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# FROM RAMBOUILLET TO VERSAILLES: A SYMPOSIUM

C. FRED BERGSTEN, RUDIGER DORNBUSCH, JACOB A. FRENKEL,
STEVEN W. KOHLHAGEN, LUIGI SPAVENTA, AND
THOMAS D. WILLETT

INTERNATIONAL FINANCE SECTION
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PRINCETON UNIVERSITY
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*This Essay is a collection of six brief papers commenting on the Versailles Communiqué. The authors are introduced in the Foreword, which describes the origin of the Essay.*

PETER B. KENEN, *Director*
*International Finance Section*

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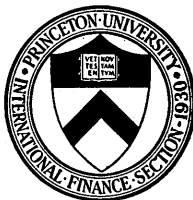


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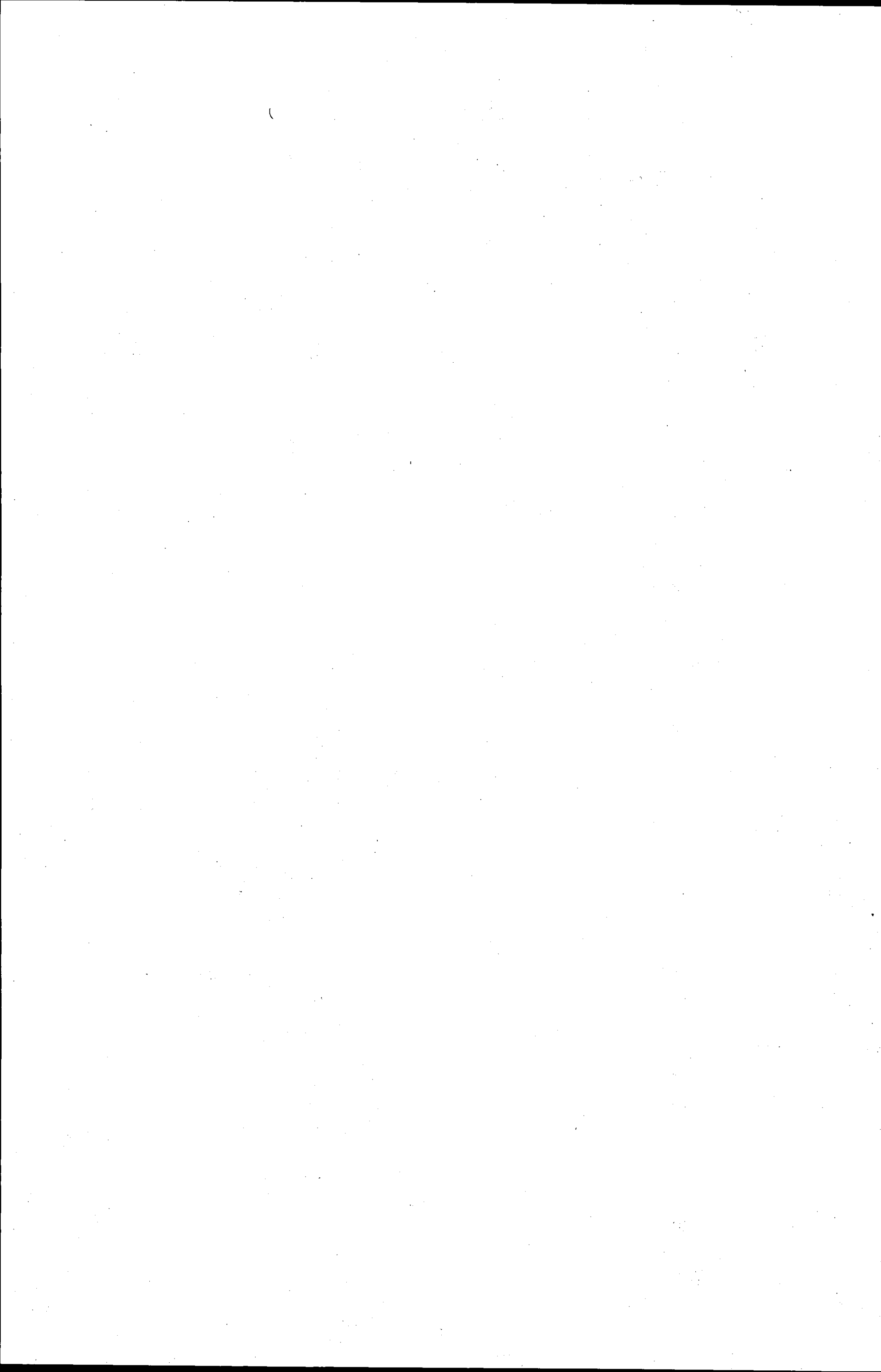

## FOREWORD

On June 4, 1982, the leaders of the seven large industrial democracies, Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States, met at the Château de Versailles to review economic problems and policies. This was the eighth annual economic summit and was the start of a second cycle. The first meeting was held at Rambouillet, not far from Versailles, in 1975, and was perhaps the most successful; it produced the compromise between U.S. and French views that led to the Jamaica Agreement on revision of the Articles of Agreement of the International Monetary Fund. Subsequent meetings were held in Puerto Rico (1976), London (1977), Bonn (1978), Tokyo (1979), Venice (1980), and Ottawa (1981).

After the Jamaica Agreement of 1976, I asked a number of economists to write brief assessments of it. Eight of them accepted my invitation, and their papers were published in *Reflections on Jamaica* (Essays in International Finance No. 115, April 1976). Because the Versailles summit dealt with the same basic monetary issues and was seen by some participants and observers as starting new discussions on the long-term evolution of the monetary system, I decided to assemble another symposium. Shortly after the Versailles summit, I invited twelve economists to write brief papers commenting on the Communiqué, with particular attention to those parts dealing with monetary and macroeconomic issues. Although I asked them to meet a difficult deadline, nine of them agreed to participate. Unfortunately, two had to withdraw because of events in their own countries that made new demands upon them, and one has not been heard from. Therefore, this symposium is a bit slimmer than its predecessor (and is a bit tardier than I had hoped). The six contributions, however, touch on a wide range of issues and come at them from different points of view. The contributors, whose papers appear in alphabetical order, are:

C. Fred Bergsten, Director of the Institute for International Economics, who was Assistant for International Economic Affairs to the National Security Council from 1969 to 1971 and Assistant Secretary of the Treasury from 1977 to 1981. He has been a senior fellow at The Brookings Institution, the Carnegie Endowment for International Peace, and the Council on Foreign Relations, and is the author of several books, including *The Dilemmas of the Dollar: The Economics and Politics of U.S. International Monetary Policy*.

Rudiger Dornbusch, Professor of Economics at the Massachusetts Institute of Technology, who is a research associate of the National Bureau of Economic Research and a senior fellow of the Center for European Policy

Studies. He is the author of *Open Economy Macroeconomics* and of many articles, including the outstanding survey, "Exchange Rate Economics: Where Do We Stand?" in the tenth anniversary issue of the *Brookings Papers on Economic Activity*; he is the coauthor with Stanley Fischer of *Macroeconomics* and *Economics*.

Jacob A. Frenkel, David Rockefeller Professor of International Economics at the University of Chicago, who is a research associate of the National Bureau of Economic Research and an editor of the *Journal of Political Economy*. He has been a consultant to the Bank of Israel, the International Monetary Fund, and the World Bank. He has written extensively on international monetary economics and was the coeditor with Harry G. Johnson of *The Monetary Approach to the Balance of Payments* and *The Economics of Exchange Rates*.

Steven W. Kohlhagen, Associate Professor of International Business and Economic Analysis and Policy in the Schools of Business Administration at the University of California, Berkeley, who was Senior Staff Economist for International Trade at the Council of Economic Advisors in 1978-1979 and has been a consultant to the U.S. Treasury, the Federal Reserve System, the OECD, and several multinational corporations. He is the author of *The Behavior of Foreign Exchange Markets: A Critical Survey of the Empirical Literature*.

Luigi Spaventa, Professor of Economics in the Faculty of Statistics at the University of Rome, who is a Member of the Italian Chamber of Deputies and of its Finance and Treasury Committee. He was visiting fellow at All Souls College, Oxford, in 1968-1969 and Advisor to the Italian Minister of the Budget from 1971 to 1974. His recent publications include papers on the European Monetary System and macroeconomics in the OECD countries.

Thomas D. Willett, Horton Professor of Economics at the Claremont Graduate School and Claremont McKenna College, who was Deputy Assistant Secretary of the Treasury for International Research and Planning from 1972 to 1977. A research associate of the Keck Institute for International Strategic Studies, he is the author of *Floating Exchange Rates and International Monetary Reform* and the coauthor with Edward Tower of *The Theory of Optimum Currency Areas and Exchange-Rate Flexibility*.

I have added a brief comment of my own and appended the Versailles Communiqué, consisting of the Declaration on broad policy issues and the Statement of International Monetary Undertakings.

PETER B. KENEN

## C. FRED BERGSTEN

The world economy in the second half of 1982 is severely threatened on four interrelated fronts. First, economic growth is virtually nil in all major countries. Unemployment and bankruptcies are at record postwar levels and rising. There is very little sign of recovery anywhere.

Second, world trade is declining in real terms for the first time in the postwar period. When the OECD countries grow at less than 1 to 1.5 per cent annually, OECD imports decline at a rate roughly three times the shortfall.[1] This in turn pushes economic activity down further, creating a negative spiral between economic stagnation (or recession) and falling trade. Protectionist pressures threaten to accelerate the cycle and are themselves fostered by the absence of economic growth.

Third, massive currency misalignments are distorting international trade and capital movements. The dollar is overvalued by at least 20 per cent, on average, and the yen is undervalued to an even greater extent in relation to the underlying competitive positions of the major national economies. These imbalances are as great as those in the final, breakdown stage of the Bretton Woods system of fixed exchange rates.[2] They add significantly to national growth problems, both in countries with overvalued currencies (which suffer competitive losses) and countries with undervalued currencies (which are driven to adopt restrictive monetary policies); they intensify protectionist pressures; and they set the stage for a renewed round of severe international monetary instability.

Fourth, an immense debt burden overhangs the world economy. A large number of countries, including several major debtors, are seriously in arrears on their payments of both principal and interest. There is substantial risk that some private banks may cut and run, triggering the very moratoria they desperately wish to avoid. It is unclear whether all major debtors will be willing and able to come up with stabilization programs adequate to restore even a minimum of lender confidence.

All of these issues raise important systemic questions as well as immediate problems of crisis management (or avoidance). How is macroeconomic coordination to be achieved among at least the major countries? How can the GATT system respond to the severe pressures to restrict trade and reverse the liberalization of the postwar period? How can the monetary system prevent, at a minimum, such extreme exchange-rate misalign-

[1] C. Fred Bergsten and William R. Cline, *Trade Policy in the 1980s*, Washington, Institute for International Economics, November 1982, pp. 14-15.

[2] C. Fred Bergsten, "What to Do about the U.S.–Japan Economic Conflict," *Foreign Affairs* (Summer 1982), pp. 1059-1075.

ments? How can the national and international regimes that provide the framework for foreign lending cope with the massive level of current debt and prevent the recurrence of debt problems in the future?

The major countries thus had a full agenda for Versailles, and for the subsequent meeting of Governors of the International Monetary Fund and World Bank in Toronto in early September. They failed almost totally to respond to any of the central problems, let alone to the overall impact of those problems on the world economy or their systemic implications. The world has come to expect little from such conclaves but, in light of the gravity of the issues, Versailles and Toronto must have set new records for failing to discharge effectively the responsibilities supposedly exercised by the major countries.

Indeed, the failure of those nations to act makes a mockery of the words adopted in the Versailles Declaration and Statement of International Monetary Undertakings. Numerous examples can be cited.

On the issue of the IMF and world debt, the summiteers agreed to "give [the Fund] our full support in its effort to foster stability." But neither they nor the Governors at Toronto were able to agree on a quota increase for the Fund or on a bridging arrangement to supplement its resources in the short run. Yet the threatened shortage of Fund resources could prevent the Fund from helping to avoid a collapse of the debt situation.

The Fund's "seal of approval" for new stabilization programs is essential to restore the confidence of private lenders in the outlook for individual debtor countries. Moreover, the Fund needs an unquestioned ability to help such countries if market confidence is to be maintained in the overall process that seeks to avoid debt moratoria or defaults. On present trends, however, current Fund resources will probably be exhausted in 1983. Augmentation of those resources is thus critically important to avoid the risk of severely disrupting the international credit process.

Agreement should have been reached at Toronto to increase Fund quotas from the current level of SDR 60 billion to at least SDR 100 billion. In addition, agreement in principle should have been reached to provide bridging loans of SDR 20 to 25 billion, perhaps along the lines of the Witteveen Facility in 1978. Finally, the terms of Fund programs need to take full cognizance of the difficulties forced on debtor countries by the dismal world economic situation.[3] But the Ministers agreed only to try to reach agreement on quotas by April 1983 and to study possible backstopping arrangements. Where was the "full support" pledged at Versailles?

On the issue of exchange rates, the summiteers made three pledges: to "strengthen our cooperation with the IMF in its work of surveillance," to

[3] See John Williamson, *The Lending Policies of the International Monetary Fund*, Washington, Institute for International Economics, August 1982.

"rule out the use of our exchange rates to gain unfair competitive advantages," and to "use intervention in exchange markets to counter disorderly conditions." Though it was not mentioned explicitly in the Statement of International Monetary Undertakings, they set up a new committee (of the Big Five) to "intensify" the surveillance process, and they established a new study group to assess retrospectively the influence of intervention on exchange rates and to consider how intervention might be used in the future.

As noted, the major exchange-rate relationships—dollar/yen, dollar/DM, sterling/DM—are now severely misaligned. As of early November 1982, however, no actions had been taken to deal with the problem under any of the three "commitments" made at Versailles:

—There was no evidence that the IMF had made any new efforts to restore equilibrium rates, and nothing of that sort emerged from the initial meeting of the new surveillance group in Toronto.

—None of the big countries was deliberately "using" its exchange rate to gain competitive advantages, but neither were any of the weak-currency countries doing anything to reverse their undervaluations.

—Countries whose currencies remained under pressure continued to intervene, but the United States stood almost wholly aloof from the exchange markets, adding substantially to the disorderly character of the entire international monetary system.

The United States did take two steps, however, that should help to reduce the currency misalignments. During the summer and again in the early fall of 1982, U.S. interest rates fell sharply. Also during the summer, Congress passed legislation raising taxes by about $100 billion over the coming three years. By moderating somewhat the looseness of U.S. fiscal policy, this step improves the policy mix and thus presumably contributed to the easing of interest rates. Nevertheless, there was no easing of dollar exchange rates, and the Toronto meetings were silent regarding the need for further action.

To be sure, the solution to these international monetary problems lies well beyond what could have been expected to emerge full-blown from Versailles or Toronto. It is now clear that the current system of nationally managed flexible exchange rates permits, or even fosters, substantial and persistent overshooting of equilibrium levels. The goal should thus be to devise new measures to limit the degree of overshooting, perhaps by adopting a target-zone system. Such a system would provide guideposts for limiting the amplitude of fluctuations and trigger remedial steps by the affected countries (including, but certainly not limited to, intervention).

Again, however, the absence of action is striking. No official effort to reassess the effectiveness of current exchange-rate arrangements has been launched or, seemingly, even seriously discussed. The study group on in-

tervention that was created at Versailles could logically address this central issue. At a minimum, that group should note that the current Fund guidelines governing intervention are at best incomplete and at worst perverse: by emphasizing "leaning against the wind," they attach priority to the *volatility* of exchange rates rather than their *misalignment*. Hence they can even retard a movement toward equilibrium by calling for intervention to slow the pace of *any* currency swing. More broadly, the study group should focus on the huge disequilibria that have developed over the past two years and at least begin the process of rectifying the system that has permitted them to occur. Unfortunately, there is no evidence that it intends to do so.

The Versailles Statement expresses a determination "to see that greater monetary stability and freer flows of trade and capital reinforce one another in the interest of economic growth and employment." Unfortunately, the opposite is occurring, and neither the summiteers nor the relevant international organizations have yet done anything about it.

Indeed, the extreme degree of exchange-rate misalignment is undermining the free flow of trade. Throughout the postwar period, dollar overvaluation has probably been the most accurate leading indicator of the emergence of protectionist pressures in the United States. Such pressures appeared in the late 1960s and early 1970s, during the last years of the Bretton Woods system, in spite of low levels of unemployment; they appeared again around 1976-77; and they are most severe at present. It is clear that dollar overvaluation is *a* central cause, perhaps *the* central cause, of the sharp rise in import penetration affecting the steel and automobile industries in the United States, among other sectors.

It is thus essential to correct the overvaluation of the dollar to avoid a major protectionist outbreak in the United States, particularly toward Japan. Since U.S. trade policy tends to be decisive for world trade policy, a correction of the monetary misalignments is likewise central to the outlook for the world trading system.[4]

Some capital flows are also undermining the prospects for maintaining an open trading system, via their effects on these exchange-rate relationships. Indeed, it is the massive net capital outflow from Japan that is depressing the value of the yen so substantially. Part of this overflow has been caused by the sizable interest-rate differentials between Japan and the rest of the world, but the flow did not decline much when U.S. and European interest rates fell sharply in late 1982.

The phenomenon must also derive to a considerable extent from the belated liberalization of the Japanese capital market late in 1980. This gave

[4] For details, see C. Fred Bergsten and John Williamson, "Exchange Rates and Trade Policy," in William R. Cline, ed., *Trade Policy in the 1980s*, Washington, Institute for International Economics, forthcoming.

high-saving, wealthy Japanese access to trillions of dollars worth of foreign securities for the first time in the postwar period. At the same time, it gave foreigners access to only a relatively limited array of yen assets, because of the prolonged incubation of the Japanese capital market. The liberalization of that market is highly desirable for the long term, but for some time to come it is likely to promote sizable net capital outflows from Japan and downward pressure on the yen. Paradoxically, a temporary reinstatement of controls on Japanese capital outflows (along with aggressive borrowing abroad by the government) is needed urgently to promote the strengthening of the yen. The Versailles Declaration thus stated incorrectly the relationship between trade and capital flows, at least in the one very important case, and nothing was done at Toronto or elsewhere to come to grips with the issue.[5]

Finally, and perhaps most important, the Versailles endorsement of IMF surveillance (and creation of a new surveillance committee) relates directly to global macroeconomic policy as well as to exchange-rate management. Yet the record is just as dismal on this front: with the world economy dead in the water, sliding perilously close to a further sharp decline, and reaching such low levels of employment and capacity utilization that the risks of reigniting inflation are slim, both Versailles and Toronto continued to preach the virtues of fighting inflation. To be sure, stimulus should be prudent and cautious. Excessive fiscal expansion or monetary easing could rekindle inflationary expectations, even if their direct effects were modest. But the time had clearly come for a decisive turn in macroeconomic policy, and both the summiteers and IMF Governors missed the boat.[6]

This was a particularly costly error. Events of the past decade have demonstrated the crucial importance of the international coordination of macroeconomic policy, especially when all major countries are headed in the same direction. The failure to coordinate undoubtedly contributed to the inflationary excesses of the boom in 1972-73. The failure to adopt a concentrated recovery-cum-stabilization approach in 1977, as proposed by the United States, contributed significantly to the dollar crisis in 1978 and to subsequent instability in Germany and Japan.[7] The failure to coordinate during the past year or so has contributed to the downward spiral now engulfing the world economy, because all countries have been pursuing restrictive policies without full cognizance of the cumulative impact of their actions. Moreover, it appears most unlikely that any country alone—including the

[5] Details are in Bergsten, "What to Do About the U.S.–Japan Economic Conflict," as cited.

[6] A detailed program is offered in C. Fred Bergsten, "Preventing a World Economic Crisis," *Vital Speeches* (Nov. 1, 1982), pp. 54-59.

[7] Richard N. Cooper, "Global Economic Policy in a World of Energy Shortage," in Joseph A. Pechman and N. J. Simler, eds., *Economics in the Public Service: Papers in Honor of Walter H. Heller*, New York, Norton, 1982, especially pp. 98-107.

United States—will be able to achieve satisfactory recovery from the current global stagnation.[8] The need is acute for a coordinated international approach to the recovery phase of the cycle and for new techniques for more effective macroeconomic coordination on a continuing basis, but there is no indication that any such effort was launched, or even seriously discussed, at either Versailles or Toronto.

The Versailles summit (and the Toronto meetings) thus failed to address meaningfully the several critical issues that now confront the world economy or the systemic problems whose continued nonresolution plagues all contemporary policy efforts. Both sessions were long on words and on commissioning new studies. Neither took action, thus fiddling while the world at least smoldered.

One common cause behind the various failures was the opposition of the United States to the actions that were needed: a prompt and sizable increase in IMF quotas, a large and rapid adjustment of the present currency misalignments, consideration of new arrangements for international monetary management and for meaningful coordination of macroeconomic policies, and a reversal of the present direction of those policies. None of these approaches seemed compatible with Reaganomics, at least as it persisted into late 1982.[9]

Two sets of changes thus appear essential in 1983. First and foremost, major changes in U.S. policy will be needed if there is to be any hope of restoring satisfactory world economic conditions or even of avoiding a severe global economic crisis. Fortunately, there are a few signs of increased pragmatism and recognition by the administration of the need to change policy: support for the recent tax increases and the easing of monetary policy by the Federal Reserve System, the expeditious rescue package for Mexico when its financial crisis erupted in August 1982, and the proposal for some kind of "emergency fund" just prior to Toronto. But much of the opposition to constructive action remains, and a coherent U.S. policy adequate to meet the current challenges has yet to emerge.

Second, the rest of the world will simply have to use international meetings like Versailles and Toronto better, whatever the posture of the United States. The other Governors could probably have agreed to increase Fund quotas to SDR 100 billion at Toronto. The major countries they represent could probably make significant progress toward developing plans for avoiding extreme currency misalignments, as indeed the Europeans have imple-

[8] See C. Fred Bergsten, "The International Dimension," in G. William Miller, ed., *The Decline and Rise of the American Economy*, Englewood Cliffs, N.J., Prentice-Hall, forthcoming.

[9] C. Fred. Bergsten, *The International Implications of Reaganomics*, Kieler Vortrage No. 96, Tübingen, Mohr, 1982.

mented among themselves the European Monetary System. The Japanese, in particular, should have instituted new measures to begin to correct the currency misalignments even if the United States did not participate actively at the outset.

Multilateral management of the world economy is difficult in the best of times. It is particularly difficult when any major participant, such as the United States now or France in earlier periods, is reluctant to join the majority, let alone take leadership. But an inability to move ahead sometimes risks the imposition of enormous costs on all countries. The failure to do so is the story of Versailles and Toronto, a failure that could turn out to be a tragic chapter in the history of the world economy of the 1980s.

Before Versailles, European pragmatism and U.S. dogmatism led to a set of principles distinctly out of line with a well-functioning, open world economy:

> We are ready, if necessary, to use our exchange rates to gain unfair competitive advantages.
>
> We rule out the use of intervention in exchange markets to counter disorderly conditions, as provided for under Article IV of the IMF Articles of Agreement.

We are told that Versailles has changed all that. There is to be harmony and stabilizing intervention. But the agreement misplaces the emphasis, paying too much attention to the exchange rate and too little to world economic activity.

The great international monetary issue of 1982 is the level of the world real interest rate, not the question of intervention. The real rate of interest, certainly on a cyclically adjusted basis, has not been as high since the Great Depression. Not surprisingly, growing bankruptcies and default risk, nationally and internationally, evoke once again concern about whether "the system" is safe or whether a collapse of credit and activity like that of the 1930s is a possibility. Few believe that the economy could get that far out of hand. But persistent financial tightness can make a deep dent in macroeconomic performance for years to come. This is particularly the case in developing countries, especially Latin America, where growth has been negative and worse than at any time since the 1930s.

The extent to which real interest rates have been positive can be seen from Table 1. In judging the deflationary impact of these real interest rates, one wants to compare them with an estimate of cyclically adjusted returns to real capital. There is little doubt that they exceed the return to capital and thus amount to a highly deflationary redistribution of income from operating firms and debtor countries to bondholders and banks. The important policy initiative therefore is one that would restore growth at the center and repair the damage at the periphery through extended, funded recovery programs. The United States has been setting the tone for world deflation by espousing a dogmatic monetarism. It is now time for it to lock in the disinflationary gains and revive growth.

Over the last three years, the dollar has appreciated in real terms by nearly 25 per cent from its low. An index of the real effective exchange rate for manufacturing stands more than 10 per cent above the average level for the 1972-81 period or more than 15 per cent above the average for the last five years (Table 2). Yet the United States has not experienced a gain in