International Economic Management, International Liquidity and Resource Transfers in the 1990's

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I. Introduction

Issues of international macro-economic co-ordination, of international liquidity and of net resource transfers have each been extensively analyzed in the 1980's both in the academic literature and in the debates of policy-makers. It is surprising, however, that two crucial areas have been almost totally ignored: a) the key areas of overlap between macro-economic co-ordination, international liquidity and net resource transfer, particularly but not only as they affect developing economies and b) discussion of institutional aspects and changes required, so that desired policy objectives can be achieved. Though this paper will examine co-ordination, liquidity and transfer issues, it will particularly stress the neglected yet crucial areas of overlap and of institutional arrangements.

For example, macro-economic policies of the major industrial countries' (and their co-ordination or lack of it) have a very strong influence on the nature and magnitude of private liquidity and resource flows to developing countries. This was perhaps most vividly illustrated by the effects of industrial countries' macro-economic policies in the late seventies and early eighties (both directly, via interest rates, and indirectly - via bankers' perceptions of LDC creditworthiness) on capital flows to and from developing countries. One of the reasons why the Bretton-Woods institutions should be intimately involved in the process of industrial countries' macro-economic co-ordination is precisely to evaluate and attempt to influence their impact on financial flows to and from developing countries. In the 1980's, the Bretton-Woods institutions spent much of their financial and professional resources on managing and containing the international debt crises; it would have been far more efficient from the point of view of those institutions - and more broadly, for the development process - if the Bretton-Woods institutions could have been able to exert influence on individual industrial countries (and on the aggregate of their actions) earlier to help avoid, or at least diminish, the gravity of the debt problem in the first instance. As we shall see below, this argument is reinforced by the growing evidence that more (and better) macro-economic policy coordination among industrial countries' governments is of benefit to their own economies.

The Bretton Woods institutions are too often criticized for what they do and how they do it; it seems far more crucial to concentrate on remedying "their sins of omission", on what they should do, but have not been able or willing to do until now, and to design mechanisms for them to act in those areas.

Either if one approaches the issue from the perspective of their effect on liquidity and resource transfer needs for developing countries or from the perspective of the relative weight of industrial economies in the world economy, it seems obvious that the Bretton Woods institutions, and particularly the IMF, should focus in the 1990's relatively far more energy and resources on influencing policy-making in industrial countries than they have in the seventies and eighties, (in particular, the Bretton Woods institutions should focus on analyses of the global impact of major industrial countries' policy actions or lack of actions) Perhaps a good rule of thumb would be, particularly for the IMF, to devote analytical and policy advice effort to countries, in proportion to their relative importance in the world economy (measured for example, by the size of their GDP, as proportion of world GDP, or by the size of their current account result-surplus or deficit - as proportion of the aggregate sum of total and current account surpluses and deficits). Furthermore, the IMF - and to a lesser extent the World Bank - should give more attention to its' direct and indirect role in influencing the global economy, in areas such as the creation and regulation of global liquidity. By moving in this direction, the Bretton Woods institutions would both enhance the significance of their role in the world economy, and hopefully improve performance in both developed and developing countries.

II. International co-ordination of industrial countries' macro-economic policies

At a time when world economic interdependence has increased significantly, an important group of analysts agree that the need for global economic management is far greater than in the past (though there are some analysts, who do not share this view). This trend coincides with the decline of the United States as a world economic leader, with no other country quite ready to replace its' leadership role; it also coincides with a period of relative weakening of the Bretton Woods institutions, institutions ideally suited for the role of global economic management.

The role of the IMF was greatly reduced by the breakdown of the fixed exchange rate system in the early 1970's, the limited use of the SDR mechanism to create or absorb liquidity and the very limited ability of the IMF to influence industrial countries' monetary and fiscal policy

For twenty five years after World War II, exchange rate arrangements were governed by the Bretton Woods system. The fixed exchange rate system provided an automatic signal for policy adjustment in the form of imminent or actual inflows and outflows of reserves, whilst the desire to manage the system without crisis led to the practice of multilateral policy discussion and surveillance of industrial economies, in which particularly the IMF, but also the working parties of the OECD, played a major role. When the fixed exchange rate system broke down, there was an attempt to design a new, more flexible and more symmetrical world system, through the IMF's Committee of Twenty. This attempt failed largely due to the widespread belief - at the time - in the industrial countries that floating exchange rate not only afforded freedom of manoeuvre and far greater sovereignty, but also was thought not likely to have negative economic effects. Large capital movements and the first oil crisis reinforced then the view that floating exchange rates were the industrial countries' best option.

The new regime was called a "*non-system*" [1], because of its' clear lack of collectively agreed rules about exchange rates, about modalities for creating and absorbing liquidity, about the adjustment process and about the desirable scope of co-ordination of economic policies. With the Second Amendment to the IMF's Articles of Agreement (in 1976), the old obligation to propose new values to the Fund was replaced by the requirement that members keep the Fund informed about their exchange-rates; more importantly, the need for Fund approval of changes in par values was replaced by the far weaker requirement that the Fund "exercise firm surveillance" over its' members' exchange rate policies. The IMF's power and influence was further limited by economic circumstances in which conditional assistance to industrial countries was far less likely to be called upon.

More generally, the introduction of generalized floating weakened the links for cooperation and multilateral surveillance which, as pointed out above, had been designed for - and explicitly revolved

1 J.Williamson (1977)"The International Monetary Non-System" in Artis, M and Nobay A (eds) Studies in Modern Economic Analysis Blackwell, Oxford.

round - the Bretton Woods system of fixed exchange rate. As Artis and Ostry [2] point out "generalized floating not only removed the rules of the game which had enforced a degree of policy cooperation, but also removed the occasion, and seemed to reduce the need for, explicit multilateral policy discussion."

Furthermore, in contrast to the continued liberalization of trade that marked the Bretton Woods period, the floating exchange rate period was marked by an increase in "new protectionism", which has taken the form of selective, non-tariff restrictions (NTB's). Although increased use of non-tariff barriers since the early seventies certainly cannot be attributed to malfunctioning of floating rates alone, there is some empirical evidence that large swings and persistent misalignments of exchange rates have in some instances encouraged protectionism[3]. Under floating exchange rates, there may be less incentive to use tariff barriers than in the past, as sharp swings in exchange rates can potentially swallow the effective protection that tariff barriers provide; however, NTB's have the attraction of predictability in the face of large exchange rate swings. Because initial NTB's do not protect the share of domestic industries in import competing markets when domestic demand slows down, once they have been introduced, pressures can mount for tightening them when the economy slows down; thus once NTB's are introduced for exchange rate reasons, pressures can mount for

2 M Artis and S Ostry "International Economic policy Co-ordination", Chatham House paper 30, Routledge and Kegan. London and New York 1986.

3 For a discussion of the evidence, see, for example, UNCTAD Secretariat "The Exchange Rate System" in UNCTAD, International Monetary and Financial Issues for the Developing Countries. New York 1987.

tightening them. An OECD document[4] argues for example how the sharp rise of the dollar after 1980 was an important factor for the rise in the share of restricted products in total manufactured imports into the United States from 6 per cent to 13 per cent. Protectionist pressures continued even after the dollar fell, because activity slowed down. This would seem to indicate that the sequence going from exchange-rate misalignment to import penetration and from the latter to protectionism is not symmetrical. Bergsten and Williamson[5] cite several cases in the U.S. where protectionist pressures were maintained long after the exchange-rate overvaluation was reversed. De facto, permanent protection is sought in order to compensate for long-term exposure to exchange rate risk.

Floating exchange rates have thus been seen as increasingly problematic, both by policy-makers and academic economists.

Firstly, floating exchange rates have fluctuated far more than early supporters had expected, both as reflected in short-term volatility and long-term misalignment: by both accounts, it has been shown that variability has increased since the Bretton Woods system was abandoned. [6] This increased variability (and particularly the misalignments) are seen as negative, by a large body of literature, particularly due to the misallocation of resources and real resource costs that they create in industrial countries, the damage to a free-trading system via protectionism and discouragement of trade and investment flows and by the fact that they have discouraged

4 OECD Costs and Benefits of Protection, Summary and Conclusions. Paris 1985.
5 Bergsten F. and Williamson J. "Exchange Rates and Trade Policy" in W.R.Cline (ed) Trade Policy in the 1980's. I.I.E Washington 1983.
6 See, for example, IMF (1984) Exchange Rate Volatility and World Trade. Occasional Paper,July.

discipline and co-ordination in the conduct of macro-economic policy of industrial economies. Peter Kenen [7] has summarized the critiques clearly in saying: "The core of the case for exchange rate management is the sad but simple fact that policies and markets are imperfect and interact in costly ways under floating exchange rates"

Both economic arguments and practical concerns have encouraged industrial governments to take important steps towards a far more structured exchange rate system since the Plaza Agreement in 1985, and particularly since the more ambitious Louvre agreement in 1987, which seemed to imply an agreement by the G -7 finance ministers to fairly precise "reference ranges" for their exchange rates. Furthermore, the discussion of a system of co-ordination of developed countries' policies has moved beyond focussing exclusively on exchange rates to the broader issue of macro-economic management; however, no real progress on an analytical and procedural framework has yet been developed, though there seems to be somewhat of an emerging concern in this area at a technical level (see below).

7 P Kenen Managing Exchange Rates. Chatham House Paper. Routledge and Kegan. 1988, especially Chapter 2.

Two important areas of concerns have emerged in the economic literature, which are increasingly reflected in discussions among policy-makers. The first is that greater fixity in exchange rates can only be brought about efficiently by providing also for some co-ordination of macro-economic policies among industrial countries.

As industrial governments do not wish to participate in a system of pegged exchange rates, they are exploring ways of imposing exchange-rate management without at first reforming exchange rate arrangements, and have to a certain degree emphasized policy co-ordination. Industrial governments now again on the whole tend to accept that, by controlling their own monetary policies, they can attempt to manage exchange rates. Kenen [8] therefore concludes that industrial governments see mutual surveillance as the framework for achieving the necessary changes in national policies. A further important step is that developing country governments and also <u>increasingly</u> industrial governments are <u>not</u> just interested in consistent policies (so as to achieve greater exchange rate stability), but are also concerned with improving <u>quality</u> of policy as well.

The objectives of quality enhancing and consistent macro-economic policy co-ordination are perhaps most clearly set out in Williamson and Miller [9];"the primary objective of international macro-economic policy coordination is the achievement of as high a level and rate of growth of output in the participating countries, and indeed the world

8 P Kenen "What Role for IMF Surveillance?" <u>World Development</u> Vol 15,no 12, pp 1445 -1456, 1987
9 J Williamson and M Miller <u>Targets and Indicators: A Blueprint for the International Co-ordination of Economic Policy</u>. Institute for International Economies. September 1987

as a whole, as is possible on a sustained basis...Policy co-ordination should help each country to achieve their objectives by presenting rules that are both helpful to itself and to ensure that when its' major partners follow similar rules the result is a set of mutually consistent policies".

An important body of literature has emerged to support the rationale for, by pointing out the benefits of, policy co-ordination in an inter-dependent world. [10] One strand views co-ordination as the logical extension of an optimizing process by which national governments pursue their policy objectives: from this point of view, policy co-ordination serves to internalize the effects of economic inter-dependence that no single government can capture on its' own. This school attempts to measure potential gains from co-ordination. Thus, Holtham and Hughes-Hallett [11] have reported welfare gains, for industrial economies, from policy co-ordination, measured in income equivalent units, as large as 6 or 7 per cent of their GNP, under certain assumptions. Such estimates should give a firm encouragement for industrial countries to pursue the path of co-ordination more rapidly. Furthermore, additional benefits would be obtained by developing countries; indeed, a study by Sachs and McKibbin [12] has reported that developing countries would have been the principle beneficiaries of co-ordination among industrial economies, even if industrial countries only took account of their collective self interest in deciding their policy actions.

10 See, Kenen, (1988) op cit for a detailed discussion.
11 Holtham G and A J Hughes Hallett (1987) "International policy Co-operation and Model Uncertainty " in R C Bryant and R Portes (ed) Global Macro-Economics: Policy Conflict and Co-operation Cambridge,Cambridge University Press.
12 Sachs J and J McKibbin (1985) "Macro-Economic Policies in the OECD and LDC External Adjustment." Brookings Discussion Paper no 24, December 1985.

Another strand (the public goods approach) views policy co-ordination as the process by which governments pursue commonly agreed or collective objectives and defend the international economic system from economic and political shocks. This argument is based on the assumption that individual governments acting alone - and persuing their own national objectives - would not necessarily be able to achieve commonly shared objectives, such as sheltering the international economic system from major economic or political shocks (the reference of "international public good" in this context is not to failures or gaps caused by the sum of individual private market actors, but to failures or gaps resulting from the sum of actions of individual governments). The "international public good" of developing and enforcing rules for assuring a stable and growing world economy was previously performed by the US, as the US loses relative importance (and influence) and no other power replaces it completely, the task should be carried out by a collective of governments. New mechanisms of co-ordination need to be devised, and above all new institutional arrangements created, so as to respond to the new economic and political reality. Viewed from this perspective, international policy co-ordination, like international public health, is an "international public good", which if not deliberately, actively and properly pursued, will imply an explicit cost. In this sense, international co-ordination of economic policy is an activity which would benefit all but which without conscious co-ordination will not be supplied at all - or will be supplied incompletely - by governments acting on their own.

Kenen, (1988), op.cit, clearly argues that the US economy may benefit even more than other industrial countries from policy co-ordination leading to managed exchange rates, because of the particular rigidity of nominal wages in that country, giving the nominal exchange rate an especially strong influence over the real exchange rate, and thus increasing the welfare cost of larger exchange rate changes. The US has another reason for being particularly supportive of international exchange rate management. The dollar has declined in relative importance, both as an international currency and a reserve currency, at a time when foreign holdings of dollars have continued to increase. An important part of those holdings could potentially be dislodged by exchange rate movements, and the resulting capital flows would amplify those movements; this risk is, however, somewhat reduced by the interest of holders of dollars (or dollar instrument), such as Japanese savers, to avoid a fall in the real dollar value, as the latter would imply a loss of real wealth to them. For other industrial countries, there are - as pointed out above - also clear advantages of exchange rate management, not least because of possible increase in US protectionism if the dollar were to be too strong. However, because it still has the largest economy in the world, because its' influence on international monetary matters exceeds the relative weight of its' economy and because its' gains from exchange rate management and policy co-ordination are particularly strong, it would be hoped that the US government would take a clear lead in these matters.

Even though an important - and apparently growing - group of analysts favour international coordination, there are influential dissenting voices. Some critics argue that even limited exchange rate management, as applied in the context of the Louvre Accord is not only wrong in principle but also will not work in practice; Martin Feldstein[13] has, for example, argued that governments should not attempt to second-guess markets and that - in practice - they will not wish to coordinate their policies closely enough to achieve effective exchange rate stabilization. Indeed in the aftermath of the stock-market crash, Feldstein[14] had even argued that the false (according to him) impression created by governments that healthy expansion of industrial countries requires policy coordination, had contributed to the sharp decline; (this is in sharp contrast to the view expressed by most observers) that it was precise lack of macro-economic coordination that contributed to the stock-exchange problems.

Other influential analysts, sceptical of the benefits of policy coordination, are far more measured in their critique. For example, Fischer[15] makes the interesting point that "there would be little need for coordination if each country were taking good care of its' domestic policies". There is indeed evidence from simulation exercises (see Kenen, 1988 op.cit) that the welfare gains obtained by optimizing policies tend to exceed the gains obtained - in a second stage - by moving from non-cooperative to cooperative policies. Two comments can be made here. Firstly, an important part of policy coordination is, and increasingly would, ideally be geared towards influencing, persuading or pressing countries to pursue optimal policies, even from their unilateral interests. Indeed the same (or

13 M. Feldstein "The Case Against Trying to Stabilize the Dollar" American Economic Review May 1989.
14 M. Feldstein "The End of Policy Coordination" The Wall Street Journal 9 November
15 S. Fischer (1988) "Macro-economic policy" in M. Feldstein (ed) International Economic Cooperation University of Chicago Press.

similar) political and institutional rigidities which inhibit policy optimizing coordination, may be contributing to lack of policy optimization nationally. Secondly, such criticism tends to focus on the policy optimizing element of coordination, neglecting somewhat the "international public good" advantages of policy coordination; indeed, as pointed out above, there are additional advantages deriving from policy coordination, even when all governments were pursuing optimal policies.

Perhaps the most important reason for relatively slow progress in policy coordination is not so much analytical sceptisism about its' benefits (though these play a role), but political and constitutional constraints. As Kenen (1988) op.cit. rightly points out, the political obstacles are stronger when the need for policy coordination is perceived as an "international public good", where costs seem clear and whose benefits are a bit less so.

The political problems for coordination, for example, industrial countries' fiscal policies seem clearest if referred to the United States, where the Executive and Legislative Branches have had difficulty in agreeing an appropriate fiscal policy; it would be even more difficult to reach a formal agreement with an international institution on such matters, as the President cannot commit the Congress' approval formally. Indeed, involvement of the I.M.F. in difficult negotiations on coordination of fiscal policies with the U.S. Executive and/or Congress might be particularly awkward, as it is often the U.S. Congress and/or less often the U.S. President which delay or make difficult the increase in the size of the Fund's quotas; these latter issues could therefore, at certain points, become slightly entangled in the bargaining process on policy coordination, which would be unfortunate.

Policy coordination is also made more difficult by juridictional divisions within governments; the problem arises particularly clearly on the monetary side, in countries like West Germany and the U.S, which have independent central banks. However, it seems easier to change monetary policies in a discretionary and discreet way than to alter fiscal policies, for which a new political consensus in parliment may be required. This could be a very important practical reason to focus initially more on monetary policy coordination rather than on fiscal policy coordination.

Returning to emerging areas of consensus in the literature, a second one relates to the nature of explicit rules or guide-lines which would provide most benefit to the world economy in terms of superior performance. Such an emerging consensus on a blueprint for co-ordination is of course crucial to policy-makers (both at a national level and in international institutions) as it provides a concrete basis on which to start acting.

A very important step in developing such a blueprint for international co-ordination seems to be the framework designed by Williamson and Miller, op.cit. Building on their own earlier work on exchange rate target zones [16] and on the work of Nobel Prize Winner James Meade [17] and others, on treating the growth of countries'

16 J Williamson (1985). The Exchange Rate System. Policy Analyses in International Economies 5. Washington. Institute for International Economics.
17 J Meade (1984) "A New Keynesian Bretton Woods". Three Banks Review, June

nominal income as an intermediate target, Williamson and Miller designed a set of rules for the conduct of monetary and fiscal policy in the major industrial countries that would stabilize <u>both</u> real exchange rates and nominal demand growth. A summary of the Williamson blueprint can be found in Table 1.1.

Figure 1.1 The Williamson-Miller target-zone proposal

The Blueprint

The participating countries [the Group of Seven] agree that they will conduct their macroeconomic policies with a view to pursuing the following two intermediate targets

(1) A rate of growth of domestic demand in each country calculated according to a formula designed to promote the fastest growth of output consistent with gradual reduction of inflation to an acceptable level and agreed adjustment of the current account of the balance of payments

(2) A real effective exchange that will not deviate by more than [10] per cent from an internationally agreed estimate of the 'fundamental equilibrium exchange rate', the rate estimated to be consistent with simultaneous internal and external balance in the medium term.

To that end, the participants agree that they will modify their monetary and fiscal policies according to the following principles.

(A) The *average level* of world (real) short-term interest rates should be revised up (down) if aggregate growth of national income is threatening to exceed (fall short of) the sum of the target growth of nominal demand for the participating countries

(B) *Differences* in short-term interest rates among countries should be revised when necessary to supplement intervention in the exchange markets to prevent the deviation of currencies from their target ranges

(C) National *fiscal policies* should be revised with a view to achieving national target rates of growth of domestic demand

The rules (A) to (C) should be constrained by the medium-term objective of maintaining the real interest rate in its historically normal range and of avoiding an increasing or excessive ratio of public debt to GNP

Source Williamson and Miller (1987), p 2; brackets and italics in original.

Though there are some important critiques of the Williamson-Miller framework and some broader areas of disagreement, the Williamson-Miller blueprint does seem to crystallize an initial emerging consensus on which international policy co-ordination could be built. It is interesting that a recent authoritative study evaluating different blueprints [18] concludes, using the simulations of the National Institute Global Econometric Model over the 1975-86 period, that gains associated with the proposal advocated by Williamson and Miller were larger and more substantial, than those of an alternative scheme [19]; the latter, alternative, *scheme* uses interest rates to stabilize national income, while fiscal policy is assigned to controlling the current account. This is in contrast with the Williamson Miller scheme, where monetary policy is designed in part to avoid real exchange rate disequilibrium while fiscal policy stabilizes domestic demand. It is perhaps of interest to emphasize the sources to which Currie and Wren-Lewis, op.cit. attribute the Williamson-Miller's superior performance. Firstly, allowing monetary policy to respond to exchange rate disequilibrium not only helped improve welfare directly (given the presence of the real exchange rate in their objective function) but on some occasions it also provided valuable advance information about potential developments in demand and inflation. Secondly, the results of their evaluation suggest that fiscal policy had a comparative advantage over monetary policy in directly controlling demand at a national level.

18 D Currie and S Wren-Lewis "Evaluating Blueprints for the Conduct of International Macro-Policy" American Economic Review. May 1989.
19 Boughton J "Eclectic Approaches to Policy Co-ordination" in B. Eichengreen et al,(eds), Blueprints for the Exchange Rate System. CUP, forthcoming.

From the point of view of developing countries, the Williamson-Miller blueprint, also has an important direct advantage in that it targets the average level of world (real) short-term interest rates, a crucial variable for LDC's, as excessively high levels of interest rates in the 1980's have been a major cause for lower LDC performance.[20]

The Williamson-Miller blueprint is also interesting in that some of its' proposals coincide with arrangements de facto made by industrial governments for a far more structured exchange rate system than had existed since 1973[21], while other of its proposals go beyond what has been agreed, and implemented by industrial governments. In the first place, the industrial governments agreed in February 1987 (the Louvre Accord) to rather precisely defined "reference ranges" for their exchange rates. These have some technical differences with the Williamson-Miller proposals, such as the fact that they are defined in nominal bilateral rates against the dollar rather than real effective rates. Most importantly, the Louvre Accord does not clearly define a set of more long lasting rules for exchange rate management, which would for example indicate publicly what the margins for the reference rates are, till when they are applicable (and what happens afterwards) and what will the policy reaction be if the exchange rate reaches the edge of the range. Furthermore, though industrial governments have endorsed the more ambitious aims of comprehensive macro-economic policy coordination (at Tokyo in 1986

20 See, S Griffith-Jones (1989) "International financial and monetary reform; a developing country perspective", forthcoming South Commission Discussion Paper.
21 Indeed, the previous work of economics like John Williamson, Peter Kenen, provided an important theoretical underpinning for the movement towards more structured exchange rate management.

and Venice in 1987), they have not as yet formally taken any action to define rules for coordinating macro-economic policies.

Though valuable progress has been made in the literature in the last few years in defining desirable targets and mechanisms for policy co-ordination, important problems still remain. However, some of these problems can be turned into advantage, for accelerating the process of co-ordination particularly if they lead to greater involvement of the Bretton Woods institutions into the process <u>and</u> if they broaden the agenda for policy co-ordination, to include variables such as current account targets, of particular relevance to both developing countries and the world economy.

A first - analytical - problem is relative ignorance. This relates in the first instance to disagreements on the economic outlook, without policy changes. Even more seriously, this relates to disagreements between different models on the size (and sometimes even the sign) of policy multipliers, that is the effect of one country's policies on its own , and above all on other economies. Williamson and Miller, op.cit argue rather convincingly that if an eclectic approach is taken such that assumes that most views contain some truth, and that different relations hold under different circumstances, apparent differences of view may still be integrated into a single system of guidelines. Their conclusion is rather positive; if the world views of the parties involved do differ quite substantially, this will make it more difficult to agree on a set of rules, but will have the advantage- given the uncertainty about the nature of the reactions - to increase the likelihood that any agreed set of rules would still be likely to bring mutual gain under a wide range of circumstances. Using simulation models, Holtham and Hughes Hallet (1987) op.cit., reach a similar conclusion: a) that disagreements about economic behaviour can be a serious obstacle to coordination and b) when some bargains are blocked, the gains from policy coordination are more likely.

The imperfect state of knowledge in matters crucial to policy co-ordination highlights an important role for the Bretton Woods institutions (particularly, but not only the IMF) to play. This role includes improving the quality and broad acceptability of their projections of economic variables, both for the major countries and the world economy, and improving understanding of how policy changes affect the economy of the country concerned and other countries' economies; it also could include further clarification of the need for policy co-ordination, both for individual countries and globally.

Kenen (1988) op.cit. reports that the discussions amongst the G-7 governments on policy co-ordination have largely focussed on the issue of whether to rely on the governments' own numbers or those provided by the IMF. For the reasons just given above, it would be far more desirable for the IMF's figures and forecasts to be used. Furthermore, this would not only enhance the Fund's role in the actual analysis of policies, but would also increase its' ability to speak for countries that consume the public goods produced by policy co-ordination, but in the near future are unlikely to participate in its' production, the developing countries. The participation of the World Bank in this process - both at the level of production of and of evaluation of inter-action between policies and economic variables-would be valuable both in adding a more long-term dimension and helping to focus far more on development concerns, including the issue of long-term net resource transfers.

A second - more normative - problem precisely relates to issues of capital flows, thus again presenting both a problem and an opportunity for the Bretton Woods institutions.

As Kenen (1988) and others [22] have correctly argued, a definition of equilibrium exchange rates requires a previous definition of an appropriate set of current account balances, which in its' turn requires defining appropriate capital flows. Clearly these flows need not add up to zero, for a particular sub-set of countries involved in the exercise of policy co-ordination. However, the net flow to and from the groups does need to make sense from a global stand-point . This is technically difficult, in a world of changing investment opportunities, capital controls, unclear guarantees for international property rights and largely fluctuating fiscal policies. However, it is essential for the current work of the IMF and the World Bank in the developing countries to have some estimate of future private flows to and from developing countries. If such an estimate had existed in the early eighties (and it had been accurate), then the resulting net resource outflows from much of the developing world could have been forecast, and hopefully influence could have been exerted on industrial countries' governments to avoid policies that would have led to such an undesirable result; alternatively, if this attempt was not successful, the Bretton Woods institutions should have immediately started (as a second best) to design policies that would moderate net private outflows from large

22 Frenkel J and Goldstein M 1986. "A Guide to Target Zones", IMF Staff papers, Vol 33 no 4 (December)

groups of developing countries and design mechanisms to channel liquidity and resource transfers, to them, to compensate for the negative private net flows. Similar exercises, could be carried out in the future. This would firstly test the internal consistency of the different policies to be pursued by the major industrial countries (including both the sustainability of capital flows within the industrial countries and the consistency between planned monetary and fiscal policies and projected capital flows). It would also - and this is a step not highlighted in the current discussion of macro- economic coordination - need to evaluate the consistency of the likely resulting current account results and capital flows with minimum needs of liquidity and resource transfers of different categories of developing countries. The Bretton Woods institutions would not only contribute to ellaborating the numerical and analytical framework for modelling and providing technical assistance in negotiating policy coordination among industrial countries, but also provide the analytical bridge with the needs and trends of the rest of the world, and particularly the developing countries. De facto, no other institution can provide this bridging role better than the Bretton Woods institutions.

A natural division of labour would seem to emerge between the Bretton Woods institutions in this aspect, based on their comparative advantage, experience and mandates. The I.M.F. would act mainly as a technical secretarial on issues of policy coordination amongst industrial countries, as well as exercising surveillance over industrial countries (see below), and determining liquidity needs of different categories of countries (including developing ones). The World Bank would focus more on determining the net capital resource gap of different categories of LDC's (and of LDC's as a whole), based on socially acceptable minimum growth rates in them. The World Bank would thus be more directly concerned with capital resource needs, while the IMF would integrate both its' own concerns for the liquidity needs of developing countries and the World Bank's concerns on resource transfers with the analysis and coordination of macro-policies in industrial countries. However, given the importance of the World Bank's input, ideally it too should be represented in the discussions of industrial countries' macro-coordination, and should do analytical work on the subject, with the point of entry to its' work being the resource flow and growth needs of different categories of developing countries. If the World Bank would not be able to participate directly in discussions on industrial countries' coordination of macro-economic policies, the above mentioned concerns - of resource flow and growth needs of developing countries - would need to be represented, perhaps by the International Monetary Fund.

The efforts at macro-economic coordination would thus inevitably be linked to projections, analysis and action on recycling of private and pblic flows from surplus to deficit countries, and from developed to developing countries. If the link is not carefully made, both analytically and in terms of changes in policy, coordination among industrial countries could improve policy performance in industrial countries - and offer some valuable indirect benefits to the developing world, but risk not necessarily tackling the underlying negative trends that have emerged in the eighties in financial and trade links between developed and developing countries[23]; the IMF and the World Bank could play an essential role, by explicitly attempting to avoid such a danger.

However, it is clearly not only in the industrial/LDC links that Bretton Woods institutions would need to play a crucial role.
Policy coordination among industrial countries itself, to be effective, requires institutionalised cooperation. Drawing on the lessons of the international monetary system, but particularly on his experience in the operation of the E.M.S., Padoa Schioppa[24] powerfully highlights the importance of strengthening the institutional framework (and particularly strengthening international institutions) to improve macro-economic coordination. Padoa Schioppa argues rather convincingly that the academic literature on exchange rate relationships has failed to capture the essence of a system like the E.M.S.; "after the adoption of a system like the E.M.S., the policymaking structure of a group of interdependent countries is not simply the previous one <u>plus</u> an exchange rate constraint; it is a new structure, in which policy behaviour, the ranking of objectives and the procedures for coordination are profoundly affected by the new regime".

From the E.M.S. experience, the crucial lesson is the need for <u>joint</u> action, which inevitably implies the need for supranational institutions to play a key role in the coordinated management of economics. <u>Institutionalised</u> cooperation ensures that decisions and

23 See, E. Fitzgerald, K. Tansen and R. Vos "Structural asymmetries, adjustment and the debt problem". Paper for the World Bank Conference <u>Dealing with the Debt. Crisis</u>, 25-26 January 1989, for an interesting discussion of such a scenario.
24 T. Padoa Schioppa, 1985, "Policy cooperation and the E.M.S. experience" in W. Buiter and R. Marston (eds.) <u>International economic policy formation</u>, Cambridge University Press.

actions are taken at a multicountry level, even when the parties fail to agree; it is therefore more permanent and certain than ad-hoc cooperation, where joint action is only taken when agreements are reached. Within an institution, the need for action to achieve public goals exists "a priori", with ad-hoc cooperation this need has to be established every time. International institutional management in fact in an important sense actually increases the power of national governments, insofar as it makes it possible to regain control over phenomena that would alternatively escape any form of management.

The reasons why proper multicountry coordination requires a strengthening of institutions are several: 1) Even when ad-hoc cooperation works well, it is often too slow, causing unnecessary friction and welfare losses. 2) Institutionalised cooperation is far better at giving general goals priority over particular interests, and far less likely to be subjected to pressure from local constituencies. 3) Institutionalised cooperation often allows far greater stability of officials in charge of cooperation. 4) Institutional cooperation finds it easier to reach consensus, if the number of negotiating parties is large. 5) Officials in international institutions tend to have a broader perspective, thus ignoring small controversial points as a reason to delay or prevent agreements.

Naturally, multicountry coordination has limitations, based for example on the fact that most of the officials of particular institutions may have a particular bias (e.g. to deflationary) in the policy advice or suggestions that they offer, to the extent that this bias does not reflect the preferences of the governments which compose such an institution, the resulting policy-mix may be sub-optimal, from the point of view of particular (or most) governments. Therefore it seems essential that - for stronger institutional cooperation to be effective - the international institutions share the policy objectives of the majority of member countries.

Summarizing the previous discussion, the justification for strong international institutions (the Bretton Woods institutions) to provide the framework for policy coordination arises partly from the need for the non G-7 countries' interests to be considered, but equally strongly from the need of the G-7 countries themselves to pursue more pervasive and more permanent coordination.

A problem arises from the hierarchical structure of the institutional apparatus currently existing for coordination, which creates incentives for the delegation of authority to groups further up the scale (G-7, G-5, G-3) in the largely incorrect belief that more restricted fora are more likely to take decisions that favour the major countries' interests; this makes it difficult for an institution like the IMF to assert its' authority. It is part of the role of the IMF - in the early stages of macro-economic coordination - to persuade the major industrial countries that they (and the rest of the world) will both benefit from the task being carried out mainly in established institutions, which represents all countries, such as the IMF and the World Bank. The increasingly positive experience of the E.M.S. - and the significance within it - of <u>institutional factors</u> can play an important role in such persuasion.

However, the special factors backing the E.M.S. must be recognised; particularly important seems to be the political shared commitment of strengthening Europe. The difficulties of applying a similar thrust to institutional policy coordination amongst countries with fewer common characteristics should not be under-estimated; on the other hand, it needs to be stressed that the perception of common European interests has certainly not always existed (as shown in the extreme by the numerous wars fought in the past among European nations) and that the perception of common interest not only encouraged, but was largely - at a later stage - the <u>result</u> of greatly achieved economic success.

An important reason for locating exchange rate management and policy-coordination in the I.M.F., rather than in a more restricted and informal forum like the G-7, is the need to back such management with better reserve arrangements than are currently in place. One of the sources of strength of the E.M.S. is that governments can automatically mobilize infinite amounts of resources by drawing on reciprocal short term credit facilities[25], these short term facilities can be partly funded by long term credit facilities of the European Monetary Cooperation Fund. The existence of theses facilities discourage speculative flows, as the markets know they cannot commit more funds than the governments can mobilize.

Tighter exchange rate management within the G-7 would also require the existence of sufficiently flexible currency reserves in the short term to discourage speculators from forcing governments to change

25 For details, see Micossi. S (1985) "The Introduction and Financing Mechanisms of the E.M.S. and the Role of the E.C.U". Banca Nazionale del Lavoro Quarterly Review. December.

exchange rates. Kenen (1988) op cit., for example, suggests that a) G-7 reserve supplies are made more elastic in the short-term by altering the terms of the existing bilateral swap arrangements and adopting guidelines for their long-term funding and b) exchange rate risks are redistributed and U.S. reserves are increased by receiving and extending the "substitution account" proposed. While the first change could be done possibly within the G-7 or an industrial countries' institution like the B.I.S., it would seem far more appropriate to place these arrangements within the I.M.F., an institution which could put them in the broader context of the global economy; indeed, the first objective of the I.M.F. - according to its' own Articles of Agreement is "To promote international monetary cooperation through a permanent institutions which provides the machinery for consultation and collaboration on international monetary problems". The creation and management of facilities to support exchange rate management would clearly fall into this category. The second change proposed - the revival and extension of the "substitution account" - could, of course, only be implemented through the I.M.F.; it would also increase the significance of the S.D.R., as S.D.R. denominated claims would increase and be used as assets. In the short-term, the I.M.F. could play an important role in examining the different options for mechanisms to support exchange-rate management and defining its' own part in future arrangements. Indeed, it seems correct to argue, as J.J. Polak[26] does, that reform of the international monetary system - and within that the design of a framework for enhanced policy coordination among industrial countries - is essentially "the business of the fund", and

26 J.J. Polak "Strengthening the Role of the I.M.F. in the International Monetary System" in C. Gwin and R. Feinberg (eds) The I.M.F. in a Multipolar World: Pulling Together. Transaction Books (U.K. and U.S) 1989

not the sole "business" of a restricted group of countries (G-7),even if they are the major industrial countries.

Furthermore, a greater role for the Fund in policy coordination of industrial countries would increase the Fund's legitimacy to influence policy-making in other countries. As Polak, op.cit, points out, legitimacy in the case of international organizations is particularly essential. If the Fund (and the Bank) was seen to be even-handed (or symmetrical) in its' policy advice, its' effectiveness in influencing policy in the non G-7 countries would be significantly enhanced.

Finally, a strong argument in the spirit of Winston Churchill can be made for institutionally led international coordination of industrial countries' policies[27]; attempting to maintain a well functioning international monetary order - including appropriate coordination of the major countries' macro-economic policies - should be done through a universal institution, because even though this method may have its' problems, it is in the long-run better than all the alternatives.

This argument, though very powerful, may be somewhat less convincing at present, because G-7 coordination has since 1985 been fairly successful in limiting large exchange rate fluctuations and misalignments of exchange rates of industrial countries, and in contributing to the achievement of fairly rapid, non-inflationary growth in those countries. However, the risks to the world economy - of fast landing of the U.S. economy, of worsening of the debt problem

27 See D. Finch "Conditional Finance for Industrial Countries" in Gwin and Feinberg op. cit.

etc. - though reduced at present, have not disappeared; furthermore, other risks may emerge. Policy coordination - through an international institution such as the Fund - should institutionalize protection against such risks in future having major de-stabilizing effects on the world economy.

A final point needs to be made about the institutional arrangements for policy coordination, a subject on which there seems to have been relatively little writing and debate. The current approach towards limited policy coordination is basically carried out within the framework of meetings held among the G-7 Finance Ministers, with the I.M.F. playing a supporting role. Corrective action seems to be taken as a result of bargaining within the G-7, with use of peer pressure within countries whose policies were out of line. As pointed out, this procedure, together with other factors, seems to have contributed to some improvement in the performance of industrial countries since late 1985 when the process began.

If a more structured process of policy coordination is to be developed (for example, moving towards a blueprint a la Willamson-Miller), institutional aspects need to become more formalized. For reasons discussed above, both the I.M.F. and the World Bank should participate very actively in the process. An important issue is whether the definition and monitoring of indicators should at all points be multilateral (with agreements reached on the basis mainly of bargaining between industrial countries, with the I.M.F. and the World Bank playing the role of technical adviser and of representatives of the interests of the rest of the world) or if a part of the process should be bilateral, with the I.M.F. playing a stronger role, to include not just comparing actual outcomes and targets, but also the discussion of remedial actions when the two diverge. The latter option originates in the suggestions of the International Monetary Fund's Committee of Twenty in 1972-74, which argued that "pressure" should be brought to bear by the I.M.F. on industrial countries, and has been further developed by the G-24, representing developing countries[28] in their suggestion that, "the I.M.F. devise procedures for exercising pressure on industrial countries in the course of its' consultations with them". Furthermore, the G-24, as well as Williamson and Gavin op. cit. suggest that policy targets (agreed multilaterally) should be used by the Fund to evaluate industrial countries' performance bilaterally. This stage would involve a comparison between actual and prospective outcomes and the multilaterally agreed targets, and a discussion of what measures are planned and would be appropriate when the two deviate.

Such a procedure may not be acceptable to some of the major industrial countries of the moment, though it is clearly very useful as a target (because it would increase the Bretton Woods institutions' influence over its' largest members and increase symmetry in the process of adjustment); it may be better, initially, to emphasize and push forward action on which there is agreement, such as progress on multilateral surveillance, and give it as concrete, operational and institutional content as possible. At a second stage, bilateral surveillance could be introduced, once

28 See, for example, G-24 "The Functioning and Improvement of the International Monetary System" in the I.M.F. Survey Sept. 1985; also J. Williamson and M. Gavin "International Monetary Issues in 1985" in UNCTAD, op.cit.

governments become more convinced of the advantages which surveillance is bringing both to them and to the world economy.

III: International Liquidity and Resource Transfers.

A. The recycling of surpluses.

In the short and medium-term, one of the potential concrete links between resource transfers to and from developing countries with the conduct and coordination of industrial countries' macro-economic policies clearly emerges in the recycling of surpluses.

There is broad acceptance in the development literature that net resource flows should go from capital abundant to capital scarce countries where the social marginal productivity of those countries would be high. Therefore, a well coordinated international economic policy would include - among its' targets - the generation of net current account surpluses in the aggregate of industrial countries to facilitate resource transfers to developing countries.

Furthermore, policy coordination among industrial countries has almost entirely focussed on attempting to reconcile imbalances only among industrial countries, in an attempt to match surpluses of some of them with others' deficits, leaving as a result, scarce resources available for them to flow to the developing countries. Particularly, initially, efforts at policy coordination amongst the major industrial countries has, in general, not included as one of their joint objectives the function of a net positive current account within their group, nor even less have they focussed on the design of appropriate mechanisms for intermediating these surpluses towards productive investment in developing countries.

However, at recent G-7 economic summits, the Japanese government has unilaterally announced fairly important funding initiatives for developing countries. Thus, at the 1987 Venice summit, the Japanese government pledged to supply developing countries with not less than $20 billion in untied funds for the next three years; this was additional to the $10 billion in untied funds pledged the previous year to the I.M.F., World Bank and other I.F.I.'s. Adding recycling, O.D.A. and private direct investment (and discounting for overlaps), Okita[29] estimates the total flows from Japan to developing countries at around $25 billion per year in the 1988-89 period. At the Paris 1989 summit, a further increase of Japanese capital recycling was announced by expanding the existing programme "of more than $30 billion over a three year period into a programme of more than $65 billion over a five year period"[30]. Though impressive, these figures have to be compared with the size of Japan's surplus, which in 1988 still reached around $80 billion. Thus total recycling to L.D.C's under Okita's broad calculations, reached less than a third of the total Japanese current account surplus in 1988, and about one fifth of the joint Japanese/West German surplus.

These Japanese initiatives, very important as they are, do not seem to be explicitly linked to the process of policy coordination, nor is there a clear scheme for defining desirable targets for Japanese (and German) current account surpluses, U.S. current account deficits and current account results for different categories or groups of developing countries. Neither does there seem to exist a clear and consistent set of policy measures (and their time paths) that would

29 S. Okita "Japan's Quiet Strength" Foreign Policy. Summer 1989
30 "Japan's Overseas Aid" Speech by K. Matsuura. Royal Institute of International Affairs. London. July 18th 1989

relate the reduction in U.S. current account deficits to, for example, important increases in some developing countries' account surpluses, nor has sufficient thought been given, particularly internationally, to the mechanisms through which large additional flows will be channelled to different developing countries, issue particularly relevant because a large part of the flows will originate in the Japanese private sector (which is the surplus sector) and because many of the developing countries with greatest capital needs are not particularly "creditworthy" in the conventional sense. These are all key areas where the Bretton Woods institutions have a major role to play in the future.

Emphasis on recycling Japanese surpluses to developing countries is not just of interest to those countries, but is also a powerful indirect way to reduce the U.S. trade deficit without deflationary consequences for the U.S. or the rest of the world. This is particularly true if much of the recycling will be channelled to Latin America, given that Latin America is a natural market for U.S. exports. This is the case, for example, of Japanese contributions to debt reduction schemes announced to reach a total $4.5 billion and Japanese new untied lending, reaching $5.5 billion (as part of the financing packages for heavily indebted countries) announced by Japan in the context of the Brady initiative. In this respect, it has been argued that channelling Japanese surpluses to Latin America would produce a larger gain in U.S. exports than using these savings to further higher investments in Japan would do. There is a treble logic in channelling increased Japanese (and West German) surpluses in an important proportion to developing countries, rather than to expand growth further in the surplus countries. The former scheme has important positive-sum game elements as it favours the interests of developing countries, that of the U.S. and that of the global economy. Furthermore, it favours a more equitable and balanced pattern of growth in the world economy, as well as reducing further the risk of vicious circles of stagnation and debt moratoria in the developing world. If properly implemented, the recycling of Japanese surpluses to developing countries will offer profitable returns to Japanese savers, a reduction of the U.S. deficit without contractionary effects on the U.S. economy, much needed additional resources to developing countries and, as a result, a non-inflationary expansionary effect on the world economy. It could also be said that three different under-utilized pools of resources would be productively used: Surpluses of excess savers, under-utilized capacity and unemployed capacity in industrial countries, especially the U.S., and unemployed or underemployed manpower in developing countries would be combined to increase output.

Such a desirable global circuit of capital would naturally require that the additional recycling of Japanese flows is not tied to the sale of Japanese exports, and that already existing recycling of O.D.A. flows be increasingly untied. It is encouraging that the $30 billion recycling programme announced in 1986 and 1987, as well as its' recent expansion, seem to all be untied from Japanese exports. Furthermore, an increasing share of Japanese O.D.A. commitments are untied. Recycling via the private sector - and particularly via foreign investment - would tend on the other hand to have an implicit tied component.

A potentially useful numerical monitoring could be carried out by the Bretton Woods institutions to attempt to evaluate the direct and indirect effects of past Japanese recycling efforts (by different categories of flows), as well as potential additional efforts (by Japan and also by West Germany) in this direction. Such a calculation would bring out the important short and medium-term benefits which such recycling can generate in developing countries and in the U.S. as well as other developed countries; it could also estimate possible long-term problematic effects of such flows, particularly in cases where they create debt at commercial rates of interest, thus focussing the attention of policy-makers on the need to always try to use appropriate mechanisms to fund long-term development. Such a numerical exercise could also be a valuable first stepping stone towards projecting likely and desirable capital flows between different categories of countries (particularly, but not only, flows from developed to developing), and begin to explore required policy changes in major individual industrial countries, as well as possible coordinated macro-policy action, to make these flows possible. Naturally, actions by industrial countries in this field would be a necessary but not sufficient condition, for flows to LDC's, which would also require the creation of appropriate mechanisms and the design of favourable policies in developing countries; we will discuss briefly some of the key issues as regards the former.

As the Japanese government has already taken fairly large initiatives in increasing official flows to developing countries, and as the Japanese government is running a deficit, it is the Japanese private sector, with its' massive surpluses, which is likely to do most of the additional recycling. The Japanese private sector prefers what it sees as high yield, low risk investments, such as is offered by the U.S. capital market. To help re-channel part of this flow of private sector capital to the developing countries, it is necessary that:

a) Industrial governments and international financial institutions provide guarantees or insurance to alleviate risk.

b) Provide interest subsidies to make the yields attractive to Japanese investors, while allowing for concessionary rates of interest, appropriate for lending to developing countries, and particularly to low-income ones. Additional resources from industrial governments (and particularly the Japanese and West German one) would therefore be mainly used to help generate and subsidize additional private flows from their countries to developing ones; thus, government resources could have a multiplier effect on the resources transferred.

c) Additional support for such recycling of private flows by international development institutions, such as the World Bank and the regional development banks, to enhance multilateral guarantees and investment insurance may well be required. For example, given the recent large increases in Japanese foreign direct investment, the World Bank's M.I.G.A. may need to be expanded, so as to be large enough to support the potential volume of investment; alternatively, other instruments may also need to be developed.

d) Finally, within developing countries, it is necessary to make policy changes (particularly in the case of macro-economic policies) to make them more attractive to private flows. Developing country governments should also increase their own guarantees to incoming private flows, <u>provided</u> these flows are going into sectors - and via mechanisms - that will promote the countries' sustainable development. In the case of some developing countries, the guarantees of the borrowing government could, on their own, be sufficient.

The 1987 WIDER report[31] discussed in some detail the crucial issue of guarantees to alleviate risk. One strategy suggested was for Japan to take a unilateral initiative to raise funds in the Japanese capital market, through a Japanese government agency and on-lend the funds, with an interest subsidy being made available out of O.D.A. funds. Guarantees could either be provided directly by the government or bought by the government from the private insurance sector. The additional cost of such guarantees would be funded out of O.D.A.; this would be additional to the O.D.A. cost of subsidising the interest.

Such a Japanese Trust Fund could either lend money bilaterally or in collaboration with the World Bank; even closer association with the Bank was mentioned as desirable (including disbursement in accordance with World Bank programme procedures) if other countries were also to join in adding resources to the facility. In this sense, it is noteworthy that discussions (by WIDER, but also by others) always focus on Japanese surpluses; though these are by far the largest - and the Japanese government is the most flexible in increasing their use for recycling to L.D.C.'s, - Japan is not the only country to have large financial surpluses. In particular, West German surpluses (as well as others) should be brought into international discussions,

31 S. Okita, L. Jawardena and A. Sengupta "Mobilizing International Surpluses for World Development: a WIDER plea for a Japanese initiative" May 1987. Helsinki.

especially with reference to targets for an increasing share to be channelled to recycling, and to the design of the appropriate mechanisms for this to be carried out. Again here the Bretton Woods institutions would be particularly appropriate for carrying out such a study in the first instance, to encourage relevant governments to participate in such schemes, and to relate this discussion to those on international macro coordination.

The second option raised by the WIDER report - which is the one that seems to have been followed - is to channel additional funds through the Export-Import Bank of Japan (E.I.B.J.)[32]. The Export-Import Bank can tap the resources of the massive Japanese governments Fiscal Investment and Loan programme (the Zaisei-Toyushi), which includes post office savings and government pension funds, estimated to reach $150 billion annually.

The Japanese Export-Import Bank operations have the advantage that when they are used as part of very flexible co-financing arrangements with the World Bank, there is no limit to the amount that can be handled set by issues of capital adequacy of multilateral institutions, such as the World Bank; loans granted by the Export-Import Bank do not in any way infringe upon or erode the capital base of the partner co-financing institution.

32 The $4.5 billion which the Japanese government will contribute to the Brady Plan for debt reduction will be channelled through the E.I.B.J; furthermore, the additional new lending to heavily indebted countries will also be channelled via the E.I.B.J. and the Overseas Economic Cooperation Fund.

Given the size of recent increases in Japan's capital recycling programmes to developing countries (in July 1988, to $65 billion in five years, of funds reported to be additional to normally expected capital flows from Japan, which seems almost to exceed the 1987 WIDER targets, that then seemed extremely ambitious), it may seem somewhat unlikely that Japan will increase its' contribution much further, at least int he short-term. However, a further contribution is still possible, if the Japanese surpluses are sustained at their presently very high levels, and given the Japanese public's strong commitment to further increases of foreign aid, and the Japanese government's commitment to play a constructive role in the global economy, as well as its' long-term interest in sustained growth in the developing countries.

The Bretton Woods institutions should encourage further expansion of Japan's recycling efforts; they could do this in two ways. Firstly, they should, as discussed above, evaluate carefully the important measures already being taken by Japan in this area, the nature of the mechanisms used and assess their impact, firstly on short-term and long-term resource transfers as well as on developing countries economies, on the U.S. economy and on the World economy. Furthermore, the specific mechanisms being used and designed by Japan should be assessed both as regards their <u>effectiveness</u> in assuring increased flows of funds to L.D.C's and in their <u>appropriateness</u> (e.g. length of maturity, concessionality) to fund development; possible future improvements or modifications of recycling mechanisms (particularly regarding collaboration with the multilateral institutions) could be suggested by the Bretton Woods institutions. Secondly, the Bretton Woods institutions should make suggestions on how Japan could further increase its' recycling efforts, and support any such efforts in that direction.

Furthermore, the Bretton Woods institutions, and the developing countries need perhaps to make more explicit the positive aspects of Japanese efforts, and encourage other countries - particularly West Germany - to start steps in a similar direction. Indeed, the Bretton Woods institutions could suggest targets for a desirable pattern of current account results and corresponding international financial flows for the next meeting of G-7 finance ministers or the next Interim and Development committee meetings.

B. Role of public international financial institutions in liquidity creation and development finance in the 1990's.

In the 1990's, the discussion of appropriate mechanisms and levels of flows to different categories of developing countries need to be integrated far more closely to the analysis of the role which public financial institutions should play, both in liquidity creation and development finance, than it was in the nineteen eighties.

It is useful to stress in this context that the World Bank was created to compensate for the absence of a well functioning private international capital market; it was to serve as a multilateral long-term lending institution, to provide capital for countries with low saving rates and high rates of return, originally for reconstruction and then increasingly for development. As Anne Krueger[33] points out clearly: "The rationale for the creation of the I.B.R.D. was

33 A. Krueger "The Role of Multilateral Lending Institutions in the Development Process" Journal of Asian Studies, Summer 1989.

straightforward: it was to substitute for a well functioning private capital market, since it was believed that the inter-war experience would preclude the emergence of such a private market".

As regards short-term liquidity, it was believed by "the founding fathers" that a major role should be played by the I.M.F; this is reflected in the Fund's current Articles of Agreement which includes amongst its' objectives: "To give confidence to members by making the financial resources of the Fund temporarily available to them under adequate safeguards, thus providing them with an opportunity to correct maladjustments in their balance of payments".

When private international capital markets grew dramatically (since the sixties) and contributed to funding, not just industrial but also developing countries' balance of payments in a major way (during the seventies), the role of the Bretton Woods institutions seemed less central. However, the experience of the last decade (and particularly widespread debt crises and their negative effect on development) have shown that private financial markets' funding of developing countries provides an important example of market failure. Consequently, the regulation and supervision of these markets, as well as, more importantly, their replacement by public or publicly guaranteed flows, in cases where they break down, work imperfectly or cannot deliver a service on their own (e.g. funding of low-income countries at concessionary interest rates or through grants) is a necessary public good. In this context, the Bretton Woods institutions may have in the nineties as crucial a role to play as was initially believed by their founders. It is interesting in this respect that as firm a believer in the free markets as Anne Krueger, op. cit., argues similarly that "the risk that the private international capital market will not resume normal functioning" is one of the key reasons for believing that "multilateral lending institutions will have an even more vital role to play over the next decade than they have had historically".

The Bretton Woods institutions role in the nineties will naturally be different in many ways to the original concepts that lead to their creation, in particular as regards the links with the large private international capital markets existing at present.

The role of the Bretton Woods institutions in ensuring appropriate resource transfers and liquidity creation to developing countries would need, in the nineties, to include action in the following areas:

a) Determining minimal liquidity and resource transfer needs of individual developing countries and of categories of developing countries, in a medium-term framework, assuming politically acceptable minimum growth rates and maximum realistic national efforts at domestic savings mobilisation in L.D.C's.

b) Attempting to influence process of policy macro-coordination in industrial countries, so as to make them consistent with providing a favourable international environment to developing countries, and in particular to avoid excessively high interest rates and "crowding out" of developing countries (particularly middle-income ones) from international private capital markets.

c) Channel sufficient public flows to developing countries, in areas where the markets are unable or unwilling to carry out such a function appropriately. The four areas where there is increasing agreement that the "market mechanism" cannot operate appropriately are:

i) Funding of low-income countries' development on concessionary terms

ii) Funding of some large projects in middle-income countries

iii) Sufficient provision of counter cyclical funding and

iv) Sufficient creation of international liquidity for different categories of countries.

As regards the first two items, there is little disagreement. Relating to public counter-cyclical funding and, especially to the public role for the creation of international liquidity, there is at present far more debate.

The rationale for counter-cyclical flows seems clear. Because of the inevitability of business cycles, and their unexpected and disruptive effects on growth and on private financial flows, public counter-cyclical liquidity and credit mechanisms are desirable both to counteract the effect of the trade cycles and the pro-cyclical nature of private flows. In this context, it seems desirable to expand the size of compensatory funding now being provided by the I.M.F. and lower its' conditionality.

Secondly, if the problem is examined from the perspective of the liquidity needs of the developing countries, there is a clear case for renewed issues of S.D.R'S, as the unsatisfied demand for international liquidity by a large proportion of developing countries has increased, as did the cost to these countries' economies that this demand was not met by the international creation of liquidity via the I.M.F.

Their urgent liquidity need may be difficult to perceive by some industrial governments, as they are able, at present, to obtain resources almost automatically, by borrowing as much as they wish, from the very large and integrated private international capital markets; for them, the elasticity of supply of privately lent resources seems to be infinitely elastic, at least at present.

There is growing consensus, however, that developing countries - by their very nature - cannot have the same access, on a sustained basis, to international private capital markets. As the Managing Director of the I.M.F., M. Camdessus[34], has clearly pointed out, in spite of impressive adjustment efforts carried out by heavily indebted countries, "there has been a general withdrawal of commercial banks from voluntary lending to developing countries. This is a structural change in the international financial system which makes it more difficult for many countries to finance reserve additions". These recent events have shown that even if countries are willing to make major sacrifices in adjustment and improve their trade balance, the private capital markets may not respond with an increase in their supply of lending to them. There is here a clear case of market discontinuity, and a need for action by the I.M.F., to contribute to the "public good" of sustaining the provision of liquidity to L.D.C's.

34 M. Camdessus "Chairman's Summing Up at the Conclusions of the Discussion on the Question of SDR Allocations" March 23 1988. I.M.F. mimco.

A specific proposal has been made[35] that builds on the <u>reserve asset character</u> of the S.D.R. and would relate its' allocation directly to the reserve needs of countries, to be made available in a special overdraft account. This mechanism would deal with the problem that there are a number of countries (e.g. industrial) which do not have unmet reserve needs, while a large number of countries see their reserve needs unsatisfied.

Alternatively, the issue of S.D.R's could be more general, with allocations also made to industrial countries. There are two main reasons why industrial countries may need S.D.R's. Firstly, it could provide necessary reserves to control sudden disruptions of exchange markets; more ambitiously, it could provide the basis for a revival of the "substitution account", that could provide a valuable mechanism to stabilize exchange rates (see above). Secondly, an issue of S.D.R's to industrial countries could increase the proportion of "owned reserves" (as opposed to borrowed ones), thus ensuring their longer-term stability.

d) An increasingly important function of the World Bank is and will be to design appropriate mechanisms, provide incentives (such as guarantees) and, where necessary, give subsidies to channel private flows in appropriate modes to fund developing countries' long-term needs. Valuable experience in this field has already been acquired by the World Bank, and is being acquired by the Japanese government in its' efforts to channel private flows towards developing countries.

35 A. Sengupta "The Allocation of S.D.R's Linked to the Reserve Needs of Countries" in UNCTAD, op.cit.

e) Finally, there is a need for the Bretton Woods institutions to make a significant input into the increasingly important and complex task of supervision and regulation of private financial flows. A recent OECD[36] study has concluded that there is an increasing need for taking a global view of financial system development and financial regulation. This global view concerns both policies for the development and adequate regulation of national financial systems and cooperation for developing a coherent approach towards financial systems integration and regulation internationally.

Much of the debate and measures on regulation of international banking has taken place in limited fora, such as the G-10 or the B.I.S. It would be important for the Bretton Woods institutions (and particularly the I.M.F.) to be more closely involved in this process, so as to represent this global concern; however, in practice, industrial governments may not wish these matters to be debated in broader fora.

Amongst the areas where the Bretton Woods institutions could have a key contribution to make would be:

i) Link developments and possible regulation in international financial markets with macro-economic policies in the industrial countries.

ii) Relate issues of possible regulation and control of international financial flows in industrial countries with issues of particular relevance to developing countries, such as capital flight and international borrowing by developing countries.

36 OECD Competition in Banking. Paris, May 1982

A concrete example relates to the impact of capital flows on exchange rate management in developed countries with capital flight from developing countries. Distinguished analysts of industrial countries' exchange rate problems, such as Williamson and Gavin op. cit (1985), Kenen (1988, op. cit), and Sidney Dell[37], argue that speculative private flows often lead to misaligned exchange rates.

Following Nobel Prize winner James Tobin[38], it can be suggested that a tax could be applied to short-term international financial transactions, so as to discourage them and so as to mitigate what Keynes[39] called "the predominance of speculation over enterprise". This measure has been proposed in the context of discouraging speculative flows causing exchange rate misalignment; it could also, if properly structured, provide a valuable disincentive for capital flight from developing countries.

The task would be a somewhat complex one, to design and implement as it would be necessary to throw "sand in the wheels of speculative flows" while continuing to "oil the wheels of trade, international investment and other financial flows related to productive activities". This would pose important analytical and practical problems. No other institution could be better qualified to take a global view in tackling these problems than the I.M.F., in collaboration with national authorities. Though difficult to implement initially, such a measure could potentially contribute to stabilizing exchange rates and help to discourage capital flight from

37 S. Dell (1988) "The Future of the International Monetary System". UNITAR mimco September.
38 J. Tobin (1980) "A proposal for International Monetary Reform". Cowles Foundation paper no. 95, Yale University, New Haven.
39 Keynes J. M. (1936) The General Theory of Unemployment, Interest and Money. London. Macmillan.

L.D.C's; the resources generated could either be used to strengthen the I.F.I's lending capacity, especially for concessional lending to low-income countries, or used to pursue clearly identified international public goods, such as spending on the natural environment. Perhaps a first step would be for an institution like the I.M.F. to carry out (or more discreetly commission) a preliminary study evaluating the potential costs and benefits of such a measure, and the broad features that such a tax could have to achieve the objectives spelled out above.

At present, more controversially, it could be argued that some forms of capital control may, at some point, be necessary to reinforce a desired configuration of exchange rates in industrial centres. One of the Fund's Occasional Papers[40], as well as other analysis, stress that the success of the E.M.S. has (among other factors) been helped by capital controls maintained by the weaker members of the system. In this sense, if the industrial countries are seriously going to work towards a system of exchange-rate management, the possibility of some limited controls (to curb speculative flows) may need to be examined. Though such measures may seem very controversial at the moment (given the political consensus amongst industrial governments on the benefits of free capital movements), it may, in future, be seen as desirable to allow somewhat less freedom in capital flows, so as to ensure freer and more efficient trade and international investment flows. In a parallel way, some developing country governments may find it necessary to use capital controls as part of a battery of instruments (including consistent and realistic macro-

40 I.M.F. Strengthening the International Monetary System: Exchange Rates, Surveillance and Objective Indicators, by A. Crockett and M. Goldstein. Occasional Paper No. 50, Washington D.C. February 1987.

economic policies) to control capital flight, so as to ensure progress in - and sustainability of - trade liberalization. Given its' vast experience and influence in this area, the I.M.F. could evaluate these issues and possibly adopt a more flexible attitude in selected cases and particular situations on capital controls.

As regards the issue of regulating international private lending to developing countries, this is a matter of great importance but possibly not of great urgency. Recent experience has again confirmed that - if unregulated - international private lending to developing countries can grow excessively in times of upward expansion of the business cycle, and that it can then contract dramatically, at times of slow - down of economic activity. When the latter occurred (and contributed to widespread debt crisis) both the governments of industrial countries and the I.F.I's were called in to intervene and devote a large part of their financial and personnel resources, so as to moderate the negative effects of the crisis on both private creditors and L.D.C debtors. It seems therefore essential that the Bretton Woods institutions (and particularly the I.M.F) make an important input into the setting up of a system of supervision and regulation of private flows so as to ensure that in the long-term future, private flows do not again become excessive, as happened in the seventies[41]. Furthermore, the Fund could further strengthen its future policy advice to developing countries, in aspects relating to avoidance of excessive overborrowing from private capital markets, and in encouraging modalities of borrowing that are more appropriate for funding long-term development.

41 For a more detailed discussion see, for example, S. Griffith Jones and M. Lipton "International Lenders of Last Resort; Are Changes Required?". Midland Bank. Occasional Paper 1. 1984

As regards the topic of international debt management, we will stress only one aspect in this paper. This point illustrates again the value of the Bretton Woods institutions having greater influence on policies in industrial countries than they do at present. Progress on debt management has been slowed down by differential tax, accounting and regulatory environments existing in different industrial countries[42]. Though the problem has been both noted and clearly analysed by staff members of the World Bank[43], action on changes in tax and regulatory international debt, so as to provide greater uniformity and above all desired flexibility for debt management, has been somewhat slow, this is partly because decisions on these matters are either taken by national authorities or by their coordinating body (at a G-10 or B.I.S. level); the objectives of national regulators (and to a lesser extent, of the G-10 or B.I.S. bodies) are different from those of policy makers (in industrial and developing countries) concerned with flexibility for debt management. A greater role for the Bretton Woods institutions (to put forward the global view and to introduce the concerns of the indebted countries) would be very valuable; it can be arranged on an ad-hoc basis, but this issue again illustrates the importance of the Bretton Woods institutions participating regularly in (and influencing) G-10 institutions meetings, whose decisions affect closely resource transfers and liquidity flows to developing countries.

42 See, for example, S. Griffith-Jones (ed). Managing World Debt. Wheatsheaf, U.K. and St. Martin's Press. U.S. 1988.
43 See, for example, M. Bouchet and J. Hay "Survey of Banking Regulations in the O.E.C.D.Countries Relating to Market-Based Debt Reductions". Mimco. World Bank. April 1989

The suggestions presented in this part and in the first section (or similar ideas) would imply both an increase in size and influence of the Bretton Woods institutions as well as some change in the distribution of this work.

As regards to the size of the institutions (topic whose details escape the scope of this paper), it is crucial to emphasize the need for easier mechanisms to be found to expand the Bretton Woods institutions' capital base (and borrowing capacity) to levels sufficiently large to allow them to play directly a larger role in net resource transfer and liquidity creation.

This is to an important extent a political and procedural problem. However, also technical changes could be helpful here. For example, the size of Fund quotas is fixed in nominal S.D.R's for long periods (of at least five years), which leads to its' automatic erosion in real terms. If the level of quotas could be fixed in terms of "real" S.D.R's, rather than in nominal values, inflation in the countries whose currencies compose the S.D.R. basket would automatically lead to an increase in the size of the nominal quotas, so as to preserve their constant purchasing value (given the Fund's deep commitment to the fight against inflation, any potential risk of moral hazard for the Fund would be practically nil!). More generally, it would be highly desirable to tie the size of the Fund quotas to some appropriate technically defined criteria, and to attempt to establish some level of automaticity in the approval of these technically defined quota increases.

Similarly, mechanisms should be sought to make decisions on S.D.R.allocations more technical (relating to the needs of the global economy and of different categories of fund member countries) and less dependent on major countries' political decisions[44].

Finally, the distribution of work implied by the suggested changes would lead to a somewhat larger focus by the staff of the Bretton Woods institutions on industrial countries' policies and their effects, and somewhat less emphasis on developing countries' policies. This would increase the impact of those institutions' policy advice on the world economy.

IV: Conclusions.

At a time of growing world economic independence, there is increasing consensus that the need for global economic management is far greater than in the past. This clearly requires strong international institutions which give substance and continuity to global economic management; almost by definition those are the Bretton Woods institutions and particularly the Fund.

This major new challenge would require the Fund to focus a far greater part of its' efforts on influencing policies of the industrial countries and on emphasising more the international effects of national economic policy. In carrying out such a shift, the Fund would not just be following the suggestions of developing

44 For an interesting suggestion relating to the U.S, to facilitate S.D.R. allocations, see P. Kenen (1986) Financing, Adjustment and the International Monetary Fund. Washington. The Brookings institution.

countries' governments and independent analysts, but also a clear call from a major G-10 report[45] which argued that:

"Surveillance has not been <u>sufficiently effective</u> in inducing policy changes in countries which have adequate access to external financing and do not require an I.M.F. supported adjustment programme. These countries appear to have been able on occasions to sustain policy courses not fully compatible with the goods of international adjustment and financial stability"

There is growing agreement internationally that industrial countries' exchange rate management is a desirable objective and that macro-policy coordination is also valuable. Two factors contribute to this convergence of views: a) Growing perception that macro-policy coordination is an important international public good, that cannot be provided by governments acting on their own. b) There seems to be growing agreement in the technical literature , not just on the objectives of macro-policy coordination, but on the intermediate targets which would be most appropriate and a technical blueprint on how such a system would operate.

To turn the general commitment of industrial governments, and the useful work of academics, into a concrete process of policy coordination, essential tasks need to be carried out, mainly by the Bretton Woods institutions. These tasks go from the apparently mundane (but actually essential) work of improving economic projections, adapting them to the needs of policy coordination and ensuring those figures are used as a basis for policy coordination,

45 Deputies of the Group of Ten. <u>Report on the Functioning of the International Monetary System</u>, reprinted in <u>I.M.F. Survey</u>, Supplement, July 1985. I.M.F. Washington D.C.

to improving analytical understanding of policy changes' effects on national economies, and on the rest of the world, whilst continuing to emphasise the importance of policy coordination.

The essential role of the Bretton Woods institutions in the process of macro-policy coordination needs to be emphasised, to avoid this process developing, as it largely has until now, in an ad-hoc fashion and in restricted fora (basically the G-3, G-5, and G-7). The need to involve the Bretton Woods institutions (and particularly the Fund) arises on the one hand from the need for institutionalised cooperation among industrial countries, which experience (for example, with the E.M.S.) has shown to be far superior to ad-hoc cooperation for a number of reasons discussed above. Secondly, both Bretton Woods institutions need to play a central role in the process of coordination so as to represent the interests of the rest of the world, and particularly the developing countries.

In this context, for example, the Bretton Woods institutions should play an essential role in evaluating and attempting to influence the projection of future current account trends in different industrialised countries (and the policies which determine them) <u>with</u> minimum levels of liquidity (as defined by the I.M.F.) and positive net resource transfers (as defined by the World Bank) to different categories of developing countries. Clearly, no other institution could technically provide this essential bridging role better than the Bretton Woods institutions. Furthermore, this exercise could provide a more realistic framework in which the Bretton Woods institutions (and the L.D.C's themselves) could programme future flows to and from L.D.C's. Also, the Bretton Woods institutions could better define their own targets for liquidity creation, I.M.F. credit and World Bank resource transfers in the context of likely projected global trends. In the immediate future, there may be resistance from governments (particularly but not only industrial ones) to thus widen the scope of the Bretton Woods institutions' role. However, much of this opposition would come not from a defence of national interest, but from an unwillingness to change existing procedures and enlarge the role of international institutions. However, recent history shows again that industrial governments (and perhaps most clearly the U.S. one) have the ability to be flexible, and modify apparently fixed views (e.g. on exchange rate management, on the international debt) when economic and political circumstances demand the need for such a change. What is suggested here basically broadens the scope of this new flexibility from its' application to specific key international management problems (such as exchange rates and the debt) to the creation of a more systematic managed approach, which, among other benefits, would handle at an earlier stage, or even avoid, such problems. In this sense, the measures and approaches suggested here build on policy changes already occurring, by both strengthening and expanding them.

This more analytical and macro-economic role of the Bretton Woods institutions should be complemented with their further contribution to the design and development of appropriate mechanisms through which flows (particularly private ones) are more likely to flow from industrial to developing countries. A specific opportunity (and challenge) in this latter aspect is provided by large Japanese surpluses, lodged mainly in the private system and by the willingness of the Japanese government to encourage their recycling to developing countries; firstly,the Bretton Woods institutions should analyse this process and calculate its' effects, but above all support it with their experience; secondly the Bretton Woods institutions need to encourage other countries, such as West Germany (with surplus funds) to also be creative in recycling efforts. Again in such an action, the Bretton Woods institutions would be carrying out a bridging role between the needs of global coordination of macro-policies and the developmental needs of its poorer members. In a broader context, the Bretton Woods institutions should enlarge the range of their impact on financial flows to and from LDC's, so as to make their magnitude and modality more compatible with long-term development. Activities suggested above include a greater role for guaranteeing private flows, greater participation by the Bretton Woods institutions in the regulation and supervision of future private banking and other flows to developing countries, a greater role in influencing industrial countries' national tax and regulating rules so as to increase flexibility in debt management, and a study of the possibility of taxing short-term international financial transactions. The latter could not only minimize capital flight from developing countries but also contribute to reduce speculative flows that de-stabilize exchange-rate management on industrial countries.

In this aspect of industrial countries' exchange rate management, the Fund in particular should take the lead in suggesting improved financial arrangements by industrial governments to support greater stability of exchange rates. The Fund would also be the institution where such enhanced financial arrangements should be based.