INTERNATIONAL MONETARY REFORM: AN AGENDA FOR THE 1980s

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The establishment of the Commonwealth Study Group to examine the international financial and trading system is one more sign that the international monetary non-system that emerged from the negotiating failures of the 1970s is no longer viewed with the same complacent satisfaction as formerly. Global stagflation, repeated acute misalignments of exchange rates, breakdown of the recycling process and the threat of a financial collapse have combined to create widespread dissatisfaction with present arrangements. But that raises the question as to what arrangements might be preferable.

The present paper is intended to offer a view of those areas where changes might be particularly worthwhile. The paper takes up five areas: the coordination of macroeconomic policies; limitation of exchange-rate misalignments; non-concessional real resource transfers; expansion of compensatory financing; and promotion of the SDR. These topics are central to any medium-run reconstruction of the international financial system. The paper does not attempt to cover the related topics of trade and aid.

1. Coordination of Macroeconomic Policy

The simultaneous world recession is the principal source of the current setback to world development, just as it is the principal source of economic dissatisfaction to the people of the industrial countries. A decade ago, the simultaneous world boom of 1972-73 was the principal cause of the acceleration in world inflation. At that time it had become fashionable to argue that the Keynesian orientation of macroeconomic policy in the postwar world was not a major part of the explanation for the prolonged period of near-full employment that the world had experienced. That contention looks a lot less persuasive now, following a period in which Keynesian stabilisation policies have been quite deliberately abandoned and the world has gone into the deepest recession in half a century. If the world is ever to get back to anything approaching the prosperity of the 1960s, it will surely have to revive demand management.[1] And given the degree of interdependence that now exists, that will almost inevitably require recreation of a degree of policy coordination at least as great as that resulting

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from OECD surveillance within the context of the Bretton Woods system in the 1960s.

It is not only "Keynesians" who ascribe a significant part of the blame for the severity of the current recession to failures of policy coordination. Arguing from a "global monetarist" perspective, Ronald McKinnon (1982) has pointed to the sharp deceleration in the rate of aggregate monetary growth of the major convertible-currency countries as the principal source of trouble. He argues that this deceleration was unintended, and would not have been desired ex ante, but that it resulted accidentally as a byproduct of asymmetrical sterilisation policies. Tight monetary policy in the United States - reinforced by various confidence factors - led to a shift by money holders out of other currencies into dollars. These movements led the monetary authorities in Europe and Japan to intervene, and, as is customary, their intervention was incompletely sterilised. But in the United States the pursuit of a monetary growth rule involved full sterilisation of all exchange market intervention. The argument is that the stock of dollars in the hands of the public therefore remained unchanged following (for example) German intervention to limit the fall in the DM, while the stock of DM declined, so leading to contraction in the world money supply.

Coordination can be pursued either by laying down a set of rules[2/] intended to ensure consistency if they are pursued by all parties, or by periodic discussions intended to promote the adoption of mutually consistent policies. The main advocate of a rule-based approach has in recent years been McKinnon. He has urged monetary coordination between the three major countries (the United State, Japan, and Germany), to take the form of an agreement to a common[3/] rate of domestic credit expansion (DCE) and pegged mutual exchange rates maintained by unsterilised intervention. Such an agreement would prevent shifts in the demand to hold dollars, yen and DM affecting either the mutual exchange rates of the three currencies or the aggregate money supply of the three countries. If one believes that demands depend more on total money supply than on its currency breakdown as a result of asset-holders substituting among the three currencies, and that there is little gain from allowing exchange rates to change so as to promote the price changes needed to adjust to real shocks[4/], such a rule would be attractive and could be expected to stabilise the world economy. The rule could be extended to accommodate more countries and even to accommodate differential inflation rates (with a higher rate of DCE being allowed to a more inflationary country, whose exchange rate would be depreciated through a crawl).

Most advocates of coordination have, however, envisaged periodic international discussions to coordinate either the objectives or the instruments of economic policy. At one level, international gatherings have no difficulty in agreeing on objectives like price stability, full employment, and sustained and balanced growth, but this does not take one very far. The Versailles Summit declared that the countries whose currencies comprise the SDR accept a special responsibility to work for greater stability of the world monetary system, and to that end undertook to strengthen their cooperation with the IMF in its work of surveillance. There is no published record of what that has involved so far, but it has been asserted that the only proposal to have been made is that the five major countries seek to achieve convergence of their inflation rates in the range of 3 percent to 5 percent. If correct, that report is indeed disquieting, for it is by now well established that the one thing exchange rate flexibility really can do rather well is to neutralise the effects of differential inflation. (Moreover, a minimum inflation rate of 3 percent would actually require Japan to increase its inflation!) There is a case for seeking to limit real exchange rate fluctuations, and a good case can be made for coordinating current account targets or real growth rates, but it seems that the authorities have started off by seeking to coordinate the one objective that is better left uncoordinated.

Proposals to agree to a consistent set of current account targets were much discussed in the OECD in the 1960s. At that time the exercise was rather academic, in as much as countries did not actually wield any effective policy weapons intended to influence the current account outcome if this appeared likely to differ from the target. The subject reappeared in more acute form at the time of the Smithsonian, where some rough compromise was achieved. A number of writers (e.g., Solomon, 1975) reopened the subject after the first oil price increase, arguing that attempts to pass on the oil deficit could lead to competitive devaluations, payments restrictions, or deflation. Nothing was done, and the lack of overt signs of competitive policies in the late 1970s led to a general belief that the absence of agreed targets had not mattered. With the hindsight provided by the debt crisis, one might wonder whether agreed current account targets would not have provided a valuable early warning signal when the large industrial countries passed on the entire oil deficit. Similarly, if international lending is no longer to be left entirely to the atomistic decisions of individual bankers, one way of introducing some collective guidance as to how much borrowing is appropriate would be to have the Fund develop a set of current account targets. That would have the advantage of providing some reassurance that attempts by deficit countries to adjust would neither be

thwarted by the reactions of surplus countries nor lead to a further downward spiral in world income.

It is the concern to stabilise world income around a full capacity trend that has occasionally provoked proposals to coordinate target growth rates - most notably at the time of the locomotive debate. More commonly, however, the emphasis has been placed on coordinating the fiscal and monetary instruments that are major influences on the growth of demand. This had indeed traditionally been perceived as the central issue in policy coordination (Cooper, 1968, 1982). It is an ambition that is out of favour with the authorities of the leading countries at the moment for ideological reasons, as a result of which the international organisations have largely abandoned any attempt to give a lead. In an attempt to fill the resulting vacuum, the Institute for International Economics convened a conference in November 1982, where the measures called for to support a concerted global recovery were discussed. The resulting statement of 26 economists (1982) provides a model of the type of policy coordination that some of us believe the international organisations ought to be aiming at. In order to do that, what is needed is a change of heart rather than any institutional reform.

It has been argued in this section that policy coordination is vitally important but is presently obstructed by the dominant ideological predisposition of the major countries. As and when these countries permit the international organisations to resume a positive role in policy coordination, one might hope to see both an attempt to set consistent current account targets and guidance to monetary and fiscal policies in the major countries. (But the one thing that is an official target for convergence at the moment, inflation, is best left uncoordinated. This is not to say that it would not be nice if all inflation rates converged on zero, but rather that one country's success or failure in that regard has absolutely no bearing on what any other country should be aiming at.)

There may also be a case for more formal monetary coordination of the McKinnon type and for exchange rate targeting, but those topics are best dealt with under a separete head.

2. Limitation of Exchange Rate Misalignments

It has lately been found useful to distinguish between exchange-rate volatility and misalignments. By volatility is meant the short-run variability of an exchange rate. There is abundant statistical evidence that volatility has increased several times over, on any measure,

since the advent of floating. But the evidence that this has had a serious adverse impact on economic efficiency is rather slim: there is some evidence that it has had a modest effect indiscouraging trade (Williamson, 1981, p. xvii), and continuing worries that it may reduce investment and ratchet up inflation, but little hard evidence of either effect. By a misaligned exchange rate is meant a rate that results in a level of competitiveness far from an appropriate medium-run norm, or equilibrium. The past few years have witnessed repeated major and persistent misalignments of all the major currencies (except the French franc), involving overvaluations and undervaluations in some cases larger than those experienced in the breakdown phase of the Bretton Woods system. Naturally this had led those who were critical of the adjustable peg because of its inability to prevent the emergence of misalignments to take a jaundiced view of present arrangements.

In contrast to the apparently limited costs of exchange rate volatility, the costs of misalignments are clearly substantial. An overvalued rate causes recession, bankruptcies, protectionist pressures, and deindustrialisation. An undervalued rate causes inflationary pressures and provokes protectionist pressures abroad. Alternation between overvaluation and undervaluation is likely to increase the overall rate of inflation (through ratchet effects), reduce productive potential (through bankruptcies and the closure of capacity), and encourage protection.

Any attempt to limit exchange-rate misalignments would have to start off some notion of a correct level, or at least range, for the exchange rate. A first question concerns the concept of "the exchange rate" that is relevant for expressing target rates or, less ambitiously but more realistically, target zones. There are two dimensions here: bilateral versus effective exchange rates, and nominal versus real rates. The choice between bilateral and effective rates becomes important only when some rates are misaligned; choice of a bilateral rate target would mean that in that situation other countries would encourage their rate to move out of line with the generality of currencies along with the currency in terms of which their target is expressed, which would be counterproductive. An effective exchange rate target therefore seems natural. Given that the desire to limit misalignments stems from concern for the impact that misalignments have on inflation and recession, it would make no sense to fix target zones in nominal rather than real terms. (For purposes of short-run management targets would of course have to be translated into nominal rates, but those nominal targets would be automatically revised in the light of accruing price data.) One may therefore assume that target zones would be

expressed in real effective exchange rates.

A second question is where target zones should be calculated/negotiated. The natural forum would be the IMF. The Fund could start making such calculations on an experimental basis in advance of any agreement that they would influence the policies of Fund members in any systematic way.

A third question is whether target zones should be publicised or not. Provided that target zones were in fact set on the basis of an evaluation of where rates ought to be to avoid distorting prices, rather than on "prestige" grounds, it would seem highly desirable to publicise target zones so as to provide a focus for stabilising speculation.

A fourth question is the principles on which target zones should be calculated/negotiated. Bergsten and Williamson (1983) argue that the correct conceptual criterion is what they term the "fundamental equilibrium rate," using that term to connote an absence of "fundamental disequilibrium" in the Bretton Woods sense. That is, the Fund should be asked to estimate the real effective exchange rates that would be expected to produce reasonable current account outcomes over the cycle as a whole. Naturally these will depend upon the employment levels that countries expect to achieve on average over the cycle. "Reasonable" current account outcomes would of course be the set of coordinated current account targets discussed in the previous section, if these existed; if they did not exist, they would have to be invented. No one imagines that a calculation like this would give a pinpoint answer that would deserve any credibility, but it would be reasonable to hope for an estimate that would be meaningful within a range of plus or minus 5 percent. That is indeed one argument for preferring target zones to target rates. (Note that the Fund already routinely makes such calculations when advising its small borrowing members how much they should devalue, while a multilateral negotiation along these lines was once successfully concluded at the Smithsonian.)

The final question concerns the policy adjustments that countries should be expected to make in order to limit deviations of their rates from the target zones. Although mere proclamation of target zones might have some effect in providing a focus for stabilising speculation, one would expect this effect to be rather small (and it might conceivably be perverse, given the track record of governments in making pronouncements about exchange rates). It is natural to think of intervention as a major instrument for influencing exchange rates. The Versailles Summit commissioned a study of the effectiveness of intervention,

which by all accounts is going to report that, while sterilised intervention has some effects and can at times be a useful tool in curtailing volatility, it is unreliable and its longer-term effects are weak.* This implies that if one wishes to limit misalignments - which are by definition rather persistent deviations from target - then it will be necessary to resort to some more forceful instrument.

The natural candidate is monetary policy (this is the element of truth in Mundell's (1962) "assignment" of monetary policy to external balance). A systematic way of directing monetary policy to the task of limiting misalignments would be to intervene to that end and then to avoid completely sterilising the monetary impact of intervention. This might encounter objections both from monetarists who believe that the key to macroeconomic stability lies in stable growth of some aggregate measure of the domestic money supply and Keynesians who would wish to maintain national autonomy over interest rates. Both groups would view an exchange rate target as a constraint on domestic monetary policy. There is admittedly an alternative viewpoint, represented by McKinnon's argument presented in the previous section and by all those who advocate stabilising domestic inflation through a nominal peg for the exchange rate, which regards an exchange-rate peg as a use of domestic monetary policy rather than as a constraint on it. But that alternative view rests on the presupposition that international arbitrage can control domestic inflation without creating the type of price distortions that give rise to concern about misalignments. Thus if one worries about misalignments, one is perfectly entitled also to worry about the trade-off between the monetary actions needed to limit misalignments and the actions needed to promote domestic stability. One argument[5/] for McKinnon's proposed monetary rule of having the major countries agree on DCE targets and then not sterilise is that this would offer hope of securing an international environment where the competitiveness/monetary ease tradeoff is not acute.

The potential constraint on monetary policy will presumably limit countries' willingness to enter into firm commitments to curb misaligned exchange rates. But it need not lead to rejection of any initiative in this area. There would be absolutely no constraint on monetary policy in adopting the "reference rate proposal" of Ethier and Bloomfield (1975), under which intervention that had the affect of pushing the rate away from the reference rate - presumably the centre of the target zone - would be

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* Report of the working group on Exchange Market Intervention, Chairman, Philippe Jurgensen, Jan. 1983. Ed.

prohibited. Furthermore, intervention tending to push rates toward the target zone whenever they lay outside it could be encouraged without being mandatory.

This section has argued that a second important area for reform lies in making a reality of what is now an empty process, IMF surveillance of exchange rates. To that end the Fund should negotiate (and revise as necessary) a set of target zones for exchange rates. Intervention tending to push exchange rates away from the centre of their target zones should be prohibited, while intervention pushing rates outside the target zones toward those zones should be encouraged. Such intervention should not be completely sterilised.

3. Non-concessional Real Resource Transfers

Even before the first oil price rise, the commercial banks had become significant lenders to developing countries. All the parties involved found it convenient to allow such lending to expand greatly after 1974; the developed countries, because this enabled them to pass on the oil deficit while limiting the recession; the developing countries, because this enabled them to maintain investment and growth without accepting conditionality; OPEC, because this enabled them to acquire liquid bank deposits; and the commercial banks, whose deposits and profits grew. The commercial banks thus came to dominate the recycling process.

The commercial banks lent on relatively short maturities (no more than 8 or 10 years) and with floating interest rates. The inevitable result was that debt service payments built up relatively rapidly and could rise as a result of a rise in world interest rates, independently of the policies of the borrowing countries. So long as real interest rates remained low or negative, financial markets remained liquid, and the exports of the borrowing countries were booming, banks had little hesitation in rolling over maturing debts and extending new credits. But, because of the high and unpredictable level of debt service involved in any given level of borrowing, it was a process that was inherently vulnerable to any reversal of confidence.

As we now know, such confidence reversals hit Eastern Europe in early 1982 following the Polish crisis, and Latin America in late 1982 following the Mexican moratorium. Even though Asian borrowers have been largely unscathed, it now seems to be generally accepted that the flow of new bank credit to developing countries will be roughly halved in the next few years, from a figure of over $40 billion per annum to something in the region of

$20 billion per annum . This is significantly below the level of interest payments by the developing countries to the commercial banks, which implies that developing countries in aggregate will be transferring real resources. Given the greater marginal productivity of capital that theory implies and evidence suggests to exist in developing countries, this is not consistent with an economic allocation of world investment. There would be a net world benefit in repairing the recycling process so as to allow the developing countries to resume net borrowing.

There would seem to be three general ways of seeking to achieve this (none of which will be at all feasible unless developing countries continue to make strenuous efforts to meet their existing debt-service obligations). One would be to continue to look to the commercial banks for the bulk of the lending, though no doubt at a more measured pace than in the 1970s. Various guarantee schemes have been proposed to this end. On the other hand, it can be argued that it is neither probable nor desirable that the commercial banks resume the leading role. It is not probable because the scare that the banks got in 1982 will not be quickly forgotten, either by the banks themselves or by the authorities that are responsible for supervising them. It is not desirable because banks have short-term liabilities denominated in nominal terms, and therefore have to acquire assets with corresponding attributes: the rollover loan permitted a degree of maturity transformation, but (a) the acceptable maturities are still limited relative to the time-scale of development, where anything under 30 years maturity is essentially short-term; and (b) borrowers are exposed to the risk of arbitrary variations in the real rate of interest on their debt.

A second solution is through the official sector. Those who deliberate on questions of international finance tend to have an occupational bias toward calling in the public sector to remedy perceived deficiencies in the operation of the private sector. Accordingly, most proposals for increasing the flow of resources to developing countries have envisaged creation or expansion of some international financial intermediary, like the World Bank, the Brandt Commission's World Development Fund, the regional development banks, and sundry proposals for massive resource transfers. But however sympathetic one may be to doing what is feasible in this direction, realism dictates recognition of the fact

that there are two constraints which may mean that this is fairly modest. (1) Most of these institutions operate primarily by providing project aid, and there are limits to the number of worthwhile projects, and especially to the foreign exchange component of the capital value of such projects. This constraint should surely be relaxed where possible, e.g., by raising or abolishing the ceiling on the proportion of the World Bank's lending in the form of structural adjustment loans, but it is doubtful that countries will be willing to authorise large enough changes to achieve a major impact. (2) The political climate is not propitious to major new commitments by Northern governments on behalf of Southern development. It can of course be countered that it is the job of politicians to change such political constraints rather than to accept them as data, but acceptance of that riposte need not preclude economists from seeking approaches less out of tune with the ideology of the moment.

The third general approach to repairing the recycling process involves attempting to tap private-sector lenders who would be in a position to lend on more suitable terms than commercial banks can. Given that most savings are now institutionalised, this means essentially trying to tap the portfolios of pension funds and insurance companies, institutions that have long-dated liabilities and that are more interested in real yields than in being assured of a given nominal book value at each moment of time. (Until recently the low-absorbing OPEC members would also have been natural targets for assets with assured real yields but fluctuating nominal values.) I have developed a possible scheme intended to appeal to such investors (Williamson, 1982b) with the following principal features:

- indexed long-term bonds issued by an international financial institution like the IMF or World Bank acting as the agent for a collective of developing countries;
- partial guarantees provided by the stock of IMF gold and/or non-interest bearing bonds to be donated by graduating developing countries, as an initial step toward their assuming aid obligations:
- the volume of bonds issued each quarter to be determined by the intersection between the demand prices bid by potential bond purchasers and the supply prices offered by eligible borrowers, with the permissible level of borrowing by each country being limited by

(a) a constraint on its proportionate participation in each bond issue, so as to ensure that each issue represents a well-diversified package of risks, and (b) a rolling limit on total cumulative borrowing, designed to ensure that borrowing countries make proper use of their borrowings to support investment and growth.

Although the various features of the above proposal were intended to complement one another, there is no intention to claim that this is the only way, or even the best way, to tap the portfolios of the pension funds and insurance companies. The subject has received far too little consideration to justify any such claim. It is possible that individual countries would be able to issue long-term bonds if they were prepared to index. My own guess is that the attractions of a highly-diversified bond with a measure of international support would be much greater than those of bonds issued by individual countries, but at the moment that remains a conjecture. The subject is one that merits far more consideration than it has received.

It has been argued in this section that there is a general international interest, as well as a strong developing country interest, in repairing the recycling process, interpreted as a significant transfer of real resources to developing countries on non-concessional terms. However, it is doubtful whether it would be desirable to do this by placing major reliance on the commercial banks or whether the political will exists to do it by expanding official institutions. A third approach, in which an official institution would act strictly as a manager in organising sales of long-term indexed bonds issued to the private sector by a collective of developing countries, was sketched.

4. Compensatory Financing

The first change in the rules of the international monetary system that the developing countries succeeded in securing was the introduction of the IMF Compensatory Financing Facility in 1963. This provided for low-conditionality drawings to finance temporary shortfalls in earnings of exports of primary commodities below the estimated medium-term trend caused by circumstances beyond a country's own control, subject to limits set by the size of a country's quota. Those limits were so strict that the total sums drawn under the facility were distinctly modest until the limits were liberalised at the Jamaica meeting of the Interim Committee in 1976. That resulted in a

substantial increase in the scale of lending. Nevertheless, borrowing under the facility remained modest by comparison with the terms-of-trade deterioration experienced by developing countries in 1979-82, for two reasons: the quota limitation, and the ineligibility to draw against terms-of-trade losses occasioned by price increase, e.g., of oil.

One of the most persuasive reform calls to have been advanced in recent years is for an extension and rationalisation of the low-conditionality facilities of the IMF to encompass all cases where a country's balance of payments on current account goes into deficit for reasons beyond its control. This case was argued by Dell and Lawrence (1980) following the UNCTAD study on the balance-of-payments adjustment process in developing countries after the first oil shock. They argued that the bulk of the payments deterioration suffered by developing countries after 1974 had resulted from circumstances beyond their control, notably the oil price increase and the Northern recession. For the world to extend automatic credit to developing countries that encounter such adverse exogenous shocks was only an extension of the logic already embodied in the Compensatory Financing Facility and the Oil Facility.

The Fund has made a small step toward recognising the logic of this argument, through its introduction in 1981 of temporary excesses in the cost of cereal imports as a second criterion, parallel to export shortfalls, for qualifying for compensatory finance. But it has resisted any more comprehensive extension of low-conditionality finance (and deliberately avoided creating a new Oil Facility following the second oil price increase), despite the fact that the existing Compensatory Financing Facility financed no more than 4 percent of the catastrophic terms-of-trade losses suffered by sub-Saharan Africa between 1979 and 1982 (Helleiner, 1982).

The logic used to justify this resistance is that deficits that are not inherently self-correcting need to be adjusted rather than financed, even if they are caused by events exogenous to the country involved (Nowzad, 1981). That is a perfectly reasonable position in itself, but it does not dispose of the case for providing a greater capacity to finance those exogenous shocks that <u>can</u> be presumed to be temporary. One may also argue the desirability of providing low-conditionality finance on a <u>tapering</u> basis when a country encounters what is judged to be a permanent adverse exogenous payments shock (Williamson, 1982a, p. 16). That would preserve the appropriate incentive for countries afflicted by permanent shocks to initiate promptly the adjustment policies that are called for, while providing the finance to permit the adjustment to be undertaken gradually

and in a manner of the country's own choosing. Countries that did not make effective use of this grace period to achieve adjustment would still be thrown back on the high-conditionality facilities of the Fund in due course.

A rationalised low-conditionality facility would presumably involve projecting countries' trend import capacities, and spelling out the assumptions underlying those trend projections ex ante. If the assumptions about variables exogenous to the country proved adverse to the point of reducing import capacity by more than 10 percent (say), then the country would be entitled to draw some percentage of the value of the shortfall in import capacity. The eligible percentage rate of entitlement would presumably increase with the percentage extent of the shortfall. (For example, countries might be eligible to draw 50 percent of any shortfall of between 10 percent and 20 percent of the projected trend, and 100 percent of any excess over 20 percent.) If the shortfall was accompanied by a downward revision in the projected trend (i.e., if the deterioration was due to factors judged to be permanent rather than temporary), then drawings equivalent to the difference between the prior and revised projections would be tapered over time.

It would be necessary to consider whether the entitlement to draw under such a scheme should be limited by the size of a country's IMF quota. The logic of the scheme would seem to argue against such a restriction, since the scheme embodies an alternative objective criterion for rationing access to Fund credit. But the need to safeguard the liquidity of the Fund argues in favour of retaining such a restriction (though perhaps in a liberalised form). If the Fund were to be reformed to be based entirely on the SDR (Polak, 1979), this objection would disappear, which is an important argument for seeking such a reform.

It would be logical to provide that the repayment obligations under an extended Compensatory Financing Facility should be based on similar principles as the entitlement to draw; i.e., that repayment should depend on ability to pay, as measured by import capacity relative to its projected trend, rather than on a fixed schedule. For example, countries with outstanding debt under the facility might be expected to use 50 percent (100 percent) of their earnings more than 10 percent (20 percent) above the projected trend. To ensure that borrowing did not build up cumulatively even if the trend projections were on average somewhat over-optimistic, one might add an asymmetrical requirement that 20 percent (say) of earnings above trend by less than 10 percent should be devoted to repayment.

If the world had a conscience, one might dream of adding a provision whereby the drawings of very low-income countries produced by exceptionally severe shortfalls in import capacity - say, of greater than 20 percent - would take the form of grants rather than loans, financed by some special international Trust Fund. Despite the STABEX precedent, the cynical indifference with which the world has disregarded the suffering inflicted on the poorest sub-Saharan countries by the decision to curb inflation through unaided monetary restraint forces one to conclude that it would be unwise to expect much from appeals to the conscience of the rich. Perhaps the best chance of getting some redistributive element into such a scheme would be by way of interest subsidies on drawings by low-income countries. It could be argued that interest subsidies on drawings from such a facility would be largely free of the customary moral hazard objection (which argues that the availability of a subsidy gives an incentive to countries to adopt policies that would qualify for a loan), as well as being largely immune to concerns for the rather arbitrary redistributional impact of most interest-subsidy schemes.

5. Promotion of the SDR

The criteria adopted when the SDR was created for determining the volume of SDR allocations referred to the Fund seeking "... to meet the long-term global need ... to supplement existing reserve assets in such a manner as ... will avoid economic stagnation and deflation as well as excess demand and inflation in the world" (Article XVIII, Section 1(a)). By that criterion, there is a far stronger case for an SDR allocation now than there has ever been before since the SDR was invented. Given the need for financial reconstruction and a stimulus to real activity, there is a good case for a very substantial allocation. But given the equally important needs to avoid undermining the incentive to persevere with determined adjustment policies in the large debtor nations and to avoid restimulating inflation, there is a case for making that allocation on a once-for-all basis rather than in a series of installments over a "basic period."

While the author has traditionally sympathised with the demand for the link, on the ground that the assorted technical arguments for and against are marginal and unpersuasive while the distributive effect would be progressive, this is not a topic that merits any further investment of scarce negotiating capital. Now that the SDR interest rate has been raised close to a commercial level, the redistributive impact of the link would be modest. Furthermore, pressure for the link is jeopardising the prospects of the SDR and is in that way ensuring that the

seigniorage benefits of reserve creation all accrue to the large industrial countries. Withdrawal of the traditional LDC negotiating position on this issue would be an act of statesmanship.

However, any major development in the SDR is going to require more than new allocations or a willingness to end the controversy over the link. There seems to be increasing support for the proposition that any major role as a reserve currency, and even as a currency peg, will require the SDR to become usable as an intervention currency. That in turn would require that the SDR both become widely held in the private sector and transferable between the official and private sectors. If that were to occur, it would make the option of pegging to the SDR vastly more attractive, since it would dispose of the current objection that an SDR peg buys the advantage of greater macroeconomic stability at the microeconomic cost of depriving one's traders of any link with a major international currency in terms of which they can invoice and cover. And clearly countries that pegged to and intervened in the SDR could be expected to seek to hold a substantial part of their reserve portfolio, including their working balances, in SDRs.

The key step required in order to open up the possibility of such developments is the introduction of clearing arrangmenets that would permit SDR transactions among private banks and between private banks and the official sector. It has long been assumed that the present Articles of the IMF, which prohibit private SDR holdings, rule out official transactions with the private sector and also any official involvement in private clearing. Accordingly only those daring enough to contemplate a third amendment to the Fund Articles could envisage steps that might permit a major expansion in the role of the SDR. But recently Coats (1982) described a scheme which would permit use of the SDR as a means of payment among commercial banks. This scheme involves commercial banks opening SDR accounts with their central banks, which would net out intra-national transactions and then settle international balances by drawing on their SDR accounts with the Fund. But the Coats Plan would still not permit SDR intervention.

A proposal that would permit both clearing of SDR transactions among commercial banks and SDR intervention is developed in a new paper by Peter Kenen (1983). He proposes to create a Clearing House, which would be an official institution eligible to become a holder of official SDRs but also prepared to accept SDR deposits from commercial banks. Banks could acquire SDR deposits at the Clearing House through their national central bank, which would purchase national currency from the bank and transfer an equivalent

value of SDRs to the Clearing House. Transactions among commercial banks would be cleared on the books of the Clearing House with no change in the assets of the Clearing House, while official intervention would be settled by countries transferring SDRs between their account at the Fund and the Clearing House. At no time would official SDRs be owned by the private sector, so that an amendment to the Fund Articles would not be needed.*

6. Concluding Remarks

This paper has outlined five major developments in international monetary arrangements that appear feasible and desirable in the circumstances of the 1980s:

- macroeconomic policy coordination, covering the articulation of consistent current account targets and guidance to fiscal and monetary policies in the major countries;
- the negotiation of a set of target zones for exchange rates, backed up by a measure of intervention that is not completely sterilised;
- the issue of long-term indexed partially-guaranteed bonds by an official institution on behalf of a collective of developing countries;
- extension and rationalisation of IMF compensatory financing to provide low-conditionality finance for any substantial shortfall in foreign exchange earnings below the projected trend as a result of exogenous developments;
- creation of an SDR Clearing House to facilitate private use of the SDR and permit SDR intervention.

These proposals are mutually consistent but operationally independent. Any one (or more) initiatives could be pursued in isolation as and when a groundswell of support for such a change should develop. They could equally well be adopted simultaneously, if there were a widespread will to make sweeping changes in existing arrangements. In that event it would no doubt make sense to convene a "second Bretton Woods conference." But in the

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* See also R.N. Cooper, "The Evolution of the International Monetary Fund toward a World Central Bank", in this volume. Ed.

absence of a general consensus on the broad outlines of desirable change, a conference would be more likely to waste time and engender acrimony and disappointment than to agree on constructive changes. This suggests that diplomatic efforts would be better directed to pressing for such of the above speicfic reforms as commend themselves than to calls for a new Bretton Woods.

Footnotes

1. "Demand management" is sometimes libelled by treating it as a synonym for demand expansion or the pursuit of high levels of demand regardless of the consequences for inflation. That usage is not adopted here. The term is used to connote a policy of varying fiscal and monetary policy with a view to achieving a target pressure of demand, and at least some of us take it as axiomatic that target has to be chosen with a view to controlling inflation.

2. It is convenient to use the term "rules", even though in international relations these normally take the form of guidelines rather than of hard obligations, transgression of which brings automatic retribution.

3. The agreed rates of DCE might need to differ somewhat to accommodate differences in trend real growth rates or income elasticities of demand for money.

4. One might believe that because one doubts either the importance of real shocks, the need for prices to change to offset real shocks, or the ability of an exchange-rate change to facilitate price changes.

5. An argument that does not depend on McKinnon's faith in the power of goods arbitrage.

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