Comment on "Reforming the International Monetary System," by Peter B. Kenen

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Professor Kenen asks what changes in the monetary system might most directly meet the needs of developing countries. To be realistic, he adds, we must confine our attention to those changes in the system that do not impose unacceptable costs on industrial countries and do not crowd out other forms of development assistance. He regards this last constraint as daunting, since the governments of the industrial countries are deeply preoccupied with their own economic and social problems. But one may well ask whether the objectives of the developing countries generally differ from those of industrial countries. I would submit this is not necessarily the case, as there are a number of improvements in the international monetary system that would benefit all countries. For the sake of brevity I shall only refer to:

1. The exchange rate system.
2. The adjustment process and the role of the Fund.
3. International liquidity.

This is not to say that there are not several other topics that would merit careful review.

The exchange rate system

The stability of the exchange rate system is fundamental to the development of world trade and investment flows. Exchange rate crises introduce uncertainty and are thus disruptive of world trade, particularly for developing countries that may not have ready access to hedging techniques. More importantly, exchange rate misalignments prevent growth and foster protectionism.

There can be little question that unsound and inconsistent policies give rise to volatility and misalignments of the exchange rates for major currencies. Exchange rate stability depends on current and prospective macroeconomic policies and performance.

The recent European exchange market crisis has demonstrated that massive financial resources can be rapidly mobilised in international capital markets to bring enormous pressures against an exchange rate parity,

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overwhelming any plausible official intervention if this is not supported by other policy actions.

For developing countries as for the world, exchange rate alignment and stability of the major currencies is important. So, the improvement of the exchange rate system would be of benefit to them. This is consistent with Professor Kenen's remark that the developing countries should give priority to strengthening an open trading system. But of course, improvements in policy coordination and thus in the exchange rate system would also benefit industrial countries.

More than aid, most developing countries need an international economy that is growing, stable and generally in good working order. Undoubtedly, as the recent events in exchange markets show, the present system has not achieved an adequate degree of policy coordination among industrial countries. The stability of the exchange rate system depends importantly on whether a high degree of convergence in the economic performance and the domestic policies of the major countries can be achieved and maintained. Such convergence will reduce the conflicts between domestic economic objectives and the objective of exchange rate stability.

An orderly international exchange rate system requires the willingness and the ability of countries to coordinate their policies. Countries must maintain strong fiscal discipline and avoid divergent trends in actual or expected inflation that could undermine the sustainability of the exchange rate. Strengthening of fundamentals and increased policy coordination have been the stated goals of the G-10 countries and of the EC countries over the last decade. However, the results to date leave something to be desired.

Adjustment process and the role of the Fund

The persistence of large deficits in a number of G-7 countries over long periods of time must be seen as a major shortcoming of the present system. These deficits have the effect of absorbing a significant portion of world savings, contribute to raise international interest rates, discourage investment, and aggravate the problems of debtor developing countries and more generally of capital importing countries. Secondly, countries with large fiscal deficits find that the countercyclical role of fiscal policy is severely limited. This had led to the virtual abandonment by many countries of fiscal policy as a tool of stabilisation, consequently placing excessive reliance on monetary policy to achieve both internal and external balance.

A third point in the adjustment process and one which is a major shortcoming of present arrangements, is that there is no provision to encourage adjustment by surplus countries or by reserve currency countries. Consequently, the burden of adjustment is not shared symmetrically between

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surplus and deficit countries, (which would reduce the efforts required of the latter) but falls entirely on deficit countries.

A fourth point relates to adjustment in developing countries. In the conditions described above and in the context of a semi-stagnant international economy, which for most developing countries means rising protectionism and declining terms of trade, debtor developing countries turn to the IMF for assistance. Now the theory is that the IMF will provide financing to facilitate the adjustment process. However, Fund programmes are generally underfinanced. The experience of Latin America over the last decade has been that countries had to undertake adjustment while sustaining massive net negative transfers of resources abroad. This lengthens the time necessary to solve the debt crisis and imposes very great costs in terms of investment, lost output and employment. It also adds greatly to the political difficulties of achieving a successful adjustment. The result has been a far cry from the model of "adjustment with growth". No wonder that, in recent years, between half and two thirds of the programmes have broken down before completion.

The original Bretton Woods Conference gave the Fund wide responsibilities which included: (Article I)

i. To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.
ii. To promote exchange stability, to promote international monetary cooperation and to maintain orderly exchange arrangements among members.
iii. To make the resources of the Fund temporarily available to members (under adequate safeguards), thus providing them with the opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.

My comments on the adjustment process and exchange rate system are an indicator of how successful the Fund has been in attaining these objectives.

International liquidity

Mr. Kenen stresses that since 1981 a substantial and generalised increase in the international reserves of LDCs has been recorded, thus making it "hard to argue that there is an acute shortage of reserves or that the global stock is very badly distributed". Allow me to make some comments in this respect.

Let me start with the figures themselves. Mr. Kenen compares the evolution of the ratio of international reserves to merchandise imports in two

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years: 1981 and 1991. We can reach a very different conclusion by using a slightly different base for comparison. Thus, according to IMF figures, by 1992 over 50 per cent of the Fund's total membership had international reserves below 12 weeks of merchandise imports, and over 40 per cent fell short of 10 weeks. The situation would be much worse if debt service payments were included. In addition, the role of import compression in sustaining those liquidity levels should be considered. This shows the fragility of any analysis based exclusively on the use of statistics.

I am convinced that the case for (or against) an increase in international liquidity is more conceptual than statistical in nature. Presently, the world economy is characterised by low levels of economic activity and high unemployment, and prospects in the major industrial economies are not bright. Indeed, except for the United Kingdom, Europe is entering into a recession and is expected to have negative growth in 1993. Therefore, it should be clear that since the present danger is a worldwide recession rather than a renewal of the inflationary process, an allocation of SDRs could make an important contribution to restore demand, economic growth and increase employment.

Stabilisation efforts in important parts of the world, including in particular countries in Eastern Europe, the former Soviet Union, and many small low-income countries in other regions, are currently being put at risk by inadequate levels of international reserves. Moreover, these countries' ability to build reserves to satisfactory levels, as well as to meet the projected growth of reserve demand over the longer term, is heavily constrained by two factors. First, they generally lack access to private international credit markets and face very high costs in earning additional reserves. Secondly, these countries, most of which have already experienced serious import compression in recent years, are not in a position to absorb the economic costs of building up reserves through further import compression, very low rates of economic growth, or reliance on controls on trade and payments.

The high cost of acquiring and holding reserves is particularly harmful in a period of historically low commodity prices and high variability of payments. Tolerating a further compression of imports, when there are other means of at least partially alleviating the reserves constraint, would be in contradiction with any strategy for world economic recovery. In fact, the sustainability and success of economic stabilisation and reform in many of the former centrally planned economies and many developing countries would be considerably enhanced with a new SDR allocation. This would clearly brighten the prospects for the entire world.

As Mr. Kenen points out in his paper, there are some people who oppose an SDR allocation because of its potential inflationary impact. There are no solid grounds for concern on this front, particularly in the case of an

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allocation substantially less than the projected increase of world demand for reserves. [1]

I would like to make two final points on the liquidity issue.

Firstly, as Dr. Witteveen has recently recalled, today international liquidity creation is a consequence of the mostly uncoordinated monetary policies followed by the major industrial countries in the pursuit of their own domestic objectives. The creation of international liquidity results as a residual. Consequently, the major role it plays in the development of the world economy as a whole, is not sufficiently recognised.

Despite its important effects on world economic activity, neither the IMF or any other international body have much influence on its evolution. It goes without saying that the great majority of countries in the world, developing and industrial, have no say in the determination of international liquidity.

Secondly, the current system is not only inefficient, it is also grossly unfair since the benefits of liquidity creation, i.e., the seignoriage of say, an additional $100 billion a year, accrues roughly, by over 50 per cent to the U.S., by some 20 per cent to Germany, and 9 or 10 per cent to Japan, which is a less than equitable arrangement. Not surprisingly, some of these countries are staunch enemies of the SDR.

To conclude, let me briefly comment on the measures Mr. Kenen proposes to support LDCs as an alternative to an SDR allocation. I fully support the suggestion that the decision that attaches conditionality to the use of the IMF's Compensatory and Contingency Financing Facility be reversed. Since the shortfall is temporary and due to causes beyond the control of the country, this decision makes no sense from an economic point of view. This is a position repeatedly supported by LDCs in many fora.

I also find the proposal to give supplementary IMF credit under some circumstances to countries facing a sudden reduction or cessation of capital inflows appealing. In fact, a very similar proposal was put forward by the Mexican government in 1976. Nevertheless, one must be aware that this sort of schemes could carry some dangers as they may lead some countries to excessive indebtedness. One way to avoid this, would be to allow access to this facility only to those countries with solid economic fundamentals.

In closing, I would like to note that I do not see why these two proposals ought to be considered as alternatives rather than complementary to other measures to reform the international monetary system.

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1 Estimates of the IMF based on projections for the growth of world imports in the period 1992-96, and on the assumption that the ratio of non-gold reserves to imports for all countries remains at its end of 1991 value, show that the world demand for non-gold reserves may be expected to rise by 300 to 400 billion SDR over the next five years. An annual allocation of say 10 billion SDRs during this period, would amount to only about 15 per cent of the projected growth in the world demand for reserves. This could hardly have an impact on inflation.

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Mr. Kenen's agenda for reform is far too modest given the magnitude of the problems faced by the world. In my view bolder initiatives are required.

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