Issues & Policy

Three Challenges for Better International Monetary Management

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Twenty years ago who would have guessed what dramatic changes were destined to occur in the world financial system over the next two decades? In 1961, the system was essentially the same one that had been created at Bretton Woods, New Hampshire, in 1944. Exchange rates were still formally "pegged" within relatively narrow limits around declared par values. International monetary reserves were still based on a fixed price relationship between a convertible United States dollar and gold. And the biggest creditors in the system were still the main industrial powers of Europe, North America, and Japan.

Today, all that has changed. Exchange rates now float. The gold-exchange standard is but a memory. And the system's biggest creditors now speak Arabic and live in the Middle East. Yet how many of us would profess to be satisfied with the results? How many, with Voltaire's Dr. Pangloss, would argue that this is now the best of all possible worlds?

Certainly not those who had hoped that change would occur as a result of careful, premeditated design — such as Robert Triffin, whose *Gold and the Dollar Crisis*, published in 1960, did so much to stimulate a generation's quest for the holy grail of monetary reform. When change did come, it came as a result of events, not deliberation; in the heat of crisis rather than in the cool light of reason. No wonder that the outlook for the world financial system is still a matter of vital concern.

Not that it could ever be otherwise, really. As I have written elsewhere:

> If any general lesson emerges from this long discussion [of the world financial system], it is that in an imperfect world there are no perfect solutions. The potential for improvement exists — but it is finite, not infinite. Aspiration must be tempered by humility. The monetary order can be better or-

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> ganized; both efficiency and consistency can be promoted. But nothing can ensure for all time that monetary relations will always remain stable and free of policy conflict. So long as there are politically sovereign states and formally independent national currencies, there will be international monetary problems. All we can really hope to do is to minimize the probability that such problems will occur and to restrict the extent of their damage when they do. We can never hope to eliminate them completely.[1]

It is in this spirit that the outlook for the system today must be assessed. Current or prospective problems can be grouped under three broad headings: (1) exchange rates; (2) reserves; and (3) balance-of-payments financing. Each of the three may be considered a challenge for better international monetary management.

Exchange Rates

Although conceived in haste, generalized floating among the major currencies was widely acclaimed when it began back in 1973. Here at last was what seemed an efficient corrective for the distortions of competitive positions that had been allowed to build up among the industrial nations under the par-value regime — a means to ensure that external balance would now be maintained through frequent, small changes of currency values rather than through irregular and precipitate jumps. Our governments would now have an extra degree of freedom in dealing with the dilemmas of domestic stabilization. Flexibility of exchange rates would accommodate differences in national policies or other underlying economic developments.

More recently, however, disillusionment has set in. Flexibility has not lived up to its advance billing. Rate movements among the major currencies continue to be irregular and precipitate. Our governments have not escaped the constraint of the balance of payments. And divergences of economic performance frequently have been exaggerated rather than accommodated. One symptom of that disillusionment is the European Monetary System, whose very raison d'etre is to create a "zone of monetary stability" in a sea of exchange-rate volatility.

To be sure, a certain amount of volatility had to be expected when floating first began, as the distortions of the Bretton-Woods era were worked off. Some time, clearly, would be needed to learn how to play

1. Benjamin J. Cohen, *Organizing the World's Money: The Political Economy of International Monetary Relations* (New York: Basic Books, 1977), p. 273. This book was written at the Atlantic Institute during 1975-76.

the new game. But after more than eight years it is hardly plausible to blame either past errors or slow learning for the sharp and often disorderly fluctuations of rates that characterize the markets today. To promote adjustment, nominal rate movements should in principle bear some more or less systematic relation to differentials of price performance between countries; that is, "real" exchange-rate changes should be relatively small. In practice, however, especially since 1978, real rate changes among the industrial nations have actually been quite substantial, have borne relatively little relation to inflation differentials, and in some cases have even amplified them, leading to significant shifts in international competitive positions.

To some extent, these developments since 1978 may be attributed to an unusual coincidence of relatively favorable current-account positions in high-inflation, high interest-rate countries (e.g., the United States and Britain) and unfavorable current accounts in low-inflation, low interest-rate countries (e.g., Germany and Switzerland). As the Bank for International Settlements pointed out in its 1981 *Annual Report*, looking at the years 1977-1980 as a whole, only the pound sterling among major currencies recorded a large *net* movement of its real exchange rate (presumably reflecting *inter alia* the effects of North Sea oil on the British balance of payments). For other major currencies, the "overshooting" of rates in 1979-80 for the most part merely reversed trends that had prevailed during the previous two years, leaving competitive positions at the end of 1980 not far from where they had been four years earlier.[2]

Still, little comfort can be drawn from such comparisons, as the BIS *Report* itself suggested.[3] For shorter periods, exchange-rate movements have manifestly been more volatile than necessary to accommodate shifts of national policies or underlying economic circumstances. And this in turn has made Western governments even more sensitive to developments in their balance of payments than during the old days of pegged rates (when payments developments, in the short run at least, could be absorbed by movements of central-bank reserves) — a case in point being European and Japanese reactions to the high and fluctuating level of interest rates in the United States in 1980 and 1981. Rather than accept sharp depreciation of their currencies, as funds were attracted to the United States, they countered with high interest rates of their own, albeit under protest. It is no secret that the height and variability of American interest rates were among the most contentious of the topics discussed at the Ottawa economic summit conference last July.

2. Bank of International Settlements, *Annual Report, 1981* (Basle: 1981), pp. 130-138.
3. *Ibid.*, p. 5.

Not surprisingly, therefore, the debate over fixed versus flexible exchange rates has revived, and voices are now being heard — particularly on the European side of the Atlantic — calling for a return to fixed parities among the major currencies,[4] even though this runs directly counter to the declared views of the new administration in Washington, which prefers an even greater reliance on floating, and has formally announced its intention to refrain from exchange-market intervention except in the most dire of circumstances. The dissonance could hardly be greater. A safe prediction is that this administration, like its predecessor, will in time come to rue reliance on the markets alone to determine currency values, and eventually return to more active intervention. But even so, given its free-market predilections, it is hardly likely to satisfy those in Europe and Japan who call for stabilization of exchange rates now. The question is likely to roil Atlantic relations for years.

Simply put, the question is: How do you get the benefits of exchange-rate flexibility without the volatility? The answer is: not easily. To go back to formal par values would be to resurrect the kind of speculative crises that characterized the Bretton-Woods era; to go forward leaving exchange-rate determination solely to the markets would be to perpetuate the disorderliness of the more recent past. Floating exchange rates must be managed. The challenge is a practical one — to ensure that official interventions encourage stability without rigidity, flexibility without volatility. This in turn demands both imagination and craft — imagination to design a suitable set of guidelines for national policies; craft to convert conception into execution. Neither comes easily.

My own preference is for a "code of conduct" based on the so-called "reference-rate proposal" (whereby each government would be obligated not to defend some "target" rate or zone but rather, merely, to refrain from any form of intervention having the effect of forcing the market value of its currency away from a multilaterally agreed reference rate),[5] though I recognize that this is not a popular favorite; nor does it find any place in the guidelines promulgated in 1977 by the International Monetary Fund. The advantage of the proposal is that it avoids any bias toward rigidity that might be generated by target zones or the like, while at the same time restricting the scope for "dirty" interventions by central banks and providing a fulcrum around which stabilizing expectations in the markets might coalesce. Its disadvantage is that, by itself, it might not suffice to eliminate all excess volatility of rates. But complementary measures of macroeconomic coordination are not precluded by such a code.

4. See e.g., Rinaldo Ossola, "A Modest Step Towards Fixed Parities," *Banca Nazionale del Lavoro Quarterly Review*, March 1981, pp. 69-74.
5. Cohen, *Organizing the World's Money*, pp. 190-196.

Moreover, at least it would be a start — and a start, clearly, is now what is needed, if the frictions bred of the present exchange regime are not to erupt into open policy conflicts among the industrial nations.

Reserves

Policy conflicts among the industrial nations may also be bred of the present arrangements for provision of international monetary reserves. To suggest that these arrangements, since Richard Nixon's suspension of dollar convertibility a decade ago, lack coherence would be understatement. The standard is neither fish nor fowl — neither a gold-exchange standard (since the dollar can no longer be exchanged for gold, except in private markets) nor a pure dollar standard (since the dollar does not stand alone in monetary reserves). The dollar is still *primus inter pares* among reserve assets, *pace* those who had predicted that without convertibility it would be finished as international money. But like America's role in the world economy in general, the dollar's role in liquidity arrangements in particular has declined in relative terms. Pride of place now is shared with a miscellany of other assets, including several other national currencies (most importantly, the Deutsche mark) as well as gold, Special Drawing Rights, and, prospectively, perhaps even the new European currency unit (Ecu).

In fact, what we have today is a "multiple-reserve-asset" standard — the disadvantages of which are familiar to all. Not only does the existence of so many rival assets imply a persistent risk of disruptive "runs" (the Gresham's Law — or "confidence" — problem); worse, since the international use of most of these assets is entirely unregulated, there is no effective multilateral control over the supply or rate of growth of monetary reserves in the aggregate (the "liquidity" problem). Nor are these problems merely academic. Can anyone doubt that the stubbornness of inflation in so many countries in recent years has somehow been related to the considerable elasticity of supply of major currency reserve assets (via, in particular, the international financial markets)? Certainly no one can doubt the role that Gresham's Law played during the great sell-off of the dollar in 1977-78, or might again play in the future should the Ecu eventually become available to private or non-Community dollar holders anxious to diversify their portfolios.

Precisely because of these problems, thought is once again being turned to the possibility of reducing the system to a single reserve asset — though opinions differ on what that asset ought to be, the SDR or gold. (Understandably, little is heard these days about a pure dollar standard, despite the dollar's recent — but perhaps fleeting — popularity in the exchange markets.) On the one hand are those like Professor Triffin who, after twenty years of tireless advocacy, is still actively promoting the idea of substituting SDRs for national currencies and gold in international reserves.[6] On the other hand there are the new gold "bugs," like Lewis Lehrman and others influential in Republican circles in the United States — who want to go back to the gold standard of the late nineteenth century.[7] What unites the two groups is their preference for a homogenous reserve supply capable of exerting effective discipline on the supposedly inflationary proclivities of national monetary authorities. What divides them is whether that discipline ought to remain in human hands or not.

The gold bugs want to take control of reserve supply out of human hands by making liquidity dependent solely on the physical availability of gold. In testament to their influence, the Reagan Administration has appointed an official commission to study the question of restoring the gold standard (with Lewis Lehrman numbered among its members). One can only hope that the nostalgia of today's gold bugs pursuing their Proustian *Recherche du temps perdu* — when, according to the mythology, convertibility of a currency into gold was enough to assure that all would be well with the world — will not blind Washington to the critical defects of the idea. The gold-standard model is both politically naive and economically costly (to say nothing of its being inconsistent with the administration's professed faith in freely floating exchange rates). It assumes both a greater willingness on the part of governments to sacrifice their monetary sovereignty to the discipline of gold convertibility, and a greater flexibility of prices in the face of an inelastic gold supply, than is warranted by the facts. In reality, a gold standard could work in the modern world only if the official price of the metal were to be periodically increased, to ease the discipline on governments as well as downward pressures on prices. But then gold would be no more than a "funny money," inviting massive speculative runs in anticipation of such changes (once again, the Gresham's Law problem). Far from stabilizing the system, a gold standard could threaten even greater instability of monetary relations. Surely the wit of man is capable of better than that.

Superficially, the case for an SDR standard is more appealing. It is, in fact, based on the same logic that led nations individually to standardize their domestic money systems on just a single currency issued and managed by a national monetary authority: the logic of rational control of a homogenous reserve supply. But it too founders on the rock of political naiveté. Governments are scarcely more likely to surrender their monetary

6. See e.g., Robert Triffin, "The Future of the International Monetary System," *Banca Nazionale del Lavoro Quarterly Review*, March 1981, pp. 29-55.
7. See e.g., Lewis E. Lehrman, "Real Money," *Harper's Magazine*, August 1980; and Jude Wanniski, "A Job Only Gold Can Do," *The New York Times*, 27 August 1981.

sovereignty to multilateral decisionmaking through the IMF than to the discipline of gold convertibility. The logic of an SDR standard stops at the national frontier.

In fact, the same defect cripples any proposal for a single-reserve-asset system. So long as nations remain politically sovereign, they will be loath to make themselves dependent on but a single source of liquidity. Diversity of reserve composition in effect is viewed as a guarantee of policy autonomy. Messy or not, therefore, the multiple-reserve-asset standard must be regarded as here to stay. The question is: How can we tidy it up to make it easier to live with?

The answer, once again, is: not easily. In fact, three complementary approaches are required, dealing respectively with the roles played by gold, the SDR, and national currencies in the system.

As far as gold is concerned, the objective should be to minimize any residual role that the "barbarous relic" may continue to play. Presently, gold's role is ambiguous — effectively demonetized by Richard Nixon ten years ago, yet still a shadowy presence behind the scenes, aided most recently by the European Community's decision to include gold as well as dollars in the reserve pool backing the Ecu. Any decision that has the effect of reviving a monetary role for gold should be strenuously resisted. Rather, incentives ought to be offered to encourage governments either to keep gold "at the bottom of the heap" as at present, or else to divest themselves of as much of it as possible (via, perhaps, a gold-SDR substitution account at the IMF).

Conversely, the role of the SDR should be promoted as much as possible, in order to augment the share of total liquidity under effective multilateral control. Recent decisions of the IMF to reduce the complexity of regulations affecting SDR use, to raise its interest rate, and to streamline its system of valuation have contributed substantially to its attractiveness as a reserve asset. But much remains to be done — particularly in the area of promoting the *private* use of the SDR (or SDR-denominated assets) — before it can stand eye-to-eye with the dollar or other national-currency assets. Establishment of a gold-SDR or dollar-SDR substitution account at the IMF would of course also help greatly.

Finally, as regards national currencies, the objective should be to develop collaborative arrangements and agreements among the countries whose currencies figure most prominently among reserve assets — namely the United States, Germany, and a few other industrial nations (plus the European Community as a group, if and when the Ecu becomes more widely available) — to forestall the risk of disruptive runs from one currency to another, and to ensure a more orderly growth of each. In passing, it may be noted that this would help as well to dampen the volatility of exchange relations among these currencies; alternatively stated, the code referred to earlier may be regarded as a necessary first step toward a more efficient management of the multiple-reserve-asset standard. Stated either way, the message is clear: the system needs better management of monetary relations among the industrial nations.

Balance-of-Payments Financing

But that is not all. Beyond the industrial nations is the massive imbalance of monetary relations on a global scale, stemming primarily (though not exclusively) from the repeated increases of oil prices since 1973. The system also needs better management of the balance-of-payments financing problem.

The familiar dimensions of the financing problem are summarized in the accompanying table. Clearly, the gravest difficulties are to be found among the non-oil developing countries, whose combined current-account deficit remained large even in 1976-78, when the real price of oil was falling and OPEC's net surplus was in decline; and has risen rapidly since the second round of oil prices in 1978-79, to $80 billion in 1980 and near $100 billion in 1981. Worse, according to the IMF's latest *World Economic Outlook*, under even the most favorable assumptions, that deficit

Table
Global Payments Balances on Current Account,[a] 1973–81 Projections to 1985[f]
(billions of dollars)

	1973	1974	1975	1976	1977	1978	1979	1980	1981	1985[f]
Major oil-exporting countries[b]	6.6	67.8	35.0	40.0	31.1	3.3	68.4	112.2	96.0	50
Industrial countries[c]	19.3	−12.4	17.1	−2.1	−5.5	30.1	−10.7	−44.0	−29.5	65
Non-oil developing countries[d]	−11.5	−36.8	−46.5	−32.9	−29.6	−37.1	−56.1	−80.4	−96.5	−140
Total[e]	14.4	18.6	5.6	5.0	−4.0	−3.7	1.6	−12.2	−30.0	−25

Source: International Monetary Fund, *World Economic Outlook* (June 1981).

a. On goods, services, and private transfers. Figures for 1981 and 1985 are estimates rounded to the nearest $0.5 billion.

b. Includes Oman and all members of OPEC except Gabon and Ecuador. This group comprises only those countries whose net oil exports both account for at least two-thirds of the country's total exports and are at least 100 million barrels a year.

c. Includes all members of OECD except Greece, Portugal, and Turkey.

d. Includes all other IMF members (except People's Republic of China).

e. Reflects errors, omissions, and asymmetries in reported balance-of-payments statistics, plus balance of listed groups with other countries (mainly the Soviet bloc).

f. Projections to 1985 are based on the IMF's "Scenario A" (which assumes moderate rates of growth and gradually declining rates of inflation in industrial countries, along with constant oil prices in real terms).

can be expected to continue to swell to at least $140 billion in 1985. Unless requisite financing can be found, non-oil LDCs will have little choice but to reduce their rates of domestic real growth (already assumed in the Fund's projections to be sharply lower in 1982-85 than previously) — at what risk to social and political stability in these countries one is loath to speculate. As the Fund suggests, "the current picture . . . does not afford cause for complacency."[8]

Until now, of course, many of the non-oil LDCs (in particular, these in the "newly industrializing" category) have been able to rely on the international financial markets for the bulk of their financing. Indeed, since the first moments of the energy crisis, the markets have been the main vehicle for recycling the surplus earnings of oil-exporting or other countries onward — via bond issues and, especially, via bank credits — to nations in payments deficit.[9] And it is true that so far, since the second round of oil-price increases, the markets have continued to play that vital role without visible difficulty, albeit with a somewhat greater selectivity than before vis-à-vis some individual borrowing countries. But can they be counted on to continue to play that role in the future? Genuine doubt exists on that score, as both the BIS and the IMF have emphasized.[10] Among private creditors in general, ther is now a heightened perception of the risks inherent in lending to oil-importing LDCs — not just economic risks (stemming from the already strained capacity of some countries to meet debt-service requirements) but also, increasingly, political risks (reflecting the political turmoil in many parts of the developing world). Among commercial banks in particular, prudential considerations (e.g., exposure limits, capital adequacy) may well limit the scope for further significant increases of such lending.

Not that this necessarily means that we are on the verge of a breakdown of the recycling process, or that some major borrowers may now suddenly find themselves shut out of the markets altogether. But it does suggest that deficit countries will have to take their place in the queue, like everyone else, and settle for whatever amounts and terms they can get; and that from their point of view, these amounts and terms are unlikely to be as satisfactory in the future as they have tended to be in the past.

8. International Monetary Fund, *World Economic Outlook, 1981* (Washington: 1981), p. 5.

9. For a comprehensive discussion of the role of private lending in the international adjustment process, see Benjamin J. Cohen, in collaboration with Fabio Basagni, *Banks and the Balance of Payments*, An Atlantic Institute for International Affairs Research Volume (Montclair, New Jersey: Allenheld Osmun; and London: Croom Helm, 1981).

10. Bank for International Settlements, *Annual Report, 1981*, pp. 110-111; and International Monetary Fund, *World Economic Policy*, pp. 12-13. See also Benjamin J. Cohen, "Balancing the System in the 1980s: Private Banks and the IMF," in Gary C. Hufbauer, ed., *The International Framework for Money and Banking in the 1980s* (Washington: International Law Institute, 1981).

During the first years of the energy crisis, borrowers actually enjoyed a windfall gain on their external financing, as nominal interest rates lagged behind higher world inflation rates; in fact, until 1979, interest rates on such credits were generally negative in real terms. But with the return to positive real interest rates since 1979, cost has become a much more important consideration, as has the greater variability of interest rates (which, given the floating rates on most credits, makes cost calculations inherently more difficult for borrowers). Many countries, particularly those with limited resources, are now apt to find themselves severely handicapped in their search for adequate financing from the private sector.

What, then, about the public sector — specifically, the IMF? The challenge here is daunting. Insofar as the markets are unlikely to play as big a recycling role as before, it is incumbent on the Fund — as the principal institution responsible for international monetary stability — to address itself now more than ever to the needs of the non-oil developing countries, if a costly scramble among them to pass around their collective deficit is to be averted. This in turn imposes two obligations on the Fund. First, it must assure itself of sufficient loanable resources to meet the legitimate needs of deficit countries. And second, it must be able to persuade deficit countries to turn more promptly to IMF resources to meet those needs.

With respect to the first issue, even after the recent fifty-percent increase of members' quotas, IMF loanable resources still remain quite small in relation to potential need. Fund quotas today correspond to only 4 percent of world imports, as compared with 12 percent in 1965. To supplement its resources the Fund basically has two options. One is to borrow directly from countries in balance-of-payments surplus — which means, of course, mainly OPEC countries, in particular Saudi Arabia and other "low absorbers" around the Persian Gulf — the other, to borrow from the markets. To a considerable extent, the first option has already been employed, e.g., in the funding of the two temporary Oil Facilities and the Supplementary Financing Facility, roughly half of which came from OPEC countries; and more recently in the well publicized agreement with Saudi Arabia to borrow 4 billion SDRs ($5 billion) in each of two, and possibly three, successive years. Such deals, however, require difficult and protracted negotiations, and are frequently hampered by political considerations (e.g., the issue of whether to seat the Palestine Liberation Organization as an observer at IMF annual meetings). Accordingly, in coming years attention will have to be paid as well to the second of the Fund's two options — namely borrowing from the markets, either through direct loans or through issuance of its own bonds or notes. A crucial question is whether the organization's major members will be prepared to provide the necessary assurances of backing of IMF commitments to ensure a favorable market reception.

With respect to the second issue, the crucial need is to reconsider the Fund's traditional concept of policy conditionality. Very early in its life, the Fund institutionalized the practice of attaching policy conditions to loans for deficit countries; and over the years these conditions came to concentrate on curbing domestic monetary growth and balancing the government's budget, for the most part regardless of whether a country's external deficit could be attributed primarily to defects of its own monetary and fiscal policies or not. From the point of view of deficit countries, one of the great attractions of market financing has been precisely the opportunity it gives them to evade that conditionality for as long as possible, justified often on the grounds that the Fund's traditional interpretation is unresponsive to their present needs. In many cases they are right.

Indeed, in an era of persistent OPEC surpluses, it may fairly be argued that most deficits can no longer be treated as if they were simply a transitory phenomenon resulting from incompetence or carelessness on the part of domestic policymakers, and amenable to traditional policy prescriptions for domestic demand restraint. Oil-induced deficits perforce must be expected to continue for much longer periods, until such time as oil importers can make the necessary "structural" adjustments to the altered relative cost of energy. In the meantime, it does not seem unreasonable to expect the Fund to make a greater effort to supplement private lending by reforming its own lending policies, e.g., to make more money available for longer-term, structural measures designed to narrow net dependence on oil imports and/or to broaden the foreign-exchange earning capacity of deficit countries. This does not mean abandoning conditionality or ignoring altogether the role of conventional monetary and fiscal policy instruments. But it does suggest a need for more flexible interpretation of conditionality than has traditionally been characteristic of IMF lending.

Significantly, in 1979-1980 the Fund actually began to move seriously in this direction, by issuing (in 1979) a new set of guidelines on conditionality explicitly acknowledging that adjustment in many cases might require a longer period of time than traditionally assumed in IMF stabilization programs, and pledging to "pay due regard to . . . the circumstances of members, including the causes of their balance of payments problems."[11] Also, an increasing proportion of IMF lending began to be directed through the Extended Fund Facility, thus making available more financing for longer periods than had generally been available in the past. More recently, however, this trend has shown some signs of abating,

11. *IMF Survey*, 19 March 1979, pp. 82-83.

under pressure from the fiscally conservative Reagan Administration, which has misgivings about what it regards as the unduly easy terms of the Fund's new "enlarged access" policy. One can only hope that the setback proves temporary. If the global financing problem is to be successfully managed, it is imperative that the Fund be able to continue making more, not less, such adaptations in its traditional lending practices.

Conclusion

In summary, the outlook for the world financial system is clouded by a variety of problems — volatility of floating exchange rates, inefficient management of the multiple-reserve-asset standard, and the massive burden of balance-of-payments financing. No doubt it would be excessively pessimistic, not to say alarmist, to predict outright collapse: the system has shown considerable resiliency, after all, in recent years. But I doubt that even Dr. Pangloss would deny the possibility of any improvements at all in our international monetary arrangements. The system could be better managed. Why not begin?