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PROBLEMS OF THE INTERNATIONAL MONETARY SYSTEM

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For more than five years there has been a stream of discussion and reports on the functioning of the international monetary system. The system has been charged with having a variety of ills, and a variety of plans have been offered for reforming it. Now, the Group of Ten countries are engaged in discussions to see what basis for agreement can be reached on improvements in the system, and it is expected that their report will be available before the next annual meeting of the International Monetary Fund. Thus, it seems that the moment of truth has arrived—the time for crystallizing all this debate and for deciding on the practical course of action for the future.

It is not the aim of this paper to review all the alleged faults of the system and plans for reform; this could lead to endless detail from which clear conclusions would be unlikely to emerge. Rather, I propose to put in sharp focus the key problems that governments have been arguing about and to try to distil from actual experience the reality of those problems.

It is well to admit at the outset that this is a difficult subject—which should be evident enough from the diversity of views that intelligent and well-meaning men hold about it. For one thing, as I will try to show shortly, it is difficult because in practical affairs the problems of the system present themselves mixed together; yet, to deal with them effectively, they must be rigidly separated in analysis and treated by different kinds of policy action. It is difficult also, because the appropriate measures for dealing with the issues that arise are seldom simple matters of right or wrong: besides technical analysis, the issues demand wise judgments which in the end involve the kind of trading and financial world we want to have—and even the power and sovereignty of nations. Mutual understanding and cooperation among the principal countries are needed every step of the way.

THE OFFICIAL VIEWPOINTS

The main official study of the system has been by the Group of Ten—that is, the ten industrial countries participating in the General Arrangements to Borrow of the International Monetary Fund. The study was initiated at the IMF meeting in Washington in September 1963, and the Report of the Deputies was published in August 1964.

This report ostensibly deals with the longer-term problems of the

system, but it was understood by all the participants that any arrangements made for the future would have practical implications for the present. Under the circumstances of a continuing U.S. balance-of-payments deficit, many of the countries were reluctant to make future commitments which might in practice have helped to perpetuate that deficit. While the report is expressed in negotiated language, it still makes clear that the countries have quite different attitudes about the present functioning of the system. The report says that the system has shown great flexibility in the face of changing conditions and that the volume of international liquidity is fully adequate for present needs. Despite these soothing words, it is difficult to read it without getting the impression that some action is needed to improve matters but that there is dispute about what that action should be.

In the end, the Group of Ten did compromise on two concrete steps. First, the countries agreed to support an increase in IMF quotas; the general increase of 25 per cent, that has now been negotiated, was a compromise between the much larger and much smaller amounts that the various countries really considered necessary. Secondly, the Ten agreed that Working Party No. 3 of the OECD should in the future exercise multilateral surveillance over the financing of balance-of-payments deficits and surpluses. Working Party No. 3 was to be helped in this task by new information collected by the Bank for International Settlements and by discussions among the BIS Governors at their monthly meetings. The compromise on this step, aimed at securing stricter standards of financing, was intended, at least by some of the countries, as a counterbalance to the increase in quotas. I believe it has been useful, not only in providing better data on current developments but in helping to focus official discussions on the essential points. As one may imagine, however, with sovereign countries involved, the "multilateral" part of this exercise has proved to be much easier than the "surveillance."

On two important questions, the Group of Ten was unable to reach agreement during their year of discussion, and these questions were passed on to study groups. The first group, with Mr. Ossola as Chairman, published a report dealing with possible new reserve assets. This report clarifies the nature of the various proposals that the group reviewed, but it shows little progress in resolving the differences among the countries on what type of assets may be most appropriate. The second group, dealing with the ways and means of improving the process of adjusting deficits and surpluses, is still at work. But, as most countries are wary of making commitments on adjustment policies, it will be difficult for the group to reach effective conclusions.

Thus, it may be seen that official discussions have revealed basic differences of viewpoint. On the surface, it would appear that the disagreement is about what improvements may be needed in the international monetary system in the future. Behind this, however, the fundamental debate is on what the real problems of the system are, here and now. Obviously, so long as there is disagreement on the essential problems, there is little chance of reaching agreement on their solution.

The crux of the dispute is concerned with the nature of the payments imbalance, with the argument concentrating on the persistent deficit of the United States. To oversimplify somewhat, there are two opposing points of view. One side believes that balance-of-payments deficits can usually be corrected only over a rather long period of time—particularly since the surplus countries are not under the same pressure as the deficit countries to assist in the adjustment process. This side considers that to take measures to correct a deficit which interferes too much with internal economic growth is to get the priorities wrong, and that measures likely to lead to internal deflation or unemployment are not to be tolerated. Moreover, at least some of the countries on this side have been reluctant to invoke controls over capital movements to help restore equilibrium, and they just about exclude the use of changes in exchange rates as an instrument of adjustment, particularly for a reserve currency. One can understand, therefore, why they feel that the correction of external deficits is likely to be a prolonged process; it is because they think it inappropriate or not feasible to use policy measures of such kind and strength as would make the correction a more rapid process. The inevitable conclusion they draw from this view of the nature of imbalances in international payments is that there must be ample borrowing facilities available to supplement official reserves, so that countries will be able to finance their deficits in the interval of time required for the longer-term adjustments of the domestic economy to take place.

In answer to this view of the matter, the other side in the debate more or less says: nonsense—all that is just an excuse for not taking effective corrective measures. In their view, deficit countries are generally too cautious in using monetary and fiscal policy to promote the adjustment process and put too high a priority on avoiding disturbance to the domestic economy. The surplus countries, on the other hand, rather than not being under pressure to help in the adjustment, are, they feel, by being subjected to excessive surpluses, left to make most of the adjustment through the internal inflation induced by these surpluses. This side accepts the idea of controls over capital movements in

case of need and, indeed, believes that a deficit caused by the outflow of capital (apart from temporary flights of funds) should not be financed by international assistance. While they are in theory less shocked by the idea that exchange rates may sometimes have to be adjusted, they are naturally reluctant to say when and where this drastic remedy should be applied. The inevitable conclusion which they draw from their view of the matter is that borrowing facilities should have strict limits, because, if the surplus countries continue to finance the deficit countries, there will never be an end to it.

Thus, the two key problems of the system in the official debate are the efficacy of the adjustment process and the adequacy of international liquidity. These questions are matters of judgment rather than of rigid proof, but I believe that the experience of the various countries during the past ten years provides the basis for an objective view. I will take up both of these problems, starting with the adjustment process.

THE ADJUSTMENT PROCESS

By the adjustment process is meant the chain of corrective changes in the domestic economy, and even directly in transactions of the balance of payments, whereby countries in deficit or surplus come back into equilibrium.

Political Obstacles

It is perfectly clear from experience that this adjustment process cannot be left to happen all by itself, simply with the passage of time, but that effective policy measures must be instituted by the authorities to promote adjustment. At the same time, it is equally clear that the main obstacles which get in the way of prompt and effective action, and thereby drag out the adjustment process, are not economic difficulties but political difficulties. In case after case in the postwar period, we have seen deficit countries procrastinate and play around with half-measures while the situation deteriorated, reserves were drawn down, and liquid resources were borrowed from abroad—not because the need for policy action was not clear but because political difficulties stood in the way of firm action. And then, as the means of financing the deficit became scarce and a crisis developed, we have seen such obstacles brushed aside; the policy actions previously claimed to be impossible and unworkable suddenly became possible and did work.

It is not only in the deficit countries that political considerations have interfered with appropriate policy-making. In the surplus countries where there was need to curb excess demand, to take one example,

restraint by fiscal measures has often been sidestepped because of their political unpopularity, while the task of suppressing inflation was left to monetary policy. The result was higher interest rates and an inflow of money from abroad, contributing to the imbalance in international payments.

If further evidence of the importance of political considerations in stabilization policy-making were needed, one would only have to review some of the policy programs put forward by governments in election years.

Can anything be done in our real world to reduce the political hazards to stabilization policy so that the adjustment process will work more promptly and in a shorter time? While there is no possibility, of course, of the authorities being able to take measures, in a political vacuum, as it were, that affect the lives and pocketbooks of a good many citizens, it is feasible, I believe, to improve on past practice—and I am optimistic enough to feel that it is being improved. The main thing is to have a more general comprehension that flexible use of policy instruments is essential in managing the economy so as to maintain not only high employment and expansion but also domestic and external monetary stability. It is not only the government that has to take this need to heart, but also the political opposition and the important interest groups in the general public.

Besides this, it is feasible to improve matters by separating more clearly the technical adaptations of policy measures from the fundamentals of policy that are necessarily political. In many countries this is largely the case in the area of monetary policy, so that such measures as changes in the central bank's discount rate not only do not require Parliamentary approval but arouse little political controversy. In the field of fiscal policy, however, such flexibility is generally not available at present, even though it is quite clear from experience that fiscal measures must play a key role in maintaining monetary stability. It is not too much to say that the whole mechanism of the annual budget, which involves the impossible job of forecasting developments a year to eighteen months in advance, and which largely freezes fiscal policy over that period, is no longer adapted to the flexible role that fiscal changes have to play in the management of the economic climate. This inflexibility could be reduced by delegating to the stabilization authorities circumscribed powers within which they could make technical adjustments to increase or decrease overall demand as the situation might require.

No doubt, however, politics will always be politics, and that means that the advocates of international hard money have a strong case in

saying that there must be limits to liquidity. Reserves and borrowing facilities must be able to run out, because in the end there must be a liquidity pinch to assure that action is taken to restore external balance.

Economic Obstacles

Leaving the political factor aside, let us come to the economic side of the adjustment process and ask whether, in the nature of the case, correcting imbalances must necessarily be either slow or rapid in a contemporary industrial economy. Experience has shown that there are different kinds of situations or cases in this matter.

The relatively simple cases are those in which an external deficit has been directly linked with excessive domestic demand and internal inflation. In such cases there is no dilemma for policy, because measures to restrain excessive internal demand will at the same time act to correct the external deficit. It is evident from the experience of numerous countries that this adjustment can be quite rapid and that in as little as six months after effective measures are taken there can be dramatic improvement in the situation. From an international standpoint, the real difficulty in such cases is in denying borrowing facilities to the country in question until it is prepared to institute an effective program of restraint—for this also is a problem that cannot be free from political considerations.

But, while we can say on the basis of observation that a good many instances of external deficit are of the kind that can be fairly quickly resolved, there have been cases in recent years that, even with prompt and pointed action, would have taken a longish time to overcome. In these more difficult cases policy has been confronted with a clear dilemma, owing to the fact that the external deficit was not obviously linked with excessive internal demand. Hence, the taking of forthright restraining measures to reduce the external deficit would have been against the interest of the domestic economy, which was not in need of demand restraint. Similarly, countries with an external surplus have been confronted with domestic inflationary pressures, so that expansionary policy measures, which would have been helpful in reducing their surpluses, would at the same time have threatened the domestic economy with even more inflation.

In considering policy action for these difficult cases, it must be recognized that in our accepted scale of values the objectives of full employment, economic growth, and price stability do have relative priority, and it is evident that neither deficit nor surplus countries are willing to sacrifice them wholly to the goal of external balance. Indeed, the perplexing aspect of reconciling domestic and external objectives arises

because all countries want to maintain a shock-absorbing cushion around the domestic economy to isolate it in some degree from outside forces. In this type of situation, deficit countries are unwilling to accept all the deflation that might be needed to eliminate the deficit quickly; surplus countries are unwilling to accept all the inflation that might be needed to eliminate the surplus quickly. While one must agree that this position is reasonable, one must also insist that if there is to be any sort of adjustment process, domestic objectives cannot have absolute priority. At times it must be possible to shift the emphasis of policy to favor the correction of an imbalance of payments—even at some sacrifice of the domestic aims.

Current-Account Imbalance

The nature of the adjustment process in these cases depends upon whether the imbalance is concentrated on the current or on the capital transactions of the balance of payments. If it is on the current account, what makes the situation difficult is that the cost and price levels have gotten out of line and thereby, from the standpoint of the deficit country, have weakened the international competitive position of the economy. In such a situation, exports tend to be sluggish and a normal expansion of economic activity induces rising imports and a deterioration of the current external balance. The adjustment process requires that domestic incomes, particularly wages, be held in check for some period of time, during which the normal increase in productivity operates to strengthen the competitive position. A firm wages policy, combined with the avoidance of demand pressure on the labor market, has been effective in a number of cases in securing this kind of adjustment. In other cases, this type of policy has failed to improve the relative competitive position of the deficit country, either because wage restraint was not firmly held or because it was frustrated by demand pressure. The outstanding case, of course, was that involving the United States and western Europe a few years ago, in which the successful outcome depended not only on the maintenance of wage restraint and stable prices in the United States but on some upward movement of prices in the surplus countries of Europe. Between 1958 and 1964 this process resulted in marked improvement of the U.S. trade position and in a large reduction in Europe's current-account surplus.

Thus, experience shows that the adjustment process can work for this type of imbalance and shows also what kind of adjustment policy measures must aim to bring about. It is evident, however, that sufficient adjustment of cost and price levels by these means cannot be accomplished overnight; the process will take time if the deficit to be

overcome is at all significant. It seems to me that the surplus countries would be quite prepared to make allowances for this stickiness in the corrective mechanism. That does not mean, however, that the process should take forever and, indeed, signs of improvement should emerge without unreasonable delay. If the supposed policy action does not produce results, it is generally safe to conclude that there was more exhortation than action. Some attempts at wage policy, for example, remind one of those disarmament agreements of former times which always seemed to end up with an increase in armaments.

Before leaving this matter of imbalance on current account, it may be noted that there are often cases where the disparity between the cost and price levels has become so large that it is rather hopeless to expect wage restraint and rising productivity gradually to restore the international competitive position of domestic enterprises. In such cases, there is nothing for it but to adjust the exchange rate to a realistic level. While changes in exchange rates may be looked upon as the ultimate instrument for assuring the adjustment process, they are definitely part of the mechanism of the international monetary system. I stress the point because more than a third of the less-developed countries today have overvalued exchange rates, which are handicapping their efforts to develop their economies. Of course, if all the instruments of adjustment are to be ruled out, if the price of the currency is to be a matter of prestige, the price of foodstuffs a matter of politics, and the price of labor a matter of monopoly—with some cartel pricing thrown in besides—one will have to wait a long time before seeing anything that could be called an adjustment process.

Capital-Account Imbalance

We may turn now to an imbalance due to excessive flows of capital funds. In this aspect of the adjustment problem experience is less of a guide to an objective appraisal, because the only outstanding case since convertibility was restored at the end of 1958 has been that between the United States and continental Europe. And it is the more difficult to appraise because it has been complicated by the rapid growth of the Euro-dollar market. While there have been other disturbing movements of funds, they have not been an independent cause of imbalance but have been associated with threats to exchange stability from other causes.

In the case before us, the imbalance reflected the fact that in the United States capital funds were fairly plentiful and interest rates relatively low, while in Europe the supply of such funds was more limited compared with demand, and interest rates, therefore, were relatively

high. The differences between the two areas were substantial and persistent enough to be called a structural problem. The classic remedy of a tighter monetary policy in the United States and an easier monetary policy in Europe seemed to be indicated, in order to reduce the differentials in the availability of funds and in interest rates. I may say that, in advocating this line of policy, I for one did not consider that the whole of the U.S. balance-of-payments deficit would thereby be corrected, or even that it should be. But the policy should have been able to make a significant contribution—along with other measures to improve the trade and invisible balance and the balance on government transactions. Some progress was made in this direction up to 1963, as interest rates in Europe tended to decline gradually after 1958 despite booming conditions in 1960-61, and short-term rates were held up in the United States. But, as the United States was reluctant to tighten the monetary situation enough significantly to affect long-term rates for fear of stopping domestic expansion, and as Europe began to shift monetary policy to restraint in 1963 to combat inflation, first Europe and then the United States introduced special techniques to limit excessive capital flows.

In the circumstances, these measures were clearly needed. But one may go further: if there is to be a reasonable margin of freedom to use general monetary policy to restrain or stimulate the domestic economy, the authorities must be able to use special instruments of control over flows of capital funds to help manage the balance of payments—when there is a conflict for monetary policy between domestic and external objectives. One must, however, guard against thinking that this is the end of the matter—thinking, that is, that such controls, which are sanctioned in the Bretton Woods Agreement, can always be relied upon to assure a rapid adjustment process and that other policy measures are not needed. The use of control instruments is a retreat from convertibility which involves dangers of its own. For one thing, controls are not likely to be effective over a long period if they imply too great a suppression of market forces. For another, their continual use is likely to put a growing burden of adjustment on the capital account of the balance of payments, which would not be justified on strictly economic grounds. Hence, it is necessary that the appropriate mixture of monetary and fiscal policy be used to move towards a basic equilibrium of market forces. As with the difficult adjustments in the current account, an adjustment to a true equilibrium of interest rates and capital flows in present circumstances would involve a slow process of adaptation and structural change, unless other objectives were drastically sacrificed.