

The Changing International Monetary System

1. The Experience with Floating Exchange Rates

Since the switch to floating after the collapse of the Bretton Woods system some ten years ago, the exchange rates of the major currencies have been highly unstable and there is growing dissatisfaction with the functioning of the present system.

To be sure, most countries' exchange rates have moved consistently with the need to offset inflation differentials and correct current account imbalances. Export and import elasticities with respect to (real) exchange rate changes have been high enough to produce the required corrections in trade flows, albeit only after long lags. Floating exchange rates have contributed to maintaining an open trade and payments system in the face of large real shocks in the world economy.

However, the exchange rates between the key currencies have displayed both very high day-to-day volatility and large swings, in nominal as well as real terms, and have often departed from the path that seemed justified by underlying economic conditions.

High volatility increases the risk involved in international transactions and distorts the relative price structure to the detriment of foreign trade and investment. However, with well-developed hedging facilities available in foreign exchange markets, volatility cannot be seen as a major source of concern. By contrast, large swings in the real value of currencies and persistent misalignments pose more serious problems. Such swings are hardly consistent with an orderly process of international product specialization: they distort the pattern of world trade and displace resources; they fuel protectionist pressures; and, in the absence of downward price flexibility, they can "ratchet up" inflation. The fact that economists have not yet found satisfactory ways of measuring these costs does not mean they are not being borne.

Countries' behavior can surely be taken as an indication of preference. Thus, while most countries have been more willing to adjust

their exchange rates in the direction required by external equilibrium since the switch to floating, they have opted for exchange rate regimes designed to prevent large swings in the external value of their currencies. The most important attempt to reduce exchange rate variability at a regional level was the creation, in the wake of a long period of dollar instability, of the European Monetary System in 1979.

At present, only eight currencies are classified by the IMF as "floating independently", most of the others being pegged to one of the major currencies or to a currency basket. Indeed, the system has tended to polarize around a few currencies, with three main "currency blocs" emerging: Europe, the American continent, and the Asian Pacific basin centered on Japan. This development has increased the role of the key currencies in the system and thus the impact of large swings in their value on the world economy.

Some of the macro-policy arguments in support of floating have also been eroded. Rising inflation coupled with rising unemployment and the rational expectations "revolution" in macro-economic thinking have undermined the belief that a trade-off between inflation and unemployment is available to policy makers beyond the short term.* Furthermore, confidence in the "insulating" properties of floating exchange rates has faded: the period since the early seventies, with its large real shocks of external origin, has seen the cyclical synchronization of the major economies increase rather than decrease.

2. Causes of Exchange Rate Instability

The question to be addressed is therefore: how did we get here and what are the main causes of the observed instability in key currencies' exchange rates?

The Bretton Woods system was based on an "implicit agreement" between the United States and the other countries. As the reserve currency center, the US would pursue domestic policy objectives consistent with the maintenance of price stability. The technically

* The argument that floating exchange rates would allow each country to choose its preferred combination of inflation and unemployment, although not shared by all the advocates of floating (certainly not by Milton Friedman), was no doubt influential in rallying not a few non-monetarist economists and policy makers to the floating rate flag.

tenuous, but psychologically important commitment to gold convertibility was the concrete expression of this obligation. The other countries would adjust their domestic policies in conformity with the stable exchange rate requirement; the commitment to intervene in the foreign exchange market would ensure automatic adjustment of domestic monetary conditions (insofar, of course, as such intervention was left unsterilized). Respect of these rules also ensured consistent monetary policies among countries; by pegging their currencies to the dollar, third countries "imported" the Federal Reserve's monetary stance.

The system broke down when economic policies in the United States became inconsistent with price stability. At that point it became apparent that the "rules of the game" tended to amplify US policy impulses, rather than offset them, as the other countries resisted pressures on their exchange rates.

This destabilizing feature of the Bretton Woods system has not been eliminated by floating exchange rates. The automatic rule for monetary policy coordination having broken down, interest rate differentials have created strong incentives to shift funds between assets denominated in different currencies. In turn portfolio shifts have tended to amplify the effects of policy divergencies on exchange rates and/or domestic monetary conditions in the major countries, depending on the extent of their intervention in foreign exchange markets. At the same time, the rapid expansion of the Euromarkets during the last twenty years has created new channels and opportunities for moving funds between markets and currencies, and the growing integration of international financial markets has gradually reduced the effectiveness of capital controls.

The behavior of foreign exchange markets thus needs to be seen against this background of uncoordinated policies and highly mobile capital flows.

The instability that followed the breakdown of fixed exchange rates was initially attributed to the increasing differences between the competitiveness of the major countries. It was also believed that, after a "learning" period, stabilizing speculation would again play its role in maintaining exchange rates in line with fundamental economic conditions. As exchange rate instability persisted, attention shifted to the growth and inflation rate differentials between the major countries. However, experience in recent years shows that, although it is important, convergence of these factors is not sufficient to reduce exchange rate instability substantially.

An explanation of instability cannot ignore the "physiology" of foreign exchange markets. The asset approach to exchange rate determination has emphasized the role of portfolio motives and expectations. The combination of virtually instantaneous adjustment of financial markets with much slower adjustment of trade flows results in a tendency for exchange rates to overshoot. In a highly uncertain environment, where expectations about "fundamentals" may be weakly held, exchange rate changes become an important piece of information, so that overshooting may be amplified by "bandwagon" effects with expectations feeding on expectations.

In a market where expectations play such an important role, it is inevitable that the authorities' actual or perceived behavior should have a strong influence on exchange rates, and that divergent policy courses should tend to be rapidly discounted. Hence a reliable and stable trade off between domestic policies, on the one hand, and the rate of change in the external value of the currency, on the other, will not be available.

These considerations all point to the need to manage foreign exchange markets to some extent and to provide guidance in order to prevent the emergence of a clearly unwarranted set of exchange rates.

3. International Reserves and Liquidity

The termination of the gold convertibility of the dollar and the transition to floating also gave rise to important changes in the domain of official reserve instruments and international liquidity, notably the emergence of a multicurrency reserve system and the "endogenization" of international liquidity creation.

In the first years of floating, with confidence in the dollar faltering as a result of accelerating inflation and expansionary policies in the United States, the demand for Deutsche marks, Japanese yens and Swiss francs by official reserve holders increased substantially, fostering the development of a multicurrency reserve system. This tendency came to a halt in 1980, however, when the United States returned to sounder domestic policies and the dollar started to strengthen. Indeed, after falling by about ten percentage points during the seventies, the share of dollars in official foreign currency holdings has since recovered part of the lost ground, and now stands at about 70 per cent. What is impor-

tant, however, is that the freedom arising from reserve currency status — in the sense of ability to pursue more expansionary domestic policies than other major countries — has diminished considerably. Reserve currencies have become more sensitive to actual or perceived changes in domestic policies, since the more a currency is held internationally, the greater its exposure to portfolio shifts by official and private agents.

As for the mechanisms of liquidity creation, the growth of international financial markets has made the supply of payment instruments less dependent on reserve centers' official liabilities, as external deficits have been increasingly financed through borrowing rather than settled out of reserves. Market assessment of borrowers' creditworthiness has thus come to play a greater role in controlling liquidity creation in the system.

In addition, the factors that govern the extension of credit are strongly influenced by monetary conditions in the major countries, notably the United States. However, domestic monetary policies are not generally formulated with a view to ensuring a satisfactory growth of international lending and liquidity. It is thus quite possible that an appropriate policy for domestic purposes may prove inappropriate from an international standpoint.

The experience of the seventies indicates that the present system is not satisfactory. In the years after the first oil shock the over-rapid expansion of international credit, which was encouraged by easy monetary conditions in the United States, enabled many countries to postpone adjustment and led to an excessive build up of foreign debt. When real interest rates became strongly positive in the early eighties, the debt of many developing countries became a major problem: regional "syndromes" and a "split market" developed, making the supply of liquidity unduly tight even for creditworthy borrowers.

Contrary to expectations, the passage to floating has not led to any marked decline in the demand for official reserves, and intervention by central banks in foreign exchange markets has remained sizeable. The need for reserves may be reduced by floating rates insofar as external adjustment is borne by the exchange rate, but it may also be increased by the higher interest rate elasticity of international capital flows, the variability of exchange rates, and greater uncertainty. These factors themselves affect the attractiveness of the various assets and liabilities available for financing external imbalances as well as their value and liquidity, and may therefore add to the difficulty of measuring the state of liquidity.

In short, with the advent of floating and the growth of international capital markets, the authorities' ability to measure and to regulate international liquidity has greatly diminished.

4. The Directions for Change

I will now try to indicate the direction I believe we must take to correct the shortcomings which have emerged in the present system. The primary aim must be to achieve greater stability in exchange rate relationships as well as in the creation and distribution of international liquidity.

As I pointed out earlier, despite the switch to floating the domestic policies of the leading countries still play a major role in determining the international environment. We have also seen that sound domestic policies in these countries are a necessary, but not a sufficient condition for a stable international environment. The international interaction of policies is the other major factor involved, since it affects the relative advantage of holding alternative currencies as well as agents' expectations. Monetary conditions that are adequate for domestic purposes may nonetheless be inconsistent with orderly international markets. In these circumstances the risk of conflict between domestic needs and those of the international economy is very real and may well materialize from time to time.

It follows that greater stability in international monetary relationships will not be achieved unless major countries are willing to give greater weight to international considerations when formulating their domestic policies. Recent experience suggests that Europe and Japan may be more willing than the United States to modify their national policy objectives in return for greater exchange rate stability. This does not mean that the United States will not come to accept the view that some exchange rate management is necessary and actively participate in cooperative arrangements to achieve it. The fact is that the "monocentric" economic world of Bretton Woods has gradually turned into a "polycentric" one, in which the United States is much more interdependent with the rest of the world, and its share of the industrial countries' GDP and foreign trade has diminished. International monetary relationships and institutions will eventually have to reflect this new balance.

It is in this context and with these goals in mind that the industrial countries in the G-10 are studying ways to improve the functioning of the present system.

To be sure, there are difficult technical problems to be solved. Taking exchange rates first, the size and mobility of capital flows make a degree of flexibility in key currencies' exchange rates indispensable; on the other hand, to reduce instability and keep rates closer in line with underlying economic conditions, there will have to be greater policy harmonization among key currency countries. At all events, exchange rate developments contain information about divergencies between national policies and these signals should not be ignored.

Monetary authorities cannot, of course, know exactly what exchange rates would be appropriate for key currencies at any given moment. By contrast, they can normally recognize rates that are clearly inappropriate and tell the direction in which they should be moving. In such cases policy makers will have to determine the nature of the disturbance and agree on corrective measures.

The initial response could be intervention to resist or moderate unwanted exchange rate changes. Action in other areas, notably monetary policy and fiscal policy, might also be required to counter persistent pressure on the exchange rate. Systematic consultation among the countries concerned could open the way both to mutually supportive changes in domestic policies and to coordinated intervention in foreign exchange markets.

Implementation of such an approach involves varying degrees of rigidity in the exchange rate commitment. Ronald McKinnon, for instance, proposes a rather rigid pegging of exchange rates, in order to stabilize the aggregate money supply of the key currency countries while making allowance for shifts in portfolio preferences between those currencies. He seems to attribute less weight to the need for supporting changes in other policy areas, perhaps on the assumption that convergence in these areas has already been achieved. However, if this is not the case, there is a danger that the rule of monetary coordination to maintain the pegging may result in unwarranted monetary expansion or contraction in the countries concerned.

A less rigid approach than that based on pegging is implicit in the proposals to establish target zones for the exchange rates of major currencies. While the authorities would still make a judgment on a permissible range of exchange rates, they would not be committed to

the defense of a given parity and the link between external commitment and domestic policies would be looser.

An even less rigid approach would consider exchange rate changes only as an indicator of emerging policy inconsistencies serving to trigger consultations and policy reviews.

The common feature of all these approaches is that a link would be re-established between domestic policies and exchange rates; this is tantamount to saying that at least some "rules of the game" would be reintroduced for major countries. Such arrangements would involve some loss of freedom in domestic economic management, but the gains from greater exchange rate stability are likely to outweigh that loss.

On liquidity, we have seen that the advent of floating and the rapid growth of international financial markets have weakened our ability to regulate the creation of international means of payment; indeed, we have experienced periods of rapid expansion and sharp contraction.

A rapid shift from easy to tight liquidity conditions, in the wake of the large rise in real interest rates, was a factor in the emergence of the foreign debt problem in 1982. Since then, effective adjustment policies in debtor countries and a major cooperative effort by international institutions, commercial banks, and the monetary authorities of the industrial countries have made it possible to avoid serious disruptions in world financial markets. The approach that has been followed, based on a case-by-case evaluation of individual countries' conditions, has proved appropriate: there has been substantial progress in external adjustment, while debt maturities have been lengthened through rescheduling.

However, return to normal conditions in international financial markets will not eliminate the aspects of the system that have given rise to the present difficulties. In this regard, one influential view holds that the transition to a multicurrency reserve system is irreversible and that, on balance, the world can live with it. Personally, I believe that in the longer run the issue of making international liquidity less dependent on the major countries' national policies will have to be addressed. The Group of Ten plans to devote some time to these issues at a later stage. The starting point could be a rethinking of the role of the SDR in the system, especially as regards the creation and composition of reserves. In this context, it would also be worth taking up the idea, aired a few years ago, of making the IMF a fully SDR based institution.

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To conclude, the system that emerged from the ashes of Bretton Woods has withstood the strains induced by major real shocks and has helped to overcome them. However, drawbacks and shortcomings in its operation have become apparent. Above all, the system has displayed a high potential for instability. An eminent American scholar and public figure recently stated that, while the present system is not in any immediate danger of collapse, it must eventually evolve into something else.

We should seek to guide the adaptation and reform of the international monetary system in a rational and orderly manner. It is important to re-establish a "sense of direction" and to reach agreement on how to move the system in that direction. The immediate priority is for all the members of the international community to be more willing to give greater weight to international considerations when formulating their domestic policies.

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