Is There a Need for Reform?

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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 situation 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 practical 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 initiatives 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.