ATLANTIC INSTITUTE FOR INTERNATIONAL AFFAIRS

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Comments on Professor Triffin's Paper

"THE EVOLVING INTERNATIONAL MONETARY SYSTEM"

Brussels, November 20, 1986

1. As a preliminary general comment, I would say that the best way to assess Professor Triffin's reform proposals would be to read them in the light of the title of the conference -- Managing entry into the 21st century. Indeed, if one takes the "long" view and compares the present system with the desirable requirements of orderly international monetary relationships, one is bound to agree that we need to restore a more stable system of exchange rates and make the reserve creation mechanism less dependent on national currencies and market mechanisms.

The basic reason for the breakdown of fixed rates was the incompatibility that developed between the policy goals of the major industrial countries, after the US shifted in the late sixties to strongly expansionary aggregate demand policies. These policies were inconsistent with the maintenance of price stability and the dollar's gold convertibility. In addition, the United States could no longer afford to sustain the expansion of world trade with its increasingly overvalued currency.

Floating was expected to allow each country to pursue its national objectives in full autonomy and isolation, with exchange rates moving smoothly to accommodate divergent performances and policies in the major countries. In other words it was seen as offering an efficient, costless device with which to eliminate policy conflicts. These expectations proved mistaken. Real exchange rates between the key currencies have oscillated sharply and have become a source of new real shocks.

With exchange rates playing a larger role in shaping macroeconomic performance, a temptation to manipulate them for national purposes has developed. Rather than diminishing, the scope for policy conflicts has increased. The illusion that all external constraints on policy had been removed and failure to appreciate the consequences of incompatible policies, have led both to imbalances in international payments that are unsustainable in the long term, and to mounting protectionist pressures.

The mechanisms for the creation and regulation of international liquidity have also revealed important shortcomings. Since the seventies, as Professor Triffin shows, growing recourse to liability financing (rather than asset settlement) of external deficits, coupled with the rapid growth of international capital markets, has resulted in market mechanisms playing a bigger role in the regulation of international liquidity. This has come to depend largely on banks' and markets' assessments of countries' creditworthiness. The fact that international liquidity is denominated in the national currencies of the major countries means that they are only loosely subject to the external constraint, while their domestic financial policies strongly influence the creation of international liquidity. In practice, periods of overrapid growth of liquidity have been followed by sharp contractions. There have been sudden large shifts in the terms and conditions on which liquidity has been made available, as well as late recognition of and abrupt response to changes in creditworthiness. In addition, some groups of countries have not had adequate access to market borrowing. More importantly, as Professor Triffin noted more than 25 years ago, a system based on national currencies for the provision of liquidity cannot be stable in the long run, oscillating as it does between the opposite risks of insufficient creation and a confidence crisis.

In sum, while the present international monetary arrangements are not in any immediate danger of collapse, they

are not satisfactory, and cannot be considered stable in the long run. 1/ Their very shortcomings tend to promote change. Clearly, one would hope to see the road leading towards a system in which exchange rates would move to correct "fundamental" imbalances, rather than being one of their sources, and the mechanisms for the provision of liquidity would be geared to the need for trade expansion and an appropriate discipline on countries' external positions. Professor Triffin is certainly raising the right questions and pointing in the right direction with his stated objectives, although his diagnosis of the problems as well as his specific policy prescriptions to improve the world monetary system are highly debatable.

2. In the first place, on the question of how to get from here to where we would like to be -- i.e. with a stable exchange rate system and a rational mechanism for liquidity creation -- I find Professor Triffin somewhat unrealistic and, perhaps for this reason, excessively critical and rather unkind to policy-makers. Though not explicitly stated, running just below the surface of the paper there is the belief that the solutions are intellectually clear and that what is lacking is determination on the part of policy-makers to implement them.

Allow me to indicate some symptoms of this attitude. Was the "brushing aside" of the Committee of Twenty's reform proposals (p. 10) really an arbitrary decision of officials, or was it not a realistic recognition of what could and could not be done at that time, taking due account of the quadrupling of the oil price? And, can we really regard the advent of floating as the consequence of a "victory" in a debate (p. 11), or the second amendment of the IMF as "belated legalization of the

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1/ Cf. in the same vein R.N. Cooper, "Is there a need for reform?", in The International Monetary System: Forty Years After Bretton Woods, Proceedings of a Conference held in May 1984 at Bretton Woods.

illegal repudiation of Bretton Woods commitments" (p. 10)? In the same vein, can we really accept that the decline of the US dollar since 1985 has been the result of a "radical reversal ... of previous ... neglect policies", and that, if "adopted earlier, the new policy could obviously have moderated considerably the intervening exchange rate fluctuations and their perniciously disequilibrating impact ..." on the world economy (p. 14)?

My own view is that by the late sixties the disequilibria which had accumulated for years under fixed rates and the breakdown of the implicit policy compromises which had underpinned the Bretton Woods arrangements had already jeopardized the old exchange rate regime, and that the transition to floating was Hobson's choice after the first oil shock. Especially in the early years the new system -- or non-system -- did not encourage efforts to restore any kind of external constraint on the national policies of the major countries, and this was to lead to new shocks and instability. However, in the light of the divergences in real performances and the conflicting policy responses to the two oil crises, it seems to me that floating rates have made a very considerable contribution to adjustment and the maintenance of an open trading system. Similarly, international capital markets have provided sufficient flexibility in the creation of international liquidity to accommodate imbalances of unprecedented magnitude in international payments.

By the same token, it seems to me that the most the Plaza agreement did was to accelerate a turnaround in exchange rates that was already in the offing. Monetary policies consistent with the new trend had been in place since early 1985. The new course reflected the changed macroeconomic picture, with inflation seemingly under control, growth faltering and policy-makers increasingly concerned about the trade imbalances between industrial countries. In other words, a new configuration of national priorities and policies had already emerged. Moreover,

the consensus underlying the Plaza agreement should not be overstated. The first part of 1986 has clearly revealed the persistence of widely differing views on how to correct trade imbalances and share the burden of adjustment. The result has been continuing pronounced variability in exchange rates.

To come to the point, Professor Triffin focuses almost exclusively on the objectives and the ideas, and while I basically agree with his indication of direction, I believe account also needs to be taken of the factors underlying the evolution of the system and of the constraints on policy-makers' freedom of action.

In view of these constraints it seems to me that it would be highly unrealistic to call a conference today with the purpose of launching a comprehensive reform of the international monetary system. As Professor Branson recently noted, such a conference would risk repeating not the successes of the 1944 Bretton Woods conference but the failures of the 1933 World Economic Conference, which was called without sufficient preparation or appreciation of the conflict between the American and European objectives. 2/

3. I will now look more closely at Professor Triffin's proposals regarding liquidity, exchange rates and capital flows. During this examination I shall mention some of the steps that are already being taken or considered to make the international monetary system more stable.

4. First, <u>international liquidity</u>. Professor Triffin's proposals in this area have the undeniable merit of consistency

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2/ W. Branson, "The limits of monetary coordination as exchange rate policy", <u>Brookings Papers on Economic Activity</u>, no. 1, 1986.

over the years. Basically, he advocates a system of centralized international liquidity management by the IMF. The SDR would take the place of national currencies in international settlements; (official) liability financing of external deficits would be forbidden; an appropriate mix of adjustment and financing would be achieved by a simple rule for SDR creation (proportional to the desired nominal growth of trade, or some other suitable aggregate); some flexibility would be provided by the endogenous creation of liquidity through IMF conditional financing of balance-of-payments deficits. These were basically the proposals put forward in the early seventies by the Committee of Twenty (which was considerably influenced by Professor Triffin's thinking). Events in the last fifteen years nonetheless suggest that some additional factors need to be taken into consideration when examining these proposals today:

(i) in the final analysis, every international currency has to win its spurs in the market. Public support can help (by enhancing confidence and encouraging use of the instrument) but it cannot be a substitute for broad use and acceptance of the instrument by private agents. The notion of a colossal, one-shot substitution operation that would put the SDR at the center of the system is highly unrealistic;

(ii) even at the national level, there are no simple rules for money management. At the international level, the search for a stable relationship between some liquidity aggregate and world trade, for example, is complicated by shifts in exchange rates, terms of trade and trade flows. Furthermore, effective monetary management is hardly compatible with the cumbersome decision-making mechanisms of international institutions. 3/ Short of the utopian establishment of a world central bank, it is hard to

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3/ The record of past allocations of SDRs is not good: allocation decisions tended to coincide with an acceleration of liquidity made available from private sources and this has helped to discredit the SDR in official circles.

envisage a practical arrangement for the management of an officially issued world currency;

(iii) official settlement of external deficits -- through intervention in foreign exchange markets or official transfers between monetary authorities -- has in any case come to play a minor role in the financing of current payments imbalances. Among other things this is a result of the growth and integration of international financial markets. This development, which further weakens the notion that official liquidity can be "fine tuned" to regulate external adjustment, appears unlikely to reverse.

All in all, the idea of making the SDR the principal reserve instrument seems overambitious today. It would be more realistic to try and increase its role in the international monetary system and importance in official reserves by fostering its use in the market, along the lines of the development of the ECU in Europe. SDR allocations would be geared less to "regulating" international adjustment and more modestly intended to reduce recourse to borrowing to sustain the medium-term expansion of international means of payment, thus increasing the share of owned reserves in official portfolios. The supply of reserves could thus be made less dependent on credit markets and, by the same token, on national currencies -- on both accounts this would improve the system's stability. With this low-key, but undeniably more realistic approach the idea of basing SDR creation on a simple formula such as that proposed by Professor Triffin makes more sense, since the aim is to increase the share of the instrument in overall reserve creation (rather than to "regulate" the system).

This pragmatic approach to the role of the SDR does little to reduce the risk of unstable policies in the reserve currency countries leading to undesirable oscillations in the creation and cost of international liquidity. This, of course, is but another facet of the general problem of how to ensure that these

countries take due account of the external repercussions of their policies. I will come back to this issue shortly.

5. Turning to exchange rates, I am more in agreement with some of Professor Triffin's concrete proposals for driving the system in the desired direction. I fully agree, in particular, that "the primary goal of a well-functioning exchange rate system should be the stabilization of real exchange rates at competitive levels among the major currencies ...". (p. 11)

This is more than a mere statement of principle; it offers concrete guidance in approaching the transition to a more stable system of exchange rates. In the first place, by stressing the need for exchange rates to be restored to a passive role in the adjustment process, in the sense that they should move to absorb "fundamental" disequilibria rather than be used as active policy instruments for furthering national goals. This was a basic feature of the Bretton Woods arrangements, and is essential if compromises between conflicting national goals are to be lasting, since it excludes the possibility of beggar-thy-neighbour policies. In the second place, by identifying an operational criterion permitting policy-makers to agree on what should not happen to exchange rates or, in other words, on a range of acceptable exchange rate oscillations. This is the basis on which international cooperation in exchange rate management has been sought since 1985. Indeed, it is the core of the philosophy underlying the EMS exchange rate arrangements.

It is worth stressing, I believe, that relative price differentials have been accommodated in the EMS with some delay and on average less than fully, so that the system has imposed some discipline on higher inflation countries. As a general rule, complete and automatic accommodation of inflation differentials would surely be undesirable.

Nonetheless, I am much less optimistic than Professor Triffin seems to be about the possibility of applying EMS-type arrangements to the key currencies in the near future. Indeed, I even have serious reservations about the viability of the "soft" target zone approach that some observers have been advocating. The main grounds for my doubts are the existing payments imbalances of the major countries and the divergent courses of their fiscal policies. Further, the large changes in real exchange rates and commodity prices of the last 18 months are still working through the system and we really do not know how "right" or "wrong" current exchange rates between the key currencies actually are. Nor do we know what effect the necessary adjustment in fiscal balances would have on these exchange rates or on "fundamentals" -- including growth differentials. The size of the real and financial imbalances still present in the system means that we cannot exclude new real exogenous shocks. We also have to consider the possible consequences for capital flows of this uncertain picture and of changing expectations regarding major countries' policies. It is clear therefore that we still need a lot of flexibility in exchange rates; and I am not sure that we can afford to announce new exchange rate commitments and risk their breaking down at the first serious test by the markets.

6. This does not mean, of course, that nothing can be done to improve exchange rate stability. It only shows how difficult it is to disentangle the "systemic" problem from that of reaching a practical agreement on how to correct existing payments imbalances. In other words, we have to work simultaneously to foster appropriate, mutually consistent policies in the major countries and to lay the foundations of a more stable system.

This is the approach developed in the Report, so much deprecated by Professor Triffin, on the functioning of the international monetary system prepared by the Deputies of the

Group of Ten and published in June 1985. The analysis and recommendations of that Report have become a linchpin for efforts to strengthen the monetary system. Its main conclusions can be summarized as follows:

(i) greater stability in the exchange rates of the key currencies requires sound, stable and mutually consistent policies in the major countries; let me stress that this was the first time that the inadequacy of the "house-in-order" approach on its own was sanctioned in an official document;

(ii) in order to promote such policies, with strong emphasis on the requirement of mutual consistency, it is necessary to set up an effective mechanism of multilateral surveillance over countries' national policies; this surveillance should also ensure that conditions in financial markets are not inconsistent with the stable creation of international liquidity on a sufficient scale;

(iii) countries will have to give greater consideration to exchange rate stability in framing domestic policies, as well as stand ready to undertake coordinated interventions in foreign exchange markets to reinforce the signals sent to private agents by national policies; I stress that the role envisaged for intervention is a subsidiary one.

The Plaza agreement primarily reflected the third of these recommendations; the Tokyo Summit in May gave greater emphasis to the second by formally endorsing the creation of a system of indicators as an objective, quantitative basis for policy assessment in multilateral surveillance. Progress in implementing the recommendations of the G-10 Report has been slow. On the other hand, there are no short-cuts available: greater stability of international monetary relationships presupposes appropriate adjustment in the major countries' national policies and effective mechanisms to ensure that these policies remain on track after today's imbalances have been

eliminated. The obstacle to rapid progress is the difficulty of finding a compromise between conflicting national goals decided by Parliaments, which cannot be "forced" on to a different course overnight.

7. Let me comment briefly on the role of indicators in the surveillance process. I believe that we need to set up procedures that involve an element of effective constraint on national policies. Countries' willingness to cooperate must be tested in practice. To do this, there will have to be agreement on what constitutes a situation of policy inconsistency, as well as on the common goals and the minimum requirements for greater exchange rate stability.

An indicator system, based on the key variables of international economic interactions -- exchange rates, current payments imbalances, growth and inflation differentials, etc. -- can be of help in building and consolidating such an agreement. However, no matter how good the set of indicators or how much agreement on its analytical underpinnings, a great deal of judgement will still be required when identifying unsustainable policy configurations and appropriate corrective action. It is simply not feasible to devise automatic response mechanisms for the purpose of ensuring full consistency of national policies.

8. Finally, a brief comment on capital flows. There is no doubt that high capital mobility, international integration of capital markets, and financial innovation have made life more difficult for policy-makers. It is also true, however, that they have offered more flexible financing and investment opportunities at more attractive interest rates and thereby raised overall efficiency.

In this new environment there is a greater need for international coordination of monetary and exchange rate policies, and more care will have to be taken to prevent monetary policies from generating large new shocks. In other words we must accept that we are already operating under more stringent constraints on our domestic policies.

We can neither put our heads in the sand like ostriches or, like King Canute, try to stem the tide of financial innovation and integration. We must learn to live in the new environment and to make the best of it. We cannot hope to "roll back" innovation and change. We cannot manage exchange rates as if this more responsive environment did not exist. From this standpoint I fully agree with Professor Triffin when he says (p. 21) that "the reduction of undesirable capital flows ... should be expected ... from a better coordination of interest-rate policies".

9. I have come to the end of my comments. I hope that they do not sound too negative or critical. I consider Professor Triffin's paper to be a thoughtful and provocative statement of the major issues confronting us.

Professor Triffin has emphasized the objectives. I hope that I have clarified some of the problems to be tackled to make their achievement feasible.

I have also given, I believe, some reasons why the next meeting of the G-10 Ministers and Governors is unlikely to issue the press release proposed by Professor Triffin at the end of his paper.