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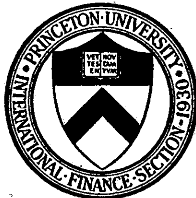

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The IMF: The Second Coming?

In this essay I speculate on the future of the international monetary system in the light of its present crisis. I consider two *extreme* possibilities that could occur in the next few years. The more likely possibility would be a gradual return to Bretton Woods—but to a system in some respects more like the one planned in 1944 than the one that has emerged in recent years. This development would spell increasing integration of the world economy. At the other extreme, in the event of failure of the first, would be the division of the world into two or a very few monetary blocs that would be defensive in origin and therefore likely to lead to increased barriers to economic intercourse among the areas. I pay special attention, where appropriate, to the problems posed for the less-developed countries (LDCs) by the present situation and its development.

The first section briefly sketches the background of the crisis of August and the realignment of December 1971. The second section presents a suggestion for reshaping the international monetary system that might prevent future monetary crises and describes the steps by which the system created by the realignment could evolve toward this model. The third section draws some conclusions and reflects on possible further developments.

From Crisis to Realignment

The unilateral and formal suspension by the United States of dollar convertibility into gold on August 15, 1971, led at first to the widespread belief that the Bretton Woods system of stable exchange rates had finally collapsed and that the trend toward increasing international economic cooperation evident since the Second World War might be reversed. These fears were heardly surprising. The U.S. action had been preceded by a succession of increasingly severe monetary crises that had resulted, among other things, in the floating of major currencies, including, since May 1971, the Deutschemark. President Nixon had spoken of the need for a new international monetary system.

As an immediate result of the U.S. action, strategic rules of the international monetary system were put into suspense. Despite their legal obligations under the Articles of Agreement of the International Monetary Fund (IMF), member countries generally felt free to change the relationships of their currencies to the U.S. dollar and to each other. On the same day that the United States closed the gold window, it also

adopted or planned a series of exceptional measures to discourage imports and stimulate exports: an import surcharge, exclusion of imported capital equipment from the proposed "job development" (investment) tax credit, tax advantages for exports through domestic international sales corporations, and a cut in foreign-aid expenditures. The first two measures, it is true, were to be removed after an exchange-rate realignment, a new deal with allied countries on the sharing of defense costs ("burden sharing"), and an agreement with the major industrial countries on the removal of "specific trade barriers," provided these together yielded a strong balance of payments for the United States.

As the result of an unprecedented multilateral negotiation on exchange rates, by December 18, 1971, a new rate structure had already been agreed upon by the members of the Group of Ten—the countries associated in the General Arrangements to Borrow (more accurately, to lend to the IMF), including the United States, the United Kingdom, Japan, Germany, France, and five other industrialized countries, with which Switzerland is associated. By the end of the year, most IMF members had also indicated new exchange rates to the Fund. Thus, less than five months after the dollar went off gold, the period of discretionary floats seemed to be over (except for Canada and a few LDCs). The surcharge and the buy-American feature of the investment-tax credit had been terminated. Negotiations were under way to settle other questions of immediate concern.

The dollar remained inconvertible into gold, but its effective convertibility had been severely limited even before August 1971. Thus, for all practical purposes, the world seemed back where it had been—not in mid-1971, when the system was already disrupted by the floating of major currencies, but in mid-1970, when only the Canadian dollar, among the currencies of industrial countries, was floating. Yet all recognized that none of the underlying problems of the international monetary system had been solved. Whether the realignment can hold (subject only to orderly modification) or will collapse, and possibly reverse the trend toward increasing integration of the world economy, depends in part on whether necessary reforms of the international monetary system can be enacted in time. The mechanics of reform will not be decisive, but much does depend on the policy intentions underlying the enactment of reforms.

The Background

The basic deficit of the U.S. balance of payments had been rising for years. This deficit might possibly have been reduced to a rate that the world could tolerate even without an exchange-rate realignment.

Under conditions of relatively rapid growth of the world economy, a few years' relative wage and price restraint in the United States and only moderate price rises elsewhere might have produced the same effects as the realignment (which resulted in an average devaluation of the dollar by somewhat less than 9 per cent, compared with April 1970).

Such a solution, however, would have required assurances by other countries that they would not present existing dollar balances for conversion into U.S. reserve assets. Actually, in the weeks before August 15, 1971, U.S. reserve liabilities and losses of reserve assets had risen dramatically. It is also possible that there were indications of large future demands for the conversion of dollars into gold. The tacit agreement to refrain from such demands by which many major central banks had apparently been bound (in addition to explicit understandings with others) seemed to be at an end. Moreover, there may have been signs of a breakdown in the network of bilateral credits (swaps and others) by which major central banks were in the habit of assisting each other in difficulties and which had been used on a large scale by the United States.

The Realignment

The measures adopted or announced on August 15, 1971, could do little directly to improve the U.S. balance of payments and could do nothing directly to bring about the desired realignment. Essentially, each country (except the United States) determines the value of its currency in its own territory by *both* buying and selling it freely at the desired rate(s) in terms of dollars (i.e., using the dollar as "intervention currency"). Consistent rates against other currencies are maintained by private arbitrage operations. (A few countries use sterling or francs as their intervention currency or supply other currencies at consistent rates.) Under this particular system of intervention, the United States does not need to intervene, even in its own territory, to maintain the value of the dollar against any other currency. (Indeed it must not do so; between any currency and the remaining $N - 1$, there are only $N - 1$ independent exchange rates, and simultaneous intervention by all N authorities could lead to contradictions.) Convertibility into gold, in other words, is not needed to maintain the value of the dollar in terms of other currencies. Its function, if it had existed on a substantial scale in fact, not only in form, would have been, at most, to limit the ability of the United States to finance deficits (i.e., to "discipline" U.S. policy). The suspension of convertibility into gold could not by itself affect the foreign-exchange value of the dollar.

The suspension of convertibility could and did create an expectation

of revaluation of other currencies against the dollar, inducing the "Gnomes of Zurich" to force the respective monetary authorities to validate the expectation (if they could not ward off speculation by imposing controls or by intervention). By the beginning of December 1971, almost three-quarters of the eventual average dollar depreciation enacted formally in the realignment of December 18, 1971, had been accomplished, compared with exchange rates prevailing in April 1970, before the Canadian dollar was floated. (At the time the U.S. dollar went off gold, the floats and revaluations that had taken place earlier in 1971 had already achieved one-quarter of the eventual depreciation.)

The surcharge and the buy-American feature of the investment-tax credit made no direct contribution to the realignment. These two measures, in fact, limited market pressure for realignment. Nor was the promise of their removal an incentive toward it. Except for Japan, these measures hit heavily only countries from which little or no (further) revaluation or other action was expected—Canada and LDCs such as Mexico. Furthermore, given the damage to a country's exports caused by these measures, the promise to remove them was an economic incentive to revaluation in inverse proportion to the extent of the (further) revaluation desired from each country: the larger the desired additional revaluation, the more painful it would be compared with continuation of the measures. Finally, few of the major countries suffered acutely from the exchange-rate uncertainty—least of all, of course, the United States itself. Thus there was little direct economic pressure on other countries for further appreciation or on the United States to agree to a degree of dollar devaluation (in terms of gold and foreign currencies) acceptable to those other countries.

What did bring about the additional realignment was, in part, political pressure on the countries whose rates had moved least by those that had already "done their share" and wanted to diminish competition from the laggards. More important was the fear in one or more countries, Germany among them, that recessionary tendencies, even if slight at the moment, might be strengthened by the persistence of the prevailing uncertainties. The United States presumably also realized that such a development would make any further realignment progressively more difficult. The major reason for agreeing on an early realignment, however, was fear that the unsettled situation resulting from delay might lead to the proliferation of measures that would reverse the movement toward increasing integration of the world economy. The surcharge and the buy-American feature of the investment-tax credit were signs of the direction in which policies might move and in this sense only may have contributed to the realignment. No government,

it should be stressed, seemed prepared to opt for the alternative form of agreed solution—a *commitment* to freely floating rates.

The realignment left no country completely satisfied. The United States had wanted a realignment which, together with the other concessions it demanded of the Group of Ten, would have improved the full-employment equivalent of the U.S. current account by $13 billion in 1972, had the realignment and other measures been in force long enough to have taken full effect. The United States apparently thought an average devaluation of the dollar close to 15 per cent was required to bring about this swing, which was considered necessary to compensate for the prospective net capital and aid outflow and to provide a margin of safety. The actual realignment was close to 9 per cent, but market rates will be allowed to fluctuate between wider margins than in the past. Thus the realignment alone could perhaps produce a swing approaching $11 billion, to which would be added the effects of the other concessions. As part of the realignment, the United States promised to propose to the U.S. Congress a devaluation of the dollar in terms of gold by 7.89 per cent, as soon as agreement had been reached on the other concessions. It had at first opposed this devaluation for political reasons and because it feared a possible adverse effect on the willingness of private individuals to continue holding dollars. A few European countries had insisted on it, to ease the political problem they would face of appreciating vis-à-vis the dollar and to compensate them in part for losses in the purchasing power of the dollars they held as reserves. The United States made no commitment to resume convertibility of the dollar in any form, but agreed that establishment of a "proper degree of convertibility of the system" should be studied in the context of a long-term reform of the IMF. The Group of Ten, other than the United States, had wanted a small realignment and a small swing in the U.S. current account. Many felt that the requisite improvement in the over-all balance of payments should be achieved partly on capital account, by U.S. restrictions on direct investment in developed countries. Some felt that the appreciation to which they had agreed for their own currencies had been inequitably large, not vis-à-vis the dollar but vis-à-vis other currencies of the Group of Ten.

The leading role taken by the Group of Ten in the realignment was somewhat inappropriate. Some participants' currencies had no strategic role in the realignment, while the entire financial community has an interest in the outcome. The LDCs were at no time consulted substantively on these negotiations. One of their fears concerned recessionary tendencies stemming from exchange-rate uncertainties and an excessively sharp realignment. On these points, the realignment itself seems

reassuring. At the same time, should the realignment be insufficient to strengthen the U.S. balance of payments, they fear that aid and capital outflows to LDCs may decline further. They are also apprehensive about the increase in the gold price. First, some LDCs have debt in depreciating currencies subject to gold clauses. Second, few hold their reserves primarily in gold or other assets that will benefit from the increase, while they fear that the benefits accruing to holders of gold-guaranteed assets, including Special Drawing Rights (SDRs), will discourage the creation of additional SDRs, slowing the growth of their reserves.

A moderate and brief flow of dollars back to the United States in the first month after realignment brought the spot dollar to a slight premium in relation to more than half the major currencies. By the middle of April 1972, however, the spot dollar had moved to a discount vis-à-vis most major currencies, albeit one well within the newly widened margins for permissible fluctuation of the spot rate. The forward (three-month) dollar in mid-April almost invariably showed a discount in relation to the spot rate of major currencies. Except during a short speculative flurry in late March, intervention by monetary authorities had been minor since the realignment. The speculative flurry occurred before the action of monetary authorities in the United States and elsewhere seemed to reassure dollar holders that interest rates here would move higher relative to those abroad.

The Need for a New System

The August crisis, as already indicated, was the reflection of what many have long perceived to be deep-seated defects of the Bretton Woods system. This view was widely endorsed at the 1971 Annual Meeting of the IMF, as well as subsequently. Reforms are urged regarding the process of balance-of-payments adjustment, the process of liquidity creation, and the resulting structure of the world's liquidity. The adjustment process, it is widely felt, has operated too slowly, especially where disequilibria were so serious that they could be cured only by exchange-rate changes. For this reason, adjustment in recent years has too often come only in the context of severe monetary crises. The process of liquidity creation, it is said, has come to depend on one country's balance-of-payments performance and should be brought under international control. Moreover, the process has contributed to the malfunctioning of the adjustment process, and the structure of international liquidity must be changed if the adjustment process is to function properly.

More specifically, there seems to be fairly wide agreement among

governments on the following points, although (or perhaps because) these points are by no means unambiguous:

1. Need for the par-value system.
2. Need for increased exchange-rate flexibility within that system.
3. Need for measures to deal with movements of liquid capital.
4. Need for the subjection of all countries to the obligations of the adjustment process.
5. Need for giving SDRs an increasingly important role as a component of international liquidity, for a corresponding change in the role of reserve currencies, and for a proper determination of the volume of international liquidity.
6. Need for ensuring a proper degree of convertibility.
7. Need for redefining the role of gold.

There is less agreement on the need for a stronger role for the IMF, which some of the reforms may imply. Points 1 to 4 are relevant to the reform of the adjustment process. Points 5 to 7 refer primarily to the reform of the process of liquidity creation and to liquidity composition.

Work on reform has already started in the Fund. Pending revision of the Articles of Agreement to enact permanent modification of the system, some provisional arrangements have been adopted and others may be needed. The existing provisional arrangements are not, of course, fully consistent with the requirements of the Articles. By suspending certain of the latter (under Article XVI), the Fund could make the provisional arrangements fully legal. But no suspension can exceed 360 days, and the corresponding amendments to the Articles could not be approved within that time span; on technical grounds alone, they are more likely to require up to two years for enactment. It is also likely that agreement on certain basic reforms will be reached, if at all, only with extreme difficulty and delay.

Adjustment

The par-value system. The malfunctioning of the adjustment process, as already mentioned, is blamed in part on the process of liquidity creation, which is thought to relieve certain countries from pressure to contribute to adjustment. But the par-value system itself—the core of Bretton Woods—is blamed for creating unnecessary mechanical difficulties by promoting exchange-rate rigidity without really contributing to exchange-rate stability, the objective of the par-value system. This accusation is false; rigidity was the choice of governments, not a requirement of the system.

The par-value system obliges monetary authorities to maintain market rates within narrow margins of the parity declared to the Fund (in the

present Articles, plus and minus 1 per cent of the parity in terms of gold or U.S. dollars of the weight and fineness existing on July 1, 1944). Various clauses protect the substance of this obligation by prohibiting exchange restrictions and multiple exchange rates except with the permission of the IMF. It is noteworthy, however, that capital movements are exempt from the prohibition; in fact, the underlying philosophy of the Articles is that capital flows that contribute to balance-of-payments disequilibrium are to be prevented, not financed—certainly not by use of IMF credit.

Unlike the classical gold standard, the Bretton Woods system does not require countries to maintain parities at all costs; these may be changed after consultation with and (generally) approval by the IMF, upon showing that the balance of payments is in fundamental disequilibrium. This concept has never been defined. Taken in historical context, however, the possibility of changing parities in fundamental disequilibrium subordinates the objective of exchange stability to the primary objectives of the Fund, namely, the growth of world trade, high employment, and development of the world's productive resources [Article I (ii, iii, iv) of the Articles of Agreement of the IMF]. On the other hand, the limitation to instances of fundamental disequilibrium is deemed to protect other countries against competitive depreciations and other unnecessary changes in exchange rates. By the same token, it is thought to protect necessary parity changes against neutralizing exchange-rate action by other countries.

As already mentioned, most monetary authorities have in one way or another endorsed a return to stable rates, and none has endorsed freely floating rates. This attitude does not mean that major countries bother much about floats of the currencies of LDCs, the repercussions of which on the former are slight, even though they may be pronounced among the LDCs themselves. More generally, there are exceptional circumstances under which few would insist on rate stability: under conditions of very rapid inflation; to achieve gradual transition from considerable misalignment to an equilibrium rate, where LDCs have used controlled rather than free floats with Fund encouragement; to ease a fairly rapid transition from one parity to another, where floats have been used by one developed country; or, finally, where the direction or extent of rate misalignment is too uncertain, as in the two Canadian experiences (1950–62 and after 1970) and the German and Dutch cases in May 1971. That there should be far-reaching loyalty to the par-value system, with the exceptions noted, has seemed surprising to some—even to those who concede that the system itself is not to blame for its many crises, only the way in which it has been operated. Two points seem relevant:

1. Despite its crises, one can hardly claim that the system has served the world badly. *Nobody, of course, can prove that a different system would not have been better*, but the growth since the Second World War in world trade and in the output of both developed and less-developed countries compares favorably with the period of very rapid growth preceding the First World War, as well as with the interwar period. It is nevertheless true that the slow growth of aid flowing to LDCs in the late sixties has often been blamed on the persistence of payments disequilibria among major aid-giving countries.

2. It would probably be impossible to prove that the par-value system is *substantively* better or worse than one that really permitted exchange rates to float freely for countries that did not want to maintain par values. The emphasis is on "permitted," because considerations of political affinity, as well as economics, will understandably suggest to certain groups of countries the convenience of maintaining fixed—even rigid—exchange rates among themselves.

There is, however, a *procedural* consideration that may persuade most countries (even major ones and multi-country monetary unions) to prefer the par-value system to one that permits floats under ordinary circumstances: the alternative of genuinely free floats is simply not available. Parities seem to have at least the advantage that rate changes are subject to international control *ex ante*; without parities, there would be uncontrolled intervention, not market-determined rates, except when market forces happened to behave as the authorities wished. Uncontrolled intervention is rather frightening even if free floats are not.

The propensity of governments to intervene in exchange markets is hardly surprising. Governments interfere with commodity prices like those of steel, which directly affect 3 to 4 per cent of GNP; they are not likely to remain neutral with respect to the exchange rate, which often directly affects as much as 15 to 20 per cent of GNP. Admittedly, the impact of the exchange rate becomes smaller for larger economic units; genuinely free floats might be more realistic among currency blocs. But, in most cases, the exchange rate would still be too important a price for governments to leave alone. One might add that, even if each government were prepared to refrain from intervention provided all others also refrained, one would be no nearer a solution: how would one enforce nonintervention credibly? This is a familiar dilemma.

One might ask whether control *ex ante* over intervention is necessary, for control *ex post* would not require the par-value system. But *ex post* control might leave too much leeway for abuse. Sanctions are hard—probably impossible—to impose effectively in respect of an act as hard to define as an unjustified intervention. The intervention may have done