominated in other currencies. This may cause sales of dollar assets against foreign currency assets. Funding abroad by banks in the United States may have the opposite effect. But it is clear that in all these cases a party, other than the bank, must be willing to take on the exchange risk. In short, conclusions drawn from the outward or inward movement of bank funds with respect to the financing needs of the U.S. current account and other components of the capital account, and with respect to resulting pressures on the dollar, must be viewed with extreme caution.

[3]In speaking of "banks in the United States," it should be noted that a not inconsiderable number of them are foreign banks. For balance of payments purposes, it is appropriate to lump together the U.S.-located offices of U.S. and foreign-chartered banks under a common heading, as the BIS statistics do. For an analysis of the international commitments of national banking systems, worldwide consolidation by country of charter is appropriate to establish "who owes whom."

A View from the Foreign Exchange Market

If the capital account is crucial in determining the value of the dollar, some reflection of this should be visible from the perspective of the foreign exchange market. What one would like to know, ideally, would be the volume and proportion of transactions related to goods and services transactions, and similarly for capital transactions. No data of this kind exist. For the New York foreign exchange market, the only statistics we have are provided every few years by the Federal Reserve Bank of New York through a survey which shows the total value of transactions, customer-related transactions, and interbank transactions.

Customer-related transactions account for only about 15 percent of the total of $26 billion daily transactions in the spring of 1983. These may be importantly related to goods and services transactions, but can also reflect capital movements, or neither of the two. A large part of total transactions, presumably, is between residents rather than between residents and nonresidents. These transactions would not imply capital movements but only a shift of foreign exchange assets among residents. Many interbank transactions presumably are related indirectly to customer transactions, as dealers who took a position in meeting the needs of a customer cover this position through other dealers who in turn lay it off on others until the risk has been adequately spread around.

To the extent that transactions occur between residents and nonresidents, they conceptually represent capital movements. Each deal represents a gross or two gross flows—a nonresident acquiring or disposing of dollars—and a resident doing the opposite. The net is always zero. Positive or negative net movements can occur only as the counterpart of a customer transaction in which the customer covers an international purchase or sale of goods or services.

The daily turnover of $26 billion at an annual rate amounts to about $6.5 trillion, not quite two times the U.S. GNP and about 10 times the sum of annual U.S. exports plus imports. Of course, transactions in the New York exchange market may cover only a fraction of total U.S. current account transactions. Some may be financed elsewhere or outside exchange markets altogether. On the other hand, some exchange transactions may cover current account movements of other countries. If the gross inflows and outflows were known and were added up, they would undoubtedly cumulate to enormous totals. Dealers seem to reverse their positions possibly many times during a day. If in the face of a given piece of news a large section of the dealers should want to import or export capital *ex ante*, these *ex ante* moves too would be enormous. Even if a large part of foreign exchange transactions in this market should be among residents and hence not qualify as "capital movements," the remainder is potentially large enough to swamp the day-to-day demand and supply of exchange from current account transactions. All this reflects the familiar dictum that exchange markets are asset markets that clear quickly if not instantaneously and, therefore, dominate markets for goods and services which clear slowly. It should be noted besides that in efficient markets prices can change without transactions.

Over longer periods of time, the daily back and forth of switching positions nets out to virtually zero. It can only be minimally reflected in the quarterly capital account data. Even quarterly flows are, of course, reversible at least in part, such as portfolio purchases and sales, or bank transactions in dollars that may reflect exchange transactions by their customers.

The U.S. International Investment Position

The impact of capital movements on exchange rates and interest rates must be seen against the background of total U.S. holdings abroad and foreign holdings in the United States, i.e., the gross international investment position of the United States. At the end of 1983, "recorded" U.S. claims amounted to approximately $880 billion; "recorded" U.S. liabilities, including equities and direct investment, about $750 billion. A current account deficit of $80 billion in 1984 would wipe out much of the U.S. net international investment position of about $135 billion at the end of 1983. On the other hand, the stocks are large in relation even to the enormous annual portfolio adjustments and ensuing flows. That suggests that demand for claims on and liabilities to the United States could be elastic enough to cope with even an $80 billion change without extreme changes in interest rates and exchange rates, provided there are no major changes in the market's overall perception of the dollar.

There may be a legitimate doubt about the existence of even the modest $135 billion net investment position of the United States at the end of 1983. This statistic ignores the statistical discrepancy in the balance of payments that has accumulated to $100 billion over the last four years, and to $133 billion starting in 1970. Normally, the discrepancy, if its sign is positive, is interpreted as an unrecorded capital inflow. This seems plausible on the assumption that the current account, with all its defects, is more accurate than the capital account. By adding the cumulative discrepancy since 1970 to foreign claims on the United States, the net position at the end of 1983 is essentially reduced to zero. Further speculations about these data are invited by the appearance of a worldwide excess of current account deficits over surpluses, of about $74 billion in 1983. Allocation of a share in this number to the U.S. current account, perhaps proportionate to the U.S. share in world trade of about 20 percent, would improve the current account by about $15 billion in 1983. No refinement of the data is likely to modify significantly any conclusions one might want to draw from the unadjusted data.

The Impact of Capital Imports on the U.S. Economy

In addition to affecting the exchange rate, the inflow of foreign capital influences interest rates in the United States. The excess demand for dollar assets is brought into balance *ex post* with supply by some combination of a higher dollar and a lower U.S. interest rate. Together these two discourage the purchase of dollar assets. Real interest rates in the United States are regarded as high while the dollar by many is regarded as overvalued. This

would seem to suggest that most of the impact of the foreign demand for dollar assets has been on the exchange rate, with less of an impact on interest rates. This presumption is supported, in some degree, by the possibility that foreign buyers of dollar assets have capitalized a large real interest rate differential in favor of the dollar over a considerable number of years. A real interest rate differential of 3 percent, for instance, compounded over 10 years would justify a value for the spot dollar 34 percent higher than the investor might think it would be worth 10 years from now. In other words, the investor could accept a drop in the dollar of 3 percent for 10 years running and still break even.

One may reasonably surmise that a given inflow of foreign funds into dollar assets could move the dollar exchange rate more easily than dollar interest rates. Nevertheless, given the modest gross and net saving of the American economy, an annual inflow of $80 billion, as may be ahead for 1984, must be expected to influence interest rates and rates of return generally in the United States. The inflow would amount to about 40 percent of the budget deficit, and to a good deal more, in the short run, than the prospective "downpayment" on budget reduction in the early years. The view that interest rates are determined only by the money supply and not by demand for and supply of savings, which was characteristic of early Keynesian thinking and today has reappeared in some non-Keynesian quarters, was found unpersuasive during the debate over Keynes's *General Theory* and remains so today.

One might inquire whether the capital inflow today is financing primarily private investment in the United States or the federal deficit. Investment has been strong during this recovery. Its relation to GNP has been at approximately its recent historical level. The new demand for savings has come from the federal deficit. In that sense, one might conclude that the budget deficit is the marginal item, to the financing of which the capital inflow has contributed.

In a more meaningful sense, this conclusion is not plausible. Should the capital inflow end, i.e., should the current account return to balance, it is not the budget deficit that would be crowded out. The conclusion is virtually unavoidable that it would be private investment, unless there should be a remarkable upsurge of saving. Presumably this crowding-out would have to occur partly through a rise in interest rates and perhaps also through a decline in aggregate demand.

The counterpart of a decline in the capital inflow would be a diminished demand for dollar assets on the part of foreigners. Conceivably this could take the form not only of a cessation of net purchases, but of an effort to sell existing holdings. In the aggregate, foreigners, of course, could not effect any change in their investment position that was not consonant with the state of the current account. To enable foreigners to effect net withdrawals would require the current account to go into surplus, or residents to repatriate foreign holdings. But before that happened, sales of interest-sensitive dollar assets and unavailing efforts to dispose of dollar assets, could substantially depress the dollar and possibly raise real interest rates. Given the heightened inflation expectations that might flow from a declining dollar, nominal interest rates

might have to rise significantly to produce real interest rates that would clear the market.

Analysis of this hypothetical case indicates the potential influence of the capital account on exchange rates and interest rates. Realization of such a case would be consistent with the premise stated earlier that the capital account of the United States tends to dominate the current account and to dominate the exchange rate. What would have to happen is a massive shift in investors' asset preferences away from dollar assets. In that case, the current account deficit would no longer tend to be overfinanced, and so cause the dollar to rise. It would be underfinanced, and the resulting fall in the dollar would tend to reduce or eliminate the current account deficit. Since the market has long discussed all these relationships and contingencies, it is hard to believe that major surprises should be ahead. Accordingly, exchange rate movements could reasonably be expected to be gradual. The outcome in good part will depend on the policies pursued by the United States, especially with respect to reduction in the budget deficit which the market probably expects with some degree of certainty.

Implications

The dominant role of the capital account in the U.S. balance of payments is an empirical regularity, likely to assert itself with greater or lesser force also in the future. Is it a good thing, a bad thing, something we must accept or that we can modify?

Since the role of the capital account reflects to some extent the role of the dollar as a reserve currency, there is not much that we can do about it. Certainly, we should resist the temptation to modify that role by some form of capital controls. Since the United States could hardly control the movement of the dollar in the Euromarket, any such control would have to be imposed by foreign countries. It is very much to be hoped that this idea will continue to be rejected.

As to the benefits and costs, the dominant role of the capital account seems to imply both. It is, after all, an advantage to be able to engage in domestic fiscal expansion without immediately being hit by a negative impact on the exchange rate, reinforced by capital outflows. No other country has been able to finance a large current account deficit such as ours as easily as the United States has been able to do in the last few years. It goes without saying that this performance is possible only in the presence of a firm monetary policy. Monetary plus fiscal expansion is a recipe for dollar depreciation, as our experience in 1978–79 showed. For many other countries, this combination has led to a vicious circle of inflation and depreciation.

The benefits of a strong capital account can become excessive, however, as we have seen. Too strong a capital inflow becomes an additional reason for deterioration of the current account. This is an evident risk inherent in the United States' international financial position.

Finally, there is the risk that the volatility of capital movements will assert itself if the underlying condition is not remedied. A delayed reaction of this kind deprives the economy of the early warning that other countries would receive from the markets if they engaged in similar budget policies. The absence of the warning should not make us oblivious to the risk. Like most discussions of U.S. financial topics, this paper ends with the conclusion that we need urgently to act on the budget deficit.

Discussion

Robert Z. Aliber*

It is a privilege to be invited to participate in this celebration of the Bretton Woods Treaty in this famous Victorian setting, and for several reasons. One is that both Robert Triffin and Henry Wallich, authors of papers for this afternoon's session, were members of my Ph.D Committee at Yale. Governor Wallich has had many occasions to comment on and grade my performance. This is the first opportunity I have had to comment publicly on his performance—and now I've learned he has been called to a meeting in Europe. The second reason I am pleased to be here is that while in high school and college, I spent much time hiking and skiing in these mountains. Some of you will associate New Hampshire with the motto of "Live Free or Die" on the license plates, or the Old Man in the Mountains, or Daniel Webster; for me, however, the dominant association is home.

The first section of this comment summarizes Governor Wallich's fiscal theory of the balance of payments. The second section discusses four aspects of this theory for the foreign exchange value of the U.S. dollar. The third section considers the policy options toward those international capital flows that "wag the tails" of the domestic economies.

Section I

Governor Wallich combines an observation about a price, the foreign exchange value of the dollar, and two quantities, the U.S. current account deficit of $80 billion and the U.S. fiscal deficit of $180 billion, to develop a fiscal theory of the balance of payments. His story is that the U.S. fiscal deficit—or the combination of U.S. fiscal expansion and monetary contraction—has led to a surge in the U.S. interest rates sufficiently high to induce foreigners to increase their purchases of dollar-denominated assets. The increase in the exports of U.S. securities displaces the exports of U.S. goods; exports of commodities are "crowded out" by exports of dollar-denominated securities. The counterpart of a larger U.S. capital account surplus is a larger U.S. current account deficit; the move of the capital account into surplus has driven the current account into deficit.

The increase in U.S. economic activity—the income effect—explains only a modest part of the shift from a U.S. current account surplus of $5 billion in 1981 to a U.S. current account deficit of $80 billion in 1984. The larger part of this shift must be explained either by the price effect, where the change in relative prices is induced by the appreciation of the dollar, or by autonomous factors, such as the impact of the debt crises on the ability of Latin American countries to buy U.S. goods. The reduction in the U.S. cur-

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rent account surplus is "overfinanced" at the prior exchange rate, which leads to an appreciation of the dollar in the foreign exchange markets. The surge in the foreign demand for dollar securities is a response to the impact of the large U.S. fiscal deficit on U.S. interest rates.

The large U.S. current account deficit results in the spectacle that the richest nation in the world is importing some of the savings of many poorer nations. The United States incurred current account deficits of about $15 billion both in 1977 and again in 1978; these deficits, however, were significantly smaller than the prospective 1984 deficit. And if the United States continues to incur current account deficits for the next several years at anywhere near the 1984 level, then it will become an international debtor. The change in the U.S. net international investment position would be sharper than that experienced by any other major international financial power; even after the shock of World War I, Great Britain remained an international creditor.

Section II

Several different issues are raised by the fiscal theory of the balance of payments. The first is whether the theory is logically consistent. The second is whether the data used to determine the external impacts of the fiscal balance are correct. The third is why the change in the fiscal balance should have such a large impact on the foreign exchange value of the U.S. dollar. And the fourth involves the possible changes that might lead to a decline in the foreign exchange value of the dollar.

Governor Wallich's fiscal theory of the balance of payments may be contrasted to the monetary theory of the balance of payments so closely identified with the Jacques Polak of IMF and some of my Chicago colleagues. The monetary theory of the balance of payments states that a country cannot control its payments balance, but only the domestic component of the reserve base. Thus if the intended growth in the domestic component of the reserve base is smaller than the increase necessary to satisfy the domestic demand for money, the country will incur a payments surplus, with the consequence that the international component of the reserve base will increase. The fiscal theory of the balance of payments is that changes in the size of the fiscal deficit lead to changes in the payments balance or the exchange rate through their impacts on domestic interest rates and on the capital account balance. Today the strong dollar is attributed to the large U.S. fiscal dificit, even though traditionally large fiscal deficits have been associated with weak currencies. Large fiscal deficits lead to increases in interest rates; in some cases, as in 1977 and 1978, higher interest rates on dollar assets are associated with a weaker dollar, and in other cases, as in 1981 and 1982, higher interest rates are associated with a stronger dollar. So the fiscal theory needs a sufficient condition if changes in the fiscal balance are to have predictive value about the strength or weakness of a currency in the foreign exchange market. If fiscal expansion leads to an increase in the domestic price level at a given constant rate of 5 or 10 percent a year, then domestic currency might depreciate at a constant rate of 5 or 10 percent a year; at least that is the prediction im-

plicit in the purchasing power parity concept. One plausible sufficient condition is when change in the fiscal balance has a larger impact on domestic interest rates than on the domestic price level. Thus if a given fiscal expansion causes a larger increase in percentage points in the domestic interest rates than in the domestic price levels, foreign capital will be attracted to domestic securities and domestic currency will appreciate.

The fiscal theory of the balance of payments can be related to two different models of international capital movements. In both of these models capital flows from low interest rate countries to high interest rate countries. Traditionally financial capital flows from the wealthier countries, since interest rates usually are lower in the wealthier countries than in the poorer countries. Capital flows from Great Britain in the decades before World War I, and from the United States in the 1920s, the 1950s, and the 1960s conform with this pattern. So do capital flows to countries like Canada.

The second model of capital movements represents stock adjustments to changes in anticipated returns in different countries because of a variety of shocks, both real shocks like the oil price increase and wars, and monetary shocks like changes in relative price levels or interest rate levels or anticipated exchange rates. Such shocks may reverse the direction of the capital flows by reversing the traditional pattern of interest rate differentials. Because of constraints on changes in the current account balance, the stock adjustment in rates of returns may not be completely effected, as it usually is in domestic financial markets. Capital flows to the United States in the last several years seem more nearly consistent with the second model, since the United States has been subject to a credit market shock. And shocks by definition are transient events. The turnabout in the U.S. current account balance reflects that U.S. interest rates are unusually high relative to the current and anticipated U.S. inflation rate.

The second issue involves the data from the U.S. current account balance and the U.S. fiscal balance used to illustrate the fiscal theory of the balance of payments. The search for accurate data for analytical purposes encounters the problem that both balances represent the difference or residual between two very large groups of payments and receipts. The data recorded in the U.S. balance of payments are a poor proxy for the data necessary to predict changes in the foreign exchange value of the dollar for two reasons. One involves the errors in measurement of the payments balance. From 1981 to 1984 the change in the U.S. current account balance was $85 billion. Over this same period, the excess of the sum of current account deficits for all countries over the sum of the current account surpluses for all countries increased from $50 billion in 1981 to $110 or $120 billion in 1984. The size and the rapid increase in the excess of the sum of the current account deficits relative to the sum of the current account surpluses mean that it is risky to place much confidence in the reported value for the current account balance data. Governor Wallich believes the U.S. share of this measurement error should be related to the U.S. share of world trade and hence would reduce the projected U.S. current account deficit by $15 billion. However, this adjustment should probably be based on the U.S. share of investment income flows and might be as large as $30 or $40 billion on the assumption that the

investment income of U.S. residents (and near U.S. residents) is greatly understated. Hence the change in the U.S. current account balance from 1981 to 1984 might be nearer $50 or $60 billion rather than $85 billion. Moreover some changes in the U.S. current account balance are independent of changes in U.S. fiscal policy. Since 1981 the current account deficits of the Latin American countries have declined by $30 billion; the counterpart of this change has been an increase in the U.S. current account deficit of $15 billion. Similar adjustments might be made for changes in the trade balances of Korea, Taiwan, and other Southeast Asian countries. The implication of these adjustments is that the change in the U.S. current account balance that should be explained by the price term, the change in the exchange rate, is significantly smaller than the reported change in current account balance.

Several adjustments might be made to the $180 billion estimate of the fiscal deficit to develop a better estimate of the impact of the changes in the fiscal balance on the foreign exchange value of the dollar. In 1981, the U.S. fiscal deficit was $60 billion, so the increase in the fiscal deficit from 1981 to 1984 was $120 billion. One adjustment involves focusing on the cash flow aspect of the U.S. fiscal deficit rather than on the accounting measure of the fiscal deficit; only the cash flow deficit estimate requires financing. The difference between these two estimates reflects the acquisition of U.S. government securities by various trust funds and by the Federal Reserve; in 1981 their holdings increased by $20 billion and in 1984 by $30 billion. A second adjustment involves integrating the cash flow estimates of state and local governments with those of the federal government, which makes extensive transfers to the state governments. And the income expansion associated with large federal deficits leads to an increase in the tax revenues of the state and local governments. This adjustment reduces the size of the fiscal deficit by $30 billion. As a result of these adjustments, the U.S. fiscal deficit has increased by $80 billion since 1981 rather than by $120 billion.

The third issue is why an increase in the adjusted fiscal deficit of $80 billion might be related to the increase in the adjusted current account deficit of $50 or $60 billion and an appreciation of the U.S. dollar of 30 percent in terms of the German mark and the Japanese yen. As the U.S. economy has expanded in the last several years, the demand for loanable funds has increased relative to the supply. And while the increase in the fiscal deficit may have triggered the economic expansion, the latter has led private firms and homebuyers to make more investments. Consequently the total increase in the demand for loanable funds may be several times larger than the increase in the fiscal deficit.

Interest rates on dollar-denominated securities have risen to induce an increase in the supply of loanable funds both from U.S. and foreign residents. These two groups of savers differ in two significant ways—one is that tax treatment of interest income differs; the marginal foreign investor is probably subject to a significantly lower tax rate on dollar interest income than the marginal domestic investor. The implication is that the increase in the after-tax return to foreign residents from an increase in interest rates on dollar assets is larger than the increase in the return to domestic investors. The second difference is that foreign investors are concerned about the possi-

ble exchange loss from the change in the foreign exchange value of the dollar between the date when they buy dollar assets and the date when they sell these assets. These investors are likely to incur a loss on the foreign exchange transaction because interest rates on dollar assets will be lower when they shift from dollar assets into foreign assets.

The larger the interest elasticity of the supply of funds from domestic residents relative to the interest elasticity of the supply of funds from foreign residents, the smaller the capital inflow and the change in the U.S. current account balance associated with the increase in the fiscal deficit and the economic expansion in the United States. To the extent that the increase in interest rates on dollar assets associated with the economic expansion attracts foreign investors, the increase in dollar interest rates is smaller than it would otherwise be. However, foreign purchasers of dollar securities must bid dollar funds away from foreign purchasers of dollar goods; competition between these two groups for dollars in the foreign exchange market leads to an increase in the foreign exchange value of the dollar.

Viewed from Western Europe and Japan, the investors attracted to dollar securities must first buy dollars in the foreign exchange market, which induces a depreciation of their currencies; these countries generate a larger current account surplus to finance the flow of capital to the United States. The sharp increase in the foreign exchange value of the dollar thus reflects three factors—the low interest elasticity of the supply of domestic savings in response to the increase in interest rates on dollar securities, the premium that foreign investors require for acquiring the exchange risk associated with dollar assets, and the premium that foreign investors must pay to acquire dollars in competition with foreign buyers of U.S. goods.

One additional factor should be noted. The more eager foreign investors are to acquire U.S. securities, the smaller the increase in U.S. interest rates required to close the U.S. savings gap. Thus an autonomous increase in the foreign demand for dollar assets, perhaps attributable to the "safe-haven" effect, could lead to an increase in the foreign exchange value of the dollar and a decline in U.S. interest rates at the same time. The low interest elasticity of the supply of domestic saving in response to higher U.S. interest rates explains why the increase in the federal fiscal deficit has had such a sharp impact on the foreign exchange value of the dollar.

The fourth issue involves the types of changes that might lead to a depreciation of the dollar in the foreign exchange market. An autonomous increase in the U.S. saving rate would lead to a decline in interest rates on dollar assets. So would a decline in dollar borrowing by business firms or households or the government in the United States. If the foreign demand for dollar assets should decline while the U.S. business expansion continues, then U.S. interest rates would rise while the foreign exchange value of the dollar falls.

One consequence of the appreciation of the dollar is that U.S. production in the tradable goods sector is relatively depressed in the context of the economic expansion. And the slower growth of income in this sector means a lower level of U.S. saving. Hence the inflow of loanable funds from abroad means a reduced supply of domestic loanable funds because of the increase in

the foreign exchange value of the dollar leads to reduction in the level of income (or the rate of growth of income) in the tradable goods sector, and hence to a reduction in the saving by factors in this sector. Thus the net increase in the supply of loanable funds is smaller, perhaps significantly smaller, than the adjusted change in the current account balance. As a result the effective interest cost on funds loaned to foreigners may be significantly higher than the net interest payments.

Governor Wallich's fiscal theory of the balance of payments admirably explains the surge in the foreign exchange value of the dollar, and the turnabout in the U.S. current account balance.

Section III

The concern that the "tail" of the capital account wags the exchange rate or the domestic economy has been traditional in international finance, although the phraseology has changed. At one time the concern was whether speculation in the foreign exchange market was destabilizing or stabilizing. Thus in the early 1920s an increase in the demand for foreign securities by French residents depressed the foreign exchange value of the French franc and led to increased inflationary pressures in France. The sharp decline in the external value of the French franc reflected that French importers of foreign securities had to bid U.S. dollars and British pounds away from French importers of foreign goods in the foreign exchange market. The same concern is expressed by the question of whether the goods market stabilizes the money market when shocks occur, or whether instead the money market stabilizes the goods market; this is one argument in the traditional debate between the proponents of floating exchange rates and the proponents of pegged exchange rates in the foreign exchange market.

The tails have been more potent under the floating exchange rate regimes than under pegged exchange rates. The evidence is that the magnitude of the changes in real (or price-level adjusted) exchange rates has been substantially larger under the pegged exchange rate regime.

These versions of the similar story suggest economic welfare might be enhanced by measures to reduce the potency for the tails to wag the dogs. Several policy responses might be noted. One approach toward limiting the capital flows became embodied in the IMF Articles of Agreement; countries were permitted to use exchange controls to limit capital flows. Two different types of motivations were almost certainly evident in the negotiations. One was to permit use of exchange controls on current account payments as a temporary device during a postwar transition following the end of World War II. The second was to permit use of exchange controls on capital movements as a way to cope with the "vicious and virtuous circle." In such cases, the private interests of those moving funds internationally might not coincide with the public interest. However, several decades of experience suggest skepticism toward the efficacy of controls, especially since the borders among currency areas now are much more extensive than the national borders.

The second policy option to limit the incentive for the tails to be wagged

is to coordinate national macroeconomic policies. Policy coordination is rather like motherhood; there's little payoff in being asked to carry the negative side of the debate. The arguments against policy coordination are much like those against currency unification. Thus if several national economies are subject to nonidentical shocks, then economic welfare may be enhanced if macropolicy is directed toward domestic economic objectives. The costs that can be attributed to the lack of policy coordination are extremely high in both economic terms and in foreign policy. Sharp changes in real exchange rates have significant costs to the domestic economy.

A third policy option involves official intervention in the foreign exchange market to limit the amplitude of movement of exchange rates in the foreign exchange market. Intervention by the authorities may be of limited effectiveness if the monetary impacts are not sterilized. Moreover, even then, intervention may be of modest effectiveness, unless the authorities can establish the credibility of their intentions to limit the movements of the exchange rate in the foreign exchange market. The authorities will tend to "lean against the wind," and the market may tend to lean against the authorities.

The fourth policy option is to return to some form of pegged exchange rate system. Capital flows under the floating rate system are responsive to the difference in interest rates relative to the anticipated change in the exchange rate. Frequently—although not always—the dominant factor in this equation is the anticipated change in the exchange rate. The authorities can reduce the anticipated return by committing themselves to maintain their parities. Paradoxically, it may be easier for the authorities to establish credibility about maintenance of the parities then about intervention. One reason for the success of the gold standard and of the Bretton Woods system in the 1950s and the early 1960s is that the commitment to parities lessened both the scope for currency speculation and for nationalist or inward-looking monetary policies. The tails became important only when the system began to unravel in the late 1960s. The reason that the tails appear more powerful under floating rate regimes than under pegged exchange regimes is that independent monetary policies have much less scope; a pegged rate system forces a commitment to policy coordination that may not be attainable under a floating exchange rate system.

The vision of those who were at Bretton Woods 40 years ago is that nationalist monetary or financial policies are expensive in terms of the international system. That vision has been lost.

General Discussion

Edward Bernstein agreed that international capital movements tend to dominate exchange rate movements, and he expressed dismay at the absence of a good theory of capital flows. Conventional theory suggests, according to Bernstein, that a rise in the U.S. interest rate relative to other countries' rates could induce large capital inflows and a rise in the foreign exchange value of the dollar. Yet recent massive U.S. capital inflows could not be explained entirely by the small interest rate differential in the United States's favor. Part of these inflows might have stemmed from the dollar's increase in value, which created an expectation of a further appreciation and induced more capital inflows.

Bernstein expressed doubt about a near-term fall in the dollar's value because of recent shifts in international borrowing and lending patterns. Traditionally, large industrial countries were the dominant sources of international capital while developing countries and the British Dominions were the dominant borrowers. Recently, oil-exporting developing countries have become significant net lenders. With Latin American developing countries no longer creditworthy and Japanese, Canadian, and several large Western European countries stressing current account surpluses, is not the U.S. capital market the only one that can readily absorb foreign capital inflows? That is, has not the world's saving and foreign investment environment changed enough to explain the dollar's strength and to suggest that the dollar's value is not likely to decline soon?

Aliber rejoined that an important difference between Bernstein's view and his own is that in the former foreign investors are eager to buy dollar-denominated assets while in the latter such investors must be bribed to accept these assets. That is, as the U.S. economy expands, the U.S. interest rate will rise sharply, according to Aliber, to reflect the additional premium necessary to induce foreigners to hold dollar-denominated assets.

Scott Pardee discussed the effects of inflationary expectations and the U.S. tax system on the U.S. interest rate. First, Pardee argued that inflationary expectations are still very strong, as evidenced by the recent surge in borrowing by firms for leveraged buyouts, acquisitions, and the like. Second, Pardee noted that foreigners do not enjoy the tax breaks on domestic interest payments that U.S. residents do. Consequently, a high real interest rate for U.S. loans to foreigners is consistent with a zero, or even negative, real interest rate paid by U.S. residents.

William Poole expressed surprise that Wallich paid little attention to the issue of efficient allocation of capital internationally. Poole suggested that high real U.S. interest rates and the strength of the dollar are consistent with a relatively high after-tax real rate of return on investments in the United States now, in contrast to the late 1970s. The seeming paradox is that the United States, a relatively mature economy which should have a low rate of return, is experiencing a high rate of return on investments, while developing countries are now experiencing atypically low rates of return.

Adjustments in World Payments: an Evaluation

Otmar Emminger*

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

[1]The 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 modest 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 overfinanced 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

[2]Cf. 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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[1]See 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 sancity 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

[2]The 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 Cline[3] 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 inacceptable.

[3]See 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.

The Conditions Attached to Adjustment Financing; Evolution of the IMF Practice

Adolfo C. Diz*

Introduction

For more than three decades the conditionality attached to the use of the IMF resources in some of its operations has been one of the most controversial issues in the academic and political circles of Latin America and other parts of the world. It has equally been the subject of learned academic articles, political campaign speeches, or graffiti.

The term "conditionality" does not refer to the many obligations and conditions that a member country has to comply with in order to continue being a member of the Fund in good standing (as, for example, the obligation to furnish economic information, or to make punctual repurchases or other conditions in the SDR Department). Rather, as Sir Joseph Gold has defined it, "conditionality in the IMF refers to the policies the Fund expects a member to follow in order to be able to use the Fund's general resources."[1] That is, it encompasses the economic policies and other measures and decisions the institution expects a member country to adopt, maintain, or avoid, when making such use, under certain circumstances. More specifically it refers to conditions attached to such use when the resources are those of the General Department (as opposed to the SDR Department) and, in particular, when such use causes the Fund's holdings of the member currency to increase above its quota, to the so-called "upper credit tranches."

The basic reasons for this conditionality are to ensure that the IMF resources are used in accordance with the purposes of the Fund and to maintain the revolving character of those resources. For these reasons the Fund, in turn, is required by member countries to make its general resources "temporarily available to them under adequate safeguards."[2]

The conditonality attached to the use of Fund resources has been an evolving concept which grew and developed through the practice of the IMF, rather than by explicit definition, agreement, or description in the Articles of Agreement. In fact, the word has not appeared in any of the three versions of the successively amended Articles and, until the first amendment (1969), when the Fund was legally required to have policies on the use of its resources (without defining them), voices questioned its legal capacity to impose conditionality. Or as Sir Joseph Gold has said:

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[1]Joseph Gold (1979) p.1.

[2]IMF, "Articles of Agreement," Article I (v).

> The desirability of a concept of conditionality is usually accepted, and the legal necessity for it cannot be questioned at all since the date of the First Amendment...[3]

implying that those voices have been probably misled by the lack of precision of the original Articles.

Prehistory[4]

At the Bretton Woods Monetary and Financial Conference in 1944, there was little discussion of the issue of conditionality.

The revised version of the American proposal issued by the U.S. Treasury department and entitled "Preliminary Draft Outline of a Proposal for an International Stabilization Fund of the United and Associated Nations" (revised July 10, 1943, i.e., one year before the Conference) contained certain provisions implying specific policy conditionality.

Its Preamble stated that

> The resources of the Fund would not be used to prolong a basically unbalanced international position. On the contrary, the Fund would be influential in inducing countries to pursue policies making for an orderly return to equilibrium.[5]

Section V.2 of the outline stated that the Fund could sell to any member the currency of any other member provided that there was a balance of payments need ("predominantly on current account") and Fund holdings of the member's currency were below 150 percent of quota during the first year or below 200 percent of quota thereafter. These two limits called the "permissible quota" could, however, be exceeded but only if at least one of the following two conditions was met:

> (i) In the judgment of the Fund satisfactory measures are being or will be taken by the country whose currency is acquired by the Fund, to correct the disequilibrium in the country's balance of payments; or
>
> (ii) It is believed that the balance of payments of the country whose currency is acquired by the Fund will be such as to warrant the expectation that the excess currency holdings of the Fund can be disposed of within a reasonable time.

Furthermore, when in the judgment of the Fund a member (whose currency holdings by the Fund exceeds its quota) "is exhausting its permissible quota more rapidly than is warranted" or is using the Fund resources to prevent or delay a sound balance in its international accounts, "the Fund may place such conditions upon additional sales of foreign exchange to that country as it deems to be in the general interest of the Fund."[6]

[3]Joseph Gold (1979) p. 14.

[4]It seems appropriate for a paper presented at Bretton Woods, N.H., 40 years after the now historical Monetary and Financial Conference of July 1–22, 1944, to give some emphasis to the prehistory of the Fund.

[5]*Proceedings,* Vol. II, page 1601.

[6]Ibid., p.1606.

So in this second version of the American proposal, unless there was a strong belief on the part of the Fund directors that the imbalance will reverse itself within a "reasonable time," specific conditionality in terms of "satisfactory measures" to be taken applied essentially to purchases that would cause the Fund holdings of the member's currency to go beyond its "permissible quota," that is, purchases increasing those holdings beyond the 200 percent of the member's quota (the "permissible quota" of 150 percent of quota would only apply temporarily during the first year of operation of the Fund). But there was also the possibility of specific policy conditions being asked beyond the 100 percent of quota in case of accelerated use of "permissible quotas" or misuse of resources to prevent or delay external adjustment.[7]

Almost at the same time of publication of the original American version, the British government published its proposal for an International Clearing Union through the BIS (the British Information Service). This proposal was basically nonconditional. Its preface stated:

> There should be the least possible interferences with internal national policies and the plan should not wander from the international terrain. Since such policies may have important repercussions on international relations they cannot be left out of account. Nevertheless, in the realm of internal policy, the authority of the governing board of the proposed institution should be limited to recommendations, or, at most, to imposing conditions for more extended enjoyment of the facilities which the institution offers.[8]

An interesting feature of the Plan was that conditionality and adjustment were to be as symmetrical as possible.

> In recognizing that the creditor as well as the debtor may be responsible for a want of balance, the proposed institution would be breaking new ground.
>
> We need a system possessed of an internal stabilizing mechanism, by which pressure is exercised on any country whose balance of payments with the rest of the world is departing from equilibrium in either direction, so as to prevent movements which must create for its neighbours an equal but opposite want of balance.[9]

The principle of symmetry was also emphasized by the special charge of 1 or 2 percent per annum that members should pay on the amount of their annual average debtor or creditor balances if they were larger than 25 or 50

[7]The revised version of the American proposal was prepared at the U.S. Treasury after consulting on the first version with experts from nearly 30 countries. However, the basic ideas and most of the language remained as it was in the original American version, which appeared three months before the revised version. The only significant differences on this matter are that the Board's decision to exceed the 200 percent of quota in the original version required a four-fifths majority, instead of a simple majority, and that the country making the purchase "agrees to adopt and carry out measures recommended by the Fund designed to correct the disequilibrium in the country's balance of payments" (Ibid., p. 1538). Thus, the original version implied a stronger language and a more active exercise of conditionality on the part of the Fund.

[8]Ibid., p. 1549.

[9]Ibid., pp. 1550 and 1551.

percent of their quotas, respectively.

The way in which this symmetry operated was as follows. As a condition to allowing members, having debit balances equivalent to half their quotas, to increase their negative balances, the Board could require all or any of the following measures: a devaluation, the control of outward capital transactions, or the surrender of gold or other liquid reserves.

> Furthermore, the Governing Board may recommend to the Government of the member State any internal measures affecting its domestic economy which may appear to be appropriate to restore the equilibrium of its international balance.[10]

Beyond three-quarters of quota the member could be asked to take measures and if the debit balance was not reduced within two years the Board could declare that it was in default and unable to draw.

A creditor country with balances beyond half its quota "shall discuss with the Governing Board (but shall retain the ultimate decision in its own hands) what measures would be appropriate to restore the equilibrium of its international balances,"[11] including expansion of domestic credit and domestic demand, appreciation of its currency, increase in money rates of earnings, reduction of tariffs and other discouragements to imports, and international development loans.

Thus there is an attempt at symmetry but complete symmetry is not achieved. On deficit countries there is a limit which does not exist in the case of the creditor countries and the wording of the provisions is stronger in the former than in the latter case, including the parenthetical reference to the "ultimate decision."

For that reason it seems fair to describe the mechanism of the British proposal as the Paper does

> The object is that the creditor should not be allowed to remain entirely passive. For if he is, an intolerable heavy task may be laid on the debtor country, which is already for that very reason in the weaker position.[12]

The "tentative Draft Proposals of Canadian Experts for an International Exchange Union" appeared in June 1943 and contained provisions which were more similar to those of the American proposal than those of the British proposal. An interesting remark with respect to these proposals is the following:

> . . . both plans provide that foreign credits are to be available under certain conditions to countries having need of them, and that they shall be made available through an international monetary organization rather than through bilateral arrangements between pairs of countries.[13]

Once those different proposals were discussed by experts of more than 30 countries, a "Joint Statement" was issued in April 1944, almost one year

[10]Ibid., p. 1555.
[11]Ibid., p. 1556.
[12]Ibid., p. 1562.
[13]Ibid., p. 1577.

later. In this proposal for the establishment of an International Monetary Fund (apparently the first published document to name the institution as we know it today) the question of making the Fund resources available under "adequate safeguards" and the requirement of balance of payments need remained as before but there were no specific references to measures to be taken or to policies to be adopted when using the Fund's resources. Rather a maximum limit was established to the use of Fund's resources per year (25 percent of quota) with a maximum of 200 percent of quota at all times. In addition, the wording was reversed in the sense that a member may be

> suspended from making further use of the Fund's resources on the ground that it is using them in a manner contrary to the purposes and policies of the Fund.[14]

At the Bretton Woods Monetary and Financial Conference delegations were presented with the "Joint Statement" plus alternative and supplementary texts for almost every article and section submitted by the attending delegations to the Secretariat. In this particular area of "Transactions with the Fund," alternative texts were presented jointly by the U.S. and the British delegations and individually by the delegations of Australia, Czechoslovakia, France, and Belgium. Most of them, however, were proposals to increase the limits on the possible yearly use of the Fund's resources (Australia, France, and Belgium), which became a subject of intensive and extensive discussions during the conference. Only the joint U.S.–British proposal offered an alternative text on the questions of "using the resources of the Fund in a manner contrary to the purposes and policies of the Fund" stating and clarifying the procedure to follow in those cases.[15] Essentially it was the Fund that should take the initiative in those cases by presenting a report to the member and prescribing a time for reply. After that the Fund could limit the use of its resources by the member and if no reply was received within the stated time, or if the reply was not satisfactory, the Fund might continue to limit the member's use of the Fund resources and after reasonable notice, declare it ineligible to use the Fund resources. This proposal was the basis for what at the end of the Conference became section 5 or Article V entitled "Ineligibility to Use the Fund's Resources" of the original Articles of Agreement. The only significant difference with the original joint U.S.–British proposal was deleting the words "and policies" so that reference was only made to the "purposes of the Fund." This deletion has some importance because the "policies of the Fund on the use of its resources" returned to the Articles with the first amendment in 1969, and became the undisputed legal basis for the exercise of conditionality.

At the end of the Conference the Secretariat issued a press release entitled "IMF (Purposes, Method, Consequences)."[16] It was a four-page explanatory document in which the sole reference to this subject was the following:

[14]Ibid., p. 1632.
[15]Ibid., p. 28.
[16]No similar explanation was given for the parallel World Bank proposal.

> No safeguard provided for the Fund is more important than the provision that the countries' request for foreign currencies must indicate that the uses to which these currencies will be put are consistent with the purposes of the Fund. This means that countries which conduct their affairs in good faith in accordance with the undertaking to act in conformity with the purposes of the Fund will not in any circumstances divert the resources of the Fund to inappropriate uses.[17]

The preceding description seems to allow several observations.

First, that the idea of economic policy conditionality attached to the use of Fund resources existed with varying degrees in the different proposals discussed during the prehistory of the Fund. It was, as the British proposal stated (albeit in a different context) one of those "general ideas belonging to the contemporary climate of economic opinion...which are born of the spirit of the age."[18]

Second, that some of the proposals were rather specific and mentioned things like appropriate or adequate measures to be adopted, additional conditions in certain circumstances, internal measures to be recommended, etc.

Third, that in the "Joint Statement" there was a reduction, a limitation, of the maximum yearly usable amounts of Fund resources and an apparent loss of specificity in the conditions for such use, which were written in a broader language than originally was the case. This is most interesting. The maximum possible yearly use of Fund resources amounting to 25 percent of quota substitutes in the "Joint Statement," the preexisting policy conditionality. Thirty-four years later, with the second amendment to the Articles (1978), this 25 percent limit is deleted precisely because "the Fund's policies on the use of its resources" (i.e., policy conditionality) "have been more adequate safeguards of the Fund's resources than the deterrence implied in the necessity for waivers"[19] to exceed the limit of 25 percent of quota, that had become a commonplace.

Fourth, that the different delegations seem to have arrived at the Bretton Woods Conference with a fairly large consensus on this question as it was a subject on which there seems to have been little discussion. No alternatives suggesting substantial changes were presented, and no final reservations were recorded on these issues (contrary to what happened with other issues).

Finally, it appears as if during all this period there was a sufficiently strong trend away from the original specific policy conditionality so as to even change its nature. Or, as Sir Joseph Gold has said:

> It is still true, therefore, that conditionality cannot be defined by reference to the "conditions" of Article V, Section 3 (b).[20]

[17] *Proceedings,* p. 1213.

[18] Ibid., p. 1551.

[19] IMF—"Proposed Second Amendment to the Articles of Agreement of the IMF.' Washington, D.C. 1976, p. 22.

[20] Joseph Gold (1979) p. 1. Section 3 (b) of the current Articles which he mentions corre sponds to the former Section 3 (a) which included the balance of payments need, the annua limit, and the reference to section 5 of Article V, mentioned above.

History

The history of the Fund policies on the use of its resources (1946-84), can probably best be divided according to the four periods separating the adoption of the three main Executive Board decisions on the subject of 1952, 1968, and 1979.[21] The reason for this is that an important characteristic of these decisions is that they showed the practice that had developed in the day-to-day business of the Fund up to the moment of their adoption and thus allowed one to know the state of this practice as it has evolved through time.

1. *The period 1946-1952*

In the first (1952) decision there was a statement by the Managing Director with a reference to "a period of relative inactivity of the Fund" and a sentence that describes most graphically the state of the art of conditionality at that early stage on the use of Fund resources: "We shall have to feel our way."

In the early years of the Fund there were totally unconditional transactions, within the limits established by the Articles. In fact many drawings of relatively small amounts in terms of the member's quota (5 percent of quota per month) were decided directly by the Management without prior intervention of the Executive Board. This practice, however, increasingly came to be criticized because, in the view of some important members, it did not provide sufficient assurances to the Fund that its resources were being utilized in a temporary manner.

Thus, the concern that such use should be temporary, as a way of assuring the revolving character of the Fund's resources, was the main consideration that led to policy-conditionality.

During the first year of operation of the Fund, at the request of the Governor for the United States, its Executive Board decided that the correct interpretation of the Articles implied giving members "temporary assistance in financing balance of payments deficits on current account for monetary stabilization operations."[22]

This, in turn, implied that the Fund would be assisting members that might be in trouble and a consensus has developed around the idea that access to the Fund should not be denied because a member was having those problems. Precisely this was the time to help, when commercial banks and other lenders might feel reluctant to do the same, and the Fund might reestablish confidence that the country would overcome its difficulties. But the question remained, however. How could the Fund make sure that the member's problems were temporary, that they could be solved within a reasonable time like three to five years? By analyzing the policies pursued by the member. On this question the Managing Director's statement was very forceful: "The policies, above all, should determine the Fund's attitude."

[21]Decision No. 102-(52/11), February 13, 1952; Decision No. 2603-(68/132), September 20, 1968; and Decision No. 6056-(79/38), March 2, 1979.

[22]Board of Governors, Resolution No. IM-6, March 18, 1946 and Executive Board. Decision No. 71-2, September 26, 1946.

Moreover, the Fund would pay attention to the member's record with the Fund (prudence in drawings, willingness to offer voluntary repayment, promptness in reporting monetary reserve data and discharging repurchase obligations).

This decision (1952) is also important because among the different options envisaged by the Managing Director for members approaching the Fund there is one that constitutes the earliest description of what later became known as stand-by arrangements:

> At other times discussion between the member and the Fund may cover its general position, not with a view to any immediate drawing, but in order to ensure that it would be able to draw if, within a period of say six or twelve months, the need presented itself.

One other aspect of the use of Fund resources was clarified at this point by assuring memebers the virtually unconditional use of the gold tranche, that is, of purchases which would raise the Fund's holdings of a currency to not more than the quota of a member.

Thus during the first six years of the Fund there was relatively little use of the Fund's resources and virtually no policy conditionality. But the seed for the future stand-by arrangements was planted.

2. *The period 1952-1968*

The second period goes from 1952 to 1968, when the second main Executive Board decision on the use of Fund resources and stand-by arrangements was approved.

This Decision of September 1968 was adopted shortly after the Board of Governors had approved the first Amendment to the Articles of Agreement, but before they were effectively amended. This Amendment introduced three important elements in the area under consideration. The first one is that it required the Fund "to adopt policies in the use of its resources," although without specifying them. Thus, after 24 years, the words "policies of the Fund," deleted from the joint U.S.-British alternative text at Bretton Woods, reentered the Articles of Agreement. Here again the modification was largely declaratory of practice because by then the Fund had already built up a system of fairly well-defined policies. But one can still say that, in a sense, the 1968 decision was a direct by-product of the first Amendment. Second, it made the use of Fund resources policy conditional by requiring the Fund to challenge a member's representation[23] if it thought that a proposed purchase would not be consistent with the Fund's purposes and policies. Thirdly, by expecting gold tranche purchases from this challenge it gave legal unconditionality to the use of the gold tranche, confirming the trend adopted by the 1952 Decision.[24]

This period of the 1950s and the 1960s was the period in which the concept of conditionality became fully developed, the use of the stand-by agreement was refined and its diverse and complex techniques were frequently ap-

[23]The word "represents" in the Articles means "declares."
[24]Articles of Agreement, Article V, Section 3 (c) and (d).

plied, initially in the Latin American countries and later on in other parts of the world.

As early as December 1953, an IMF Decision[25] defined the stand-by arrangements and set forth the general framework for them. Those original arrangements were limited to periods of not more than six months, but the Fund would give "sympathetic consideration" to a request for a longer arrangement, subject to understandings additional to those needed for the six-month arrangements. This decision followed the first two stand-by agreements concluded by the Fund during the financial year 1953.

In the statement introducing the 1957 Annual Report of the executive Directors to the Board of Governors, the Managing Director states "once again" the Fund policies that have been recorded in the Annual Report of 1955, only three years after the 1952 Decision:

> ...access to the gold tranche is almost automatic; and requests for drawings within the next 25 percent (the so-called "first credit tranche") are also treated liberally but, even so, such requests will be approved only if the country asking for assistance can show that it is making reasonable efforts to solve its own problems. For drawings beyond that tranche (i.e., beyond the first 50 percent of the quota), substantial justification is required, and among the justifications foreseen are transactions in support of the establishment or maintenance or convertibility. [These latter requests]...are likely to be favorably received where they are intended to support well-balanced and adequate programs which are aimed at establishing or maintaining the enduring stability of the currencies concerned at realistic rates of exchange, and may therefore reasonably be regarded as establishing the conditions for substantial progress toward convertibility.[26]

This means that during the financial year 1954 the Fund had already defined its tranche policies differentiating the conditions required for drawings in the gold tranche, the first credit tranche, and the upper credit tranches.

The frequent use of the stand-by agreements showed that they provided the intended assurances to both the member country and the Fund. To the member the stand-by agreement provided the assurance that it could draw resources from the Fund during a certain period of time (usually one year, but sometimes six months) provided the economic policies implemented produced the intended results. And to the Fund, the assurance that its resources were being used in accordance with its purposes and policies. Further, the agreements also began to give assurance to third parties—the "seal of approval" effect—that were thus more inclined to help the member financially—what used to be called the "parallel arrangements"—or in other cases, less inclined to be a part of a capital outflow. In many cases member countries renewed their one-year stand-by arrangements during several consecutive years for precautionary reasons and to prolong the benefits and side effects of the operation. But this practice was not generally encouraged.

As to the techniques that were developed during this period the Decision itself is an interesting source of information. By 1968 the agreements had

[25]Decision No. 270-(53/95), December 23, 1953.

[26]Per Jacobsson, "International Monetary Fund Monograph Series," No. 3, p. 20.

"consultations," "phasing," "performance clauses," "performance criteria," arrangements that went or not "beyond the first credit tranche," "evaluation of the program," etc.

Two of these techniques played a crucial role in the development of the practice of conditionality: the concept of an economic program and the technique of consultation.

The idea of a program helped to organize the economic decision-making—particularly in those early years, in many developing countries—and, by focusing on the interactions of different variables in the overall performance, helped to better understand the relative strength and importance of different decisions. By insisting on "comprehensive economic programs" the Fund, in many instances, introduced what could be characterised as the simultaneous equation approach to situations that could otherwise have adopted the isolated, barren policy measure. Additionally, the fact that these programs usually aimed at, and were evaluated by different statistical measures, gave a great impetus to the development of economic statistics in many countries and the use of objective standards of performance. The development of monetary and fiscal statistical information in many developing countries during this period owes much to the application of these techniques.

One important but sometimes negative aspect of these economic programs was the length of time involved in these arrangements. Time was needed to implement the program; time was needed for decisions to produce their intended effects; time was needed by the authorities to react to new information and new economic signals; time might show that the situation would get worse before improving, etc. The "shock vs. gradual treatment" controversy of the fifties and early sixties in Latin America was an exercise in economic policy timing—and sometimes, political impatience—which owed much to the length of these Fund supported economic programs. The one-year (and sometimes six-month) mold in which all stand-by arrangements of that period were exclusively cast created many unnecessary problems. Manuel Guitian has probably presented the best explanation for the one-year limit:

> The policy programs did not normally extend beyond a year, a period short enough to permit an economic forecast to be made but long enough to permit results of the policy measures to be assessed and judgement to be made as to whether additional measures or modifications of existing measures were warranted. Of course, this did not mean that adjustment was expected to be completed within such a limited time, regardless of the particular country circumstances. In fact, members often enter into consecutive stand-by arrangements with the Fund—a strategy that provided them with continued financial support until the imbalances were redressed.[27]

However, the fact that now the Fund has extended the time of these arrangements tends to show that probably the Procrustean one-year limit was not, after all, the most convenient one to operate with.

[27]Manuel Guitian (1981) p. 14.

The techniques of consultation usually through the Fund missions sent to the various member countries—which on some occasions seemed to reach the heights of missionary zeal—were a most important instrument. The innumerable personal acquaintances and contacts and the extended discussions the Fund staff had during that period, significantly contributed to providing the staff members a broader perspective, a better understanding of the problems faced by the authorities, of how diverse institutions functioned in different countries, and of the difficult political environment and climate in which sometimes hard decisions had to be taken. It also gave the authorities a better understanding of the working of the Fund and of the nature of its economic diagnosis and conditionality.

Performance criteria evolved, with the availability of new and better statistical information, economic research both at the Fund and elsewhere, and a clearer view of the problems at hand. During the 1960s the number of criteria also increased but this added complexity—and implicit assurance to the Fund—was not generally reflected in arrangements implying a larger access to the Fund resources which, on average, continued to represent roughly 50 percent of quota. Also, the number of performance criteria in the Latin American and Asian stand-by arrangements were much larger than in the European arrangements.

The 1968 Decision emphasized "the need for flexibility while ensuring uniform and equitable treatment of all members..." This equalitarian emphasis was due to the fact that the discussion of the request by the United Kingdom for a stand-by arrangement at the end of 1967, triggered—together with the first Amendment of the Articles—a general review of the Fund's policies on the use of its resources under stand-by arrangements whose final result was, precisely, this decision.[28]

The guiding "conclusions" of the 1968 Decision were very simple. All stand-by arrangements would carry consultation clauses, appropriate phasing, and performance clauses, except that the last two would only apply to purchases beyond the first credit tranche, to make this consistent with the fact that they also were to be omitted from arrangements that did not go beyond this limit. A major exception was introduced "when the Fund considers it essential that the full amount of the stand-by arrangement be promptly available" (as it had been in the U.K. case). Since in those cases there is no possibility of phasing the purchases, the consultation clauses should be drafted as performance clauses requiring the member to consult the Fund to reach understandings, if needed, on new or amended performance criteria. The number and content of performance criteria necessary to evaluate implementation of the program were not defined, given the diversity of problems and institutional arrangements of members.

[28]The United Kingdom stand-by was an arrangement for an amount equivalent to more than half the U.K. quota and took the Fund's holdings of pounds sterling to almost 200 percent of quota. The agreement had no phasing, no performance clauses, and only a few ceilings on certain economic variables. Instead of these provisions that were already standard clauses in all stand-by arrangements at the time, the agreement envisaged quarterly consultations on the economy and the balance of payments. It is only fair to add that despite the discussion on the particular techniques chosen for this important stand-by arrangement, the Executive Directors supported the request unanimously.

Toward the end of this subperiod the stand-by technique was well established. Between 1952 and 1968 the Fund approved 207 stand-by arrangements with member countries for a total amount of SDR 12,941 million. Starting with the first two arrangements during financial year 1953 the Fund approved an average of 12 arrangements per year up to a maximum of 25 during financial year 1967. During 1964 and 1965 commitments reached SDR 2160 million each year, the highest for the whole subperiod.

The economic content of policy conditionality as it developed during these years was basically geared to stabilize situations of external deficit and chronic inflation particularly, but not exclusively, in the Latin American countries. Obviously not all the variables chosen were the same, because the situations themselves differed, but there were certain similarities in the basic policy framework. Fiscal performance clauses included increased revenues through new taxes or increased rates on existing taxes, reduced government expenditures and reduced central government or public sector deficits. In certain cases the prices of government goods and services were included as a way of keeping revenues in line. The discussion of government expenditures, however, was not very detailed. Different expenditure compositions respond to alternative, and sometimes complex, political decisions and it was a subject difficult to deal with. Rather, in many cases, there was a preference for establishing ceilings on the financing of potential public sector deficits, leaving the authorities room to decide by themselves on the level and composition of revenues and expenditures within the financing ceiling. The insistence on limits to government deficit financing was thus the most natural procedure to follow but tended to give these arrangements an added monetarist flavor whose raison d'être was not properly understood.

Credit ceilings were very important. At times the emphasis was on central bank credit to the public sector or net domestic credit of the central bank. At other times the ceiling included the secondary expansion through the banking system and increased reserve requirements or higher than average marginal reserve requirements. This latter mechanism, in particular, caused some difficulties in certain cases in the early years. As fiscal discipline was only slowly regained, the base expansion triggered increasing average reserve requirements which affected secondary expansion and the flow of credit to the private sector, adding to the government crowding out effect and affecting growth.

The usual balance of payments performance test was the variation of the net international reserves for which minimum targets were usually established as a way of strengthening the reserve position and making sure that a realistic exchange rate was maintained. The avoidance of new or intensified restrictions and the possible elimination of existing restrictions on the making of payments for current international transactions were usually included.

Generally few, if any, commitments by the authorities on wages, prices, or interest rates were included, and if they were, they were not subject to performance clauses.

The question of foreign indebtedness and new borrowing entered these agreements only toward the end of the period and was one of latest variables to be considered.

In addition, up to the end of the 1950s, noncompliance with most of these ceilings and targets did not trigger the suspension of the right to make further purchases from the Fund; but this has changed completely since the early 1960s.

3. *The period 1968-1979*

The third period goes from 1968 to 1979, when the third major decision on conditionality was adopted, almost one year after the second Amendment of the Articles of Agreement became effective.

In this Amendment the provisions of the Articles dealing with the use of Fund's general resources were revised largely in order to give expression to the practices that have evolved in the course of the years since the first Amendment, as explained in the Proposed Second Amendment[29] of the Executive Board, but no substantial changes were introduced in the area of conditionality. Three points, however, merit a brief comment. First, the limit on purchases expressed in terms of an increase in the Fund's holdings of a member's currency of no more than 25 percent or its quota during the 12 months ending on the date of the purchase, was deleted. Waivers to this limit had become almost automatic practice and it was felt that "the Fund's policies on the use of its resources have been more adequate safeguards of the Fund's resources than the deterrence implied in the necessity for waivers."[30] Second, the word "stand-by" entered the Articles for the first time, its meaning was one of those concepts carefully defined in the "explanation of terms" (Article XXX), and other "similar arrangements" were also contemplated as additional facilities that could become the subject of policies to be adopted by the Fund. This expression was meant, for instance, to include agreements like the extended arrangements under the Extended Fund Facility. Third, the capacity of the Fund to develop and adopt "special policies for special balance of payments problems" was explicitly recognized. This expression was meant to include ad-hoc policies on the use of conditional resources like those of the compensatory financing or the buffer stock financing facilities, as different from those applying to the use of resources under the basic or regular credit tranche policies of the Fund.

The third period was also a period of transformation and adaptation of the Fund to the very difficult world economic circumstances. This period includes very significant events for the international monetary system and the international trade and payments system. In the early years of the 1970s increasing tensions and uncertainty disturbed the functioning of the foreign exchange markets. Recurrent crises in these markets led to the abandonment of the fixed exchange rate arrangements, established 30 years before at Bretton Woods, and to the adoption of new flexible exchange rate arrangements deemed more efficient to sustain the strains and pressures of the foreign exchange markets.

[29]IMF, "Proposed Second Amendment to the Articles of Agreement of the IMF," Washington, 1976, 19.

[30]Ibid., p. 22.

During 1973-74 the world economy was shocked by a very high increase in the price of oil which created or increased external payments disequilibria in many countries, changed surplus to large deficit in others, and shifted positive and negative imbalances across regions in an unprecedented manner in terms of size and duration. Prices began to accelerate, inflation reached intolerable levels in usually stable economies, and as the different authorities reacted to these significant disequilibria combating inflation, conserving energy and, in general, reallocating resources, the industrial countries entered a severe recession with very negative repercussions in the developing countries.

In those circumstances the demand for Fund resources increased very significantly and the Fund had to react to a new, critical situation. During the seventies the number and variety of Fund's policies and facilities increased considerably. Some of them were created on a temporary basis and have by now been discontinued but others will most probably become a permanent and positive feature of the institution. The degree of conditionality was changed in both directions. It was somehow lowered around the mid-70s and then it was increased, as more and more member countries used the Fund resources in the upper credit tranches. The size of the Fund resources was enlarged through quota increases and especially through new forms of borrowing. The length or duration of the use of the Fund's resources was increased in order to accommodate members subject to prolonged situations of disequilibrium.

From the sixties to the seventies the amount of drawings by members from the Fund for balance of payments assistance and reserve tranche drawings[31] increased from an annual average of U.S. $1,632 million to an annual average of SDR 3,049 million. During the seventies these figures ranged from a minimum amount of SDR 732 million registered in 1973 to a maximum amount of SDR 7,010 million in 1976; an increase of almost 10 times in only three years.[32] The decline after 1976 was due to the phasing out of the unconditional oil facilities of 1974 and 1975.

The format of the Fund's reaction to the economic turbulence of the seventies can briefly be described in terms of three dimensions or directions: somewhat lower conditionality through certain new, temporary facilities; continued degree of conditionality with longer-term use of resources than up to that time; and additional resources through still other facilities.

a) The first type of reaction was implemented through the now discontinued oil facilities of 1974 and 1975. The first one was a virtually unconditional facility in response to the problems created by the 1973-74 oil price increases. The 1975 facility, however, was characterized by a higher degree of conditionality than the initial one, although without performance criteria or phasing, like the one applying to drawings in the first credit tranche. The reason was that the Executive Board felt at the time that the effects of the oil price increases were not temporary, "that the rise in energy prices would be largely nonreversible and that financing should therefore be accompanied by

[31]The old "gold tranche drawings" changed their name to "reserve tranche drawings" after the Second Amendment, in order to harmonize language with the ongoing reduction in the role of gold in the Fund.

[32]A.W. Hooke, *The IMF. Its Evolution, Organization and Activities* (1981) p.42.

positive efforts of adjustment."[33] Another example was the Trust Fund, established temporarily in 1976, financed by the profits of the Fund's gold sales with a low conditionality similar to the one attached to the use of Fund's resources in the first credit tranche, for the benefit of the low-income developing countries.

b) The second type of reaction, the lengthening of the period of use, can be exemplified by the adoption of the Extended Fund Facility[34] in 1974, still in operation. The facility was intended for (i) an economy with "serious payments imbalance relating to structural maladjustments in production and trade," or (ii) situations in which "slow growth and an inherently weak balance of payments" prevents an active development policy. Given the middle-term nature of possible solutions to these problems the facility envisaged arrangements for larger amounts in relation to quota and longer periods than was the case under regular tranche policies. The arrangements' periods could extend up to three years and a longer repurchase period was also established. Conditionality under extended arrangements is similar to that of the stand-by arrangements. A three years' arrangement implies an extended basic program setting forth the objectives and policies for the whole period and a detailed statement of policies and measures for the first year. This latter procedure is repeated before the start of the second and third years. The arrangement carries with it performance criteria, performance clauses, and phasing.

The extended arrangements are a most welcome addition to the IMF-related facilities and financing techniques and they should become a permanent feature of the Institution. In this connection four ideas are worth emphasizing. First, as the Decision itself points out, "the facility, in its formulation and administration, is likely to be beneficial for developing countries in particular." The kind of situations amenable to be supported by this type of arrangement would obviously be encountered more frequently in developing than in developed countries. Second, the explicit recognition that these types of situations require longer than one-year programs to show results and the implicit notion that the one-year arrangements have probably been impeding the necessary ease that would allow these types of adjustments to take place. The number of such situations has probably increased during the seventies as a consequence of the sharp rise of energy prices, combined with recession in the industrial countries, but surely in the fifties and sixties many countries could have substantially benefited from the advantages of more extended facilities than those available at the time. Third, the idea of combining medium-term objectives and policies with a more detailed short-term set of specific policies and measures, sequentially designed within the medium-term framework, will probably have a highly positive effect on the task of the persons responsible for economic management in developing countries. It is, as if it were, the natural continuation of the earlier notion of a "comprehensive economic program" now expanded in its time dimension. This, together with the implicit continuity of purpose and sustainability of ef-

[33]Ibid., p. 57.
[34]Executive Board Decision 4377—(74/114).

fort of a medium-term framework, so indispensable for sound economic management, will probably enhance economic policymaking in many developing countries. Fourth, the notion that resource allocation is pertinent and should be more efficient even to help solve medium-term balance of payments problems is important. In other words, the extended arrangements recognized the continued importance of financial stabilization without overlooking the real side of the economy. Thus the extended arrangements will probably contribute to the attainment of medium-term policy conditional arrangements incorporating stabilizing aggregate demand management with supply side policy concern.

c) The third type of reaction may be exemplified by the creation of the Supplementary Financing facility[35] of 1977, operational in 1979, to provide supplementary financing in conjunction with the use of the ordinary resources of the Fund to members with serious payments imbalances that were large in relation to their quotas. The facility was financed by resources borrowed from members in a sufficiently strong balance of payments and reserve positions. This temporary facility also provided for stand-by agreements that could exceed the one-year limit and could extend up to three years in appropriate cases. Use under this facility carried with it the same degree of conditionality as a stand-by or an extended arrangement in the upper credit tranches.

The preceding pages show how the Fund reacted to the challenges of the seventies in the way circumstances required. Two slightly negative aspects of this reaction, however, need to be mentioned. Both originate in the declining relative size of the Fund in terms of imbalances, as quotas were not sufficiently increased. The first one is that, despite the consensus in the Executive Board that Fund's resources should be strengthened by quota increases, the Fund had to borrow heavily to face the increased demand for its resources and this, in turn, increased the cost of borrowing by member countries. In 1978, it was said:

> . . . the Executive Board is of the view that, in general, increased access to the Fund's resources should, over the longer run, normally result from an increase in Fund quotas.[36]

The second one is that, as more and more countries began to use resources in the upper credit tranches because of the Fund's limited size, average conditionality increased not as a consequence of a conscious political decision to change the degree of the Fund's conditionality but rather as an inevitable and negative (because not intended) by-product of an insufficient own-resource base.

In March of 1979 an important decision entitled "Guidelines on Conditionality" presented a synthesis or a codification of the practice the Fund developed during the seventies, together with a ratification of some earlier decisions on conditionality.[37] A comment on some of these guidelines follows.

[35]Decision No. 5508—(77/127), August 29, 1977.

[36]Board of Governors Decision 34-2, December 11, 1978.

[37]Executive Board Decision No. 6056—(79/38), March 2, 1979.

The first guideline constitutes an encouragement to member countries to take corrective measures and to approach the Fund for financial support at an early stage of their external difficulties or even as a precautionary measure. It is interesting that 27 years after the stand-by embryo was implanted in the 1952 decision as a precautionary procedure, the Fund felt that it has to insist on this aspect of the use of its resources by members. What the Fund was saying is that if an economy has to adjust sooner or later, it is preferable that it does so sooner than later. Delay breeds danger and most probably leads later on to more difficult adjustment, stronger corrective measures, bitter medicine, a more traumatic experience, more unwanted political repercussions, and a sense of harsher conditionality than would otherwise have been the case. Probably a large part of the political criticism directed towards the Fund's conditionality has its true origin in these delays. In many cases corrective action taken earlier than actually was the case would probably have not allowed those situations to deteriorate as they did, and would probably have not required the amount of resources and the degree of conditionality they finally required. The question then moves to a different point: Why are some authorities so reluctant to approach the Fund for early support? One of the answers might have been that if the size of the Fund would not allow a member to use its resources in an ample, reasonable way, it might not be worthwhile to approach the Fund, at least in the first instance, particularly at times when commercial bank financing was readily available. Another cause sometimes mentioned, particularly during the sixties, was that the famous expression "to correct a fundamental disequilibrium" (now, by the way, softened in Schedule C by "or prevent the emergence of")[38] was too much for a minister to admit openly, unless it was absolutely unavoidable. Richard Cooper, in a celebrated essay analyzing a number of devaluations, and with all the necessary caveats, has given empirical content to this possibility:

> The fourth apprehension concerns the political fate of those responsible for the decision to devalue, and here experience is not nearly so encouraging. A naive test is whether the government fell within a year of the devaluation. In nearly 30 percent of the cases examined it did.

And also,

> Ministers of finance fared much worse. Nearly 60 percent of them lost their jobs in the year following devaluation—half of them of course when their governments fell—compared with a turnover in a control group of only 18 percent.[39]

Another guideline insists on the one-year stand-by but opens up the possibility of extending arrangements up to three years. The practice initiated with the extended agreements and continued with the supplementary financing policy was now definitely extended to normal stand-by arrangements.

Still another guideline states that "a member may be expected to adopt some corrective measure before a stand-by arrangement is approved by the

[38]IMF Articles of Agreement, Schedule C, Par Values.

[39]Richard N. Cooper, "Currency Devaluation in Developing Countries," Essay in International Finance, No. 86, Princeton University, June 1971, p. 28.

Fund." These "preconditions," in part, were due to the short (one year) stand-by arrangements where the initial purchase was a substantial portion of the total amount involved in the whole arrangement. In other cases these are necessary assurances that the Management of the Fund needs, in order to recommend the agreement to the Executive Board for approval. If Congress or Parliament has not yet enacted the pertinent yearly budget, what value can be attached to the letter of intent's fiscal targets that so crucially depend on the final shape of the budget? In the more extended arrangements or when the member cannot responsibly establish in advance some of the performance criteria, provisions will be made for a review, for later understandings, for the remainder of the agreement.

The last two guidelines reflect an internal practice of the Fund that can be generalized. With the first one the Fund will analyze and assess the economic performance of individual programs supported by the use of the Fund's resources in the credit tranches, once the arrangement expires. The Fund will do this in connection with the Article IV consultations (the regular surveillance consultations) or, as appropriate, in connection with further requests by the member for the Fund's assistance. According to the last guideline, the staff of the Fund will prepare studies of stand-by supported programs to evaluate and compare the appropriateness, effectiveness, observance, and results of different programs.

It would be extremely useful if the Fund were to publish regularly these two types of evaluations, with a reasonable lag, and with the consent of the members involved in each study. As was said before, policy-conditionality in the Fund has been a difficult and controversial issue and probably nothing will contribute more in throwing light and removing heat from these academic and political discussions than adequate knowledge about the facts as they evolved, the analytical basis for the authorities' original programs, and the Fund's evaluation and assessment.

Although there are interesting approaches to this question[40], there is still room for improvement and need to develop the analysis fully. The regular publication of these studies would allow a variety of other approaches to the assessment of economic programs besides the Fund's staff approach. It will enlighten and enrich the discussion with an empirical basis not now available (although in existence) and will help economic research centers everywhere (starting with those of the country concerned) to develop more fully the analysis of economic policy's difficulties, intricacies, and implicit value judgments. We still could learn much, and benefit accordingly, from a thorough analysis of some of the 239 or 332 stand-by arrangements agreed upon up to 15 or 10 years ago, respectively, and yet be chronologically far enough removed to avoid undesirable political repercussions because of their publication.

[40]John Williamson, "On Judging the Success of IMF Policy Advice," article in Williamson, ed., *IMF Conditionality*, Washington, D.C.: Institute of International Economy, 1983, p. 129.

4. *The period 1979–1984*

The last period includes the years from the 1979 decision to the present. The Fund has continued to gain experience with its practice of conditionality in the midst of a phenomenal increase in the use of its resources. From 1979 to 1983 commitments to members under stand-by and extended arrangements increased from SDR 1.6 billion to SDR 25.0 billion; gross purchases increased from SDR 1.2 billion to SDR 10.3 billion; and net purchases from SDR 3.2 billion to SDR 8.7 billion.[41] Further, as the 1983 Annual Report explains:

> The bulk of the financial assistance made available by the Fund to its members since 1977 has been through purchases in amounts and under facilities that require high degrees of conditionality in accordance with the Fund's policy of combining adjustment and financing.[42]

During this period there was little innovation in the practice of the Fund on the use of its resources except for the policy on enlarged access, approved during 1981.[43] This was a temporary policy that was to be in effect until the Eighth General Review of Quotas became effective, subject to the possibility that the Fund might extend this period. The decision became operational once the resources available under the supplementary financing facility were fully committed and adequate borrowing arrangements had been concluded. Thus this policy allowed the Fund to continue helping members with payments imbalances that were large in terms of their quotas and prolonged in time. As the enlarged access was provided to members with stand-by or extended arrangements in the upper credit tranches, the use of these resources carried with it the same degree of conditionality as these other arrangements.

In the summer of 1982 the slowdown of bank lending to developing countries, particularly in Latin America, created a critical situation and even serious concern about the proper functioning of the international monetary and financial mechanisms.

Once again the circumstance of the eighties presented new and difficult challenges to the IMF. Countries heavily indebted came to the institution for significant support and found new and imaginative responses in ways that have not been implemented before. In particular, the management of the Fund, in close contact with representatives of the commercial bank consortia, central banks, the creditor and debtor governments, and the BIS (the Bank for International Settlements), worked out ways and means to ensure that whatever Fund resources could be put at the disposal of the member concerned, sufficient additional resources would be forthcoming from commercial and official sources in the creditor countries to alleviate and support the adjustment efforts of the debtor countries. In a recent article Otmar Emminger has said

[41]IMF, Annual Report 1983, Washington, D.C; 1983, Table 20, p. 85.

[42]Ibid., p. 84.

[43]Executive Board Decision No. 6783—(81/40).

> The international action on the occasion of the debt crisis is, of course, the most spectacular example of monetary and financial cooperation.[44]

The worse phase of the crisis seems to be over now, as countries have initiated the adjustment of their economies and their accommodation to the new circumstances, with varying degrees of success.

As a consequence of all this a new period has probably dawned in the history of policy-conditionality in the IMF. The monitoring of debt management and debt servicing was one of the last performance criteria to be included in the stand-by arrangements of the sixties and a decision about them was already adopted by the Executive Board in 1979, codifying this practice.[45] But it seems clear now with the benefit of hindsight that the debt surveillance exercised by the Fund was not efficient enough, at least for the massive recycling of the seventies and that it could and should be improved to prevent countries from reaching acute debt crises in the future.

As it has been the case in the past the Fund, in collaboration with other institutions like the World Bank and the BIS, will have to develop its own early warning procedures by stages in a gradual and pragmatic way. Information gathering, external debt analysis, actual and prospective debt servicing analysis, new borrowing behavior, routine consultations and debt policy formulations would probably be some of the prerequisite logical steps to develop appropriate recommendations and performance criteria.

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[44]Otmar Emminger, "International Cooperation—a personal view" in M. Deane and R. Pringle, "Economic Cooperation from the Inside," Group of Thirty, N.Y., 1984.

[45]Executive Board Decision No. 6230—(79/140), August 3, 1979.

Appendix

A Geometrical Note on Conditionality

In this appendix the indifference map technique is used to illustrate certain characteristics of conditionality.

Let us assume economic authorities have a certain indifference map describing their preferences on the financing and adjustment mix they would like to apply to correct a particular situation of negative external disequilibrium.

Figure 1 depicts one such possible indifference map. The vertical axis (F) shows the potential amounts of financing as measured by the possible amounts to be included in the IMF-cum-banks stand-by operations. The horizontal axis (A) measures what could be described as abstract units of adjustment effort.

Let us also assume that the authorities prefer more financing to less financing, but not more adjustment to less, because the adjustment effort has a political and in the short- to medium-term perhaps also an economic cost in terms of growth or unemployment, and they are reluctant after a point to intensify adjustment. Under these circumstances the indifference curves will be positively sloped and from any point in the map a new point located in the upward or leftward directions, or any combination of the two will show a more comfortable (preferred) situation for the authorities—with more financing, less adjustment, or more time to adjust.

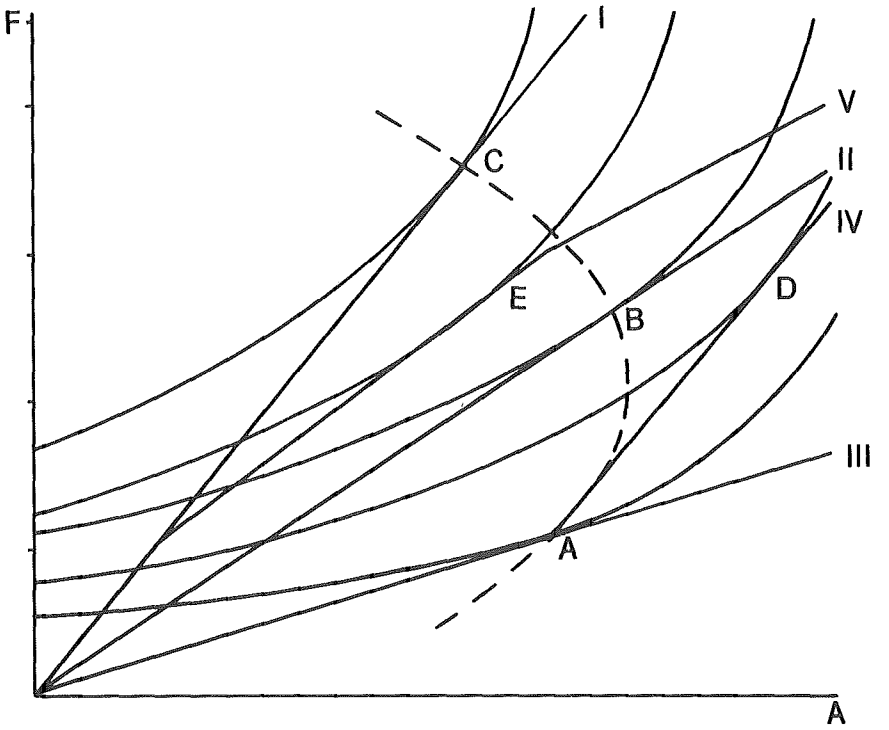
The indifference curves are also upward concave because the authorities would be ready to add successive units of adjustment effort to their policy only if they were able to marginally elicit increasing amounts of financing, or, alternatively, because marginally declining financing might increasingly discourage the will to adjust.

Obviously the positive slope of the curves might be different. Curves with a greater steepness would indicate, ceteris paribus, greater reluctance to adjust, or alternatively, that only larger amounts of financing would encourage a given adjustment effort. These variations in slopes can be peculiar to different political administrations in a given country, but also peculiar to different circumstances for a given administration (the early stages of an administration, approach of elections, etc.).

The counterpart of the budget line of indifference curve analysis—the boundary of attainable combinations of A and F—would be the conditionality applied by the IMF and the banks, at a given point in time, to this type of operation. In other words, how much financing could the authorities obtain with different degrees of adjustment effort? Different lines through or near the origin, also positively sloped, will show the maximum amount of financing they would obtain for different degrees of adjustment effort or alternatively, the minimum degree of adjustment effort they would be required to exert, for different volumes of financing.

In the figure lines I, II, and III show alternative situations with increasing conditionality (less financing per unit of adjustment effort). These lines should be seen as the boundary between the attainable (below) and the nonattainable (above) combinations of A and F.

Points A, B, and C show the most preferred attainable combination under these three alternative situations. For instance, if conditionality were to be the one described by line II, the authorities will maximize their potential economic "welfare" by choosing the F-A combination B. If the Fund and the banks were to loosen conditionality to situation I (something that probably happened, collectively, during the seventies) the authorities will move to the F-A combination C. The broken line shows that these decisions might imply moving along a backward-bending supply curve of adjustment effort.



The indifference map can also show two additional points. The first one is that if more individual country adjustment were to be desired from a collective (world) point of view, additional individual adjustment could be obtained, given the authorities' preference, by lowering conditionality marginally. For instance, in the conditions shown by line III (relatively high conditionality) the authorities will choose the A–F combination A. But if they were told that after making that effort they could obtain more financing moving along line IV (implying lower conditionality) they would most probably aim for the A–F combination D. This could be the quasi-symmetrical counterpart of the performance clause that suspends drawings for failing to attain a particular target. Here a prize (in terms of F) is given for exceeding the target agreed initially.

The second point is that the profile of conditionality in the Fund is the opposite of the conditions represented by line IV. Since as early as 1954 the IMF conditionality has been upward convex, rather than upward concave, like the situation depicted by line V. Here, as we move through the first credit tranche, conditionality is equal to the one shown by line I. Then, as we continue through the second and third credit tranches, conditionality increases to something similar to the conditionality of line II. Finally, through the fourth credit tranche conditionality increases to something similar to that of line III. If those are the conditions prevailing, the authorities will move to the A–F combination E, with as much adjustment as with the relatively low conditionality situation I, short of the results attained by uniform conditionality in situations II and III, and far shorter than the effort obtained with the marginally declining conditionality of situation IV.

Discussion

Eduardo Wiesner*

Introduction

During the last two days we have heard thoughtful presentations on the problems of the international monetary system four decades after Bretton Woods. Listening to what has been said, one cannot avoid reflecting on what has changed since then and what has not. This is an interesting analytical exercise which I suggest should be conducted at two interdependent levels: One, the changes that deal with institutional, legal and political developments. The other, the changes that have to do with basic principles and fundamental issues. Certainly, there have been profound changes at both levels. But there is one area where there has been basically no fundamental change. I am talking about the underlying principles behind the concept of conditionality. Here, little if any change has taken place in the last 40 years and this has been a good thing for the international monetary system as a whole and for the individual countries. I trust I will be able to substantiate my view in the pages that follow.

The most relevant question for us today is whether conditionality had changed or whether it should now change. These were, I believe, the issues Mr. Diz had in mind as he analyzed the antecedents of conditionality from the pre-Bretton Woods discussion to the last guidelines on conditionality that were adopted by the Fund's Board in March 1979.

I would propose, therefore to discuss Mr. Diz's paper not only on its unquestionable merits and solid content but also in the light of the central question of how much conditionality has really changed, and whether it should change now, in response to the tribulations of the countries currently facing adjustment.

Prehistory of Conditionality

After a meticulous analysis of the legislative history of the conditions attached to the use of Fund resources in the period leading to the Bretton Woods Conference, Mr. Diz comes to several interesting observations:

> First, that the idea of economic policy conditionality. . . existed in the prehistory of the Fund in varying degrees. Second, that some of the proposals were rather specific and mentioned things like appropriate measures to be adopted. . . Third, that in the Joint Statement there was a reduction in the maximum useable amounts of Fund resources and an apparent loss of specificity in the conditions attached for such use. . .

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> Fourth, that the different delegations seem to have arrived at Bretton Woods with a fairly large consensus on this question as it was a subject on which there seems to have been little discussion.[1]

Mr. Diz's observations are well documented. Sidney Dell's[2] and J. K. Horsefield's[3] review of the Atlantic City discussions leave no doubt that there was a genuine controversy (particularly between the United Kingdom and the United States) on the conditions governing the use of Fund resources. And yet, in the event, the question of conditionality was scarcely even mentioned at Bretton Woods. Different explanations have been offered for this silence. Apparently, those in favor of conditionality, as well as those opposed to it, found it better to avoid an open confrontation and tacitly agreed to leave the matter to be resolved later.

But does this really mean that the principle of conditionality was not present at Bretton Woods? Of course not. Each party was fully aware of it. Those that saw themselves as creditors as well as those that saw themselves as debtors knew that conditionality was the key factor that would determine the extent to which their hopes could be fulfilled or their fears averted. Each party knew that without some kind of conditionality, additional resources would not be available in significant amounts.

Of course, no one had in mind at Atlantic City, at Bretton Woods, at Savannah,[4] or during the first years of operation of the Fund, the kind of instrumentation that conditionality nowadays implies. All these sophisticated and refined tools to design, implement and monitor conditionality would evolve gradually in the years to come. But what occurred was the in-house gradual development of the principle, not its genesis. Even in the early years through 1952, when countries allegedly only had to "represent that the currency demanded is presently needed for making payments in that currency which are consistent with the purposes of the Fund,"[5] there was no automatic unconditional access. On May 29, 1947, after a lengthy discussion the Board of the Fund departed "from the concept of an automatic right to draw on the Fund."[6] S. Dell calls this decision a turning point in the campaign for conditionality.[7] I would call it an expression of the underlying principle of conditionality that had been there all along.

I could put my argument in another way. The fact that no country was able to draw resources—apart from its own reserve tranche—before the principle of conditionality was unequivocally established in 1952, means that up to that moment no new or additional resources were available. That is, I equate the application of conditionality to net resource availability. If net ad-

[1]Adolfo Diz, "The Conditions Attached to Adjustment Finance," in this volume.

[2]Sidney Dell, "On Being Grandmotherly: The Evolution of IMF Conditionality," *Essays in International Finance,* Princeton University, No. 144, Oct. 1981, p. 5.

[3]J.K. Horsefield, *The International Monetary Fund,* 1945-1965, IMF, Washington, D.C. 1969, p. 85.

[4]The inaugural meeting of the Board of Governors of the International Monetary Fund and the International Bank for Reconstruction and Development convened at Savannah, Georgia March 8, 1946.

[5]Original text of Article V, Section 3(a) of the Fund Agreement.

[6]J.K. Horsefield, *The International Monetary Fund,* p. 189.

[7]S. Dell, "On Being Grandmotherly," p. 4.

ditional resources are sought, conditionality is the indispensable *quid pro quo*. Otherwise, "who is going to provide the resources?" In saying this, I am not being original or ingenuous, I am reinstating an old and stubborn principle of economics: resources are limited. Conditionality is thus the link between net resource availability and the adoption of corrective policies of adjustment by a given country.

Just as adjustment is inescapable in the sense that claims on resources will have to be limited to those available, so is conditionality unavoidable if net financing is to be obtained to smooth out the process of adjustment. The tradeoff of conditionality is the possibility of an organized and controlled process of adjustment; the absence of conditionality is equivalent to a sudden calamitous adjustment, as a consequence of the unavailability of resources. The choice is not between conditional resources and unconditional resources, because there are no unconditional resources. The choice is between a conditionality that evolves out of a planned process of adjustment—based on the resources that can be mobilized—and a conditionality that is instantly imposed by the absence of resources.

Even when the adjustment is done through the market peremptorily without any mitigating conditional financing, one cannot think that conditionality has been avoided. Surely, there has not been *ex ante* conditionality but this does not mean that after the adjustment has taken place it will not be realized that *ex post* conditionality turned out to be in fact more severe and traumatic.

History of Conditionality 1952–79

Mr. Diz develops his careful analysis of the Fund's policies on conditionality by following its evolution during the periods which separate the adoption of the three main Executive Board decisions on the subject in 1952, 1968, and 1979. Commenting on the problems inherent in an automatic access to Fund resources, Mr. Diz correctly identifies the key question of "how could the Fund make sure that the member's problems were temporary, that they could be solved within a reasonable time, like three to five years?" The answer he gives: "by analyzing the policies pursued," is a clear recognition that conditionality, meaning policy conditionality, was inescapable. To this same question the Managing Director at that time, Mr. Camille Gutt, replied analogously, "The policies above all should determine the Fund's attitude."[8] He then made a proposal, in November 1950, "to break the deadlock by linking drawings to an engagement by members to take specific steps to overcome balance of payments difficulties."[9]

Although Mr. Gutt's proposal met with resistance, principally from the United Kingdom and France, it prepared the way for the Executive Board's decision of February 13, 1952 in which the principle of policy of conditionality was formally adopted. According to J. Gold, this decision on conditionality, which was negotiated by Ivar Rooth, "is to this day one of the most

[8]IMF Decision No. 102, February 13, 1952.
[9]S. Dell, p. 9.

remarkable ever adopted by the Fund. [It] clarified the meaning of the temporary use of Fund resources by establishing the basic period for use, created the gold tranche, and adumbrated the idea of the stand-by arrangement."[10]

Within the context of my initial proposition that the principle of conditionality has not really changed since Bretton Woods, I should indicate that in my view the 1952 Board decision did not create conditionality at the Fund, it merely brought out the fact that without it there would be little, if any, additional resources. The decision simply revealed the validity of the principle which was finally conceded by all. Sidney Dell says on this matter that "it was a desire to enlist the cooperation of the United States, as the principal source of credit, that prompted other Fund members to give way to American views on the question of conditionality, rather than any conviction on their part that adoption of the U.S. concept of conditionality was indispensable for a successfully functioning IMF."[11] Here I do not agree with Mr. Dell. This apparent concession to the U.S. position was not really a betrayal of a conviction, but rather a realistic acknowledgement that resources are scarce and that normally no one gives them up without some reciprocity or assurance of being repaid. Had those allegedly opposed to conditionality been asked to be creditors—instead of debtors—their views on conditionality would have been different. Let me add that, of course, no hypocrisy is involved in all of this but merely the reflection of different legitimate immediate interests.

Referring to the decades of the fifties and sixties, Mr. Diz states that "this was the period in which the concept of conditionality became fully developed." I would word the statement somewhat differently saying that it was in this period when the instruments and tools of conditionality were developed to meet the requirements of the new circumstances. It was also during this period that the idea and practice of consultations and of comprehensive economic programs came into being. These important developments were the result, to a large extent, of the progress that was taking place in the understanding of the adjustment process.

We have come now to a very interesting aspect of conditionality that has not received all the attention it deserves. I am referring to the relationships between the "state of the art" understanding of internal and external disequilibria on the one hand, and the policies to bring about and to monitor adjustment processes on the other. If balance of payments problems were only structural or self-reversing within time, there would be little need for conditionality or, for that matter, for large amounts of financial assistance. The structural problem could be dealt with through a devaluation; the self-correcting disequilibrium could be handled through the provision of financing. If these were the typical situations, then one could make a good argument for minimum conditionality and certainly for minimum monitoring and surveillance. But, as Walter Robichek says, "what the founding fathers apparently had not foreseen is that the typical balance of payments deficit is neither structural nor self-correcting inasmuch as it is caused by faulty

[10]J. Gold, "Some Impressions of the Early Fund," *Finance and Development,* IMF, March 1984, p. 25.

[11]S. Dell, p. 10.

domestic and external policies."[12] The stand-by arrangement, with all its customary features, provided a solution for the prevalent intermediate case of internal and external disequilibria.

Mr. Diz then goes on to comment on the characteristics of the stand-by arrangement and commends the Fund for having accepted that, at times, the "Procrustean one-year limit was not after all the most convenient one." Referring to the conditionality implied in the different kinds of performance criteria, Mr. Diz observes that "the number of performance criteria in Latin American and Asian stand-by arrangements were much larger than in the European arrangements." This issue of equality of treatment of countries arose at the end of 1967 when a relatively large stand-by arrangement was approved for the United Kingdom which did not contain provisions for phasing or performance criteria and specified only a few monetary and credit aims. At that time Alexandre Kafka, the Executive Director for Brazil, Colombia, Dominican Republic, Haiti, Panama, and Peru argued that such asymmetry should be corrected and that all countries should be treated equally. According to S. Dell, this episode "touched off a general review of the Fund's policy on the use of its resources under stand-by arrangements."[13] Finally, on September 20, 1968, a comprehensive decision on conditionality was adopted. The new guidelines encompassed all aspects of conditionality and "stressed the importance of providing adequate safeguards to preserve the revolving nature of the Fund's resources, and the need to allow for flexible, and yet uniform, treatment of all members. It also recognized the usefulness of phasing and of performance criteria."[14]

As the par value system came under strong pressure in the beginning of the 1970s and as the turbulence from the oil shock disrupted the world economy, the Fund responded, according to Mr. Diz, with three types of answers. The first was to create the oil facilities of 1974 and 1975 in which conditionality was comparatively low. The second was a more fundamental one. In 1974, it created the Extended Fund Facility to provide medium-term assistance to countries experiencing severe balance of payments problems. The third was the creation in August 1977 of the Supplementary Financing Facility, which permitted countries to borrow additional resources to be used in conjunction with stand-by or extended arrangements. The Supplementary Financing Facility practically doubled the amount of financial assistance that member countries could obtain from the Fund. After 1981, this facility was converted into what is now called "enlarged access."

Conditionality and Resource Availability

Before concluding his paper with an analysis of the 1979 Guidelines on Conditionality, Mr. Diz makes two important observations on the way the Fund responded to the disturbances of the 1970s. First, he believes that the

[12]E.W. Robichek, "The IMF Conditionality Re-examined," IMF, Universidad Federico Santa Maria and Central Bank of Chile Seminar, Vina del Mar, April 1983, p. 3.

[13]S. Dell, p. 13.

[14]M. Guitian, "Fund Conditionality," IMF Pamphlet Series No. 38, Washington, D.C., 1981, p. 16.

Fund was and is hampered by the small size of its own resource base which in relative terms has decreased in comparison with the magnitude of the problems it is supposed to correct.

The second point that Mr. Diz makes is, in my view, a fundamental one:

> as more and more countries began to use resources in the upper credit tranches because of the Fund's limited size, average conditionality increased not as a consequence of a conscious political decision to change conditionality but rather as an inevitable and negative byproduct of an insufficient own resource base.

This statement by Mr. Diz includes the essence of the point I have wished to make throughout this paper: that conditionality has its origin in the scarcity of resources and nowhere else. It is its inevitable by-product, as Mr. Diz puts it. Conditionality is thus a positive and not a normative concept. I find it puzzling to hear so much criticism of conditionality and so little reference to resource availability. I can only understand this as the result of a confusion of what J. Polak calls "the positive, the normative and the possible."[15]

A last comment on the relationship between conditionality and resource availability may be called for. When critics press for lower conditionality, do they mean that the proposed policy path of adjustment is wrong? Do they mean that the conditions are not, in terms of policy, the right ones?[16] Or are they really asking for a different—slower—pace of adjustment?

And yet a special caveat is in order. A rapid and major loosening of the resource constraint may induce a false sense of security and could lead to the wrong policy in the country concerned. One only needs to look at the experience of 1975–81, in terms of the external and internal resource availability of many of the countries now facing serious debt problems, to be able to conclude that additional financing by itself is not the answer. If you will excuse me for making an apparently immodest reference to my personal experience in Colombia during 1978–82, I will say that our policies never assumed that greater availability of financing meant that the country should go into debt or that our fundamental problems would be resolved if we simply, and passively, accepted all the financing that was being offered to the country. We had the view that development was much more complicated than that.

Guidelines on Conditionality, 1979

The last part of Mr. Diz's paper deals with the guidelines on conditionality that were approved by the Board in March 1979. I think his most interesting point has to do with the question of why some authorities are "so reluctant to approach the Fund for early support?" The first guideline on conditionality encouraged member countries to come to the Fund at an early stage of difficulties or even as a precautionary measure. Mr. Diz mentions two possible explanations of the reluctance observed. One has to do with the

[15]J. Polak, "The Role of the Fund," in this volume.

[16]S.T. Beza, "Panel Discussion," in John Williamson, ed., *IMF Conditionality*, Washington, D.C.: Institute for International Economics, 1983, p. 589.

size of the resources that the country may expect to get from the Fund. If the amounts are not large, it may not seem worthwhile to accept the accompanying conditionality. The other explanation refers to the political costs for a Minister of Finance to admit that a mistake has been made or that a situation is deteriorating and is out of control. In brief, and as William Dale has aptly put it, whatever the reason may be "the publicity that is given to negotiations with the Fund and the widespread impression that is created that an approach to the Fund signals a desperate situation have clearly been a deterrent to many countries that might decide to negotiate with the Fund."[17]

I will complement Mr. Diz's answers with the following comment. Coming to the Fund at an early stage is the most difficult step for a government to take because, by definition, an early approach means that the policymakers still have options or alternatives on how to handle the situation. The existence of those options creates two kinds of problems. First, the authorities will find enormous resistance to all corrective measures from the different groups that will be affected by those measures. Just warning that further deterioration should be avoided is not a very powerful or effective argument when the different vested interests are desperately trying to shift to one another—and to the public sector, of course—the burden or the cost of the precautionary adjustment. Once the economy succumbs to that struggle and no room is left for the maneuver then, and only then—in most cases—does it become politically acceptable to come to the Fund, if only because it is inevitable as there is no other recourse.

The other major obstacle to an early approach to the Fund is the possibility that a technical impasse will develop between the government, the Fund management and staff on the policies that should be put in place to redress a given situation. The earlier the approach is contemplated, the more ample and varied[18] will be the options for corrective measures and the more room there will be for different judgments "about the behavioral responses of the economy in question to this or that particular action."[19]

Conditionality in the 1980s

Mr. Diz concludes his paper with a reference to the difficult challenges that the Fund had to deal with in the first three years of this decade. He thinks that the "worst phase of the crisis seems to be over" and sees that, as a consequence of all that has taken place, "a new period has probably dawned in the history of policy conditionality in the IMF."

I began my comments on Mr. Diz's paper by stressing the immutability of the principle of conditionality. I stated that this basic principle had a permanent validity that did not change over time. While I would agree with Mr. Diz that a new era in the history of conditionality in the Fund may already have begun, I would add that the changes that have taken place since the

[17]William Dale, "Financing and Adjustment of Payments Imbalances," ibid., p. 13.

[18]It may be worthwhile to point out that in the opposite case when countries come late to the Fund, few policy options are open to design an adjustment path. Obviously, in these cases, the room for disagreement is more restricted.

[19]Richard N. Cooper, "Panel Discussion," *IMF Conditionality,* p. 571.

beginning of this decade and those that will occur in the near future, will consist of innovations and modifications in the instruments and in the modalities of conditionality but not in its underlying principles.

This, of course, does not mean that new solutions to new problems will be adopted. Recent history proves that the Fund can respond and take the initiative to tackle successfully complex and unexpected problems. Several examples could be offered. It should suffice at this point to mention the formidable task of assembling in 1982 and 1983 complex financial packages involving, inter alia, commercial banks, central banks, the BIS, creditors and debtors. Surely, there are still difficult and unresolved problems like those stemming from upward changes in the rate of interest or from the need to examine the multiyear rescheduling of debts, but they do not seem insurmountable. On the basis of what has been accomplished in the past, one can look to the future with optimism.

General Discussion

Robert Solomon posed two questions. First, no distinction had yet been made in the conference between conditionality imposed when a country's request for Fund resources arises from previous domestic policy mistakes and that imposed when a request arises from the negative impact of a foreign shock. Should Fund conditionality vary between these two cases? Second, suppose several requests emanated from the same region of the world, such as Latin America. Would the Fund design each country's program individually, or would the Fund's approach be regional?

Adolpho Diz responded that the first question had arisen within the Fund as early as 1953. Indeed, certain IMF facilities, such as the Compensatory Financing Facility, were arranged specifically to finance adjustment to shocks from abroad.

Eduardo Wiesner added that recent economic programs have been designed to take into consideration the world's economic policies. Adjustment policies within developing countries should incorporate probable policy actions within, say, the OECD countries.

Robert Roosa asked what the prospect was for designing adjustment programs and conditionality to take greater account of the complex, structural problems that many countries face. Diz responded that a new era in Fund conditionality might be dawning; he felt that the Fund rose to a new height in response to the debt crisis. He suggested that the economics of external debt be further analyzed and incorporated into Fund conditionality.

The Role of the Fund

Jacques J. Polak*

I. Introduction

The International Monetary Fund, created by the United Nations Monetary and Financial Conference held from July 1 to July 22, 1944, is a highly specialized institution. Its purposes, as set out in Article I of the Articles of Agreement, delineate with considerable precision the task that its prospective member countries wanted it to undertake. These purposes, six in number, deserve to be quoted here in full:

(i) To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems.
(ii) To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.
(iii) To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.
(iv) To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.
(v) To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.
(vi) In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members.

These purposes have lost none of their poignancy over the last 40 years. But the role of the Fund in the pursuit of these purposes has changed in response to changes in the world economy and the world financial system, changing opportunities for action and, especially on the financial side, the extent to which balance of payments financing to countries in need of it was available from sources other than the Fund.

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The Fund has probably been most consistent in the pursuit of the elimination of payments restrictions, even in its early years when support for this activity was mostly restricted to North America. On other subjects its concern and its influence fluctuated a great deal over the years. Thus, there were periods when the Fund was actively concerned with the price of gold and the role of gold in the system—from 1947 to 1951 and, much more dramatically, from the early 1970s when the market price began to deviate sharply from the official price until 1980 when the Fund's gold sales ended. Since then, gold has disappeared from the Fund's agenda. On exchange rates the role of the Fund has shown both trend and cyclical variations. For all but the largest countries the Fund has developed a steadily rising interest, expertise, and influence on exchange rate policies, with an increasing willingness to see the instrument used as a major component of adjustment policy. For its largest members, the Fund did not play a major role in exchange rate changes until about the late sixties, at first because it was too young an institution to be trusted with an important role in a matter of extreme sensitivity, and then because the major countries attempted to impose a taboo on the entire subject of possible changes in their exchange rates. As this proved impossible, the Fund played an important role in the 1967 devaluation of sterling and in the drawn-out process of adjustment of rates among all major currencies that stretched from August 15, 1971 to the Smithsonian agreement of December 18 of that year. But since the advent of floating in the early 1970s, the Fund's role with respect to major currencies has shown a persistent decline. With the subtle substitution, by the second amendment of the Articles, (agreed in Jamaica in January 1976 and in force since April 1978) of the expression "a stable system of exchange rates" for "a system of stable exchange rates," and in spite of the simultaneous introduction of "firm surveillance over members' exchange rate policies," the Fund has gradually broadened the scope but, at the same time, lowered the depth of its surveillance to a point where its role in connection with the rates for the major currencies has become marginal. This was not a matter of choice; it reflected the reluctance of governments to accept responsibility for the exchange rates of their currencies in conditions where capital transactions played a much larger role in exchange markets than had been envisaged at Bretton Woods or had been the case for the subsequent 25 years.

The financial role of the Fund has similarly shown a succession of ups and downs. The "ups" were mostly attributable to severe disturbances in the world's payments situation, such as the Suez crisis (1958), a succession of sterling crises, the first oil shock, and, above all, the second oil shock cum the disinflation crisis of the last few years. The "downs" occurred typically when the supply of international finance from other sources became particularly plentiful: in the Marshall Plan period; in 1970–72, when the payments deficit of the United States produced surpluses in almost every other country, and in the second half of the 1970s, at the peak of the euphoric years of commercial bank recycling. In anticipation of a point to which more attention will be paid below, one can note that only in the first of these three periods of low financial activity for the Fund was the financing from other sources accompanied by adequate concern for adjustment.

Considering the attention that other papers for this conference will pay to the questions of reform of the system and exchange rate arrangements, I intend to concentrate my remarks on the role of the Fund as it relates to the twin problems of financing and adjustment.

In dealing with the role of the Fund in this area, I find it necessary to strike a careful balance between the positive, the normative, and the possible. In one sense, the role of the Fund is obviously what it does now. The tasks that it now performs are indicative of the role that its membership has assigned to the institution at this moment. These tasks have evolved quite dramatically over the years, with the institution—responding with alacrity to the changes and challenges of its surroundings—giving form and substance to what were only dimly perceived outlines 40 years ago. Any discussion of the role of the Fund could not be adequate without a fair amount of description of where the Fund now stands—even for an audience as well versed in the matter as the participants in this conference.

At the same time, the role of the Fund is not a static one. The present represents an uneasy balance between various forces operative among its members. No one is entirely satisfied with where the institution stands now, and it will doubtless undergo further changes in the years to come. There is every reason, therefore, to speculate on whether the fund should continue to do everything that it is now doing, and whether it should be performing additional tasks within the general framework of its purposes.

But these exercises in normative thinking will have to be qualified by a reasonable respect for the possible. This somewhat cliché phrase is intended to suggest that, even though the Fund, while staying within the boundaries set by its purposes, may be able to expand its scope of activities beyond what it is doing at any moment of time and it has of course done so decisively on a number of occasions in the past. However, there are still certain quantitative limits that it cannot transgress for any foreseeable period of time, whatever may be the theoretical desirability of going well beyond these limits. One important reason for this constraint on the Fund lies in the manner in which it is financed: from the reserves of member countries. In a discussion of the role of the Fund attention needs, therefore, to be paid to the financial structure within which it operates and, I believe, must operate.

A particular point to be noted here—and to be elaborated further below—is that the Fund's access to finance acts as a single constraint on its two financial functions—the granting of conditional credit and the across-the-board provision of reserves through the allocation of SDRs. This is one good reason why this second financial function of the Fund—introduced with considerable fanfare in the first amendment (1969) but by now preferably overlooked in much of the industrial world—deserves a place within the scope of this paper.

II. The Extention of Conditional Credit

1. *Adjustment and financing*

Adjustment and financing are the two poles that control the field of tension within which the IMF operates. Most disequilibria in the balance of payments, especially if they are large, are not likely to disappear or to reverse themselves without measures of adjustment. If in such cases the Fund granted financing without insisting on adjustment, such financing would not contribute to the correction of balance of payments adjustment, to which the fifth purpose, cited above, refers. But adjustment without financing is also in most cases an inappropriate policy response: that is, whenever the causes of the disequilibrium are so severe that the approach would inflict serious and needless harm to the national or international prosperity and thus also conflict with the fifth purpose.

The appropriate relative dosage of adjustment and financing is therefore the crucial problem of the Fund. And not only of the Fund: the same problem presents itself to countries whether they seek financing from the fund or not. Every country has to decide to what extent it should absorb external or internal shocks by fluctuations in its reserves or reserve liabilities (financing) or should counteract these shocks by policy measures (adjustment). Countries have, moreover, the option to use certain policy instruments (such as fixed exchange rates, freely floating rates, "leaning against the wind," a target for the money supply, a target for domestic credit expansion, etc.) as automatic pilots in such a way that they will induce either adjustment or financing in response to shocks of a particular nature. But even a country that tends to rely on such automatic pilots will abandon them if the seas become too rough—see, for example, the abandonment by Switzerland in 1978 of its norm for monetary growth to avoid excessive appreciation of its currency and by the United States of the M-1 norm, in mid-1982, to protect both the domestic economy and the international monetary system.

2. *The experience of the sixties*

In the 1960s the emphasis on attempts to reform the system among the leading countries and (marginally less so) in the Fund was on problems of financing rather than adjustment. International reform focusing on the supply of an adequate level of international reserves culminated in the amendment to the Articles of the Fund creating the SDR and in the first decision to allocate SDRs (both in 1969). At the same time, adjustment was seen under the double constraint of avoiding both "situations of higher or prolonged unemployment of resources or economic stagnation"[1] and, except in extremis, changes in exchange rates.[2]

One can fault the lack of attention paid to the weaknesses of the system as far as adjustment was concerned, but not the attention given to the reserve

[1]International Monetary Fund, 1964 *Annual Report,* p. 26.

[2]*Ministerial Statement of the Group of Ten,* Annex prepared by Deputies (August 1964) p. 5.

problem. Toward the end of the 1960s—in contrast to the preceding 15 years—there were some indications that reserves were becoming less adequate; the evidence did not lie in general deflationary symptoms of the world economy but in increasing tendencies to restrict the movements of goods and capital and in an increasing recourse to international financial assistance.[3] Of course, the decision to allocate SDRs, taken in September 1969—after a few quarters when foreign official dollar balances had shown an actual decline—reflected something short of perfect foresight: such balances then increased by 50 percent in 1970 and again by over 100 percent in 1971.[4] With this flood of dollars the payments problems of practically all other countries were washed away; one consequence was that the bulk of outstanding Fund credit was paid off. (Another consequence was that in 1972, towards the end of the first basic period, no decision was taken to allocate any further SDRs.)

3. *The Oil Facility and the lessons drawn from it.*

The issue of adjustment vs. financing could have arisen in full force again after the sharp increase of OPEC's oil prices just before Christmas 1973. In fact, it did not. The common fear, as expressed in the Rome meeting of the Committee of Twenty that took place a few weeks later, was that oil importing countries (developed as well as developing) might decide to deal with their sudden problems by means of deflation, competitive depreciation, or trade and payments restrictions. Thus, the Committee warned against measures "that could only aggravate the problems of other countries"[5] and came close to approving the special oil facility in the Fund that the Managing Director had proposed (and that came into effect five months later). The oil facility was designed to meet unexpected high import costs, in much the same way as the compensatory financing facility (CFF)—on which it was patterned—assisted countries in dealing with temporary export shortfalls. The conditionality of the oil facility was only slightly greater than that of the CFF, in large part no doubt because of the existing fears of excessive adjustment. It is true that the principle was clearly enunciated that countries that financed their oil deficits by drawing on the facility should at the same time correct their non-oil deficits. This principle was not easy to apply, however, and the Fund did little to enforce it; indeed a far more stringent conditionality of drawings on the facility would have been necessary to make this principle stick. The oil facility reflected the common view of the great majority of the membership at the time: primary emphasis

[3] *"Allocation of special drawing rights for the first basic period,"* Proposal by the Managing Director of the IMF, Washington 1969, p. 6/7.

[4] The figures at year-end were as follows:

1968	$ 17	billion
1969	16	"
1970	24	"
1971	51	"
1972	62	"

[5] Communiqué of the Committee of Twenty, January 28, 1974 (in IMF, *International Monetary Reform, Documents of the Committee of Twenty*, Washington, 1974, p. 217).

on the maintenance of demand, a secondary role for adjustment, and hence major reliance on financing. In spite of the oil facility, only a small proportion of total financing, about one-tenth, came from the Fund[6]; a very large part proceeded via an expansion of the international business of the banking system.

The experience of the Fund as a participant in the recycling business led to two, diametrically opposed, inferences. Some inferred from it that recycling constituted indeed an important, and potentially major, role for the Fund which should be enhanced by giving the Fund access to much larger resources. Others saw recycling as incompatible with the Fund's role in the adjustment process: in recycling, the emphasis is on smooth operation, and in many instances that cannot be reconciled with insistence on sufficient adjustment measures. For a number of reasons, the second view prevailed in the Fund. The oil facility was not renewed after its initial, two-year run and recycling is no longer accepted as an important (or perhaps as any) component of the Fund's financial role.

The financial constraint to which the Fund is subject played some role in the prevalence of this position. Aggregate annual balance of payments deficits of deficit countries can be very large, even after surpluses of oil exporters have disappeared; if the Fund were to assume the task of intermediating a large proportion of the amounts involved, it would require a number of times its present supply of resources. Moreover, recycling of surpluses—whether from oil exporters or industrial countries—toward developing countries has so far been mainly a one-way process—hardly reconcilable with the concept of the Fund as a revolving source of finance.

But the reasons for a decisive move towards greater conditionality go well beyond the financial impossibility for the Fund to be a ready and continuous source of current account financing of the developing world. In a number of respects the experience gained by member countries and the Fund in the first part of the 1970s pointed in a different direction; and this experience continues to accumulate and to confirm and strengthen the view on the proper role of the Fund.

One important lesson of the first oil shock was that delay in adjustment was a costly policy choice for the medium term. Those among the industrial countries that acted on this assumption in 1974 and 1975 (mainly the United States, Germany and Japan) and accepted a temporary reduction in activity to contain a persistent wage-price spiral were able to turn their balances of payments around and to provide a much sounder basis for their economies than others (such as the United Kingdom, France and Italy) that attempted to offset the deflationary impact of higher oil prices. The lesson was well learnt by 1978/79—not only in the industrial countries—and many countries reacted to the second oil shock with a much stronger dose of adjustment than they had to the first.

[6]The total current account surplus of the oil exporters in the three years 1974–1976 amounted to $ 143 billion; credit extended by the Fund during the same period, mostly through the oil facility, was about $ 14 billion.

As further evidence of the change in atmosphere one can observe that in 1979/80 there was never any serious consideration of a new oil facility in the Fund. Indeed, in the Fund as among members, the emphasis on adjustment became stronger precisely at a time when the world economy was less buoyant—a clear reversal of the Keynesian approach of the 1974 decision on the oil facility. It became increasingly clear that in cases where serious adjustment is required, its total pain (e.g., in the form of lost output) is not reduced but maximized by a gradual application. It follows from this that it does not make sense for the Fund to calibrate its conditionality as applied to individual countries in response to fluctuations in the level of world activity. I disregard for a moment the practical impossibility of devising adjustment programs for up to three years as a function of anyone's guess of the status of the world economy that far ahead, as well as the credibility problem for an institution that would be prescribing adjustment with one eye over its shoulder at the latest world indexes. The objection is more fundamental: when a particular country is in need of adjustment action—to correct internal and external price distortions, to introduce fiscal and monetary control, *and* to create credibility at home and abroad that it will be able to pull off the required package of measures—considerations of the possible impact of this package on world aggregate demand cannot be allowed to enter into the decision-making process. If world demand needs bolstering, the place to do it would be in those industrial countries that have their financial policies under reasonable control, and certainly not in the countries which the Fund is assisting to seek the road to such control. The notion that IMF conditionality should vary over time, depending on world economic conditions, in order to make some contribution to a global anticyclical policy[7] should therefore be rejected not merely as impractical, but wrong in principle.

It can be noted in passing that without any attempt on the part of the Fund to adjust its policies, it will have somewhat of a countercyclical impact by the cyclical movement in the demand for its resources. The compensatory financing facility will be drawn on more heavily when world trade slumps than when it booms.[8] The normal resources made available under the quotas will also be used more when the general economic climate is difficult than in a period of worldwide prosperity.

[7]John Williamson, *The Lending Policies of the International Monetary Fund,* (Washington, D.C.: Institute for International Economics, 1982) page 44.

[8]While CFF drawings in years of weak exports were important to the countries that benefited from them, their magnitude was not such that it could have had much impact on the world economy. Such drawings sharply increased, by about SDR 2 billion, from 1975 to 1976, and again from 1979 to 1982. The former figure was nearly 2 percent of the exports of the non-oil LDCs but only ¼ of a percent of world exports; for the second period, these percentages were about .7 and .1 respectively. Note, however that the figures do show sharp cyclical fluctuations (in billions of SDRs):

1975	1976	1977	1978	1979	1980	1981	1982	1983
.2	2.3	.2	.6	.6	1.0	1.2	2.6	2.8

4. *The Fund and the commercial banks*

At the same time that there was a growing recognition of the need for more adjustment and of the role that the Fund should play in bringing this about, the Fund was losing ground in performing this function. As the commercial banks discovered an almost unlimited market for credit in the LDCs and the smaller OECD countries, conditional credit from the Fund became an unattractive alternative for these countries, even though it was much cheaper than bank credit. Except in the near-desperate cases, the banks dislodged the Fund. From 1973 to 1979, low conditionality credit (oil facility and CFF) to the LDCs was three times as large as regular tranche credits.[9]

A somewhat overdrawn and less than prophetic picture of this situation was painted by Rimmer de Vries in the April 1982 issue of *World Financial Markets* (published by the Morgan Guaranty Trust Company) under the title "The limited role of the IMF" (pp. 7–11). Citing figures to show that in 1980 and 1981 the banks lent $ 85 billion net to the non-oil LDCs and the Fund only $ 5.6 billion, de Vries concludes that "the IMF is playing, and probably will continue to play, a qualitatively very important but nevertheless quantitatively limited role in the international financial arena" (page 9). Further analysis relates this experience to the fact that the Fund has a specialized clientele of essentially low per capita income and communist member countries, while it "has with few exceptions, failed to attract countries that are major borrowers from the commercial banks and that have large external financial requirements. Industrial countries, such as Belgium, Denmark, Ireland, and Spain do not have programs with the Fund, and neither do developing countries such as Argentina, Brazil, Chile, Greece, Israel, Portugal, and Mexico. All this illustrates that the IMF and the commercial banks increasingly have operated, and are likely to continue to operate, in different markets. As in the recent past, the bulk of the Fund's resources can be expected to be channeled to countries that by and large are excluded from ready access to private capital markets. . . . The commercial banks, therefore, must come to the realization that they are on their own when it comes to international lending because the Fund is no longer a catalyst for prompt external adjustment in the major deficit countries. . . . Thus, the Fund must not be viewed as a protective umbrella under which the international banking community can find shelter in times of trouble."

In part, this displacement of the Fund was attributable to the inadequate size of the resources that it stood ready to provide to its members, at a time when their payments problems were unusually severe and the banks could supply credit virtually without limit. Inflation, and quota increases that did not take adequate account of inflation had, by the middle seventies, reduced at least by half the quotas as a percent of imports both for the membership as a whole and for its main customers, the non-oil LDCs (Table 1).

[9]In the next four years (1980 to 1983) the proportions were approximately reversed.

Table 1
Ratio of Quotas to Imports
(percent)

Year[a]	World[b]	Non-oil developing[c] countries
1963	10.6	9.4
1964	9.6	8.9
1965	8.9	8.9
1966*	10.4	10.3
1967	10.1	10.3
1968	9.2	10.1
1969	8.1	9.4
1970*	9.4	10.7
1971	8.6	9.8
1972	8.0	10.2
1973	6.4	8.2
1974	4.4	5.2
1975	4.3	5.0
1976	3.6	4.6
1977	3.2	4.1
1978*	3.9	4.9
1979	3.2	4.0
1980*	4.0	5.3
1981	3.7	4.5
1982	3.8	4.8
1983*	5.6	7.0

[a]Quota figures at end of year. Asterisks indicate years when general quota increases went into effect.
[b]Total of Fund quotas divided by world imports.
[c]Sum of quotas of non-oil developing Fund members in each year divided by imports of all non-oil developing countries.
Source: IFS, various issues

As a result, the amount of financial assistance that a country could expect from the fund under its prevailing policies became too small, in relation to the size of its payments problem, to make recourse to the Fund an acceptable political choice. Around 1980, the Fund took major steps to remedy this and other drawbacks in its disadvantaged position vis-à-vis the commercial banks. It adopted access limits for conditional credit of 150 percent of quota *per year*, with an overall limit of 600 percent of quota—a six-fold increase over the overall limit of 100 percent of quota that prevailed until a few years earlier; it shifted emphasis from one-year to three-year arrangements; and it lengthened the maximum period of repayment under the "Extended Fund Facility" (EFF) from eight to ten years.[10]

The consequences of the Fund's decision on enlarged access went well beyond compensating for the relative decline of quotas to world trade. That

[10]See Group of Thirty, "Balance of Payments Problems of Developing Countries," (New York, 1981).

decline had reduced quotas to somewhat below one-half of their previous relation to trade; the combination of these quotas with the new access rates[11] produced a theoretical availability, in relation to trade, that was about double that before 1972. Accordingly, enlarged access has always been considered a temporary policy related to the exceptional payments difficulties of recent years, and in conjunction with the entry put into effect in the 8th Quota Review a beginning was made to reduce enlarged access.

These modifications of policy played an important part in inducing countries that faced adjustment problems to conclude arrangements with the Fund—including a number of larger countries, such as India, Korea, Morocco, Pakistan, the Phillipines, Turkey, Romania and Yugoslavia. The banking crisis of mid-1982 did the rest. Some part of the enlarged activity of the Fund can be attributed to a short period during which conditionality was somewhat weakened. This is, of course, an area in which comparative judgments are difficult to make, but there can in any event be no doubt that since 1981 the Fund's conditionality has been more demanding than it was in any earlier period. The hardening of conditionality is not seen in the Fund as a matter of arbitrary choice, but as the necessary response to the worsening situation of many countries' payments position and outlook.[12]

There occurred, at the same time, a substantial hardening, over the last year or so, of the conditions applicable to CFF drawings. Previously, such drawings required, at least for the first 50 percent of quota, no more than a serious undertaking on the part of the country to discuss with the Fund the measures that might be required to bring its payments to a more satisfactory position. At present, however, CFF access even for the first 50 percent of the quota requires the member to take prior action that gives reasonable assurance that corrective policies will be adopted. For the remaining access of 33 percent of the quota (reduced from another 50 percent of quota when quotas were recently increased), the conditions are now practically the same as those for drawings in the higher credit tranches. As a result of these changes the CFF has largely become a supplement to general conditional access for those countries that meet not only the general test of the fund's conditionality but also the criteria for an export shortfall.

5. *The Fund as a lender of last resort?*

In connection with the proper scope of the Fund's lending activity, considerable attention has been given to the question whether the Fund is, or should be, a lender of last resort.[13] The question relates to an important issue of Fund policy; unfortunately, by being couched in terms that originated in

[11]Of which so far the figure of 450 percent (of the 1983 quotas) for three years has normally been operative, rather than the overall limit of 600 percent of quota.

[12]Explicitly on this: "A conversation with Mr. de Larosière," *Finance and Development,* (IMF/IBRD) June 1982. pp. 4–7.

[13]William B. Dale (Deputy Managing Director of the Fund), "Financing and Adjustment of Payments Imbalances" in John Williamson, ed., *IMF Conditionality,* Washington 1983, p. 11: "Is the Fund to be regarded as a lender of last resort, or is it to be a routine provider of financing to meet balance of payments deficits?"

the theory of central banking, it evokes associations that do not apply to the Fund and that make it difficult to produce a clear answer. There are, in fact, two entirely different answers.

(1) During the 1970s, when commercial banks were readily lending to many countries, countries had a tendency not to approach the Fund except when their financial position was in extreme distress (indeed, the continued absence from the Fund of OECD countries in recent years suggests that many countries with access to bank credit still prefer such credit at a higher cost to drawing on the Fund). The Fund has explicitly deplored this tendency when it stated, in the first of its "guidelines on conditionality" (adopted in March 1979) that members should be approaching the Fund for assistance "at an early stage of their balance of payments difficulties." It is necessary to report, however, that since the adoption of this guideline the opposite view has also surfaced in the Fund. One of the main reasons why the United States initially opposed the large stand-by arrangement for India (in 1981) was that India had hardly used its ability to borrow from commercial banks.

(2) When a central bank, in performance of its function as lender of last resort in the domestic monetary system, lends to a commercial bank in difficulties, it must lend extremely promptly, in very large amounts if these are needed, and typically at a penalty interest rate. There is no parallel function for the Fund in response to payments difficulties of a country. The Fund does not lend extremely promptly, but on the basis of a negotiated adjustment policy which takes weeks, more often months, to arrange; it does not lend a very large sum at once, but in installments, on the basis of performance; and it does not have to charge a special interest rate to deter frivolous use of its resources. In some cases, the instant lending role is performed by others, e.g., by the central banks of other countries under existing swap lines, or in some recent cases by the BIS; in other cases that role is simply not performed and the country struggles along without outside money, perhaps by incurring arrears. While experience over a long period suggests that national banking systems are in need of a true lender of last resort (which, of course, need not—and indeed should not—step in on every occasion where a commercial bank might fail), the international experience of the last few years suggests no clear need for a general lender of last resort; from a systemic point of view, a mechanism for the Fund's instant rescue of a country that had landed in serious payments difficulties, on the principle of "pay first, talk later," would almost certainly be worse than the present approach—messy as it sometimes is—which seeks to ensure an adequate adjustment effort in exchange for international financial assistance.

Beyond the question of "lender of last resort" there are other fundamental differences between the role of a central bank within a country and the, actual or potential, role of the Fund in the international monetary system. At least two of these deserve mention here:

(a) the Fund has no territory where the currency it creates is *the currency;* hence the value of the Fund's currency, the SDR, must be a derived value (initially from gold, thereafter from a basket of currencies); and

(b) the Fund is not backed up by an international government that can impose and enforce an unlimited "acceptance obligation," i.e., an unlimited

legal tender status, for the Fund's currency.

The question whether the Fund is, or is developing toward, a World Central Bank is therefore essentially spurious. The Fund may, over time, perform many more useful functions for its members than it already does, and some of its present or future functions have close counterparts in what central banks do within individual countries. According to one's taste, one may proclaim at some stage that the Fund is, or is almost becoming, a World Central Bank. But it should always be remembered that such a statement cannot be more than a figure of speech.[14]

6. *The expanded role of the Fund*

In spite of the fact that the Fund has raised very considerably the resources it is prepared to make available to a member—both in absolute terms and even more as a percentage of quota—the payments disequilibria in recent years have been so large that even these amounts have often been greatly insufficient to cover the debtor's minimum balance of payments deficit, i.e., the deficit that remained after the maximum feasible adjustment effort. When the Fund faced such situations it has taken the position that it would not commit its resources to an inconsistent program and that the remaining gap would have to be filled before the Fund would approve its contribution to the program. Procedurally, this approach has led the Fund into an explicit two-stage decision-making process: (i) agreement between the country and the Managing Director on a program and (ii) approval of this program by the Executive Board.

More important, and substantively, the Fund Management stepped into an international void and accepted a new international role for the institution: the role of the leader of coordinated balance of payments assistance. The Fund was first faced with situations that needed such intervention a few years ago, in certain countries where the additional resources to fill the gap would have to come from aid donors. Jamaica and the Sudan were two early cases in which the Fund gained experience with the fulfillment of this novel role. Its scope became much larger when the banking crisis affected large borrowers from the banks one after another; but the need to complement Fund resources by aid flows also spread, in particular in connection with Fund programs for African countries.

[14]When William McChesney Martin addressed the question "Toward a World Central Bank?" in the September 1970 Per Jacobsson lecture, he implied an affirmative answer. This was, indeed, the ideal short moment in history when such a view could plausibly be taken. The SDR had just come into being. "We may regard," he wrote, "the SDR mechanism in the Fund as a regulator, imprecise though it may be, of the growth of world reserves. This is truly a world central banking function—as distinct from the quite different task performed by the United States when it was (sic) the principal source of additions to world reserves." (p. 24) In addition, the Fund could act as a "restraining conscience" internationally, just as national central banks constrain their respective governments from indulging in overexpansion (p. 24). Perhaps the Fund could absorb other reserve assets against claims on itself, similar to the SDR (p. 25). The central bank function of lender of last resort "may be said already to be performed by the IMF" because of the sizable expansion of its transactions (p. 25). And, just as central banks regulate financial institutions and financial behavior, the IMF administers the par value system and promotes sound exchange practices (p. 25).

The Fund thus found itself, within a few years, in a major role of financial organizer for many of the countries that used its resources. Its activities in the field of "persuasion" affected commercial banks, that were asked to roll over debt falling due, to keep open lines of trade credit, to maintain or restore the level of overnight deposits, and to provide very large amounts of new money; ministries of finance, that were prevailed upon to reschedule debts and to provide new credit; exports guarantee agencies; aid donors in the industrial countries and the surplus oil exporters; the World Bank; and the Bank for International Settlements to provide bridging credit pending the design of a full-fledged Fund program.

In the process, further gradations were introduced in the Fund's decision-making process in order to take care of the difficult situation where every creditor wanted to be assured that every other creditor was coming along at the right time. As the occasion required, the two-step process just mentioned was lengthened by the addition of a further stage at either end. Providers of bridging credit—at the beginning of the chain—were induced to participate by a statement of the Managing Director to the effect that the Fund's negotiations with the country concerned were making good progress; and at the other end of the chain, the approval of a program by the Executive Board sometimes makes the entitlement of the country to make even its first drawing on the Fund contingent on subsequent decisions by other lenders, such as the Paris Club (for intergovernmental credits) or a consortium of commercial banks.

The Fund could influence other creditors by its willingness to stake its prestige and its resources on a particular program, provided only that the others did their duty in filling the remaining gap, if they did not, the Fund would not act either, the payments situation of the country concerned would remain unsolved, and its creditworthiness would plummet even further. In the process, it inevitably also fell to the Fund to determine the relevant magnitudes: the maximum payments adjustment it considered feasible, the extent and phasing of the Fund's credit, and the targets that it determined as the indispensable contribution of other groups of providers of funds. In principle, these magnitudes were all subject to a process of iterative decision-making among the debtor country, the Fund, and the other creditors; in practice, however, the Fund made the initial plans and the final outcome—a few weeks or a few months later—was usually not far different.

There can be no question of the invaluable contribution to the system that was made by the willingness on the part of the Fund—and, to be more precise and more accurate, of its Managing Director, Jacques de Larosière—to accept this responsibility. At the same time it is clear to all concerned that the Fund cannot in the longer run play as strong and decisive a role in the determination of the flow of financial resources to developing countries as circumstances have now forced it to perform. It cannot be the normal function of the Fund to determine how much credit each country should get, to use its best efforts to ensure that it gets that much and not more, or to persuade various classes of creditors to bring together the financial packages of the Fund's design.

Let me say specifically that I do not share Dr. Witteveen's ambition that

the Fund (by being put in charge of variable solvency ratios for sovereign loans and variable reserve requirements for Eurodeposits) should become the regulator of "the growth of international credit and liquidity. . . guided by the need for balanced growth of the world economic and financial system, leaving individual central banks free to follow their own national monetary policies."[15] Such a system would be incompatible with an international capital market in which borrowers and lenders from many countries compete. In so far as monetary instruments are to be marshaled to achieve a "balanced growth of the world economic and financial system" these instruments would have to be directed toward the control of money creation in the main financial centers. If that is done, international credit as such does not need to be—and should not be—subject to quantitative controls, although internationally agreed prudential controls would certainly be desirable; if (as seems likely for the foreseeable future) a coordinated control of national monetary targets cannot be achieved, there is no point in an attempt at quantitative control by the Fund over "international credit."

While there may be little likelihood of the Fund being entrusted with global control over the flow of credit from abroad to its member countries, it is increasingly designing its own assistance to member countries against the background of medium-term projections of the balance of payments and the resulting debt service profile. Such projections are particularly useful to obtain a consistent view of the evolution of a country's debt service as a function of current account deficits over a series of years. They tend to encourage moderation in borrowing, including borrowing from the Fund with its rather short maturities.

It has of course to be borne in mind that the medium-term development of a country's balance on current account cannot be derived from projections of the various components of the balance of payments, such as export estimates based on knowledge of commodity markets, import estimates as a function of the country's growth rate, etc. Such a method of estimation tends to miss the crucial role that financial policy—the budget deficit, domestic credit expansion—plays in the determination of the current account deficit. Thus, while it is possible and useful to make consistent *projections* of a country's balance of payments over the medium term, it is not possible to make balance of payments *forecasts* that could claim a reasonable degree of accuracy.[16]

The Fund is not responsible for the flow of development capital to its developing members. But in engaging in what is intended to be a long-term effort to project, jointly with a member country, its payments balances as a function, i.a., of its borrowing profile, the Fund will also have to tailor its own lending policy in such a way as to ensure that it is sufficiently responsive

[15]H. Johannes Witteveen, *Developing a New International Monetary System: A Long-Term View* (1983 Per Jacobsson Lecture, Washington, D.C. 1983), pages 11 and 12.

[16]This is not exactly a new finding. See J.J. Polak, "Balance of Payments Problems of Countries Reconstructing with the Help of Foreign Loans," *Quarterly Journal of Economics,* Vol. LVII (February 1943) pages 208–240; reprinted in American Economic Association, *Readings in the Theory of International Trade,* 1949, pages 459–493, especially the conclusions on page 485.

to the vagaries of the balance of payments. This cannot mean that the Fund offers unconditional finance as and when deficits occur. But it does require flexibility of the Fund in the amounts that it is willing to make available, on a conditional basis, to countries that plan and—when necessary—adjust their financial policies in close cooperation with the Fund.

III. The Allocation of SDRs

Concern about the adequacy of world reserves antedates by decades[17] the establishment of the IMF and at least one provision to deal specifically with this problem was incorporated in the original Articles of Agreement: Article IV, Section 7 providing for the possibility of a "uniform change in par values," an equiproportional change in the value of gold in terms of all currencies.[18] The concern continued in the 1950s and 60s. In two Fund staff reports, published in 1953 and 1958, it was argued that the supply of reserves was and would continue to be adequate,[19] but in 1963 extensive studies were launched by the Group of Ten and the Fund which culminated in the establishment of the SDR mechanism through which the Fund could "meet the long-term global need, as and when it arises, to supplement existing reserve assets...." (Article XVIII, Section 1)

After the first amendment had given the Fund the capacity to add[20] reserves to the system as needed, the discussion of the Group of Twenty in the early seventies envisaged generalizing that function to that of regulating the supply of reserves—perhaps by giving the Fund a near-monopoly on the supply of reserves after replacing gold and reserve currencies by SDRs via substitution accounts. These ideas did not, however, find sufficient support and all that is left of them is a pallid injunction to members in Article VIII, Section 7 to "...collaborate with the Fund and with other members in order to ensure that the policies of the member with respect to reserve assets shall be consistent with the objectives of promoting better international surveillance of international liquidity and making the special drawing right the principal reserve asset in the international monetary system."

At the same time that the G-20 patiently explored a universal system of "asset settlement" by means of a centrally controlled stock of SDRs, the actual world moved to a system of near-universal "liability settlement" (a technique of escaping balance of payments discipline that had previously been the special prerogative of the United States) in which the uncontrolled supply of dollars issued by the United States was supplemented by equally

[17]In 1922, the International Monetary Conference of Genoa believed it had found a solution to the problem—which of course was not a new problem then—by means of the gold exchange standard.

[18]The provision became redundant as a consequence of the first amendment of the Articles but was not abolished until the second amendment, when gold was dethroned generally as far as the Fund was concerned.

[19]"The Adequacy of Monetary Reserves" (October 1953) and "International Reserves and Liquidity" (September 1958), both reprinted in J. Keith Horsefield, *The International Monetary Fund, 1945–1965,* (Washington, D.C., 1969) Vol. III: Documents.

[20]It has always been recognized that the symmetrical provision to *cancel* previous allocations was unlikely ever to gather the required 85 percent support.

uncontrolled supplies of other reserve currencies and of dollar liabilities of other countries.

In these circumstances, is there still a role for the Fund to allocate SDRs? The question has not been clearly answered by the Fund membership after the first allocation in the three years 1970 to 1972. Since then there have been nine years without an allocation on January 1: 1973–78 and 1982–84, and only three years with an allocation (1979–81); but important elements in the decision to allocate for the three-year period were the recently taken commitment to make the SDR the principal reserve asset of the system (Article VIII, Section 7) and the idea that a "modest" allocation would help to keep the SDR alive for an as yet undefined future role in the system. Any decision in the near future to resume allocations for a number of years would be most unlikely to reflect a clear agreement on the place of deliberate reserve creation by the Fund, but rather follow from considerations similar to those that prevailed in the 1978 decision.

Thus, while there is a movement toward consensus on the role of the Fund in the supply of conditional balance of payments credits, its role with respect to the deliberate supply of reserves remains imprecisely defined. Space does not permit me to enter into this question at length, but a few principal considerations deserve to be mentioned.

1. While, in the 1970s, the international banking system was a reasonably efficient provider of reserves—for countries wishing to accept the risk of relying on borrowed reserves—this has no longer been the case since about mid-1982. A large number of countries—including many whose policies are endorsed by IMF stand-by arrangements—have not found it possible to maintain or regain an adequate level of reserves. Others are slowly reconstituting reserves through the painful process of earning current account surpluses, beyond what they need for debt service. In these circumstances, the Fund can make a contribution if it activates to a reasonable degree the credit mechanism created under the 1969 amendment and allocates SDRs. Part of the credit extended in this way (to all members, in proportion to their quotas) will lead to a reduced demand for credit for reserve building from banks in the main countries; thus SDR creation will in principle have to be matched by some reduction in credit creation in the reserve centers. SDR creation favors the reserve needs of weaker countries; but the fact that the stronger members of the Fund, and in particular the reserve centers, can get by comfortably without this credit mechanism of the Fund is not a good reason not to allow it to perform the useful international function that it can perform. Indeed, the stronger members of the Fund are also unlikely to need its conditional credit mechanism, but they are sufficiently aware of the international value of that mechanism to provide it periodically with enlarged resources. In a period in which the commercial banks are reluctant to expand their overseas credits, there is every reason to use both of the credit mechanisms for which the Fund's Articles provide.

2. The use of two Fund mechanisms raises the question of their compatibility. In this connection the starting premise is that prompt adjustment is necessary wherever payments positions are not in sustainable equilibrium. Conditional credit is a natural in these circumstances. Is there also a role for

the provision of unconditional credit through the allocation of SDRs? It would seem to me that the answer to this question is in the affirmative.

First, a large proportion of the countries for which adjustment is required has acknowledged this fact by concluding conditional credit arrangements with the Fund. Once there is an agreement on adjustment, ensured by the provision of resources on a conditional basis, there is no reason to insist that the supply of any and all resources must be tied with the strings of conditionality.

Second, the argument referred to above of keeping the SDR alive continues to have merit. However, these arguments should be qualified by the proviso that the amounts made available by allocation of SDRs should not be so large as to undermine the careful calibration of resources under Fund programs. These programs envisage a certain maximum flow of Fund money to a country, depending on such factors as the quality of its adjustment program, the extent of its indebtedness to the Fund, and the medium-term perspective for its balance of payments. The Fund applies a scale of access based on these factors, ranging (at present) from 25–50 percent of quota per year for some members to 102–125 percent per year at the top of the list. Annual allocations, which of course have to be the same percentage of quota for each member, must be compatible with this system of gradation. It follows that however large the established need for reserves may be—and convincing statistics on the size of this need are notoriously hard to establish—the level of allocation will have to be a low enough percentage of quota so as not to undermine the Fund's conditionality.

3. Like any bank, the Fund must constrain its credit creation to the demand that exists for the claims that it creates. It is traditional to consider this demand in two separate compartments, associated with the two Departments that form the structure of the Fund (the General Resources Department and the SDR Department). In the first Department, the willingness to hold claims on the Fund is periodically established through the quinquennial quota reviews, and occasionally by negotiated arrangements to lend to the Fund. The demand for SDRs manifests itself in the process of decision-making on allocations, where every member knows that its participation in an allocation entails its obligation to accept, in specified circumstances, and against payment in a "usable currency," a further amount of SDRs equal to twice its allocation.

The obligations of members to acquire the two types of paper issued by the Fund are separate; but since both are acquired, in many member countries, by the same agency—outside the Anglo-Saxon countries usually the Central Bank[21]—the demand for the two assets cannot be considered as in-

[21]The situation in the United States is more complicated. The SDR position of the United States is held by the Exchange Stabilization Fund of the Treasury. The ESF has the right to issue "SDR certificates" to the Federal Reserve Banks, both against allocated SDRs and to finance the acquisition of designated SDRs, and it has in fact done so for the bulk of the U.S. holdings. At the end of January 1984, the ESF had issued SDR certificates for SDR 4.5 billion of the total U.S. SDR holdings of SDR 4.9 billion. Thus SDR holdings in the United States are essentially financed by the Federal Reserve. The reserve tranche and the General Arrangements to Borrow (GAB) positions are held by the General Fund of the Treasury, and financed directly by the Treasury.

dependent. Indeed, there is increasing evidence that the financial activities of the two halves of the Fund are becoming subject to a joint constraint.

IV. The Joint Constraint on the Fund's Two Departments

Contrary to what could have been expected from the original Articles of Agreement, the development of the Fund has brought about the situation in which the activities of the Fund (of both the General and the SDR Departments) are financed by the issuance of reserve assets held mostly by central banks as part of their portfolio of foreign assets—a portfolio that must above all be liquid and that should, in addition, earn an adequate rate of return.

In the Anglo-American discussions that preceded Bretton Woods, the U.S. negotiators prevailed over their British counterparts on the question of the financial structure of the Fund: the Fund, it was decided, would operate on the basis of "a mixed bag" of contributed currencies (plus contributions in gold), not on the basis of overdrafts that would create assets for its members expressed in "bancor."[22] But this decision *not* to make the Fund a "bank," which would create international "money" by extending credit, was overtaken by the natural development of the institution itself almost as soon as the Fund began to use currencies other than the U.S. dollar in its transactions on a large scale.[23] When the Fund provides nonreserve currencies to a borrower, the normal practice is for the borrower to present these currencies at once to the issuer for conversion into dollars. Thus the country whose currency is used, while receiving an enlarged position in the Fund, loses a corresponding amount of interest-earning U.S. dollars. Since about 1958, the Fund has, accordingly, been subject to pressure to adopt practices that would offset as far as possible the effects on the countries concerned, both as to the level of their reserves and as to their interest income. Hence the policies, and then the amendment, concerning the gold tranche (later "reserve tranche") by means of which creditors of the Fund could now consider their claims as liquid reserve assets; the introduction (again by amendment) of a rate of interest ("remuneration") on such positions, and the persistent effort to increase the rate of remuneration, from the initial 1.5 percent, to 85 percent of an equivalent market rate (the SDR interest rate) until recently. In early 1984, the Fund decided to raise the rate of remuneration further under a formula that makes it likely that this rate will rise to the full SDR interest rate over the next few years.

When the SDR was created by the First Amendment, its characteristics were to a large extent patterned on those of the Fund's gold tranche positions, but a successful effort was made at the same time to give the SDR readier usability and greater liquidity than were enjoyed by the gold tranche position. Thereafter, in leap frog fashion, the qualities of the SDR became the standard to which the quality of the gold tranche position should, as far as possible, be raised. This has to a large extent been achieved. But although the interest rate gap between the two assets is now small and likely to vanish,

[22]J. Keith Horsefield, *The International Monetary Fund, 1945–1965,* Vol. I, pp. 28–30.

[23]See J.J. Polak, "Thoughts on an International Monetary Fund Based Fully on the SDR," IMF Pamphlet No. 28 (Washington, D.C., 1979), pp. 4–6.

the same catching up cannot be achieved in terms of two other characteristics that affect the comparative "quality" of the two assets: usability and liquidity.

On the first point, the reserve tranche can only be used in case of need, and by "drawing on the Fund"—a process that has unpleasant overtones; unlike in the case of SDRs, there are no provisions for bilaterally agreed transfers not subject to the requirement of need. Probably more important is the fact that at some times the liquidity ratio[24] of the Fund has been low, that is, when, as before the recent quota increase, outstanding drawings were large as compared to total quotas; in that situation, there could be some question whether the Fund's resources were sufficient for any contingent encashment of reserve tranche positions and loan claims. This contrasts with the better liquidity provisions that were built into the SDR system, by means of an acceptance obligation that equals twice a member's allocation.

Whatever the comparative "quality" of the various components of "Fund-related assets"[25] held by central banks, it is the growth in their total as a share of reserves that has become a matter of concern in some creditor countries. This share is by now important and it could become still much larger if the Fund's holdings of a country's currency, its General Arrangements to Borrow (GAB) commitment, and its acceptance obligation for SDRs were all to be used in full. Table 2 shows, for each of the G-10 countries, the present situation in the first three columns and the maximum commitment following from the increased quota and the enlarged GAB—which of course represents an extreme situation—in the next four. For the EC countries, a further relevant variable is shown in column (8), viz. that part of their "nongold" reserves as reported by the Fund that consists of ECUs swapped against gold (at prices close to the market) with the European Monetary Cooperation Fund; the inclusion of these assets among "nongold" reserves is at least open to some question. The figures show that except for the United States, whose position as the main reserve center is of course special, the current share of Fund-related assets in reserves, in the order of 10 to 20 percent, is still modest. But this figure rises to 40 percent or more (91 percent in the case of Belgium) if the gold ECUs are added in, and to very much higher figures if allowance is made for the maximum potential substitution of Fund-related assets for foreign exchange holdings.

[24]The ratio between usable uncommitted currencies plus SDR holdings to reserve positions in the Fund.

[25]"Reserve positions in the Fund" (which equal reserve tranche positions plus loan claims) plus SDR holdings.

Table 2
Share of Actual and Potential Fund-Related Assets in Reserves
Group of Ten Countries
Year-end 1983
Figures are percent of nongold Reserves

	Fund-Related Assets							
	Actual			Potential				ECUs derived from Gold Swaps
Countries	Reserve Position	SDR Holdings	(1) + (2)	Quota	GAB Commitment	3xSDR Allocation	(4) + (5) + (6)	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
United States	50	22	72	83	19	68	170	—
Canada	21	0	21	88	27	73	188	—
Japan	9	8	17	18	9	11	38	—
Sweden	5	3	8	28	10	18	56	—
EEC-Countries								
Belgium	11	9	20	47	13	33	93	71
France	7	2	9	24	9	17	50	46
Germany	9	4	13	13	6	9	28	22
Italy	5	3	8	15	6	11	32	33
Netherlands	9	5	14	24	9	16	49	42
United Kingdom	19	5	24	57	16	53	126	17

Source: IFS

In these circumstances it is not surprising that some of the creditor Central Banks have become somewhat concerned about the degree of concentration of Fund assets in their reserves.

The German Bundesbank has recently made a public allusion to the risks that it sees in this situation[26]:

> The share of our IMF-related monetary reserves (reserve position and amount of SDRs allocated and acquired) in our overall reserve assets amounted at the end of August 1983 to just over 19 percent.* The assumption is that these assets can be mobilized in case of need. However, situations are conceivable in which the exercising of definite rights would have to be weighed against the possible consequences of such a step for Fund liquidity and therefore for its ability to function in a given scenario in the world economy. The very possibility of such a conflict makes it necessary to ensure that our monetary reserves contain

[26]"The Financing of the IMF and Multilateral Development Banks" in Deutsche Bundesbank, *Monthly Report;* September 1983, p. 49. The article contains a table showing Germany's current and maximum potential holdings of Fund-related assets as percentages of reserves (the latter apparently defined ex ECUs) swapped for gold.

*The difference between this figure and the 13 percent shown for Germany in Table 2 is partly due to a difference in dates but mostly to the definition of reserves used in the calculations (see preceding footnote).

an appropriate share of reserves which are immediately available and absolutely liquid.

Germany—whose potential exposure according to the table is smaller than that of the G-10 countries—is not the only country to harbor such sentiments. These sentiments act to some extent as a constraint on the role of the Fund in terms of its financing activities—including SDR allocations.

These concerns of certain central banks regarding the composition of their reserves are no less real because they cannot be proven to be justified; indeed, the Fund and, worse, the international monetary system, would be in a perilous situation if anything approaching proof of these concerns ever materialized. At the same time, it is clear that while an individual industrial country may have to face a situation where it needs to mobilize a large proportion of its foreign assets, this can hardly occur for the industrial countries as a group. It should, therefore, be possible and indeed relatively simple for these countries to reach mutual understandings on the transfer of SDRs among them to meet the requirements of any situation. A relevant fact in this connection is that since the beginning of the SDR system the unused acceptance obligation of the United States alone would broadly have sufficed to absorb *all* SDR holdings of *all* other industrial countries.

An arrangement of the nature indicated would not enhance the liquidity of reserve tranche positions.[27] However, there are other reasons to suggest the merit of recasting the credit operations of the Fund in such a way that they would lead to creditor positions in the form of SDRs, rather than, as at present, reserve tranche positions. This would happen if the Fund were to substitute SDRs for contributed currencies in its credit operations. This would require a new power for the Fund to create SDRs on the occasion of every drawing and to cancel SDRs on the occasion of every repurchase. I have worked out suggestions to this effect in my 1979 pamphlet on a "Fund based Fully on the SDR." This would be a desirable change in itself, among other reasons to simplify the working of the Fund and make it more understandable. But in order to alleviate also the reservations of creditor central banks against their concern about the composition of foreign assets in their portfolios it would need to be accompanied either by the arrangement described above or by that mentioned in the next paragraph.

A much more radical change that would also lighten the weight of Fund paper in central bank portfolios would be to allow SDRs to be held outside the official circuit so that they could be used for market intervention. In a formal sense this could only be done by an amendment of the Articles of Agreement; but very much the same result could be achieved if some official holder (say the BIS) would, as a trustee[28], issue SDR certificates against of-

[27]Loan claims are transferable by agreement and in a few cases transfers among creditors have been arranged bilaterally.

[28]Similar ideas have been discussed by Warren Coats and Peter Kenen. See Warren L. Coats, Jr., "The SDR as a Means of Payment" IMF, *Staff Papers,* Vol. 29 (September 1982) pp. 422–36 and Peter B. Kenen, "Use of the SDR to Supplement or Substitute for Other Means of Finance," in George F. von Furstenberg, ed., *International Money and Credit: The Policy Roles,* IMF, Washington, 1983, pp. 327–73. Both authors speak of a "clearing house" as an intermediary rather than a "trustee." Kenen refers to the possibility of SDR certificates in footnote 14 on page 345.

ficial SDRs. Official holders could then deposit SDRs with the trustee (or clearing house) to acquire the certificates which they could then sell in the private market. This would take away some of the present drawbacks of the SDR as a reserve asset. In addition, the size of the possible demand for these certificates in the private market, e.g., on the part of commercial banks, would reduce the amount that needed to be kept in official portfolios.[29] It should be stressed, however, that these ideas, while undoubtedly interesting, have not been thoroughly analyzed in their many aspects, which include such questions as the effect of private holdings on the formation of the price and the interest rate on the SDR and—more fundamentally—the consequences for the role of the SDR if it were to cease being exclusively an asset for the official circuit; these aspects may well be considered more important than any impact that nonofficial holdings of SDRs would have on the constraint on the Fund's financial role.

[29]These possibilities were discussed in a panel session at the end of the Fund-organized conference referred to in the previous footnote. See Ibid., page. 433.

Discussion

C. Fred Bergsten*

The great achievement of the International Monetary Fund in the 1980s has been its dramatic, and so far successful, assertion of global leadership in dealing with the international debt crisis. As Jacques Polak points out, "the Fund management stepped into an international void" and performed a critical systemic task. Indeed, it did so even when its member countries did not fully provide the needed financial resources as in the delay in negotiating the Eighth Quota Increase in late 1982 and the uncertainties, primarily in the U.S. Congress, surrounding the implementation of the quota increase throughout 1983.

This great success by the Fund, however, must not be allowed to obscure the fact that, during the same period of time, it has fallen considerably short of fulfilling its responsibilities in managing other key aspects of the international economic and financial system. Indeed, the Fund's ultimate success in resolving the debt crisis may turn on whether it can attain similar effectiveness in promoting changes in the policies of the major industrial countries—which must provide a global framework of stable growth if the developing countries are to resume servicing their external debt on a market basis.[1] With or without a debt crisis, however, the Fund must play a much greater role vis-à-vis the industrial countries if there is to be an assurance of effective management of the world economy.

First, the Fund needs to adopt a much more creative and aggressive approach toward exercising its responsibilities for maintaining "multilateral surveillance" over the world economy. The recent emphasis on "convergence" is both inadequate and misplaced. Indeed, we now have a great deal of convergence—particularly in terms of inflation performance in the major countries (United States, Japan, Germany, United Kingdom and increasingly France). However, massive currency and thus current account imbalances remain. Hence the world recovery is sharply unbalanced, both among countries and among sectors within countries, and its sustainability is subject to much uncertainty. Protectionist pressures are intensified, especially in the United States, jeopardizing the entire world trading system.[2]

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[1]For details see William R. Cline, *International Debt and the Stability of the World Economy* (Washington, D.C.: Institute for International Economics, September 1983), particularly pp. 46–73.

[2]See C. Fred Bergsten, "The United States Trade Deficit and the Dollar," Statement before the Senate Committee on Banking, Housing and Urban Affairs, June 6, 1984. The most notable imbalances are of course the U.S. current account deficit, which is expected to reach $100 billion in 1984 and perhaps $125 billion in 1985, and Japan's current account surplus of $30-40 billion in 1984 and 1985.

The Fund must therefore find new ways to promote more internationally compatible policies among the largest countries. At a minimum, this requires addressing their *policy mixes.* At the moment, for example, fiscal policy is headed in opposite directions in the United States and in the other largest countries.[3] Fund management has spoken out increasingly against the huge U.S. budget deficits, but has said nothing about the excessive fiscal tightening elsewhere and the institution as a whole has made no visible effort to exercise meaningful surveillance over the whole evolution of events.

To be sure, doing so is no easy task. A first question is whether to attack the need for better policy coordination directly, or to do so indirectly via seeking more multilateral control over the relationships among the exchange rates of the major countries. This is of course a central question that has arisen throughout the brief history of the European Community as they have sought closer policy harmony among their member states.

At this point in time, I would advocate a serious effort by the Fund to get a better handle on national macroeconomic policies by promoting changes in the exchange rate regime—the most direct point at which national policies intersect, and hence the most logical fulcrum at which to address them. There need be no effort to return to fixed rates, nor could there be such a return. The current imperative is to find a synthesis between the excessive rigidity which came to dominate the fixed rate regime of Bretton Woods, and the incessant overshooting and excessive volatility which are seemingly endemic under the current regime of unmanaged floating.

The "target zone" approach appears a promising way to make a start in that direction.[4] Beyond its substantive merits, such an approach would provide the international community—presumably working through the Fund—with a legitimate basis for addressing the policies of individual industrial countries, *particularly* the largest of them because of their greater systemic impact, in the (proper) global context.[5] Rather than arguing that "target zones" would not have worked in recent years because of the high U.S. budget deficits and interest rates, as many do, one should ask whether the existence of such a system could have tilted the United States toward achieving its recovery with a more sustainable and internationally compatible policy mix.

I would make only one other point regarding the role of the Fund in managing the international adjustment process. Polak argues that it is wrong in principle for the Fund to attempt to vary its conditionality in such a way as to contribute to global anticyclical policy, and implies that Williamson has

[3]Stephen Marris, "Why Europe's Recovery is Lagging Behind," *Europe,* March/April 1984.

[4]Details can be found in John Williamson, *The Exchange Rate System* (Washington, D.C.: Institute for International Economics, March 1984). A possible set of guiding principles can also be found in Ronald McKinnon, *A New International Standard for Monetary Stabilization* (Washington, D.C.: Institute for International Economics, March 1984).

[5]To be sure, first steps in this direction would probably require some informal efforts in smaller circles, such as the Group of Five. It would be a mistake, however, as proposed by Robert V. Roosa in his paper at this conference, to institutionalize the process *outside* the Fund. Doing so would mean a less effective system in my judgment, and would undermine the Fund in its needed effort to play a much *larger* role in surveillance.

argued that this was desirable in order to directly limit the extent of world recessions. What Williamson in fact wrote was that "the logic is that even well managed countries can easily find themselves facing a need to borrow during a world recession, whereas this is much less likely in a boom. The proposal to temper conditionality by the state of the world business cycle would have the *additional* advantage of making a modest contribution to a global anti-cyclical policy."[6] The primary question is what is appropriate for the individual country; it is all to the good if that has a desirable effect on the global economy, but it is a secondary point.

Turning to the liquidity side, I believe that here too the Fund has abdicated a good deal of its responsibilities—even though, in this case, the relationship to its leadership in resolving the debt crisis is even more direct. One of the requirements for a return to creditworthiness by the debtor countries is that they rebuild their reserves. Indeed, most Fund programs require such an effort and the Fund staff has reportedly estimated that the LDCs, as a group, need annual reserve increases of $10 billion from 1984 through 1988 simply to restore the ratio of reserves to imports which prevailed in 1977–78.[7]

However, the obvious and least-cost method to achieve such a reserve buildup has so far been ignored: a substantial one-shot allocation of Special Drawing Rights, followed by a resumption of more modest annual increases. In retrospect, it is clear that the global liquidity situation would have been served by SDR allocations during 1982–84—the first three years of the current "basic period." Fears of rekindling inflationary expectations precluded such actions. But now that inflation has declined dramatically, it would seem safe to make up for lost time with a "rear end loaded" allocation of $30–35 billion in 1985. Doing so would meet a global liquidity need by helping to address the critical problem of LDC reserve shortages, and would also begin to restore the role of the Fund in meeting world liquidity needs.[8]

In this context, Polak puts forward the critical point, made previously by the Bundesbank, that the Fund may be constrained in issuing any kind of asset because of the unwillingness of major creditor countries to hold Fund-related assets in their reserves. But what is the real worry here? Is it the question of backing? Is it a question of liquidity, that people are afraid that in the event of a balance of payments deficit they won't be able to pass these assets on? That the acceptance obligations won't be honored?

The Fund is sufficiently close to a closed system to ensure that there ought not be a liquidity worry if countries fulfill their obligations. If it is a liquidity worry, implying a doubt that countries will in fact accept additional claims on the Fund, that creates another reason (as Polak points out) for allowing the private sector to hold SDRs directly through the mechanism of a clearinghouse or something analogous. But surely the members would not want to limit the scope of the institution to fulfill its mandate due to fears

[6]See John Williamson, *The Lending Policies of the International Monetary Fund* (Washington, D.C.: Institute for International Economics, August 1982), p. 44.

[7]The data are in International Monetary Fund, *World Economic Outlook,* Occasional Paper 27 (Washington, D.C., April 1984), Table 33, p. 203.

[8]For details see John Williamson, *A New SDR Allocation?* (Washington, D.C.: Institute for International Economics, March 1984).

concerning the usability of Fund-related assets; a direct response to any such fears would be by far the more desirable approach.

There is a third issue-area, which bridges adjustment and financing, where additional IMF action may be needed. As part of its leadership role in responding to the debt crisis, the Fund has lent heavily to a large number of developing countries. There is a major question, however, as to whether the Fund will be able to expect repayment from those countries on the timetable which has traditionally been normal for its "revolving fund" approach. Just as the commercial banks cannot on balance withdraw funds from the debtor countries without *precipitating* a major crisis, neither may the Fund be able to do so for some time to come. This would be particularly true if the next world economic slowdown occurs around 1986–87, just when repayments on major Fund loans are scheduled to become substantial.

The Fund may thus need to develop ongoing programs in these countries, going beyond the acute crisis stage of their difficulties. Moreover, it may need substantial additional funding itself to offset the absence of anticipated repayments. One obvious possibility is a simple rollover of the loans made to the Fund by the Saudi Arabian Monetary Agency (SAMA) and other monetary authorities in the early 1980s.

Another, however, would be for the Fund to start tapping the private capital markets. Doing so now, before any shortages of funding developed, would represent an orderly approach to assuring that the Fund would be fully prepared to cope with any future exigencies which emerged. Some of the policy questions surrounding such borrowing are complex, and may take time to resolve. So prudent forward planning suggests that the Fund begin the process soon.[9]

Finally, there are several other possibilities which the Fund could consider pursuing to further enhance its capability to carry out the objectives already cited. It might integrate its activities much more closely with the World Bank, to bring the latter's developmental and supply-side expertise more directly into its own programs and augment the financial resources (and thus policy leverage) available in a given country context; for example, there could be explicit linkage between the Fund extended facility programs and structural adjustment loans by the Bank.[10] It might, at some time in the future, revive the discussions on a Substitution Account to head off the further, seemingly inexorable, development of a destabilizing multiple reserve currency system.[11] More immediately, it could consider whether—if adequate resources were available—to broaden the compensatory financing facility to cover the adverse current account effects on debtor countries of

[9]I certainly do not mean to rule out future quota increases despite the problems caused by the U.S. Congress in 1983—and which, to a lesser but still considerable extent, I faced personally when bearing major responsibility for winning Congressional approval of the Seventh Quota Increase in 1980 and the Witteveen Facility in 1977–78. However, prudence dictates looking to additional means of funding the Fund, as via the private markets.

[10]John Williamson, *The Lending Policies of the International Monetary Fund* (Washington, D.C.: Institute for International Economics, August 1982), pp. 21–25.

[11]See C. Fred Bergsten and John Williamson, *The Multiple Reserve Currency System,* (Washington, D.C.: Institute for International Economics, forthcoming September 1984).

unanticipated, exogenous rises in the cost of their interest payments.

In all of these areas, the goal should be to steadily promote the role of the International Monetary Fund as manager, or at least coordinator, of the global economic and financial system. It is becoming increasingly difficult, if not impossible, for individual nations—no matter how large—to effectively manage their affairs on a unilateral basis. Real economic sovereignty is far less than nominal sovereignty, and the failure to realize and bridge this gap can only cause increasing problems for all concerned.[12] It is thus essential that the role of the Fund continue to grow, perhaps along some of the lines suggested here.

[12]See C. Fred Bergsten, "The International Dimension" in G. William Miller, ed., *Regrowing the American Economy* (New York: Prentice Hall, 1983).

General Discussion

Jacques Polak rejoined that the costs to the IMF of entering the world capital market for funds could well exceed the benefits. Once the IMF entered that market, the perceived quality of Fund paper (SDRs) held by central banks might diminish, so that the SDR's value could decline.

Also, the Fund's ability to intensify surveillance over global economic policies is constrained by existing mechanisms. The prevailing forums for discussion—economic summits, OECD meetings, IMF interim committee sessions, and the like—must operate under conflicting views on what good policy is. Surveillance has thus been quite broad, but not very deep.

Polak noted further that the severity of adjustment programs for countries such as Brazil and Mexico was necessary. The absence of creditworthiness and the degree of maladjustment in these countries justified stringent conditionality. The high real interest rates accompanying such programs were inevitable and should not have been a surprise. For several industrialized countries, even less severe adjustment programs have produced high real interest rates. Furthermore, the size of Fund resources had little to do with the severity of adjustment programs for these countries. By 1982, Fund resources had become, or were about to become, substantial.

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