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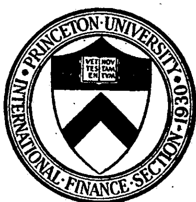
THE INTERNATIONAL MONETARY FUND: REFORM WITHOUT RECONSTRUCTION?

ALEXANDRE KAFKA



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The International Monetary Fund: Reform without Reconstruction?

The attempt at wholesale reform of the international monetary system, which started formally in September 1972, has come to at least a provisional close with the adoption by the Board of Governors of the International Monetary Fund (IMF) of the Second Amendment to the Articles of Agreement, based on the accord hammered out at Jamaica by the Fund's Interim Committee. In this essay I examine the significance of the reform exercise and the reasons for its apparent failure, and reflect on the further development of the system.

An earlier limited reform embodied in the First Amendment of the IMF's Articles of Agreement, ratified in 1969, was designed to supplement monetary gold stocks by the Special Drawing Right (SDR). The underlying purpose was to achieve at least a measure of international control over the growth of international liquidity. The creation of a new primary reserve asset issued by the IMF was expected to reduce the need for further accumulations of reserve-currency holdings, particularly U.S. dollars. The reduced need for dollars was also expected to improve the balance-of-payments adjustment process by reducing the need for, and therefore the ability of, the ultimate reserve center, the United States, to run deficits. These expectations were not realized. The United States continued to run large balance-of-payments deficits, and these led to the suspension of dollar convertibility into gold. This development reinforced the conviction, which the international financial community had increasingly felt for other reasons as well, that the existing international monetary system was contributing to the difficulties of balance-of-payments adjustment. Hence the decision to attempt wholesale reform.

While the origin of the reform exercise was dissatisfaction with the adjustment process, and in particular with the exchange-rate regime, the exercise was also concerned with convertibility and the settle-

For helpful suggestions I am indebted to Gottfried Haberler and numerous friends and colleagues at the IMF, in particular Eimar Avillez, David S. Cutler, Joseph Gold (who suggested the title of this essay), J. J. Polak, Ernest Sturc, and Winston Temple-Seminario. My friends and colleagues on the bureau of the Committee of Twenty, and particularly Edward George and Robert Solomon, also helped me greatly.

ment of imbalances and, once again, with international liquidity. Moreover, since a well-functioning international monetary system is not an end in itself, other matters were taken up at the same time. It was agreed in principle that the reformed system should promote the transfer of real resources to the less developed countries and that parallel improvements should be made in the trade regime. These were mainly, but not wholly, to be left to the "Tokyo Round" of GATT negotiations.

Before the reform exercise started, the IMF had prepared two reports on the subject. The 1970 report was concerned solely with the exchange-rate regime. It endorsed the use of par values and rejected outright prolonged floating, substantially wider margins around par values, and the "crawling peg." It mentioned but stopped short of endorsing three methods of improving the existing par-value regime: prompt(er) adjustment of par values, slightly wider margins, and temporary floating. The second report, published in 1972, discussed not only the exchange-rate regime but also convertibility and the settlement of imbalances, the problem of the coexistence of several assets in countries' reserve holdings, special problems posed by disequilibrating capital movements, and the relationship between international monetary reform and the developing countries. This report also endorsed the par-value system and, like its predecessor, made no definite recommendations for its improvement. There could be discerned, however, a slightly more positive attitude toward temporary floating and toward the special needs of the United States to acquire greater freedom effectively to change its exchange rate. Furthermore, two new ideas were mentioned: reform of the existing convertibility system through adoption of asset settlement, i.e., the view that all countries, including the United States, should be required to settle their balance-of-payments deficits in reserve assets, and the idea of a substitution account through which the IMF could issue SDRs to replace reserve currencies or gold held in members' reserves.

To draft the reformed Articles of Agreement, the Fund, on the recommendation of the 1972 report, established the Committee of Twenty, which in June 1974 ended its work with the presentation of an *Outline of Reform*. The first part of the *Outline* reflected the Committee's general view on the shape of the future international monetary system; there were numerous unresolved issues and this part, formulated by the Committee's "Bureau," was not endorsed in detail by the Committee. The second part of the *Outline* contained recommendations for immediate action that were endorsed by the

Committee. Adopting one of these recommendations, the Fund established an Interim Committee to advise the Board of Governors, *inter alia*, on monetary reform. What is the nature of the partial reform that has just been approved?

The Nature of the Partial Reform

Adjustment. The partial reform (the Second Amendment to the IMF's Articles of Agreement) legalizes the present exchange-rate regime in all its bewildering variety. This may be its chief contribution to the improvement of the international monetary system. For various reasons, but aptly, the proposed amendment finds no more precise way of describing the exchange-rate regime than "the one in force at January 1, 1976." However, the exchange-rate regime is by no means the only aspect of the monetary system that may affect the proper functioning of the adjustment process (except perhaps under completely freely floating rates that are not influenced by intervention or any other means—a regime that emphatically does not exist today).

The underlying problem is not just mechanical; it is the lack of sufficiently strong incentives to adjust, particularly to eliminate a surplus or, in the case of an ultimate reserve center, to eliminate a deficit. It is obviously desirable that countries in surplus and a reserve center in deficit should share in the political burden of initiating adjustment (all must share in the economic burden of the process once it is under way); otherwise, the start of the process is likely to be delayed. And the problem persists because the present regime is not one of completely free floating but of more or less intervention, not to speak of other forms of interference.

In principle, it appears easy to subject an ultimate reserve center to a strong incentive to adjust when it is in deficit, even when other countries are prepared to accumulate its currency despite the absence of any legal obligation to do so. It is necessary only to eliminate or reduce through reform of the settlement system other countries' freedom to accept the reserve center's currency liabilities, thereby forcing it to meet its deficits by drawing down its assets. Yet the partial reform does not deal with the matter. Nothing different could have been expected for the time being, in the absence, under present conditions, of defined obligations to intervene except to avoid disorderly markets. But nothing is foreseen specifically, either, if and when there is agreement on intervention with greater scope than at present. Thus, the dollar remains as firmly established as it has been

since the end of convertibility into gold as the world's main, or even for practical purposes sole, reserve asset.

There are, to be sure, even in the absence of a reformed settlement system, incentives for an ultimate reserve center to attempt to adjust, in particular the effects on its international competitiveness and employment if its balance of payments remains in disequilibrium for too long. But for a reserve center willing to continue to finance its deficits rather than adjust them, there is nothing like the compelling force of a reserve loss and of increasing difficulties in ordinary borrowing from the market, through central-bank swaps, or from the Fund. The reform of the settlement system would make less difference for the United States, the world's major economy, than for an ultimate reserve center in a different situation. But for any ultimate reserve center one can hardly doubt that the monetary-reserve function of its currency enables it to borrow more on any given terms than another similarly situated country whose currency is not held in reserves, at least in the absence of a perfect capital market.

To provide an incentive for countries in surplus to adjust is even more difficult in principle than to do so for reserve centers in deficit. There are, to be sure, disagreeable consequences of delaying adjustment even for countries in surplus, in particular inflation, but they are insufficiently brutal. The existing Articles of Agreement contain a specific sanction against countries persistently in surplus, the so-called "scarce-currency clause," and there are other sanctions that could be used against them (as against countries in deficit), for instance, the publication of a report that could unleash the forces of speculation against a recalcitrant sinner. None of these instruments has ever been applied. It is hard to apply any sanction against a country in a strong international position, and the difficulty increases with the extent to which the sanction is discretionary.

It was for this reason that the Committee of Twenty set out not only to establish additional sanctions (politely called "pressures") but to invent a new type of incentive to adjust that was expected to be particularly useful in its application to countries in surplus (although it would apply also to countries in deficit). Neither the additional sanctions nor the new incentives have been incorporated in the present partial reform, and at times there may be no way to persuade countries in surplus to allow adjustment to be initiated by refraining from intervention before they themselves deem it necessary to do so.

There was, first, a proposal to establish "objective indicators," the movement of which could subject a country to an obligation to take adjustment action. Since the obligation would be created not by dis-

cretionary assessment but by measurable facts, by whose verdict each member of the Fund would have agreed to abide, the idea was that the movement of objective indicators would establish a strong political argument for countries to fulfill their adjustment obligations even in the absence of sanctions. But it would also be easier to impose sanctions if they were called forth by measurable facts. Yet none of the various suggested indicators, including changes in the levels or flows of a country's reserves, commended itself to the Committee sufficiently to justify even the creation of a rebuttable presumption that adjustment was required—still less an automatic obligation, which nobody had suggested in so many words. The advantage of reserve indicators would have been particularly great if they had been reliable and effective, for they would automatically have prevented a surplus country from delaying its part in initiating adjustment action until it had reached what it regarded unilaterally as the limit of its holdings of reserve currencies.

Under these circumstances, the Committee of Twenty was led to suggest that the movement of indicators might trigger an *examination* of the balance of payments of a country. The IMF already examines its members annually (in principle). In addition, two or three times a year it analyzes the world economic outlook and, in this context, the balance-of-payments behavior of the countries that contribute most importantly to that outlook. Something was lost, however, by failing to adopt the Committee's suggestion that a statutory system of examinations be triggered by objective indicators. Such a system could still be established by decision rather than formal amendment of the IMF's Articles of Agreement, but it would not have the same force. Something was also lost at least marginally because the partial reform made no provision to apply to countries in surplus the additional pressures that were mentioned by the Committee. These included charges—or a tax—to be imposed automatically on reserve accumulations above a certain level, and the requirement that reserves above a specified level be deposited in the Fund at a zero interest rate.

In sum, the main defect of the partial reform in respect of the adjustment process in general is that it does absolutely nothing to create additional incentives for prompt adjustment action by reserve centers in deficit or by countries in surplus, however slender the chance of doing anything effective about the latter. No one can realistically maintain that the various general obligations (e.g., to promote stable underlying conditions) inscribed in the partial reform are a substitute even for minimal incentives. In connection with the possible reestablishment of a par-value system, the partial reform does explicitly

require provisions for prompt and adequate adjustment action by countries in deficit and by those in surplus, but these provisions are not defined. And, under more or less managed floating, additional incentives toward adjustment are also desirable, and they are not provided in statutory form.

What about the mechanics of adjustment? The compromise solution on the exchange-rate regime endorsed at Jamaica—the ratification of what exists and, in addition, rules to make possible without a new amendment the adoption of any other kind of regime—seems to be the only realistic one. By the time the reform exercise began, the original par-value system had been changed drastically. Most industrial countries did not declare new par values after the period of floating started in 1971 by the U.S. suspension of convertibility into gold; rather, they declared central rates, i.e., rates they intended to defend in the exchange markets but without any commitment even to their medium-term stability. In addition, countries not involved in the European "snake" enlarged the amount of fluctuation they would tolerate around the established values (whether par values or central rates); margins were set at 2.25 per cent in terms of the intervention currency, as contrasted with the previous maximum margins of 1 per cent and the effective margins of 0.75 per cent that had prevailed for some major members before the U.S. suspension of convertibility. Finally, at the time of the start of the reform exercise, one major currency, sterling, was floating again, and within six months, after a second devaluation of the U.S. dollar, all major currencies were again afloat.

What is surprising is that it took three years to reach a not very sensational agreement on the exchange-rate regime, apart from the merely semantic accord quickly achieved in 1973 (on the basis of an expression used in the 1970 report) that the future system should be based on "stable but adjustable" par values, with floating allowed "in particular situations."

Notwithstanding the ratification of the present exchange-rate regime, the partial reform provides that a par-value system may be reestablished by an extremely high majority of total voting power in the IMF (85 per cent, which gives the United States in isolation a veto), if the IMF finds that conditions are favorable, with special reference to the underlying stability of the world economy, provision of liquidity and arrangements for prompt and symmetrical adjustment both by countries in surplus and by countries in deficit, and arrangements for intervention and the treatment of imbalances. Even then, however, no country will be forced to adopt a par value, and any country may

abandon it once it has accepted it unless a similar major majority objects. A new par-value system would differ from the old in two aspects: its "normal" margins would be 4.5 per cent, and they would be flexible. (Also, the denominator or numeraire would not be gold or currencies and, to avoid confusion, may not be called SDR.) The Fund is also called upon explicitly to discourage unrealistic par values. It has always tried to do so, but the previous statutory emphasis was exclusively on discouraging competitive depreciations. All countries will be obliged to cooperate to maintain orderly exchange arrangements and to promote adjustment.

Other exchange-rate regimes that are neither the present one nor the par-value system may be established by an 85 per cent majority, but no country can be required to adopt such a regime. The power to establish other exchange-rate regimes may prove to be the most useful provision. It may make possible a temporary generalized "central-rate system" without (or with very wide) margins, which may be a more orderly substitute for the present system of discretionary managed floating (and, if a return to par values were possible, might be an essential starting point). Thus, a system of "viscous" rather than rigid or highly flexible rates might gradually come into being, as suggested at one point by President Giscard d'Estaing.

The compromise also contains a call upon the Fund to practice not just surveillance but "firm" surveillance over countries' exchange policies and for this purpose to establish "principles." Such principles, or guidelines, are obviously essential to prevent abuse under the present multifaceted regime, just as under a par-value regime—which differs from managed floating only in degree—the Fund has and must have the power to object to par-value changes and, ideally, to the maintenance of par values that have become disequilibrating.

Guidelines for floating currencies (as distinguished from principles that will apply to other regimes as well) were first established by the Fund in 1974. Most of these guidelines deal with intervention. First, there is the expectation that a country will intervene to moderate sharp, short-term fluctuations (day-to-day and week-to-week). Also, a country need not refrain from intervening to moderate slightly longer-term movements (month-to-month and quarter-to-quarter). It should, however, avoid moving the exchange rate away from what might appear to be a medium-term equilibrium level. Countries are encouraged to undertake intervention only to offset temporary factors, and even then they should not intervene "aggressively," i.e., push a currency to fall or rise more rapidly, even toward an appropriate medium-term level. But if a country has agreed with the Fund on

a target rate or zone for its exchange rate, "aggressive" intervention in that direction is considered appropriate. The Fund, moreover, is given the right to encourage a country, overriding any other rules, to assist in moving its exchange rate toward a reasonable medium-term level. What it cannot do is what was done under the par-value system—to ask or require a country to hold any particular rate against strong market pressure. Members are also encouraged to discuss with the Fund desirable reserve targets—a remnant of the idea of a reserve indicator—and interventions would be tailored to these targets when the Fund encouraged such countries to intervene. Another guideline requires countries intervening to bear in mind the interests of other members, in particular those of the issuers of the currencies with respect to which they intervene and which they use for intervention.

The *Outline of Reform* had suggested additional guidelines dealing with the choice of intervention currency and with settlement involving a country that has a floating currency and an effective choice of intervention currencies. One of these additional guidelines suggested that such a country should buy the weakest currency and sell the strongest. A second additional guideline suggested that other countries should not intervene in a floating currency without the agreement of the issuer (except for minor transactions). In other words, third countries should not through their intervention frustrate the intentions of a country with a floating currency, and the logical conclusion is that under widespread floating no intervention should take place without the consent of all countries concerned, including the issuer of the intervention currency.

It is possible that the "principles" may become both more comprehensive and more efficacious than the present guidelines, since, under the partial reform, the IMF is given explicit power to make them mandatory; the guidelines, by contrast, are only hortatory. The Rambouillet agreement provides for a system of regular consultations between a limited group of countries, including consultations on exchange rates; it would appear, however, that this agreement does not (yet?) provide for guidelines for intervention, nor indeed clearly mandate intervention except for the prevention of "disorderly" markets.

In addition to the guidelines mentioned so far, which deal with intervention, there is also a guideline adopted in 1974 which deals with restrictions: countries with floating rates should avoid restrictions on all *current*-account transactions. This goes beyond the Fund's prohibition of current-account *payments* restriction, but it is hortatory, not

mandatory. The Fund may, in future, adopt a mandatory "principle" of a similar kind (in view of the difficulties encountered by the GATT in policing its own limitations on trade restrictions). The IMF extracted a promise to refrain from aggravating trade restrictions from members drawing under the Oil Facility (mentioned below) and has attempted to extract it also from others drawing on its resources. No action has been taken on the suggestion in the *Outline of Reform* that controls over *capital* transactions should not be used to maintain inappropriate exchange rates or to avoid appropriate adjustment action, and that controls, when they are used, should be administered without excessive complexity. While the effectiveness of the suggestion in the *Outline* is doubtful, the present situation leaves countries entirely free to impose capital controls for any purpose. Such controls were the answer of the original Bretton Woods Agreement to the danger that disequilibrating capital flows might pose to the par-value system. But it has proven difficult to make such controls effective or, to put the point differently, controls effective for this purpose would have to cover all exchange transactions and trade and would therefore be intolerable. Hence, it is not surprising that the partial reform eschews the *Outline's* somewhat meaningless references to measures countries might take to avoid or moderate disequilibrating capital flows.

Convertibility and the settlement of imbalances. The partial reform retains freedom of current payments and transfers from payments restrictions (Art. VIII, Sec. 2), except those authorized by the IMF. This provision affects private economic agents vis-à-vis their governments, establishing what is called "exchange-market convertibility." It also protects the official holder of another member's currency, for at least in principle he can sell those holdings for current transactions either directly in the markets for third currencies or to the residents of his own country, who can in turn convert them in the market into any other currency. Until August 1971, the United States stood ready to sell gold to and buy it from official holders, but this kind of convertibility is not necessary to maintain exchange-market convertibility. Insofar as use is made of it, it serves two quite different functions. First, it gives official holders of currencies a means of acquiring a primary reserve asset. Second, within the limits noted earlier, it may be a means of disciplining the United States as the ultimate reserve center. To discipline other countries that are not ultimate reserve centers, it is not necessary that official holders of their currencies be able to buy from them a primary reserve asset; the purchase of any reserve asset is sufficient.