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THE IMF: THE RECORD AND THE PROSPECT

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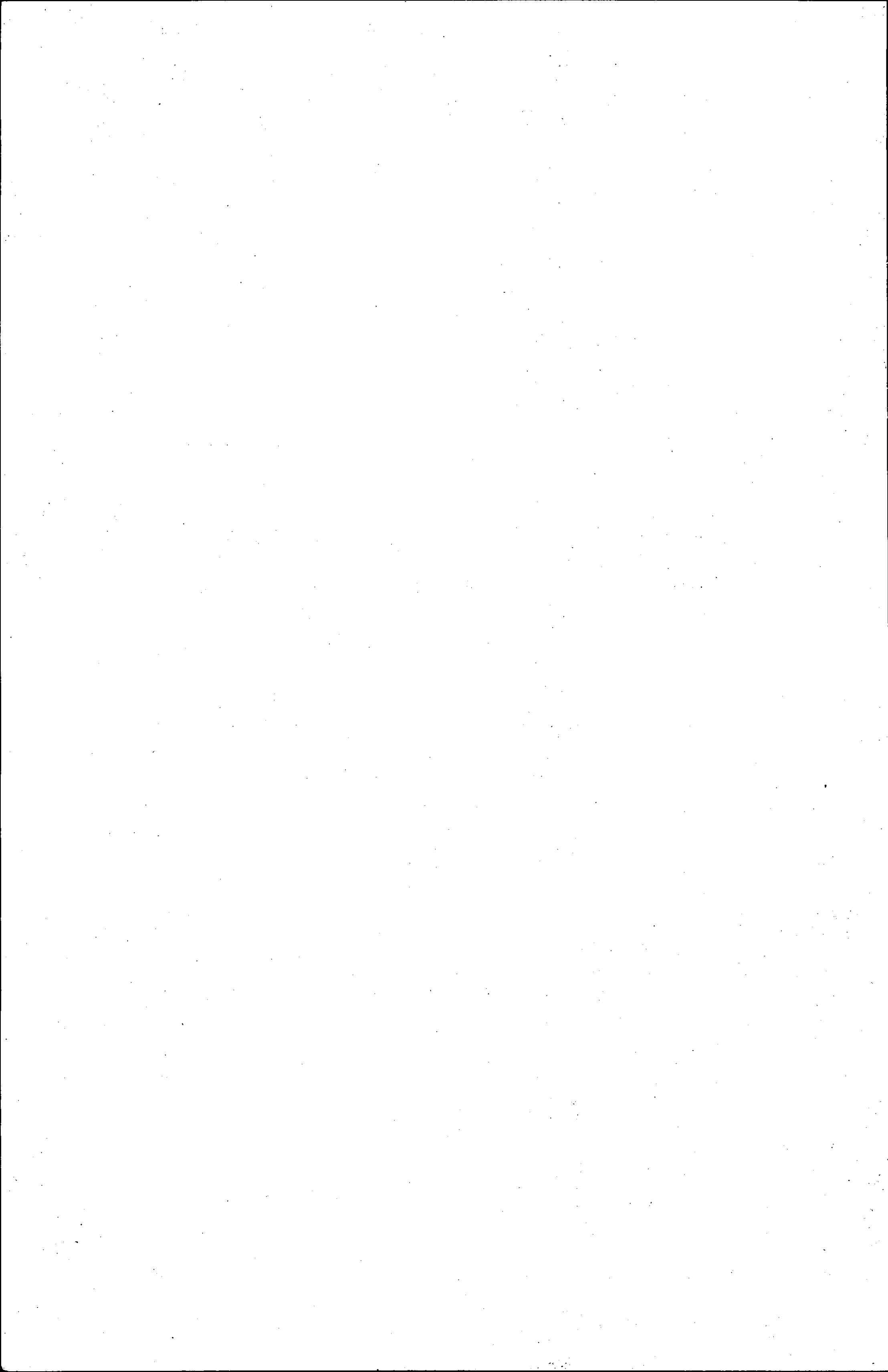

THE IMF: THE RECORD AND THE PROSPECT

1 Introduction

This essay has two purposes: to broaden understanding of the way the International Monetary Fund has functioned in the past and to encourage support for the resumption of the IMF's progress toward a greater central monetary role.

The underlying strength of the IMF throughout its existence has been that it provides a mechanism for the governments of the world to respond collectively to problems arising in the international economic system. The actual mechanism used for substantive coordination has varied widely. At first, it was the agreed exchange-rate system. The formal commitment to stabilize exchange rates was sufficient by itself to exert political pressure on governments to maintain policies that achieved the stability desired throughout the world. The IMF and its staff had a relatively circumscribed operational role, of importance largely in the rare cases when financing was essential or when one major exchange-rate action gave rise to problems of coordination with other exchange rates.

When this exchange-rate system collapsed, the member countries found it useful to support a strengthened surveillance system, under which their contacts with the IMF staff grew closer. This system nurtured the cooperative relationship essential for conditionality—the device of tying lending tightly to the implementation of policies designed to restore the payments position of the borrower. Conditionality allowed the IMF staff and management to exercise a constructive influence. At first, it was used only with the smaller developing countries, but in time it became universal, applying to large industrial countries as well, including France, Italy, and the United Kingdom.

The success of IMF conditionality in conjunction with lending led the member governments to decide that it should be used to help them with other decisions, particularly those related to debt rescheduling. Initially, this extension was also helpful; its record of achievement permitted the IMF to play a crucial role in overcoming the immediate debt crisis in 1982. However, the IMF role was later stretched too far. The subsidiary purpose of helping with debt strategy came to control decisions regarding financial assistance, which was made available even when the policies being followed by the borrowing countries were not consistent with a return to viability. Because decisions were no longer based on compatibility with repayment

terms, lending was guided increasingly by the political preferences of the leading industrial countries. The collegial relationship of the IMF staff with the financial authorities of borrowing countries crumbled, and the credibility of the IMF suffered.

Unless the major powers take a new look at the role of the IMF, there is considerable danger that it will continue on its present path—one foreseen with concern in 1979 by Frank Southard, who served for almost three decades as U.S. Executive Director and then as Deputy Managing Director of the IMF:

> It was not easy to create the IMF and it has not been easy to develop it into a world monetary authority. It *would* be easy for the leading members to reduce it to ineffectiveness or to an institution concerned chiefly with meeting the financial needs of less-developed countries. (p. 45)

There are cogent long-run reasons to change that course. The problems of industrial countries will not be solved by continuing indefinitely with the loose *ad hoc* consultations in Group of 5 and Group of 7 meetings.[1] The beginning made in September 1985 toward developing a more coordinated collegial policy must now acquire more structure. The vagueness of many of the understandings reached contributed to uncertainty and perhaps to the stock-market collapse of October 19, 1987. It is highly unlikely that the basic current problem—the persistent U.S. payments weakness—will be quickly and finally resolved. Plans must therefore be developed to ensure that future official financing of exchange-market intervention to stabilize the U.S. dollar actually encourages U.S. fiscal action.

Such plans will require early agreement on a framework for providing the United States with a lender of last resort. While Toyoo Gyohten, then Vice Minister of the Japanese Ministry of Finance, has suggested the creation of a new $200 billion agency by the United States, Japan, and Europe to provide resources to stabilize exchange markets (Gyohten, 1988), it would seem much more practical to adapt the IMF to this role.

Moreover, it now seems clear that the industrial countries are committed to pursuing policies aimed at greater exchange-rate stability. The next steps toward this end will have to be more formal if they are to increase the responsiveness of fiscal and monetary policies to this objective. Such formality would be achieved most appropriately in an IMF framework.

Looking farther ahead, provision should be made for reducing the international role of the U.S. dollar to ensure against overdependence on one increasingly strained country. The SDR was created in 1970 to meet this problem. But an early revival of SDR creation would be necessary to keep

[1] The G-5 countries are France, Japan, the United Kingdom, the United States, and West Germany. The "summit" G-7 countries are the G-5 plus Canada and Italy.

open this long-term solution, and that is not likely unless the IMF regains an industrial-country role.

Changes in the debt strategy are even more urgently needed. Political conditions in many developing countries of Latin America and Africa are now desperate, and some writedowns of existing debt are inevitable. Effective official support of such concessions for commercial-bank debt has been delayed by the unsolved problem of retaining control over the process. The key could be the requirement that relief be associated with an immediate return to viability. A revitalized IMF could guide the action through a new facility that would be available when creditors had made substantial concessions and debtors had made the necessary policy changes.[2]

Because debtors will vary greatly in their political ability to deliver such a transformation, the process of returning to normality will take years. During that interval, the effort to make the repayments due the IMF will place severe strains on some countries. Relief might be provided through a new low-conditionality facility for debtors ready to cooperate in a holding operation by maintaining order among unsettled foreign claims.

Let me stress that my proposals for an increased monetary role for a reformed IMF are not based on the judgment that nationalism's appeal has peaked. On the contrary, they are based on the judgment that the growing interdependence of countries requires the development of rules that will provide national authorities with an environment they believe will lead to the preservation of essential independence. Consequently, new rules must be expected to circumscribe, not extend, the discretionary power of the IMF in some respects.

2 The Record

The creation of the IMF was agreed upon by the governments of the major Allied powers in 1944 to encourage the development of a more open and stable international economic system at the end of World War II. The IMF was designed to promote at the international level the policies the authorities were pressing at the national level. In this section, the record is selectively summarized under five headings. Under the first, the institutional arrangements that make possible the IMF's flexibility in scope and in the provision of finance are described. The focus then shifts to the automaticity of the rules that were first established for the exchange-rate system. The discussion of financing arrangements and conditionality emphasizes the need for the finan-

[2] Since this essay was written in December 1988, U.S. Secretary of the Treasury Nicholas F. Brady has announced a new plan. As noted later, the Brady Plan goes quite some distance in the direction proposed, but it leaves some major steps to be taken before a definitive solution of the debtors' problems can be achieved.

cial authorities of the borrowing countries to subscribe freely to IMF objectives. Next, the evolution of the IMF's debt role from service to the debtors to service to the creditors is recounted. Finally, this change in role is shown to have led to conditionality problems caused by the increasing alienation of the debtors and the growing inability of the IMF to assist their return to growth.

Institutional Arrangements

The negotiations at Bretton Woods in 1944 leading to the agreement to create the IMF focused on the achievement of an orderly exchange-rate system supported by the power to give financial assistance to help maintain that order without resorting to foreign-exchange restrictions or an overly severe contraction of demand. One unique feature of this effort was the creation of a permanent financial institution bringing together the major economic powers of the world. Despite the later decision of the Soviet Union not to join, the plan to create a cooperative framework succeeded to a far greater extent than could reasonably have been expected. Germany and Japan soon joined, as did virtually all the former colonies when they gained independence. Although the number of members grew rapidly, weighted voting kept the major industrial countries firmly in power. Since 1946, the problem has not been to create the power to act but to reach agreement on how to use this power.

The machinery to develop cooperative responses to emerging problems begins with the Executive Board, which now consists of twenty-two Directors appointed by all the membership. Working full time on the problems of the world, these Directors have developed expertise on virtually all the relevant international monetary issues, ensuring that the main questions associated with any proposal are intensively addressed in advance of any formal negotiations. The Executive Board is served by a management and staff capable of either initiating proposals for action or assisting national proposals.

The grouping of members in preparation for negotiations on action has also been developed. The industrial countries have standing arrangements for achieving group policy positions in the so-called "G-10" framework (now consisting of the summit G-7 countries plus Belgium, the Netherlands, Sweden, and Switzerland). Routinely, issues are debated and draft positions produced in meetings of the deputies of the G-10 finance ministers; positions are decided at a subsequent ministerial meeting. The majority of developing countries participate in a similar grouping—the so-called "G-24"—with the same procedures, but unfortunately with limited negotiating effectiveness due both to their minority voting power and, all too often, to a lack of focus attributable to the diversity of their interests.

Since its creation in 1974, the Interim Committee, the committee of

twenty-two finance ministers, each representing the same constituency as the twenty-two Executive Directors, has been the final arbiter on any issue. As this committee meets every six months, it normally can act expeditiously on all proposals.

An important feature of the IMF organizational arrangements is its extraordinary flexibility on financing. The financing base comes from the $120 billion of currency contributions from members, much of which is not usable at any particular time because it is in the currencies of members in payments difficulty. But the flexibility comes from borrowing arrangements that at present can provide another $20 billion and have an unusual capacity for expansion when a need is acknowledged. Most countries provide resources through their central banks, which regard claims on the IMF as foreign-exchange resources, the acquisition of an asset considered to be completely distinct from foreign assistance and national budgets. In principle, the IMF—comprising all the major countries—has the ability to mobilize financing far exceeding that of any single member. But here, as with all its other powers, the actual capacity is dependent on reaching a high degree of unanimity. In practice, not only the United States but also other power blocs, including blocs of developing countries, can prevent action. The real task ahead is not to call a conference to create a new institution or to develop new powers for the IMF, but to achieve consensus for specific collaborative actions to ease the problems facing the international economy today.

The Exchange-Rate System

The most sweeping power in the original Articles of Agreement of the IMF was intended to be the power over exchange rates. In principle, apart from an initial permission to move the rate a cumulative 10 percent, all changes in exchange rates had to receive prior approval from the Executive Board. In practice, this ostensible control over a major instrument of economic policy proved to be largely illusory. Despite the commitment to prior approval, in fact decisions were made on national authority and the IMF Executive Board had little choice but to rubber-stamp approval on short notice—usually over a weekend—on the basis of hastily prepared staff papers. Although frequently the Executive Board considered the action to be inadequate, such judgments had no significant consequences unless the use of IMF resources was involved (an issue to be dealt with below). And, in the very rare cases when the Executive Board considered the action to be excessive, it could not be certain because the balance-of-payments outcome depended on domestic demand policies that were almost never precisely specified.

This does not mean that the exchange-rate rules had no consequences. On the contrary, they dominated the international economic policies of most

developed countries in that period. However, the pressure was put on their macroeconomic policies indirectly via domestic politics, not through judgmental pressure from the IMF Executive Board or staff. The pressure came from an apparent feeling of failure when the value of the domestic currency had to be reduced in terms of the U.S. dollar. Given the stability of U.S. prices from after the Korean War until the mid-1960s, the fixed-exchange-rate system greatly intensified the pressure that the weaker industrial countries put on their politicians to deliver more conservative fiscal and monetary policies. In the circumstances of the times, this contributed to the rapid development of a stable and integrated world economy.

The clear orientation of the system to stability and openness gave the IMF staff a framework for its policy advice to countries. It also opened a significant subsidiary role on exchange rates—guiding the exchange-rate reaction of partner countries when an important country altered its exchange rate. Thus, when the United Kingdom devalued the pound in 1967, the IMF staff was able to help by encouraging partner countries either to avoid or to reduce the adjustment of their own exchange rates; this increased the effectiveness of the U.K. action while limiting disruption to the rest of the world. This advisory role was last exercised at the Smithsonian meeting in December 1971, when the U.S. dollar realignment required agreement on the set of rates for the other major countries. Staff calculations on the structure consistent with a desired trade pattern provided a basis for the final agreement, and the political tensions inevitable in such a situation were curbed.

By that time, however, the basis for the system had been destroyed. The weakness of the U.S. dollar was now so evident that policymakers in the major countries no longer felt the same political pressure to take the macroeconomic measures necessary for exchange-rate stability. The market sensed this lack of policy commitment to an exchange-rate regime. The growing openness of capital movements gave rise to pressures on a scale that could not be contained by intervention and that inevitably led to a period of fluctuating exchange rates.

The IMF, in consequence, suffered a major setback. The central concept on which it was based had gone, and its progress toward becoming the central monetary institution was checked decisively. Nevertheless, the limitations on its central role were masked for a period by its growing activities in financing, including the financing of some major countries. And many believed that the departure from fixed exchange rates would be temporary. The revision of the Articles of Agreement to legalize the new, more flexible system allowed individual fixed rates (except in relation to gold) and left open the possibility of a return to a new universal system of fixed rates, a concept with continuing appeal in most countries primarily because it was thought to increase fiscal discipline.

Of more immediate relevance were the continued regulatory powers over foreign-exchange restrictions and the associated consultation process. The original Articles of Agreement prohibited foreign-exchange restrictions except with IMF approval, which was intended to be granted with time limits. To reinforce the pressure, annual reviews were to be made of the country's progress toward full elimination of restrictions. These reviews were soon developed into a system of annual consultation reports on economic policies affecting the balance of payments. This system survived the abolition of the fixed-rate system and was explicitly strengthened. The consultations now involve wide-ranging staff discussions about macroeconomic policies with the financial authorities of the vast majority of (and all the important) countries.

These discussions are particularly valuable in building contacts between the IMF staff and the financial authorities in a context that the latter usually find constructive. The IMF staff, which is composed in large part of economists with backgrounds similar to those of the officials with whom they are consulting, is able to obtain and analyze information without the constraint that normally arises in discussions with officials owing loyalty to another country. The report developed almost invariably stresses the importance of policies that the financial authorities are urging their political masters to adopt. Consequently, the closing statement of the staff team is usually considered helpful in subsequent internal policy discussions; in some countries, it is distributed to the Cabinet or even to the public.

When the report produced by this staff team is presented to the Executive Board for discussion, the community of interests of financial authorities is once again demonstrated. The Executive Directors, although representing very diverse countries, usually focus their remarks on the need for fiscal discipline—an issue that they would like stressed in subsequent meetings concerning their own countries. The meeting concludes with a summing up for transmission to the country involved. Given this spirit of cooperation, the summary frequently contains strong support for the policies the financial authorities are urging. The collegial spirit shown in individual country discussions has been one of the great strengths of the IMF: it is refreshing in the current international scene to have official representatives from, for example, Germany, Iran, Libya, and the United States regularly making similar statements in the Executive Board![3]

Financing Arrangements and Conditionality

As we have seen, the IMF from its beginning was furnished with substantial financial resources to be made available to member countries when they had

[3] I refer here to country discussions in the Executive Board. In discussions on IMF policies, the divisions stemming from divergent economic situations are continuing and deep, as any comparison of G-24 communiqués with those of the Interim Committee will show.

balance-of-payment problems. In effect, the IMF was intended to be a financial cooperative, with a pool of resources available for use on a revolving basis as differences in the phasing of the business cycle in each country created rotating temporary financing needs. Although there were divergences of views, it was initially expected that the resources, although dispensed over time, would be provided virtually on request. As the probable source of the resources in the early years, the United States was the most concerned about control, but even the U.S. negotiators, in my view, did not envisage conditionality as it in fact developed. As it developed, conditionality essentially involves the practice of withholding access to IMF loans until the adjustment policies of the requesting country are judged to be adequate.

The original plans were based on the belief that, for a variety of reasons, borrowing members of the system would find the strength needed to keep the resources revolving. Some weight was no doubt given to the moral obligation of each member of the cooperative to use the resources only for a temporary period, and some to provisions requiring interest rates to rise with the length of use. But more weight was given to the belief that every sovereign country would wish to maintain foreign-exchange reserves adequate to defend its exchange rate. Consequently, responsible authorities were expected always to rebuild reserves to an adequate level and make timely repayment to the IMF. Repayments were envisaged in a period of a few years, which was set at three to five years early in the IMF's history.

This conditionless approach was never tested. The overwhelming needs of reconstruction in most of Europe convinced the United States almost immediately that short-term IMF resources should not be used when more appropriate financing was available through the Marshall Plan. Once the United States had put IMF financing on hold for Europe, it became difficult to restart operations; the reality of a continuing world dollar shortage made the idea of automatic revolving use seem naive.

Nevertheless, the unused IMF resources created their own pressures. For some countries not covered by broad assistance programs, innovative proposals were developed to use IMF resources in support of reform initiatives. To justify an exception to the avoidance of IMF resources by the more important countries, a requesting country featured the special measures it was taking to improve its payments position. Thus the Executive Board came to expect a convincing description of adjustment policies adequate to ensure timely repayment to the IMF. Access to borrowing from the IMF was regarded as a special and unusual privilege for the borrowing country. This cast the IMF staff in the role of ally helping the country to increase the resources available to it in order to overcome its payments problems. At the same time, the staff was motivated to make certain that it had a clear case in order to preserve its ability to justify exceptional treatment. Consequently,

IMF resources were made available only after substantial investigation of the would-be borrower's macroeconomic policies and the collaborative development of a recovery program.

In this way, the staff and the financial authorities of a number of small and middle-sized developing countries with deep problems developed close working relationships. In Europe such ties developed with Turkey and Yugoslavia, and in Latin America first with Bolivia, Haiti, and Paraguay, and later with Argentina and Chile. In such countries, the programs implemented were broad-ranging and the presentation to the Executive Board emphasized the depth of the reform and the commitment of the authorities to achieving a more stable and open economy.

Given the depth of the problems to be overcome, IMF resources were released over time, concurrently with policy implementation. This required periodic staff judgments about the adequacy of implementation. While countries usually were ready to leave the judgments to the staff, some members of the Executive Board felt that the borrower needed more predictability. The issue came to a head over a Bolivian program in 1958.[4]

Bolivia had implemented a particularly dramatic reform in late 1956. It replaced a highly complex multiple-exchange-rate system with a single exchange rate. An economy with probably the highest rate of inflation in the world was stabilized within weeks by drastic fiscal reform and wage discipline. But after some eighteen months, the authorities allowed miners' wages to rise by 30 percent while attempting to maintain the exchange rate. The staff recommended suspending Bolivia's right to use IMF resources until the policy problems were resolved. The Executive Board agreed, but it found the procedure awkward and asked for new provisions. The provisions that were developed called for automatic suspension of the right to use IMF resources when specified limits (called "performance criteria") were not met. These limits were total central-bank credit and central-bank credit to the public sector. These limits were selected because they were directly connected to the decisions of the financial authorities. Provided the authorities followed the agreed financing plan, they had assurance that IMF resources would be available. However, the selection of these limits made the IMF staff vulnerable to criticism that its approach was dominated by certain financial-policy aggregates. In particular, because the control data were derived from banking data, the staff was henceforth classified as following one theory, that of monetarists.

In fact, the staff was open to all theories; it sought agreement only on policy actions. Nevertheless, this basic innovation proved to be effective in

[4] I was head of the staff team on this occasion. The following discussion of the IMF record is based on personal involvement. This has narrowed the selection of countries cited but has permitted a sharper focus on the reasons for key developments.

clarifying policymaking and monitoring. Just as budget documents facilitate national decisionmaking, monetary-performance provisions provided a uniform basis for the IMF staff to obtain and define the demand-management decisions necessary for payments recovery. The provisions were very soon used for all programs in Latin America. Quantitative targets came much more slowly to other regions, because the financial authorities there considered the precision involved to be excessive. Major countries like the United Kingdom, especially, felt strongly that there was no need for the IMF to look so closely into their policies. But, as payments problems persisted in such countries, the pressures grew for more uniform treatment.

For the United Kingdom, which had used IMF resources relatively frequently since 1956, the tightening of conditionality was shown in 1967, when the IMF management withheld resources until the pound was devalued in November. A major loan of $1.4 billion—50 percent of quota—was made immediately. But payment problems persisted in 1968, owing largely to weaknesses in monetary policy. In particular, whenever payments difficulties threatened, the price of government bonds naturally tended to fall, but the Bank of England supported bond prices to limit the losses of commercial banks, which had taken on large bond holdings with Bank encouragement. The Bank thus created a surge of liquidity at precisely the time when tightness was needed.

Like depreciating the currency, the political authorities found it hard to make the decision to allow higher interest rates by removing support from bonds in times of market pressure. Once again, linking further IMF financing to a crucial decision became a key to action. After an Executive Board decision requiring all countries to be treated uniformly, Pierre Paul Schweitzer, the Managing Director, insisted that the next financing arrangement for an industrial country include for the first time provisions releasing IMF resources over time in association with performance undertakings similar to those used in developing countries. The undertakings involved agreed quarterly limits on the expansion of domestic bank credit and on the fiscal deficit. Since the limits on bank credit could be met only if the Bank of England curtailed its support of the bond market, the Government agreed to the crucial tightening of monetary policy.

With full U.K. Treasury support, the policies were implemented meticulously. When the next exchange-market disturbance came, Treasury officials insisted, despite some Bank of England trepidation, that bond prices be left to move freely. Subsequent bond-price movements were not large, no doubt because of a generally improving balance-of-payments position. The recovery of the balance of payments led to a quick (though ultimately insufficient) improvement in the political prospects of the Government. Public opinion polls showed that the seemingly politically costly devaluation and

imposition of higher interest rates—and the adverse publicity of an IMF presence—were soon overlooked by a public that welcomed relief from perpetual payments problems.

Despite the recovery in 1969-70, the payments problems of the United Kingdom soon returned when a new government followed demand-stimulative policies. Eventually, these problems led to renewed approaches to the IMF, culminating in an agreement at the end of 1976. This time, the problems stemmed from fiscal weakness, and once again negotiations with the IMF served as a catalyst for the decisive action the financial authorities knew was necessary. After the Cabinet agreed to the necessary fiscal measures, rapid recovery in the payments situation followed.

The IMF involvement with the United Kingdom undoubtedly had unique features, but it repeatedly demonstrated that the power to withhold financing can help the financial authorities obtain the decisions they need. The IMF's success was dependent, above all, on first achieving broad agreement within the U.K. financial establishment on the immediate measures necessary. This consensus took time to emerge but, once achieved, it ensured an early response in the foreign-exchange market. The speed of the reaction greatly eased the political problems of implementation, which can so easily weaken a recovery program. But it was still important that the public see the decisions as an inevitable consequence of financing constraints, not as being imposed by external political forces. Despite adverse publicity about IMF "inspectors," there could be no impression that foreign governments were pressing their political priorities on the U.K. public. The issues had to be seen, and were seen, in the context of a straightforward financing need requiring the use of IMF resources and therefore dependent on assurances that the financial policies of the United Kingdom would be adequate to ensure timely repayment.

Debt and The IMF

Early in its history, the IMF kept relatively clear of debt issues, both official and private. The World Bank was responsible for establishing order among the unsettled long-term claims on official debtors when it began lending operations. The IMF had no part in these negotiations, even in Bolivia, which had many such problems. At that stage, the role of the IMF was essentially limited to learning what arrangements had been agreed upon.

That position was not viable for long, however, and in 1960 the issue of debt owed to official creditors had to be faced with Argentina. In order to implement the later stages of a difficult IMF program in Argentina, it became imperative that European official creditors allow some rollover of the principal repayments due them under bilateral payments agreements with Argentina. The IMF and the U.S. authorities (who were also aiding Argen-

tina at the time) therefore sought an audience at a meeting in Paris where the European creditors were negotiating with Argentina about repayment terms. The European creditors, correctly anticipating that this intervention would put added pressure on them to grant more generous terms, resisted the approach. Nevertheless, after deliberation they reluctantly agreed to allow IMF observers to report to them on the Argentine program. In the end, the meeting had a satisfactory outcome for both Argentina and the IMF, with relatively favorable terms for Argentina. More unexpectedly, the European creditors felt they, too, had gained. They were pleased with the measures Argentina took and with the greater assurance of final repayment that the IMF-supported program gave them.

Subsequent European official-creditor meetings were held *ad hoc* in several different locations, but it was soon decided that more structure was needed. Paris became the center for all meetings, and agreed procedures were developed and precedents followed.[5] Initially, this move toward more order among creditors did not change the relatively loose connections between the Paris Club and the IMF. But, as time passed, relations with official creditors began to grow closer, although with periodic problems. There were always some tensions associated with the IMF staff's desire to obtain more room for the debtor. At one time, the IMF tried to organize its own club for Ghana, but it failed conclusively to mobilize follow-up action.

After the Argentine meeting in 1960, the IMF was routinely asked to attend part of each Paris Club meeting as an observer. Although increasingly the European creditors pressed for an IMF program before debt refinancing was granted, exceptions were made. Chile, under President Allende, was one such case. Socialist governments in Europe pressed hard for a debt restructuring, but Chilean economic policies were such that balance-of-payments recovery was very doubtful. Consequently, instead of an IMF-supported program, the Paris Club accepted an assurance from Chile that it would not assume more medium-term credit after restructuring its debt. The statement was negotiated with the IMF staff and presented with World Bank support to the Paris Club.

In the late 1970s, when debt problems deepened in the aftermath of the oil shock, heightened creditor concerns led to a codification of procedures. It became virtually fixed for the Paris Club to insist that any debt restructuring await an IMF program. Because of changed circumstances, however, the meaning of the connection with the IMF was different. In the early agreements, the link was justified mainly on the ground that it created conditions under which existing debts would be paid, albeit on a more extended

[5] A more extensive discussion of these arrangements is available in IMF Occasional Papers, particularly No. 25. See also Rieffel (1985).

schedule, so that export credits could be resumed immediately or in the relatively near future. Under the new conditions in the late 1970s, there was no longer a common interest in a quick return to payments viability. Most of the cases before the Paris Club now were African countries, and there was little expectation that they would return to creditworthiness. The creditors therefore came to consider the IMF as useful primarily to improve the efficiency of aid programs, not to create conditions that would permit a return to normal lending. They were no longer willing to wait for policies that would keep the use of IMF resources temporary, and pressures mounted on the IMF to act on inadequate programs.

Traditionally, the links between IMF financing and aid were very loose. Since aid is motivated by reasons not directly related to balance-of-payment management, in principle decisions to give aid were not dependent on the negotiation of an IMF program. Of course, a number of countries with IMF programs also received aid, but the timing and amount of that assistance were largely independent of the IMF. However, events in the mid-1970s changed attitudes and led to close links. The initial impulse undoubtedly came from the increasing difficulty experienced in the Paris Club in separating the aims for policy reform that were associated with debt refinancing and those to be pursued with new aid. But, more fundamentally, it was based on a growing understanding by the countries providing aid that aid was ineffective in the absence of reasonable macroeconomic policies. Consequently, they grew more interested in using the IMF and the World Bank to achieve their aid objectives. The IMF and the World Bank welcomed these changes, which expanded their power to reward policy improvements.

The dangers implicit in the association between aid and IMF financing have become apparent over time. At first, donors appeared primarily to be adding to the resources available to meet problems. But eventually the timing and purposes of the donors began to control the actions of the international agencies. Because countries frequently provided aid in order to give political support to an incumbent government, the independence of agency judgments was undermined both in reality and in public perception.

Turning now to debt owed to private-sector creditors, links between lending and IMF financing were slower to appear. Private-sector creditors—mainly commercial banks—did not encounter significant financing problems in any country until the mid-1970s. Consequently, the banks felt confident that they could handle their own problems. When a problem did arise, they reacted by creating a worldwide steering committee of the leading banks lending to that country. This steering committee was responsible for direct discussions with the country's authorities. When the problems became serious in Peru in the mid-1970s, the banks felt confident enough to initiate negotiations on a balance-of-payments recovery program that they would

support. Even though these negotiations were led by a former IMF department director, Irving Friedman, who was fully qualified technically to develop a comprehensive program, the effort failed. It proved politically impossible for outsiders, who are responsible only to foreign creditors, to become deeply enough involved in the formulation of debtor policy. The advantage of an international-agency staff, which can be seen to be working in the service of the debtor government, is decisive.

The banks abandoned all attempts at direct policy negotiation in Peru and turned to an alternative plan that they were using at about that time with Zaire, involving links to IMF lending on the pattern set by official creditors. In this early phase, the banks were still relatively confident that their own strength would ensure eventual repayment. The IMF believed payments viability was possible with adequate refinancing of existing debt. The Peruvian financial authorities welcomed the prospect of more centralized and orderly negotiation. Harmony appeared to reign.

A transition toward a new form of IMF/commercial-bank cooperation began in Jamaica in 1978. Jamaica had suffered from excessive increases in government expenditure stimulated by the commodity boom in the early 1970s and supplemented by unwise lending by foreign commercial banks. Jamaica's first attempts to cope with its problems, in cooperation with the IMF, had failed because of inadequate fiscal improvements and a drift toward an overvalued currency. By late 1977, Jamaica's payments problems had grown to the point where it had difficulty maintaining adequate levels of imports, even of petroleum. As a result, the Jamaican authorities began negotiations with the IMF on major new loan support. Deeply concerned by the emerging disruptions, they became convinced that their only hope for recovery involved a major devaluation and massive fiscal improvement. This effort was skillfully initiated by Prime Minister Michael Manley, who was careful to explain to the public the reasons for the measures. Far-reaching actions were taken without the public disorder that would otherwise have been inevitable.

Through a large refinancing arrangement, support came not only from IMF resources but from friendly governments and commercial banks. This support, so essential for the program, was mobilized with IMF staff assistance. The staff contacted official donors and banks the day agreement was reached on a program, and meetings were held immediately to arrange for the necessary support before the IMF Executive Board made its formal decision. The commercial-bank refinancing was much larger than the aid and more difficult to organize, and there was doubt about its timely delivery. The bank steering committee, chaired by Citibank Senior Vice President William Rhodes, pioneered in this negotiation. The banks on the steering committee quickly agreed on the refinancing, including a delivery schedule with a first

installment before the end of September. But the power of the steering committee to obtain the agreement of all the other participating banks was questionable. To make certain the arrangement was implemented, the IMF staff required a minimum level of Jamaican central-bank gross foreign assets that would not be met if the banks did not pay that first installment. With the help of this deadline and the threat of adverse publicity, Rhodes forced all participating banks to agree to the refinancing arrangements during the 1978 IMF Annual Meeting, and he delivered the required amount within hours of the deadline. The experience Rhodes gained at that time stood him in good stead when he was called upon to play the key role in the infinitely more important negotiations on Mexico in 1982 and on a number of other countries thereafter.

The major debt crisis precipitated by Mexico's problems in the middle of 1982 took IMF involvement in commercial-bank debt to a new and critically important stage.[6] Mexico, like Jamaica, had allowed government expenditures to soar as receipts from mineral exports grew sharply in the late 1970s. In Mexico's case, the increase was especially great because a rapidly growing volume of petroleum exports compounded the effect of the 1973 and 1978 price increases. And, as in Jamaica, the boom was magnified by heavy borrowing from commercial banks. The banks provided these resources without paying attention to the expenditures they financed, reassured by Mexico's obvious resource endowment. In 1982 the bubble burst. The proximate cause was an attempt to maintain the exchange rate of an increasingly overvalued currency in the face of massive capital flight. This flight was stimulated in part by the fiscal weakness that is endemic at the end of Mexico's six-year presidential cycle. The scale of the debt problem was increased by a sudden surge in the short-term debt of state agencies as they drew to the limit on unused foreign lines of credit when the Mexican financial authorities tightened domestic financing conditions.

To restore order was a daunting task. The scale of the adjustment in the fiscal deficit was probably the largest attempted in an IMF-supported program. Public expenditures previously financed by massive foreign borrowing now had to be cut, not only to compensate in full for the loss of that borrowing but also to allow some servicing of the debt. Similarly, in the external sector the absence of financing was forcing a dramatic fall in imports.[7]

It was clear to the IMF staff that everything possible had to be done to mobilize financing. The U.S. government had arranged a short-term package from central banks, some short-term credits for food imports, and some

[6] Kraft (1984) provides a detailed account of the first stage of the Mexican arrangements.

[7] The scale of the Mexican adjustment from 1981 to 1983 is shown by the cut of 14 percent of GNP in the primary public-sector deficit (calculated before including interest payments), the fall of 65 percent in imports (in U.S. dollars), and the halving of real wages.

advance payments for oil exports. While these loans gave the Mexican authorities crucial evidence of foreign support, they provided little official help in maintaining imports in 1983. In fact, most of the IMF resources were mortgaged to repay this short-term assistance. It was therefore absolutely essential for the commercial banks to provide as much assistance as they could. Fortunately, on this occasion the IMF was in a strong tactical position. The banks were much concerned about the danger of a widening bank crisis if Mexico openly defaulted on its debt, and they were ready to offer a complete rollover of the existing exposure. When the IMF proposed that they lend $5 billion in addition, approximately half the interest payments due them, it became evident that they would agree.

The framework for the financial package was provided by the IMF's refusal to release its resources until the banks had individually committed themselves to provide the amounts needed. But an unprecedented cohesion of financial leaders was needed to deliver those individual decisions. The strong leadership of Chairman Paul Volcker of the Federal Reserve, supported by Governor Gordon Richardson of the Bank of England, delivered the necessary official backing. It was prompted by fear of the consequences of growing defaults on the international banking system; the interbank market was considered particularly vulnerable. Still more innovation was required to convert official support into private bank action. Key decisions were made by the CEOs of the fourteen banks on the steering committee at a meeting held at the IMF. The effective voice of Citibank's Walter Wriston helped obtain the acceptance of the financing plan set out by Chairman Paul Volcker and the Managing Director of the IMF, Jacques de Larosière. Even with that support, extraordinary technical arrangements were required to deliver the resources required from over 400 banks worldwide. The IMF framework made it much easier for the large banks and monetary authorities throughout the world to exert the pressure that was so essential.

In the event, the problems were surmounted and the feeling of crisis subsided as Mexico succeeded in reestablishing order to its finances. The next stages of the plan, aimed at achieving a gradual return to normal capital markets, took shape. The banks developed arrangements for a multiyear restructuring that would definitively rearrange future maturities and thus end both negotiations on annual terms and the requirement of an IMF program. In place of the IMF program, the banks requested access to confidential IMF reports. By creating a system permitting them to base their future financing on informed judgments about Mexico's economic prospects, the banks expected to encourage Mexico to adopt more responsible policies. Although this plan ran the risk of muting IMF appraisals because of concerns about the publicity that might be given to differences of views, it had the right intent of returning to the banks the full responsibility for their decisions. A begin-

ning was made when the IMF Executive Board rather reluctantly agreed to release consultation reports on Mexico and Venezuela to the banks.

Unfortunately, those plans went awry. Not surprisingly, given the immense task of adjustment, Mexico's policies faltered during 1985. Government expenditures were allowed to rise well above the program levels, and the exchange rate was held steady despite rising aggregate demand. When oil prices plunged in 1986, there was a relapse into a new round of dependence on IMF financing and negotiated commercial-bank relending of part of the interest payments. The search resumed for ways to lighten the debt burden through concessions, and the return to normal capital movements was indefinitely delayed. Nevertheless, the Mexican government once again demonstrated its strength. It allowed the exchange rate and interest rates to move freely to levels at which domestic capital returned and nonoil exports boomed. The problems were sufficiently contained to allow the mid-1988 presidential elections to proceed as scheduled without a payments crisis. This was a most impressive feat in view of the exchange-market crises that had occurred before the two previous presidential elections.

When the approach worked out for Mexico, one of the best performers, was used with the other major debtors in Latin America, there were greater problems, because the governments of these countries were not nearly so strong. In the first stage, the problems were contained when the IMF negotiated the largest possible support packages and the commercial banks were exceptionally cooperative. Curiously, support from official sources was much less impressive. Apart from some short-term central-bank assistance, support from official medium-term export-credit agencies was conspicuously absent. New credits fell sharply, largely because debtor investment plans were cut back, but also because export credit agencies in most creditor countries continued to follow rules that automatically stopped countries with debt problems from receiving new medium-term credits.

When the negotiations concerned smaller countries, the IMF's effectiveness with commercial banks fell rather sharply. In such cases, there was no fear that a delay in reaching an agreement would set off a global financial crisis. Therefore, the commercial banks found that IMF insistence on a commercial-bank refinancing arrangement could be converted into pressure on the smaller country's authorities to concede advantages to them in other areas. In this way, they managed to force the Chilean authorities to give a retroactive guarantee on bank loans made to now-bankrupt private companies, despite IMF objections. Thus IMF tactics that were designed to ensure greater commercial-bank support were in some cases less helpful than intended.

As time passed and debt problems persisted, the U.S. authorities recognized the need to give more encouragement to the indebted countries. In

1985 at the annual IMF meeting at Seoul, James Baker, then U.S. Secretary of the Treasury, spoke out in favor of greater flows of capital from commercial banks and multilateral development banks—especially the World Bank—to those countries implementing structural reform. This was a very important declaration of support for international development agencies by a government not previously friendly to them. It was followed by increased gross disbursements from the World Bank to some key debtors. Overall, however, too little was changed, and capital increasingly flowed away from most of the large debtors.

Conditionality Problems

The description above of the development of conditionality must now be balanced by a discussion of subsequent experience. It is not my intention to review criticisms of the IMF's policy orientation, which has been the main target of a large and constantly expanding literature by critics—one might almost say professional critics—of IMF conditionality (among others, see Dell, 1981; Taylor, 1981; Green, 1983; Killick, 1984; and Helleiner, 1986). While much of this literature suggests that the critics have not faced the problems of repayability, they are undoubtedly correct that mistakes have been made. But were these mistakes due to the orientation of the staff and management? Fortunately, criticisms related to this issue were thoroughly reviewed at a 1982 conference conducted by the Institute for International Economics and attended by most of the informed critics. No one challenged the conclusion reached there by Professor Richard Cooper (recorded in Williamson, ed., 1983) that any five people chosen from the diverse group at the conference would produce a program that "would not differ greatly from a typical IMF program."

There is more to worry about than the orientation of the policies promoted by the IMF. There is considerable evidence, much of it since 1982, of systematic difficulties that must be addressed before long, and particularly before broader reliance on the IMF and other international agencies is advocated.

These difficulties have two symptoms: growing problems in connection with repayments to the IMF, and political-image problems for the IMF. There is direct evidence of the repayments problems in the mounting level of arrears outstanding for an increasing period of time, and indirect evidence in large net repayments to the IMF by some countries that are still facing severe payments problems. The political-image problems are revealed by the growing criticism of the IMF, not only by heads of state of developing countries but also by major political figures in industrial countries. If a reformed IMF is to develop into the central monetary institution that the world needs, it must mobilize broader-based support by demonstrating to

the satisfaction of informed opinion that it has faced and overcome its problems.

On the repayments problems, a low level of arrears is not seriously damaging: it should be expected if the IMF is taking seriously its responsibility to help those countries with the weakest payments record. Given the effective protection of its resources provided by its preferred-creditor status, the IMF must be ready to take some risks. But an examination of the arrears shows that, in some cases at least, loans have been given in amounts that went well beyond any normal calculation of risk. The Sudan, for example, has arrears that now exceed a full year of recorded exports, an outcome hardly compatible with the IMF charter to provide temporary resources expected to revolve within a reasonable cycle.

Furthermore, it should be recognized that repayments problems can be serious even if there are no arrears. Members are under strong pressure to pay and in fact usually do so, even when earlier resort to IMF assistance has not solved the original payments problems. The recent heavy net repayments to the IMF by developing countries still plagued by payments problems implies that at least some countries are repaying not with the proceeds from a successful recovery but out of respect for the commitment they have made. The IMF may argue that an institutional responsibility to help in emergencies can lead to assistance that turns out to be excessive when conditions do not develop as expected, but the evidence is clear that for too many countries current levels of net repayments are inappropriate.

The political problems are just as troublesome. First, it must be said that some political tensions are inevitable. The IMF is necessarily associated with difficult periods of adjustment and retrenchment and must therefore expect to be at the center of controversy. In fact, the authorities of some debtor countries have undoubtedly used the IMF as a scapegoat—or lightning rod—for reactions to measures that they knew were unavoidable. Relations between the IMF and the authorities are frequently much better than is admitted publicly. The record on the mechanics of Fund conditionality shows that in most countries there continues to be a shared sense of purpose. The statistics used for monitoring the observance of conditionality could easily be manipulated if the authorities were in fact alienated. Furthermore, there is often evidence that the public is unexpectedly appreciative of actions demonstrating the kind of financial responsibility involved in Fund programs.

Nevertheless, the concern about recent changes in political attitudes is justified. In many countries the IMF has been so closely identified with creditor interests that government officials have found it very difficult to cooperate with the IMF. On occasion, desirable policy actions have been delayed because they appeared to involve surrender to outside pressure. In such sit-

uations, instead of acting as a lightning rod and helping to protect the authorities from criticism, the IMF presence adds to the tensions and lessens support for effective adjustment.

What is the cause of these problems? In my view, both the repayments difficulties and the political tensions reflect pressures to undertake programs before the political conditions necessary to support them are in place. And when the inevitably inadequate recovery makes continued IMF involvement necessary, problems multiply quickly. The IMF program appears to be a political protectorship imposed on behalf of creditors and donors, and the collegial basis of conditionality so essential to its effectiveness is lost.

Why is this allowed to happen? The role of the IMF staff is to work with the debtor country's financial authorities to develop adjustment plans that will ensure an eventual balance-of-payments recovery sufficient to service the additional resources the IMF is providing. Theoretically, the timing of the adjustment action is left to the country. Theoretically, the authorities are free to wait until they have sufficient political support to launch the adjustment effort or even to postpone action indefinitely. In practice, the situation looks very different. Other lenders press the IMF to act quickly. The IMF staff produces a program of fiscal and credit tightening which, on paper, assures a payments recovery and an early return to growth. To alleviate their immediate problems, the country's financial authorities are tempted to accept this quantified program in order to gain access to resources not only from the IMF but from other lenders. But all too often the authorities do not feel responsible for the quantitative plan and do not implement it—the discrepancies can be wide—and the payments recovery does not take place. Even if, under duress, they follow the plan, problems frequently arise. With little domestic commitment, political forces often develop that are able to weaken important elements of the program and delay the payments recovery.

The obvious solution is for both sides to wait until the time is ripe for successful action. But this is consistently possible only when IMF financing is first being introduced and is independent of other assistance. It is much more difficult when the IMF is the central element of a debt strategy agreed upon with other creditors to be applied to the whole class of troubled countries. Then, both the IMF staff and the authorities feel pressure to act quickly on successive debtors to keep the strategy intact. Although the initial adjustment action—by, say, Mexico—may have been properly prepared for politically, the pressure to achieve the same solution quickly in, say, Argentina, where the political situation is different, increases the probability that action will be taken at an inopportune moment. And so the pressures build that cause the IMF to be associated with failed recovery programs.

The IMF's connection with the debt strategy of creditors also extends its

involvement for too long. Because the creditors are not ready to grant adequate writedowns or multiyear reschedulings, as needed, they create conditions that force the IMF to negotiate repeated programs indefinitely. In theory, such programs are still aimed at a return to medium-term viability in the balance of payments, but in practice the IMF is forced to compromise toward very short-term objectives. Ultimately, it attempts little more than the maintenance of some sense of order for the next year. Such short-term maintenance is undoubtedly enough for some officials in major creditor countries. But the inevitable damage inflicted on the IMF by the destruction of its collegial and cooperative relationship with the financial authorities of the debtor countries makes the long-run cost high even from the creditors' standpoint.

The strains caused by these developments have inevitably led to proposals for change. There are two strategies. One seeks more independence for the IMF in the timing of programs, so that it gives support only when the debtor country has adequately adjusted macroeconomic policies. The other seeks to broaden negotiations to include microeconomic reforms. The latter creates the appearance of greater change and has much more potential for window dressing the extent of the recovery effort. But, unless macroeconomic policies are sufficiently improved, reality will soon intrude in the form of continuing payments problems, accompanied by even greater dissatisfaction. In the absence of a viable macro framework, individual constructive micro actions will be systematically undermined by the failure to achieve payments objectives. This failure will almost inevitably be followed by retrogressive micro actions, such as tighter import controls and larger subsidies, that more than negate any initial progress.

Obviously, more independence for the IMF is not enough by itself. The debtors clearly need more substantive relief than has been available so far. In section 3, where solutions to the debt problem are discussed, a framework is described that could make IMF responses more constructive for both debtors and creditors and be consistent with renewed IMF progress toward a central monetary role.

3 The Prospect

The immediate prospect for the IMF is not particularly favorable. Only a shell of its former role with industrial countries remains. With developing countries, the damage to its reputation from persisting with an inadequate strategy for dealing with intractable debt problems has become debilitating. Nevertheless, the record of the IMF shows impressive accomplishments. In particular, its application of a payments-viability standard to its financial operations gave it a respected role with large and small countries. I argue

here that this viability standard can be applied with adaptations to two key tasks—limiting the dangers of prospective U.S. financing needs and providing a basis for control in a new system of debt writedowns.

The proposals made here are ambitious, involving as they do a major break in current trends, and political conditions are not favorable to innovations that delegate executive authority to an international bureaucracy. Nationalism is still growing, and the emerging economic leaders, Japan and Germany, may well fear that the IMF is too likely to be controlled by the United States.

Nevertheless, the problems are unlikely to solve themselves, and further temporizing actions are going to look increasingly ineffective. In the search for innovative approaches, the potential of the IMF for facilitating a longer-term solution must be examined closely. My aim in this section is to stimulate interest in such innovations. For the industrial countries, while the issue is the financing of the U.S. payment deficit, solving it by giving the IMF a central role would open the way to reestablishing a stable exchange-rate system and the regulated creation of foreign-exchange reserves. For the developing countries, the issue is the establishment of procedures that enable countries with chronic debt problems to pass from debilitating repeated debt negotiations to self-reliant responsibility. With countries that depend on market sources of capital, the IMF could be given a controlling role; with aid recipients, the reforms would primarily involve creditor procedures and any IMF role would best be kept subsidiary.

Industrial Countries: U.S. Financing Needs, the Exchange-Rate System, and the SDR

U.S. Financing Needs. After the economies of France, Italy, and the United Kingdom grew stronger, the mechanism for dealing with payments problems among the industrial countries deteriorated. When an unsustainable U.S. payments deficit emerged, there was no effective international response. True, there were expressions of concern—quite sharp in a forum like the IMF Executive Board, very diplomatic in direct conversations like that of Prime Minister Nakasone with President Reagan, recorded by Funabashi (1988). Only when then U.S. Treasury Secretary Baker, fearing the outlook for U.S. trade policy, pressed for collaboration in order to keep the dollar moving back to more sustainable levels did effective cooperation begin. This cooperation was well designed and successful in the limited area of exchange-market intervention—so successful that when the decision came in February 1987 to stop the decline of the dollar, that too was organized effectively. But nothing was done internationally to help the United States overcome its fundamental problem, the deficiency of its savings. In fact, the focus of cooperation throughout 1987 on mobilizing support for the U.S.

dollar weakened pressure on the U.S. economy and reduced the concern essential for the continued reduction of the budget deficit.

This ineffectiveness on the key issue undoubtedly contributed to the severity of the worldwide stock-market collapse of October 19, 1987. The consequences of the collapse were minimized by timely central-bank action throughout the industrial world, which permitted reaffirmation of support for G-7 cooperation. But the actual future of such cooperation is hostage to the degree of progress being made on the U.S. deficit—and there the financial establishment in the United States is likely to need help.

The cause of the U.S. problem is not difficult to diagnose. Economists are virtually united on the need for an orderly reduction of the fiscal deficit to reduce the overall current-account deficit to manageable levels.[8] The difficulty lies in arousing public support for the necessary painful fiscal measures. In the broadest sense, this task involves the education of the U.S. public, which has been vigorously urged for some time by internationally minded leaders.[9] However, there is increasing evidence that continued large capital inflows have dispelled the feeling of urgency by preventing immediate problems in the form of rising inflation or major increases in interest rates. So there is a distinct possibility that U.S. savings will continue to be inadequate.

Thus, the United States may remain in the very vulnerable position of depending on financial support from non-U.S. monetary authorities to control excessive swings in market sentiment. Although the United States has so far been able to rely on such support, it has been forthcoming for unsound reasons that are likely to become less persuasive in the future. In particular, the concerns of their own exporters have induced the other major governments to accept responsibility for supporting the U.S. dollar. This is counterproductive when the pressure on the dollar is due to the U.S. savings imbalance. By underwriting the dollar and thus reducing the U.S. incentive to adjust, these governments are actually encouraging longer-term damage to the interests of their own exporters. The securities their monetary authorities purchase with the dollars they buy lead to servicing commitments by the United States that in the long run are directly competitive with these countries' exports. The more support these countries give now, the smaller

[8] There are some differences of opinion on the role of other countries. The size of its economy does not alter the basic truth that in the United States, as in all countries, increases in savings are essential to an improvement in the overall current-account balance. Greater fiscal deficits elsewhere will have some impact on the U.S. current balances, primarily by raising world interest rates and so lowering investment in the United States, but that will deter future U.S. growth. An expansion of foreign demand when U.S. contraction has been achieved is needed not so much to help the United States as to maintain conditions for world growth.

[9] Peterson is most outspoken in political terms, and Marris (1985) in economic terms. Bergsten (1988) restates the issues comprehensively.

will be their exports to the U.S. market later, when the United States will be making interest payments instead of purchasing imports.

The behavior of these countries may have been influenced by national political considerations; there could be a lingering mercantilist belief that they gain relative political strength by the continuing weakness of the United States. If so, this too is a position that will not stand close inspection. There is truth to the idea that dependence on foreign financing weakens the United States, but the reality is that the rest of the world, lacking an alternative reserve center, will suffer along with the United States. If the United States reacts to its continued payments weakness by introducing import restrictions, it could set world trade policy on the most damaging path possible. On the other hand, an abrupt end to foreign support of the dollar in reaction to frustrations arising from continuing U.S. fiscal inaction would create tremendous problems for the rest of the world. There would be unavoidable and costly consequences from the collapse of the dollar. By far the most constructive solution, therefore, is for other countries to help the United States adopt sustainable policies, not to delight in temporary feelings of superiority.

Foreign monetary authorities are most likely to change their attitude toward supporting the dollar when world demand rises enough to rekindle concern about inflation. They will then face the need to restrict domestic demand to offset the inflationary consequences of their financing of the U.S. savings gap, and they will be less willing to remain responsible for U.S. dollar stability. If that should become public, other suppliers of capital will quickly withhold their funds and even reverse the flow, forcing the United States to face its financing problems under the most difficult conditions.

Signs are appearing that the other governments are getting ready for possible changes. For some time, there have been suggestions that the U.S. government should issue foreign-currency-denominated securities for public and private purchase. This simple innovation, used in restricted form twice before, would provide foreign investors with an asset free of the risk of dollar depreciation and would signal that the U.S. authorities had taken an important step toward accepting more responsibility for support of the dollar. But such a simple step would by no means assure an appropriate outcome. It would increase the danger of market pressure on U.S. dollar assets by providing an obvious substitute asset differing only in currency denomination. The United States, as the supplier of the reserve currency, with large liquid liabilities, would be faced with the fact that investors wanting to switch out of U.S. dollar assets could do so far more rapidly than before. Increasing its vulnerability to the decisions of other monetary authorities might signal U.S. confidence that the contingency will not arise, but longer-term assur-

ance of a stable system must be sought in arrangements that provide an orderly international official response.

More promising is the recent proposal by Toyoo Gyohten, then the Japanese Vice Minister of Finance (Gyohten, 1988), for the creation of a new financing agency funded by the United States, Europe, and Japan, which should be seen as a first step toward an institutional responsibility for financing intervention. Unfortunately, the proposal is flawed by a lack of substantive suggestions concerning adjustment requirements (they are mentioned in one sentence only). That is perhaps inevitable in an agency limited to a few countries: any adjustment rules might appear to the U.S. public and to Congress to be dictated by the Japanese and Germans. But the proposal is absolutely right to stress an international responsibility for maintaining orderly conditions.

The governments of the world must develop a financing framework that gives the United States access to financing under procedures that will facilitate the restoration of its payments position while protecting it from the real costs of being the reserve center when confidence is in question. The only framework for negotiation now is the G-7. While this is far, far better than nothing, it is gravely flawed. The United States might be able to gain access to open-ended official financing from the foreign G-7 countries, but on a basis that would create increasing strains. For example, there are signs that these countries might continue to provide exchange-market financing as a substitute for sharing the burden of defense costs. This is a dangerous confusion of issues. Official financing of the U.S. payments deficit does not offset inequities in the sharing of current defense costs. An alliance based on accepting a loan when a grant is needed inevitably faces growing stress.

More generally, balance-of-payments financing must be provided according to agreed rules, which cannot safely encourage unlimited growth of the monetary authorities' holdings of U.S. dollar assets beyond their needs. It is here that the IMF should eventually play a role. The U.K. payments problems in 1976, which were dealt with through the IMF, involved some issues very similar to those in the U.S. situation today. By centering the provision of official finance on the IMF, financing issues were effectively separated from alliance issues such as the defense cost. The United Kingdom, like the United States, had above-average defense expenses. Faced with retrenchment, the Government had to consider reducing NATO expenditures, including the cost of stationing troops in Germany. Yet those issues did not attract public attention. The United Kingdom was not publicly pressured by other governments to cut its fiscal deficit. The pressure came from its financing needs, which, to the extent that they were met by other central banks and the IMF, were met under the specific rule that such financing was

temporary. This provision did not avoid tensions—which are inevitable in periods of change—but it did prevent them from becoming alliance tensions.

Assigning a role to the IMF in financing the United States will of course raise procedural issues that will take time to resolve. The United Kingdom was given more than ten years from the first almost automatic financing in 1956 to the arrangement in 1969, which involved detailed credit and fiscal ceilings. Somewhat similar procedural flexibility may be needed for the United States in order to gain time to resolve the issues.

Adopting an IMF framework may not imply actual early use of IMF resources by the United States. The normal experience of the IMF is that the borrower usually takes the necessary steps to correct imbalances before it reaches the limits of private financing. However, for the concept of financing through an IMF framework to be credible, immediate action would be needed to provide the IMF with resources on the required scale. Above all, there would have to be a major expansion of the present General Arrangements to Borrow to at least $200 billion, the level of Gyohten's proposal. If the IMF is to replace monetary-authority financing, its scale of financing must be commensurate with past levels even though its association with adjustment measures should actually reduce the amount of intervention needed.

The principle of flexible lending procedures for the issuer of the reserve currency was accepted in a key IMF decision on conditionality in 1968.[10] Then, with the focus on the United Kingdom as the issuer of a major reserve currency, it was acknowledged that the responsibility for a reserve currency led to special needs. In the case of the United States, in light of the unusual division of power with Congress, even more innovation might be necessary. In particular, any loan would require as a central feature a broad U.S. commitment to reduce the fiscal deficit enough to eliminate the balance-of-payments deficit over the medium term. Such a fiscal assurance would appropriately be endorsed by Congress in an evolution from Gramm-Rudman concepts toward a new enforcing mechanism of public commitment to the IMF. Of course, as with other countries, there would also be comprehensive descriptions of macroeconomic policies from the Secretary of the Treasury and the Chairman of the Federal Reserve Board. If U.S. actions under the first program did not prove decisive and the payments difficulties returned, as might well happen, it would have to be understood that procedures would be strengthened, as they were with the United Kingdom.

Although the purpose of IMF participation would be to provide the United States with the resources needed to protect it from the dangers of its reserve-

[10] This decision (see De Vries, 1976, Vol. 1, p. 347) allowed an exception for reserve currencies (called "exceptional cases" in the text) to the universal rule that all loans would be given in installments and released only when performance tests were met.

currency role, the U.S. authorities would have to accept willingly the implied constraints of IMF rules and procedures. They would have to understand that IMF financing, to be effective, would be withheld—even while the dollar fell—until the United States took adequate savings action. It would be absolutely essential for the U.S. authorities to be satisfied with the standards to be applied. Agreement to an IMF framework would have to be as carefully developed with the United States as it was with the United Kingdom and include provisions designed to limit possible excessive movements out of U.S. dollar holdings. This means, among other things, that the G-7 and the IMF would, throughout, encourage other holders of dollars to retain their holdings by affirming their expectation that the arrangements would effectively ensure the longer-term value of the dollar. Consequently, at no time would there be any attempt to limit financing of the dollar by the monetary authorities of non–G-7 countries or by the private sector.

A role for the IMF in financing the U.S. savings imbalance would not only attract a great deal of attention, it would also enhance the IMF's value to the system more generally. Once a role with the United States was established, the IMF would be available for any recurrence of U.S. problems. Moreover, other G-7 countries, some of which are likely to encounter serious payments difficulties themselves at some time in the next twenty years, will find the mechanism much more usable once it has been accepted for the United States. And the stronger the international framework for managing financial flows on the basis of economic viability, the easier it would be to integrate the USSR into the world system.

The Exchange-Rate System. A revitalized IMF would be crucial to recreating a world exchange-rate system. At present, there are groups of countries that cooperate to stabilize exchange rates among themselves, but there has been no central system for the world since the original IMF system collapsed. The tentative return to some order among the G-7 countries since 1985 is an important step toward formal stability, but pending resolution of the U.S. imbalance, it cannot be conclusive. In fact, in order to deal with the U.S. savings imbalance as suggested above, there would have to be a willingness to retreat from exchange-rate stability until the United States was ready to take on the full residual financing responsibility for the U.S. dollar. Nevertheless, because this framework allocates responsibility among the major countries, it is the precondition for an enduring return to exchange-rate stability. Only when that financing framework is firmly established can the major countries take the all-important step of committing themselves publicly to the defense of a system of stable rates. The founders of the IMF at Bretton Woods were right to associate financing rules with exchange-rate commitments.

The advisability of such a step will be questioned by some economists.

They will argue that flexibility has been crucial in helping the world surmount the problems of the last twenty years and will be equally helpful in the uncertain period ahead. It is certainly true that flexibility can be constructive on occasion and that the 1970s and early 1980s were such an occasion. But that does not mean that exchange-rate stability should not be sought when circumstances make it attainable, as now seems possible. It is particularly important to strive for stability at the present moment because of the dangers ahead for the world trading system. With the U.S. leadership of open trading inevitably faltering while its payments position remains weak, it is essential that the strains on the trading system from excessive exchange-rate variability be limited insofar as possible. Such fluctuations are of course inevitable if macroeconomic policies do not support exchange-rate stability. But it now seems possible that a political commitment to a more stable exchange-rate system will once again move macroeconomic policy toward providing the basis necessary for the crucially needed stability.

Let us be clear on the issues. In order to maintain progress toward a more open world trading system, foreign-exchange and trade restrictions arising from overall payments deficits must be avoided. The danger of a political commitment to stable exchange rates is that a country with the wrong exchange rate may find it politically more convenient to take restrictive action than to make the necessary policy adjustments. Fortunately, there is now strong evidence that for almost all industrial countries these pressures for restrictive measures can be contained. The experience of the European Monetary System shows that a group of advanced countries can benefit without serious economic strains from the stabilizing pressure exerted on fiscal, monetary, and wage policies by a commitment to more stable exchange rates. In this case, of course, these countries could not impose most foreign-exchange and trade restrictions because of their membership in the European Community. But the evidence strongly suggests that their macroeconomic policies were sufficiently convergent that the issue of restrictions to avoid exchange-rate depreciation rarely arose.

Recently, the G-7 countries have managed to keep their relative inflation rates closer together than were those of the EMS countries when the EMS began. There is thus less reason to fear that a G-7 declaration for exchange-rate stability would lead to inappropriate constraints on demand policies. In some countries, there would, of course, be somewhat more restrained demand policies with an exchange-rate commitment than without it. But the EMS experience indicates that such constraint has, on the whole, been constructive. Italy, which had the most to fear from a commitment to more stable exchange rates, may have gained the most from stabilizing expectations.

A public commitment to stable exchange rates is effective politically

mainly because of the perception that it enhances the prospect of price stability. This means that political pledges to stabilize exchange rates refer to nominal rather than real rates. Economists, who are appropriately concerned with world integration, would like the focus to be on stable real exchange rates. Consequently, any reconstructed exchange-rate system should build in as much nominal flexibility as possible. Nominal flexibility would minimize changes in real exchange rates or, more fundamentally, in real competitiveness—including shifting terms of trade and differential rates of productivity growth. If there is a return to an IMF framework, the IMF should be able to stress real rates when it gives advice and to encourage the preservation of real competitiveness through IMF guidance over nominal rates. Such a framework would also permit the IMF to exert pressure on most developing countries to stay away from fixed nominal rates until they have a track record of control over inflation. Premature announcements of nominal-exchange-rate stability before a country can deliver a better cost performance is a sure path to perpetuation of trade-distorting restrictions.

Very little can be done about the exchange-rate system until the U.S. payments imbalance is resolved. The present G-7 framework must remain intact until U.S. savings are adequate, and it must avoid precision on immediate commitments to stabilized exchange rates. But the eventual step to precise commitments could happen sooner if more attention were directed now to developing a stable exchange-rate relationship between Japan and the EMS countries. Observable progress, particularly if it included the United Kingdom, would go far to advance the timetable for the return to a stable exchange-rate system. Unfortunately, there is little sign of such a development; in practice, everything is likely to wait on the United States.

In the meantime, the major countries could signal that they are ready to work within a worldwide system by increasing the role of the IMF Executive Board in recording policy developments on exchange rates. In particular, it is time to honor the commitment in the revised Articles of Agreement to provide the Fund with the information necessary for surveillance by allowing the Executive Board to hold an immediate discussion of any exchange-rate understandings reached in G-7 meetings.[11] No longer should such a clear international commitment be ignored, to the detriment of other countries that need an authoritative account of the policies of the major powers.

The SDR. In the longer run, collaboration among the industrial countries should involve more than financing arrangements and a return to more stable exchange rates. It should also deal with the problem of reserve creation in order to decrease dependence on the U.S. dollar. The current trend to diver-

[11] Article IV, section 3(b) reads: "The Fund shall exercise firm surveillance over the exchange-rate policies of members. Each member shall provide the Fund with information necessary for such surveillance. . . ."

sification could be speeded up by further development of money markets in Germany and Japan: monetary institutions and banks could be given a more complete range of instruments for investment in deutsche mark and yen. This change is being held back by German and Japanese concerns about the dangers—particularly those arising from the greater exposure to external causes of instability—involved in taking on a larger reserve-currency role. SDR creation through the IMF would provide an alternative to such broadened national-currency-reserve roles. Interest in this solution could be rekindled quickly if the U.S. financing problems were handled through the IMF, as suggested here. Without more major-country cooperation through the IMF, however, the present impasse may well continue as the prestige of the institution ebbs.

More broadly, it is wise not to be too ambitious about integrating policy plans. For the foreseeable future, it is most unlikely that any agency—or any international group—will exert real influence over the domestic macroeconomic strategies of countries not in need of financing. Surplus countries will not be receptive to systematic outside advice, and little can be done institutionally to ensure a steady path for world demand. Nevertheless, the close association achieved in routine meetings, particularly those of the G-7 countries, can be very helpful in ensuring that national policy decisions are based on the fullest information. While everything possible must be done to improve lines of communication, there should be no implication that key countries would normally be expected to take directions from IMF (or any other) advisors. The one exception might be in connection with a U.S. program with the IMF. If such a program specified reductions in aggregate U.S. demand, its major creditors should be willing to assure offsetting demand growth, preferably by maintaining credit growth at lower interest rates.

Although the IMF role with industrial countries that is described here may seem ambitious, I should emphasize in concluding that it does not involve substantial devolution of powers to the institution. The G-7 countries would continue to have full control over all pending issues. Burden sharing of defense costs, political alliances, the division of functions among international agencies, and the development of new functions would all be resolved by G-7, or similar group, discussions. Any IMF role, particularly in lending, should so closely follow prescribed rules that the views of IMF staff and management would not be considered significant. This has already been largely achieved in successful IMF negotiations; later accounts of events in which IMF conditionality seemed particularly important at the time, as in the United Kingdom in 1976 and in Mexico in 1982, have taken little note of discretionary judgments made by the IMF staff and management (see, e.g., Fay and Young, 1978, regarding the United Kingdom, and Kraft, 1984, regarding Mexico). Quite correctly, attention was exclusively focused on the

issue of maintaining an IMF framework. And so it would certainly be if the IMF developed a role with the United States. The aim would not be to increase the power of an institution but to develop agreed, logical rules to deal with predictable economic events.

Developing Countries: The Debt Problems

The major immediate issue for developing countries is to establish a framework for the definitive resolution of the debt problems of most of Latin America and Africa. By the end of 1988, a new strategy more favorable to debtors was widely considered overdue. Since U.S. Secretary of the Treasury Nicholas F. Brady announced a new plan in March 1989, it has been generally accepted that such a strategy must include elements of debt reduction for many of the countries that have been experiencing difficulties since 1982 (see Sachs, 1989, for the most trenchant call for such action). Orderly and effective implementation will require agreement on a secure framework to control this relief. Financial costs will be high, and the governments of the creditor countries will insist on maintaining close supervision over procedures. Since a new agency for this purpose seems politically unlikely, almost certainly the need for supervision will lead to a stronger central role for the IMF. (The World Bank will be a serious contender only if the creditor governments gain much tighter control over its operations.) But in view of the problems that debtor countries have had with the IMF in its present role, broad support for an IMF mechanism awaits major concessions from creditors that offer cooperating developing countries an escape from the present difficulties.

The new debt strategy should enable debtors to pass definitively from perpetual dependence on negotiated compromises with creditors to independent responsibility for their own futures. It should create a better-functioning framework for future capital movements to ensure faster growth for the debtor governments that adopt confidence-creating macroeconomic policies. An environment must be developed where, country by country, each debtor government can responsibly undertake not to ask for further debt negotiation and where henceforth both domestic and foreign investors can focus their attention on the profitability of investments.

Private Lending. The damage to the mechanisms for international capital movements from writedowns on commercial-bank debt has already been inflicted on the countries in question. When Citibank, which is among the leaders in defending a continuing role for the commercial banks, reduced its Brazilian exposure by transactions involving important discounts,[12] that

[12] Described by William Rhodes in a Nov. 17, 1988, presentation to the Institute for International Economics entitled "Brazil Refinancing Plan 1988-89." Unfortunately for Brazil, most of the debt-reduction techniques involved in this agreement lead to major increases of central-bank credit and have undoubtedly helped accelerate Brazil's collapse toward hyperinflation.

bridge was already crossed. The task is to overcome the debt problems of the 1980s in an orderly fashion that gives as much assurance as possible that the lessons have been learned.

Many of the schemes for writedowns envisage a new agency that will take over or guarantee the written-down debt. Even schemes involving existing agencies usually require major commitments of public funds. These proposals raise difficult political issues. In a period of domestic retrenchment and domestic debt problems, will the U.S. Congress allow international agencies to take on major new responsibilities without imposing unacceptable limitations on the list of eligible debtor countries? Moreover, writedowns that are facilitated by new legislation are likely to give a clear signal that debt relief has political objectives, and this will make it very hard for an implementing agency to insist on comprehensive economic reforms as a prerequisite for granting relief. For example, if Congress explicitly supported writedowns to improve the prospects for debtor countries with democratic governments, would it be possible to delay support for an Argentine writedown until credible and adequate economic reform had taken place?

There is a way to limit these problems. As in domestic bankruptcy, the costs could be borne in full by the existing creditors, as advocated by Cohen (1989). This solution was not available in 1982, because the banking system was not strong enough, but by now banks have greatly strengthened their position. With a properly designed framework to control the writedowns, there is little doubt that the overwhelming majority of banks can now withstand the likely level of losses. Debtor governments, too, have learned from the long confrontation by Peru and the short-lived one by Brazil that the costs of confrontation are prohibitive. They are probably ready to accept writedowns involving discounts significantly smaller than those in the current market, provided that acceptance leads to a return to friendly relations with their creditors.

This way around major use of public funds depends completely on developing a system that limits eligibility for writedowns. The most practical procedure might be to include only those countries that have failed to overcome debt problems for a full domestic political cycle. The system would provide relief only when reforms were being implemented adequate for a firm undertaking that all obligations, including the written-down debt, would henceforth be fully serviced. Each judgment would raise problems. The first step, agreeing on the list of eligible countries, could perhaps normally be based on accepting all countries for which debt renegotiations had continued over at least six years. The second step, determining that a particular country on the list had taken fully adequate macro and micro actions, would be more difficult. It would be important to set a standard high enough for the first eligible country to establish a credible yardstick.

By charter, the IMF would seem to be the appropriate agency to have responsibility for judging whether the measures the debtor country has taken ensure future payments viability. Given its record of the past few years, however, the IMF will be useful only if this new function is sharply distinguished from present IMF programs with these debtors, which lately have sought little more than short-term order.

How could it work? Obviously, the exact mechanism would depend on developments that are not precisely predictable, but the issues can be illuminated by laying out a possible set of arrangements. The IMF could create a new high-conditionality facility with increased resources that were available only to those countries its Executive Board deemed eligible because of proven intractable problems. A country would gain access to these resources when the IMF management agreed that it had undertaken adequate policy reform and had openly committed itself to full future servicing of its obligations. Above all, access would be conditioned on a prior agreement between the creditors and the debtor on the precise arrangements for a major writedown of its debt. This requirement of creditor concurrence would parallel the practice that proved effective in 1982 for concerted bank lending to Mexico.

But there would be differences. In these operations, the amount of the writedown would seem to need greater freedom in negotiating with the bank steering committee and less dictation by the IMF. An early return to normal routine relations between the debtor and the commercial banks could be expected only if the bank committee freely embraced the new arrangements. Of course, the IMF could give advice to both parties and would need to be assured of a viable payments outcome, but it would not have as central a role in deciding the scale of relief as it played in the first determination of new money packages.

Another difference could arise from problems specific to enforcing an agreement requiring a definitive writedown. Unlike the present system, which accommodates a wide spread of views about future servicing, this negotiation would be designed to create an overwhelming presumption of assured future servicing. The banks would undoubtedly differ among themselves on the acceptability of any arrangement. The requirement that major losses be universally accepted would make it inevitable that some banks would try to refuse to participate. It is therefore very likely that enforcing machinery for majority positions would be needed. To meet this problem, creditor governments would have to take the responsibility for achieving near universal participation by making sure minority banks could not use legal action to force full payment. This might require the use of existing IMF legal power to approve nonpayment of debt service. The extent of that power cannot be stated with certainty: minority banks could claim that nonpayment

of a government obligation is a default, not a payments restriction within IMF jurisdiction. In my view, the intent of the Articles of Agreement is clear and does cover all nonpayments resulting from balance-of-payments problems. But the legal position can be finally resolved only when a problem arises. At that time, the crucial question will be the attitude of creditor governments. If they want to support a definitive solution, they have the power to give substantive legal protection to a majority settlement through the IMF, providing at worst that they undertake clarifying legislation on IMF powers.

The scale of IMF financial support associated with the new facility would have to be sufficiently liberal to impress the markets. Because recovery will take a long time and commercial-bank medium-term lending will be very limited, it would be equally important to maximize the parallel development assistance from the World Bank and other international development agencies on longer repayment terms. Creditor governments would have to be ready to reopen export-credit facilities for new projects. At least initially, the World Bank could play a crucial role in encouraging these flows by taking responsibility for assessing investment efficiency and the adequacy of the focus of policies on growth.

Implementation of the new facility would depend on reasonably speedy and appropriate writedown agreements with each debtor. Suggestions have been made that public-sector guarantees would facilitate this process. Private-sector creditors would certainly favor such guarantees to lower their own costs. But there are disadvantages that need to be weighed. The goal of these proposals is to establish confidence that all future debts will be serviced. Priority given to old debt could deter renewed inflows of foreign capital and the return of domestic capital, which together are likely to be crucial to the success of the reform. And, as mentioned earlier, guarantees inject politics into the debt-reduction process, increasing the danger that debt reduction will not await genuine policy reform.

To establish the credibility of the new facility in the markets, it would have to be clear that political factors had played no part in the IMF's decision to support a particular restructuring—that Argentina, Chile, Nigeria, or Poland (to name a possible candidate) had been judged solely on the adequacy of its actions to assure future servicing. Of course, the government would have to be judged strong enough to maintain the policies. Most programs would certainly be instituted after elections had produced a government that could look forward to a reasonable period of political stability and so inspire confidence in the required strong assurances that no more relief would be sought.

Many years would no doubt pass before all the countries with intractable debt problems were in a political position to undertake the necessary reforms. Many of those countries have fairly large payments to make to the

IMF, and making them during this period would create strains. Although repayment terms would always have to be taken seriously—the priority of IMF claims is widely agreed to be necessary to the IMF's central negotiating role—there are reasons to suggest innovations for countries in chronic debt difficulty. A matching IMF low-conditionality facility for those on the eligible list could be created to ease the position of these countries while they were waiting to gain access to the new high-conditionality facility. It would offer new loans smaller than the repayments due in order to maintain openly the principle of IMF priority. This support would not be given unless the country's policies were adequate to keep order in payments on short-term trade credit and debts to international development agencies. But low conditionality would probably mean that these countries would feel less pressure to continue servicing other loans, particularly those expected to be renegotiated later. Essentially, the country would be asked to cooperate in a holding operation, with no presumption that its policy reforms were providing a long-term solution. To recognize this situation, the associated program should probably provide that access would be interrupted only if the country failed to maintain the agreed foreign payments. But renewal of access would have to depend on requirements that were high enough to encourage the country to lay a basis for coping with its macroeconomic problems and completing a debt settlement while maintaining a politically realistic timetable.

Two-tier conditionality creates operating problems, but several precedents exist. The IMF has always maintained a softer introductory conditionality for access to the first tranche (25 percent of quota). And the oil facility created by the IMF to meet the oil-price crisis of 1973 served a similar role. These suggest that any problems are manageable for such a relatively limited period. The main resistance to the creation of this low-conditionality facility would undoubtedly come from creditor governments afraid that the availability of the low-conditionality facility would destroy the debtor's interest in making progress toward reform. Obviously, a balance would have to be struck between completely removing IMF pressure on the country to maintain interim debt service on medium-term bank debt and insisting that the country reach a definitive end to its debt problems.

The Brady Plan, which was announced after these proposals were formulated, goes quite some distance in the direction proposed. In particular, it makes debt writedown a central feature and moves toward a greater IMF role. But it differs in major respects. It does not aim at definitive relief. Instead, it seems to envisage that debt discounts will persist for some years. Nor does it offer a clear technical standard to control access to writedowns. It relies on World Bank, IMF, and Japanese resources to enhance the value of existing debt, possibly encouraging the international financial institutions to increase their exposure to countries still suffering diminishing ability to

service their present debt. And it apparently relies on voluntary commercial-bank action to overcome the free-rider problem even though plans for major debt reduction make it more serious than ever.

Implementation of the Brady Plan will put a severe strain on commercial-bank cohesiveness. Perhaps the plan will be successful without major modification, but I believe a much stronger official framework is needed for a definitive solution of the problems of most debtors. I hope the major governments react speedily to problems and are ready to develop an effective control mechanism along the lines advocated here. But there is considerable danger that they will permit continued drift, leaving major debtors in serious difficulty while further weakening the financial integrity of the IMF and the World Bank.

Official Lending. We turn first to the debt that is owed to official creditors by debtor countries that borrowed mainly in the private capital markets, typically Latin American countries. As regards official loans provided for commercial purposes—export-credit guarantees for the most part—it would be most constructive if the lead could be taken from the commercial banks. In these countries, official credits are much smaller than commercial-bank credits. To assure the smooth execution of debt-reduction agreements, official creditors should signal their support of the process by agreeing in the Paris Club to official concessions on terms similar to those negotiated with the banks. In practice, the banks may find that official creditors resist such equivalence because of the problems raised by its inevitable extension to other countries, especially aid recipients. But this should not be an insuperable barrier, because aid recipients too must be given relief from perpetual negotiations.

To overcome the persistent debt problems of aid recipients—principally in sub-Saharan Africa—more comprehensive innovations will be required, mostly by creditor governments. Here progress is already underway, accelerated by the G-7 leaders' agreement at the 1988 Toronto Summit to move to a new system that would include some debt forgiveness. During the subsequent annual meetings of the IMF and World Bank in Berlin, further details of such arrangements were announced. Most creditor governments indicated their willingness to reduce debt service permanently, some by cutting interest rates, others by forgiving some of the principal. But a few countries, including the United States at that time, were not ready to face the budgetary cost of such permanent relief; they would agree only to long grace periods as their contribution.

These plans do not go far enough to solve the debt problems of most of the aid-receiving countries that are negotiating with the Paris Club. The proposed scale of debt-service cancellation is far too small to change the perception that the Paris Club debt meetings have no end in sight. If there is

implicit acknowledgment that the debtors' policies are inadequate to avoid future problems, the pressure for improved policies will become increasingly ineffective. The financial authorities of the worst-performing countries, aware of the underlying creditor consensus that the debt is unpayable, will rely on political intervention to obtain relief. As the associated programs it negotiates become progressively weaker, the IMF's credibility will be undermined.

Nevertheless, a beginning has been made toward creating a new framework. The discussions under way could be developed further to end with the Paris Club giving selected aid-dependent countries the opportunity to make a fresh start by reducing their obligations to levels that they can responsibly undertake to service. Only under these conditions can such countries be expected to develop the financial responsibility necessary for true independence.

To maintain these conditions, however, any new framework should cover both debt cancellation and new assistance. The prospects for debtor responsibility would be greatest if all aid provided for noncommercial reasons were on grant or near-grant terms: past loans would be forgiven and new ones avoided. This would end the widespread practice of giving assistance by means of loans that are not expected to be serviced and yet have not passed through normal expenditure-control procedures in the country providing the resources. Such expenditures through so-called "loans" have fostered corruption and inefficiency on a major scale and have destroyed incentives for debtors to try to maintain financial responsibility.

Deciding that new aid will be provided only on grant terms, with end-use control set by the resource provider, will undoubtedly provoke resistance. But for recipients with a record of nonpayment this is an essential step toward creating a responsible basis for legislative control over the commitment of official resources. Of course, problems will arise concerning credits for certain exports, such as arms sales, that in some cases might be considered ineligible for inclusion in aid budgets. But if proper control over official resources is to be achieved, there should be common assent that for any country receiving debt forgiveness, subsequent commercial sales will be made at the risk of the exporter until a record of responsible management is established.

It should be possible for a new regime to be introduced with less dependence on case-by-case acceptance of aid recipients, since it primarily involves creditor-oversight procedures. For maximum political effect, however, the initial gesture of forgiveness of a particular debtor would have to be subject to the case-by-case approach. This might be perceived as a continuation of the present approach of the Paris Club and thus perpetuate the association of the new relief with an IMF program. But the provision of aid

should not be dependent on balance-of-payments viability, so that it would more appropriately be subject to triggering signals by the Development Assistance Committee of the OECD. Unfortunately, it must be recognized that the provision of debt relief will depend on important budgetary action on the part of the debtor countries, and the Treasury officials of creditor countries will therefore wish to maintain tight control. Consequently, the decision on forgiveness is certain to stay in the Paris Club, continuing the pressure to keep the IMF involved.

To limit the pressure on the IMF to make decisions based on political considerations outside its mandate, it would be desirable to develop a compromise along the following lines. Because the aid recipients in question are virtually all participants in the IMF structural adjustment facility (SAF), most of them have a SAF arrangement. Consequently, a SAF arrangement could be retained as a necessary but not a sufficient condition for definitive debt relief. The sufficient condition should be a direct judgment by the creditors that the policy changes the debtor has effected make it ready for the new aid relationship. If creditors still want oversight by an independent agency, every effort should be made to develop that role for the World Bank. Through the experience it has gained from IDA supervision of aid programs, the World Bank could create procedures involving a judgment on the readiness of the country to cooperate in a new, longer-leash approach.

Political Issues

The proposal to make financial order the basis for the cooperative use of an IMF framework for U.S. payments financing and for the resolution of the continuing debt problems of Latin America may well founder on the perception that the framework is too strongly influenced by the United States. This problem would need to be faced openly, with negotiations to provide the necessary reassurance to other major participants.

This reassurance would have to cover a wide spectrum. The most important step would be the establishment of clear rules for the implementation of any innovations. On debt, for example, creditor willingness to move collaboratively into the risky area of debt writedowns would depend on the implementation of objective criteria precise enough to make political misuse of resources unlikely. In my view, the proposal here that an immediate return to payments viability would have to precede the granting of access to the new high-conditionality facility provides the criterion needed for noncontroversial independent judgments. However, the vaguer standards for the low-conditionality facility might be divisive. Thus, an arrangement ensuring strong safeguards over a continuing review of standards would be important.

As it would be virtually impossible to provide specific assurances on the operation of a financing role for the IMF in support of the U.S. dollar, the

role of review control will be even more closely studied. The very fact that the United States agreed to a conditional-financing role for the IMF would have to be the main innovation at the first stage. Perhaps U.S. acceptance of the IMF framework would be enough by itself to elicit appropriate U.S. action. But if IMF financing was needed, those providing the resources would have to be assured that adequate safeguards would be developed in a collegial spirit, as they were with the United Kingdom.

Thus, agreements on immediate policy innovations would certainly have to be supplemented by increased continuing control over IMF policies. Obviously, much greater voting strength would be accorded to the major new providers of resources—Japan and Germany. Their quotas should be allowed to rise dramatically, perhaps by explicitly agreeing to the principle that quotas should reflect current strength more closely, with much less weight given to past history as embodied in initial quotas. Japan and Germany could also ask for more restrictive veto rights by raising the percentage of votes needed for key decisions, but this would seriously weaken the ability of the institution to react innovatively. Preferably, they would rely on the existing veto provisions of the General Arrangements to Borrow to guard against misuse of resources regarding financing for the United States.

To assure the independence of IMF staff and management, the immediate task is to convince each of the G-3 governments—Germany, Japan, and the United States—that their interests will best be served by strengthening the institution. The path to gaining the confidence of these governments cannot be charted in advance, but it is absolutely essential for Japan to have much more involvement in future management appointments. The process by which management and staff are selected must inspire confidence that the collegial role desired by the financial authorities will be faithfully pursued.

I have laid the achievement of this new spirit particularly at the doorsteps of Japan and Germany. But the U.S. attitude is just as crucial. Without U.S. support, nothing is possible. Its support has been the basis for virtually all that has been achieved to date. Moving to a broader base will test the tolerance of the United States, particularly at a time when a restive Congress is seeking a stronger role for itself. The less the IMF is involved with permanent resource transfers like those that would occur under some proposals for funding existing debt, the more these problems will subside.

The adoption of the innovations suggested here for the IMF would be particularly constructive for the developing countries. It would permit the IMF to regain broader support from this constituency and make the collegial base once again truly worldwide. Of course, developing-country interests will not coincide with those of the industrial countries in all respects, and the developing countries would need to continue negotiations for their special needs. Once the IMF was again given a part to play in the finances of industrial

countries and if, in addition, there is an association with definitive and substantial debt relief, the governments of the developing countries would be able to return to open cooperation with the IMF. No longer would collaboration be regarded as submission to the strong.

Collegiality in the IMF would be more likely to grow as similar international economic collaboration developed in other fields. Fortunately, there are signs in the area of trade that the concept of collaboration is growing stronger. The current Uruguay Round of trade negotiation has encountered serious obstacles, but impressive early progress has been achieved on new surveillance procedures and on strengthened dispute-settlement machinery. There can be no doubt that the long-term success of trade liberalization depends on a steady increase in the responsibility given to the GATT for supervising the implementation of negotiated agreements in such inevitably more judgmental areas as nontariff barriers.

In development financing, of course, the World Bank has created a similar collegial role for development officials that has grown steadily more important. But even here the role could be expanded. Developing countries have in the past resisted systematic surveillance of the development policies of individual countries by the Bank's Executive Board. But recently, in connection with the IMF's cooperation on SAF countries, the Bank's Executive Board has conducted reviews of the development plans of all SAF countries before they receive SAF assistance from the IMF. Such surveillance could be extended to all countries borrowing from the Bank. That would go far toward strengthening the hands of the officials in developing countries who are trying to emphasize economic efficiency in development programs.

Should the World Bank get the leading debt role, as others have suggested? For market-borrowing countries, principally in Latin America, my answer is "No," primarily because of the nature of the proposals propounded here. By making immediate payments viability the key negotiating objective and arguing against a major public-financing role on existing debt, these proposals tilt the advantage toward the IMF, which has closer ties to financial authorities. Nevertheless, structural-development reforms are so important that creditor countries should make every effort to increase the World Bank's role in promoting efficient development policies and the return to growth.

Finally, the political complications likely to be introduced by USSR membership in the IMF and the World Bank should not pass unnoticed. Although the USSR has not yet made a formal approach to join the IMF, the reform process underway must be expected to proceed toward that end. If an approach is made, eventually it will succeed. There can be no response but welcome for the last major outside power when it wants to enter into the closer association implied by joining the IMF and World Bank.

It would be essential, however, that the consequences of USSR entry be

thoroughly reviewed and understandings reached before membership became effective. The importance of the independence of the IMF staff and the requirement that the USSR provide complete and accurate data would have to be discussed in depth and the issues fully resolved if the agency is to remain independent and well-informed. The problems to be surmounted on these matters, as well as on the size of a USSR quota, are great, and it may well take several years to instill confidence that solutions have been found. A reform along the lines suggested here, identifying and limiting the technical role of the IMF, would undoubtedly facilitate the completion of these negotiations. The more precisely the temporary character of the financing role is specified, the less likely are problems to arise with the USSR and its associates.

4 Conclusions

The world was launched on a new path of international monetary cooperation when the IMF Articles of Agreement were adopted at Bretton Woods in 1944. The record has demonstrated conclusively that such cooperation can pay major dividends, although not in precisely predictable ways. The principal value of cooperation has proved to be the framework it provides for finding solutions to problems that require the mobilization of broad-ranging financial support.

More recently, the cooperative elements have been strained as IMF financing has come to be focused exclusively on developing countries. There is a continuing underlying agreement in these countries with the goals promoted by the IMF. But they are afraid of being increasingly dictated to by an IMF dominated by the debt and aid strategy of the industrial countries. As standards based on payments viability have become less precise, political factors have inevitably grown more important. The narrowing focus of the IMF's financial assistance and the IMF's declining ability to maintain order even in the servicing of its own loans have steadily undermined the original intention to make the IMF a central monetary institution dealing with the problems of the major countries.

Those problems are now being negotiated in a G-7 context, with virtually no substantive role for any international institution. The G-7 meetings have produced more orderly foreign-exchange markets, but they have been largely ineffective on the key problem of the U.S. payments deficit. More attention will have to be given to the means of financing this deficit. The creation of a new financing institution has been suggested. Those considering various financing proposals should quickly see the importance of conserving the IMF's financing strength as the most practical way to proceed. Although it may take time to reach agreement on the IMF's precise role vis-à-vis the

major countries, recognition of the IMF's value should not be delayed for long. If present trends continue, it will become very difficult for the IMF to play a negotiating role in the financing of any industrial country with any pretense that it is guided by uniform rules of treatment or the assurance of an early payments recovery.

A new debt strategy must also be developed. I have argued here that such a strategy should involve selective debt writedowns for certain countries that borrow in the market. The very difficult task of controlling access to such relief would be managed by providing it only to those countries clearly in chronic difficulty, and only when their economic policies promised future payments viability according to rigorous IMF economic criteria. For countries receiving aid, donors should develop a new setting that forgives much past debt and exercises responsible control over new assistance given primarily in the form of grants. The participation of the IMF should be very limited so as not to endanger its central monetary role. Through IDA, the World Bank could assume a growing role with specific microeconomic objectives. If donors wished to build on this experience, the World Bank could be asked to take on the task of controlling the entry of aid recipients to the new program.

Whether world leaders will support a reformed IMF in a central monetary role will depend on their preferences between global integration and regional leadership. Exchange-rate problems among major powers have propelled them into global understandings but have so far not forced them to assign a significant role to the IMF. Nevertheless, recognition is growing once again on a broad front that global agreements are essential and that institutions with some delegated powers are useful. If the IMF can be accorded a substantive role among major countries in providing U.S. financing, there is a real prospect that international cooperation can facilitate a new era of rapid economic growth matching the achievement under U.S. hegemony after World War II.

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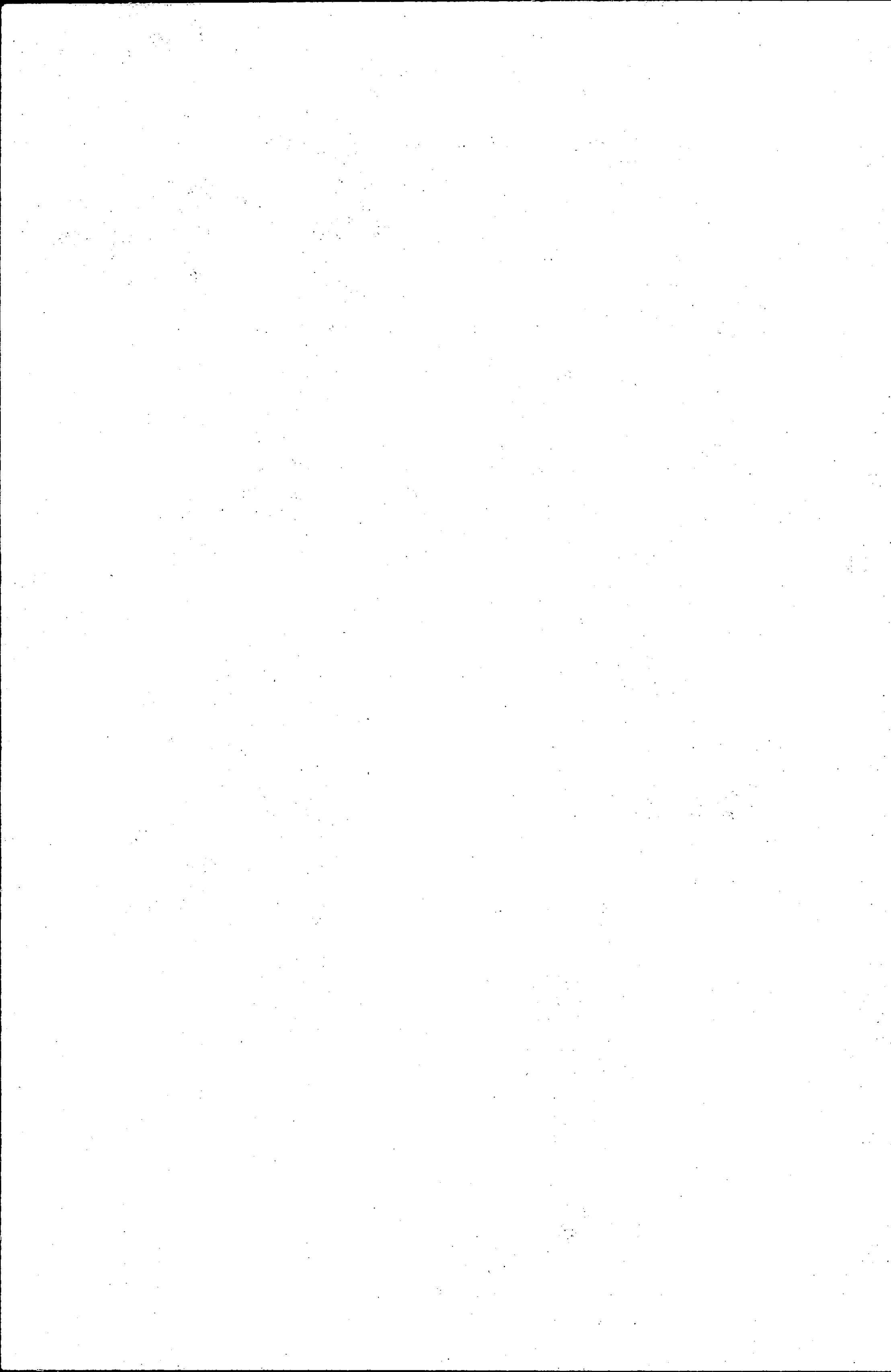

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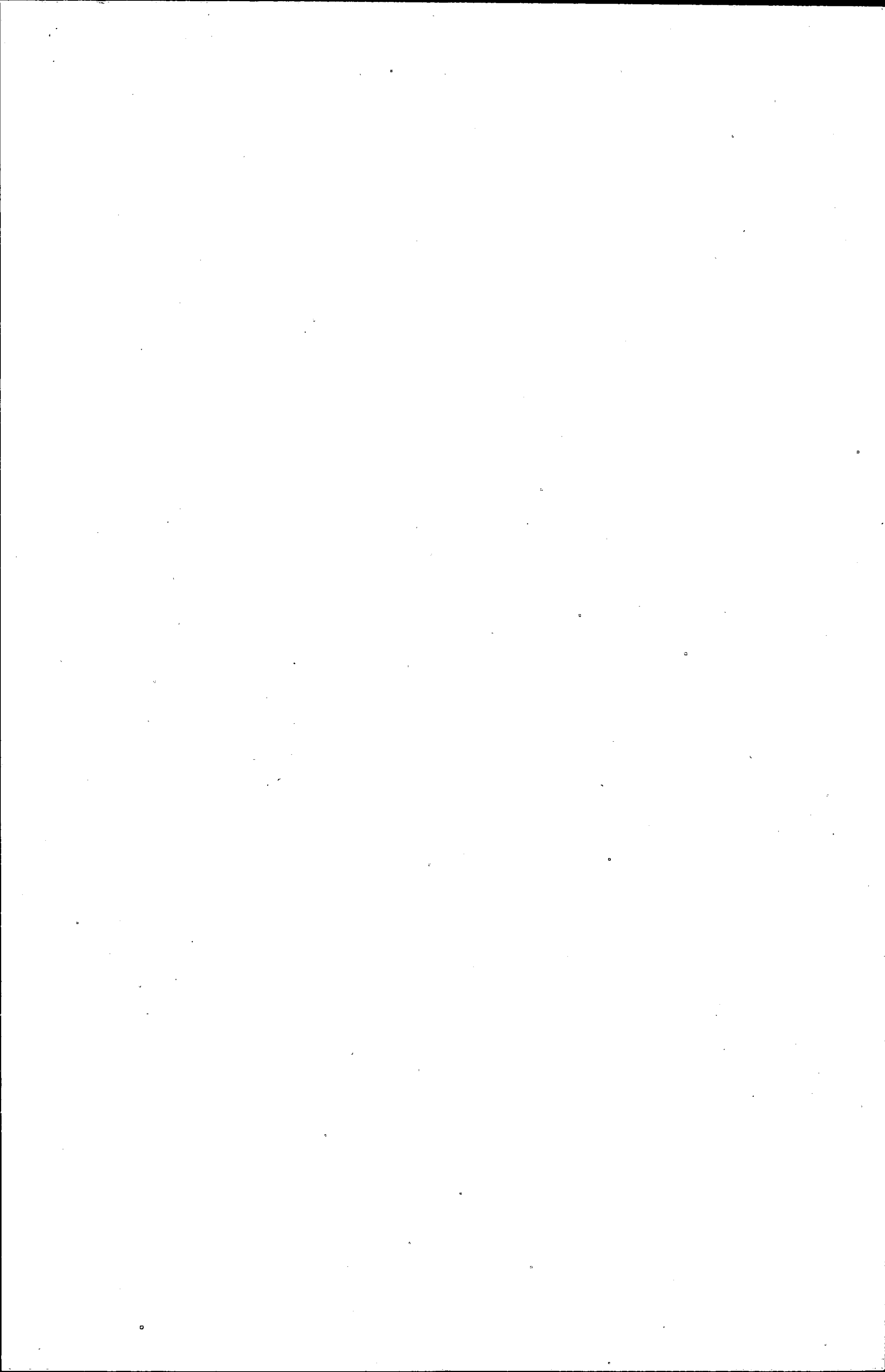

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