Comment on "International Monetary Reform and the Prospects for Economic Development," by John Williamson

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In discussing what scope exists for the reform of the international monetary system John Williamson begins by pointing out that official arrangements depend on the evolution of markets and on the position of the private sector. That leads him into a discussion of some proposals for reform that have been overtaken by events. I am tempted to add that it is not only world financial markets that have changed since the 1970s, but also that the world political balance has altered against the developing countries, in favour of the Western industrial countries, and that the 1980s have been characterised by a decline in the climate for international cooperation. This is the new world order. This may affect the prospects for reform.

The industrial world itself has now become tri-polar, as the relative weights of Asia and Europe in production, money and trade matters have approached that of North America. The increasing diversification of currencies in trade and international reserves implies greater risks of exchange rate volatility and misalignments and also greater need for shared decisions and responsibilities in international monetary matters. But increased monetary cooperation is unlikely to come about if it is not as a result of a crisis, or at least of increased tensions that are perceived as dangerous by the major industrial powers, for reasons that will become apparent.

Let me turn now to the four proposals put forward by John Williamson.

Policy coordination and improved national policies

There can be no question that the present system has not sufficiently promoted adequate national policies and policy coordination amongst industrial countries. Undisciplined fiscal policies and low levels of national savings characterised most of the G-7 countries over the 1980s and still do. It has long been recognised that unsound and inconsistent policies have been major elements in the volatility and misalignments of the exchange rates of major currencies. In a convertible currency system, exchange rate stability depends essentially on current and prospective macroeconomic policies and performance.

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As for fiscal policy, two major shortcomings come to mind. First, the persistence of large deficits, which have the effect of absorbing a significant portion of world savings and contribute to raise international interest rates, discouraging investment and aggravating the problems of debtor developing countries and more generally of capital importing countries.

The second problem relates to the virtual abandonment by many countries of fiscal policies as a tool of stabilisation, consequently placing excessive reliance on monetary policy to achieve both internal and external balance.

It would seem that the democratic process often raises insuperable obstacles to the adjustment of taxes and expenditures for stabilisation purposes. Moreover, countries with large fiscal deficits find that the counter-cyclical role of fiscal policy is severely limited. Of course, we are all aware of the practical difficulties of making fiscal policy changes in a timely manner and of pitfalls of fine-tuning. But perhaps greater reliance on automatic stabilisers as a means of stimulating or reducing aggregate demand at appropriate stages of the business cycle would be appropriate.

A third point on the adjustment process, one which is a major shortcoming of the present arrangements, is that there is no provision to encourage adjustment by surplus countries. Consequently, the burden of adjustment is not shared symmetrically between surplus and deficit countries, – which would reduce the efforts required of the latter – but falls entirely on deficit countries.

Experience suggests that the success of any scheme to improve the workings of the present system depends on the cooperation of the major industrial countries. Particularly on their willingness to submit themselves to a considerable degree of mutual policy adjustment and discipline to achieve a better economic environment for all. But the issue is not simply to have clearer rules of the game for exchange rate and macroeconomic policies, but to gain the compliance of all parties. Can the major currencies be persuaded? If clearer rules on policy coordination had been in place, would the US or Italy have reduced their fiscal deficit or increased domestic saving, so as to make a greater amount of resources available to the rest of the economy and to the world? Would Japan have run much smaller current account surpluses? It seems to me that this is not the case. As a rule, the policymakers of major powers tend not to accept limits on their freedom, except when this is the solution to a conflict whose costs can be higher. It will probably have to get worse before it gets better. Moreover, to be effective, rules have to have teeth, like the gold standard did, or a form of asset settlement. I don't believe as a practical matter that you will secure the discipline of the strong merely on the basis of goodwill (e.g. Earth Summit at Ro).

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International liquidity and SDR allocations

I think there is broad agreement that the adequacy of international liquidity does not turn only on the total amount of reserves but on their distribution among countries, and on their access to credit from international financial markets and official sources. While there may be discussion as to whether the growth of liquidity has kept pace with the expansion in world trade and other needs – here the increased needs of the former Soviet Republics would have to be considered – there is no question that with regards to the distribution issue, the current system is unsatisfactory.

Today most countries in the world, accounting for most of the world's population are not considered creditworthy, except to a very limited extent, and thus face a shortage of international liquidity.

The G-10 might argue, as they did in their 1985 report, that while most countries have no access to financial markets, this is due to their poor policies, and that creditworthiness and higher reserves are the reward of good policies. Surely this smug view is too simplistic. Is the US access to international financing due to their sound fiscal and exchange rate policies over the last ten years? Are the changes in terms of trade, in international interest rates and protectionism that affect the developing countries irrelevant to their creditworthiness? The fact is that while policies matter, "fairness" in access to markets is not assured and as illustrated by Colombia, access is often subject to important exogenous factors, including the "bandwagon" and "contagion" effects.

The fact is that the system of development financing that had evolved in the 1970s and collapsed with the debt crisis in the 1980s, has yet to be replaced by something else.

Thus, Mr. Williamson's proposal for the resumption of SDR allocations has a strong base. However, I am not sure that the formula he proposes for distribution, i.e. to base allocations on past increases in reserve holdings during the preceding period, is appropriate. For one, it continues the reverse transfer of real resources to industrial countries in order to accumulate reserves in the five years. It strengthens the deflationary bias existing in an international monetary system where liquidity is scarce for most and where surplus countries are not required to contribute to the adjustment process. Secondly, it does not take into account the impact on reserves of exogenous phenomena like changes in international interest rates, changes in terms of trade, natural disasters or of the impact of protectionist restrictions on the exports of LDCs. Thus, if the purpose of the formula is to move away from the present system of "to him that hath shall be given", this is not it.

Ideally, SDR allocations would seek to meet in part the international liquidity needs of countries. Perhaps they could share widely amongst the

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developing countries, the benefits of international seigniorage accruing to key currency countries. Instead of having real transfers from poor to rich countries as today, the system should as a minimum be neutral as regards its redistribution effects. As it is today, the SDR is left as a safety net to be activated only in case it suits the major countries.

International Debt Restructuring Agency

The IMF and the international community have for some years expressed support for the concept of "adjustment with growth". However, adjustment with growth requires, in addition to strong and sustained adjustment efforts of debtor countries a favourable international economic environment and the provision of adequate financial flows to facilitate and support adjustment programmes. In fact, the recent performance of the international economy has been mediocre. As to financial flows, debtor countries have faced the task of adjustment with substantial net negative transfers of resources. This may be contrary to Fund doctrine but is in conformity with experience and goes a long way to explain why so many adjustment programmes fail. This raises several issues relating to the size of the Fund, i.e. its resources, which even after the 9th Quota Increase comes into effect will be inadequate to meet the needs of the developing countries and former Soviet Republics; and the related point of policies on access to Fund resources, i.e. limiting access or ensuring financing flows that are consistent with the minimum requirements of adjustment with growth.

I have long favoured an agency with the authority to revise the terms of existing debt service obligations for countries whose exogenous circumstances have materially changed. Indeed, I suggested the Fund should take on such a role in 1986 and 1988. Most countries have Chapter 11, or similar procedures to save companies in difficulties from failing. Don't countries deserve as much?

However, to be viable the proposed agency would have to be endorsed by the governments of major creditor countries. Indeed, these countries would have to enact legislation or enter into an international agreement which overruled domestic law of contracts. Would they do this? I don't think so. I believe the time for this has passed. The debt crisis no longer poses a systemic problem. Creditors are satisfied with the current "case by case" approach. It allows them to recognise important differences in the policies followed by debtor countries and to assist only those that they feel merit support. To have any chance an International Debt Agency would have to condition relief to the pursuit of appropiate policies, à la Brady Plan, and be run by creditor governments in fact, if not in name. (Japan would certainly oppose any such procedure particularly if it covered debt to official creditors.) Major creditor

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governments prefer the present situation by which they can, at their discretion, offer relief to a friendly debtor country but not to another. The selectivity in the cases of debt relief for Egypt and Poland, but not for Peru which is in a more desperate situation bears this out.

Should it be established, the rights of debtor countries to resort to this agency would have to be irrenounceable. Otherwise, all future contracts would simply have an additional clause by which borrowing countries would undertake not to resort to the said agency under any circumstances.

Moreover, I suspect that most international banks would also be opposed to any scheme for the revision of debtor contracts, since in some sense this would reduce their rights and their freedom to take discretionary action, possibly in exchange for certain favours.

An international agency charged with the responsibility for monitoring country policies and issuing public warnings about unsustainable policies

No one can object to good policies or favour bad ones. Thus an international agency that would warn countries not to act against their own long-run interest, although somewhat paternalistic, may be a good idea. But why the "may be"? Several issues immediately come to mind.

The first one is the question of a possible double standard. An agency with responsibility for monitoring country policies would tend to have more leverage and put more pressure on small LDC debtor countries than on industrial countries that do not require its assistance and whose bureaucracy is often better able to answer back. An asymmetry of treatment between these two groups of countries, is particularly questionable, since the policies of the larger industrial countries have a greater impact on the world economy.

A second misgiving relates to the issue of public warnings. Note that a public warning, say by the IMF or some such agency, on the unsustainability of an exchange rate is most likely to provoke an exchange crisis. Do we want this?

On the other hand, public warnings on the need for future correction of grossly mistaken policies, such as excessive public deficits or levels of borrowing could be useful, although they would have important immediate consequences, both for domestic interest rates and exchange markets and on the availability of external credit. In any event, one cannot entirely dismiss the possibility of the international agency charged with the task, being wrong in its judgement. Since economic policy is not an exact science, this can happen.

Let me take for instance the question of exchange rate management. From the 1950s up to a few years ago, the IMF and numerous economists dealing with international adjustment tended to rely heavily on changes in exchange rates to correct current account imbalances. Since then, we have re-learned a great deal. Devaluations to be successful require the existence of "money illusion" to achieve a cut in real wages and a decline in consumption. However, in countries which have experienced high rates of inflation and successive devaluations, the money illusion is quickly lost, and exchange rate changes are usually accompanied by rapid wage and price increases that entirely offset the depreciation. The result then, is simply a new round of inflation.

This has led the authorities of many countries to think that, rather than try to compensate for inflation differentials through changes in the exchange rate, it may be best to seek a sustainable balance of payments position through demand management, particularly through diverse measures of deregulation and structural change aimed at improving the efficiency and competitiveness of the economy.

Moreover, the agency could easily fall prey to what could be called an involuntary "creditor bias". This can be described as a wish to see no loss of competitiveness in a debtor country, meaning that the real exchange rate should be held constant, however undervalued the curency was in a given base year. But, in an open economy it is impossible to maintain a substantially undervalued exchange rate, simply because the prices of traded goods in local currency will tend to adjust to the equivalent of their international price. Thus it is not surprising that the real rate should appreciate.

Moreover, it is impossible to maintain a constant real exchange rate and to stabilise an economy at the same time. Any inflation would require an offsetting depreciation, which in turn would feed inflation, giving rise to a vicious circle by which inflation is perpetuated.

On balance, if questions may arise as to the quality of the advice given and on the desirability of giving publicity to policy recommendations, countries like adults, might prefer to listen to the advice given privately and then, to consider it and to make their own decisions. That is what I would prefer. To conclude, I would agree much more with the diagnosis than with the prescriptions proposed by John Williamson.

Areas of consensus

Since I have been asked for some points of possible consensus, some broad areas come to mind:

1. One would be the lack of discipline and coordination of major countries which aggravates the asymmetry of the adjustment process, which aggravates the savings shortage, which results in misaligments of exchange rates and their variability, and which favours protectionism.

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2. A second area is the clear shortage of international liquidity for most of the world. Some form of liquidity creation – which does not imply a reverse transfer of resources – is desirable.
3. A third area might be the inadequacy or insufficiency of resources to support the adjustment process. This has certainly to do with the size of the International Monetary Fund, but it is also related to the design of the adjustment programmes. I think, a revision of conditionality and Fund policies is needed to favour adjustment with growth, which today is really more of a declaration than a fact.
4. A fourth area would be to address the problem of the shortage of development financing, since the arrangements that existed in the 1970s have broken down. This means probably dealing with greater resources for the World Bank and other development institutions.
5. A fifth area would be the persistence of the debt crisis. After ten years it is no longer a problem that poses a systemic risk to the world financial system, but it is still blocking the development of many middle- and low-income countries.