

THE FUNCTIONING OF THE INTERNATIONAL MONETARY SYSTEM

After examining the functioning of the international monetary system the Group of Ten has concluded that the floating exchange rate system has performed in a satisfactory manner. Although concern is expressed about volatility in exchange rate movements it is thought that this problem could be best addressed by improving the functioning of the existing system through the implementation of a more stable and consistent approach to domestic economic policy in the major industrial countries.

This article summarises the main points contained in a comprehensive report published in July 1985 on the functioning of the international monetary system. The points made in the report have particular relevance for New Zealand given the significant trade and financial relationships that New Zealand has with the rest of the world and given the recent shift in direction in economic policy in New Zealand.

The report was prepared by key economic policymakers in the eleven major industrial countries (Belgium, Canada, France, the Federal Republic of Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States). These countries are collectively known as the Group of Ten (G10) countries and the policymakers from these countries who prepared the report are known as the G10 Deputies. A different perspective on the same issues is expected to be presented in an alternative report currently being prepared by representatives of the 24 developing countries which make up the Intergovernmental Group of 24 on International Monetary Affairs (the G24).

The G10 report resulted from disagreement amongst the seven largest industrial countries at the 1983 Williamsburg Summit on aspects of the functioning of the international monetary system and, in particular, the international effects of high United States interest rates and the strong US dollar. The French position was that the international monetary system was in urgent need of reform and the proposed a major international conference to discuss such reform. The United States did not accept responsibility for the tensions evident in the international financial system and rejected the need for a conference. As a compromise the seven leaders decided to invite their finance ministers, in consultation with the Managing Director of the International Monetary Fund (IMF), to 'define the conditions for improving the international monetary system and to consider the part which might, in due course, be played in this process by a high level monetary conference'.

Responsibility for producing such a report was taken up by the G10 with the G10 Finance Ministers instructing Deputies to identify areas in which progressive improvements could be made in the

functioning of the international monetary system. In November 1983 the Deputies proposed a work programme, which their ministers subsequently approved, covering the following four areas:

- the functioning of the floating exchange rate system;
- strengthening multilateral surveillance;
- management of international liquidity;
- the role of the IMF.

In producing their final report the Deputies were aided by contributions from the staff of the IMF, the Organisation for Economic Co-operation and Development (OECD), the Bank for International Settlements (BIS) and the Commission of the European Communities. The report is now to be considered by the IMF Interim Committee, the principal policy advisory body of the IMF, at its next meeting in October 1985 in Seoul, South Korea.

The main points of the report are summarised below under the four headings used by the Deputies.

The Functioning of Floating Exchange Rates

The major currencies have now been floating for about twelve years and the Deputies conclude that during that period the international economy has benefitted from the greater flexibility in exchange rates. The flexibility has made a positive contribution to the adjustment to external imbalances and has allowed the continuation of largely unrestricted international trade and payments in the face of massive external shocks. The report notes that it is questionable whether any less flexible system would have survived the strains of the past decade and that such a system would probably have involved restrictions on trade and capital flows thereby constraining world economic growth. Flexible exchange rates have also helped insulate domestic economies from inflation abroad and have facilitated the pursuit of sound monetary policies geared more directly to domestic conditions.

Nevertheless, the floating exchange rate system has also exhibited some weaknesses. In particular, there has been substantial short-term volatility in nominal exchange rates and large medium-term movements in real exchange rates. Although empirical studies by the IMF have failed to find a systematic link between short-term exchange rate volatility and the volume of international trade, the Deputies express concern that such volatility may discourage trade and investment by adding to uncertainty. The Deputies also express concern that large movements in real exchange rates can lead to patterns of international transactions which may be unsustainable and which may lead to problems for domestic economies, especially if the movements in exchange rates are subsequently reversed. Such disruption to domestic economies could also carry with it the risk of increased protectionist sentiment.

In seeking improvements to the functioning of the exchange rate system, the Deputies note that exchange rates are influenced to a large degree by financial transactions which are not directly related to trade flows. Given the importance of expectations in determining these capital flows the Deputies conclude that much of the volatility in exchange rates can be attributed to inadequate and inconsistent domestic economic policies which have resulted in increased uncertainty in financial markets. Thus it is argued that the functioning of the exchange rate system and greater exchange rate stability would be fundamentally assisted by the adoption of sound, credible and stable policies in all countries such that steady non-inflationary growth and greater convergence in economic performance were achieved. This greater consistency in economic policy should be supported by further liberalization in international capital markets and in other markets, as well as by greater consideration on the part of governments of the international implications of their domestic policy.

Other possible ways to improve the functioning of the present system are rejected by the Deputies. A return to a system of fixed exchange rates or target zones for exchange rates are seen as unrealistic under current circumstances. Similarly controls on the movement of capital internationally are rejected because they are seen as ineffective in achieving greater exchange rate stability and could hamper further growth in world trade given the close link between trade and capital flows. Direct intervention in the foreign exchange markets is also not considered to be a viable alternative. Rather it is thought that intervention only has a limited role to play in support of other policies or to counter disorder in the foreign exchange markets.

Strengthening International Surveillance

One way to bring about more compatibility in policy would be through the strengthening of surveillance of domestic economic policy by international organisations. The Deputies note that since the inception of the floating exchange rate system surveillance has not been as effective as may have been hoped in influencing policy and promoting the economic conditions for greater exchange rate stability. However, to improve the effectiveness of surveillance the Deputies consider it necessary to improve the functioning of the current surveillance process rather than to make major changes to the existing institutional arrangements.

Although other organisations such as the World Bank, OECD, BIS and the General Agreement on Tariffs and Trade (GATT) are recognised as having an important part to play in the surveillance process, the Deputies agree that the central role of the IMF should be preserved. They suggest several ways in which surveillance could be made more effective. These suggestions involve refinements to the regular IMF review of member countries' economic performance (Article IV consultations) in order to provide a fuller assessment of policies and structural features that could induce exchange rate instability, an explicit analysis of domestic policies in the context of the world economy so that interdependencies are fully brought out, a more candid assessment by the IMF of domestic policies and of their impact domestically and internationally, for those countries whose policies and performance are of greatest concern for the world economy a confidential exchange of views between the IMF Managing Director and the finance minister of the country concerned, and follow-up reports on the progress made towards dealing with the problems identified by the IMF.

The major weakness of the existing system of surveillance has been the lack of leverage over countries which have adequate access to external financing and do not require an IMF supported adjustment programme. The Deputies' suggestions aim to improve the effectiveness of surveillance of such countries. The success of surveillance will depend on the full co-operation of every country and the Deputies emphasise that strengthened surveillance will require enhanced dialogue and persuasion through 'peer pressure' rather than through the imposition of external constraints.

International Liquidity

Since the transition to a floating exchange rate system the liberalization and integration of national capital markets have allowed a significant increase in international capital flows. The Deputies consider that this has been beneficial since it has allowed creditworthy borrowers to gain access to credit quickly and efficiently to meet the rapid growth in their external financing requirements. However, it is not considered that the system has worked entirely satisfactorily. Of particular concern is the scope for excessive swings in the availability of credit. To avoid the disruption that this could cause, either through the restriction of international trade when credit is too scarce or through inflationary pressures when credit is too plentiful, the Deputies suggest various ways in which the provision of international liquidity could be improved.

An important aspect of any such improvement would be the maintenance of a stable and non-inflationary policy environment. In addition, it is suggested that the collection and dissemination of data relevant to assessing individual countries' creditworthiness should be improved, that private banks should improve their risk evaluation methods and that countries should continue to de-regulate capital markets as well as strengthen their supervision of banks operating in the international markets.

For those countries presently not judged to be creditworthy the Deputies advocate the adoption of more appropriate policies aimed at facilitating their adjustment to external payments imbalances. To support such adjustment efforts, the ability of the IMF

to respond to liquidity problems should be maintained and official financing should be made available to debtor countries which, in spite of adjustment programmes, do not have sufficient access to credit.

In suggesting these improvements to the international capital markets the Deputies recognise that these markets are likely to supply the bulk of international liquidity in the foreseeable future while officially supplied liquidity — the IMF's Special Drawing Rights (SDRs) — will have a supplementary role.

In this context the Deputies discuss the role of the SDR but are unable to reach a consensus view. They suggest that the SDR may still have a useful role to play even though the international monetary system has undergone considerable change since SDRs were introduced. The proposed review of the future role of the SDR by the IMF is welcomed.

The Role of the IMF

The Deputies consider that it is important for the IMF to remain a provider of short-term assistance to countries with balance of payments problems. The assistance should continue to be conditional on agreement with the IMF on an adjustment programme and should be available to all Fund members. Although the IMF's liquidity position is currently strong, the Deputies feel that it could be weakened if the prolonged use of Fund resources is allowed to continue. Thus they would like to see the phasing out, as soon as possible, of the policy of enlarged access whereby countries with particularly large imbalances can borrow larger amounts than is possible under the normal IMF facilities.

It is noted that in order to meet the demand for its assistance over the last ten years the IMF has borrowed from official sources to supplement the funds available from members' quotas. The Deputies consider it desirable that quotas remain the major source of IMF

resources. However, given the length of time needed to negotiate an increase in quotas, alternative techniques of acquiring funds should be developed to enable the Fund to respond quickly to any unforeseen increase in the demand for its assistance.

On the question of co-operation between the IMF and the World Bank the Deputies suggest that closer co-operation would be beneficial to ensure a consistent approach to the problems of developing countries. Nevertheless, the differences between the two institutions should be preserved with the IMF providing short-term balance of payments financing and the World Bank providing longer term development financing.

Summary

The G10 report arose out of disagreement amongst the seven largest industrial nations as to the functioning of the international monetary system. After examining the issues, the Deputies have concluded that the flexible exchange rate system (in which most world trade and financial transactions take place) has performed in a satisfactory manner, and that it is unlikely that a less flexible system of exchange rate determination could have survived the disturbances in the international economy over the past decade.

The report recognises that the existing arrangements have exhibited a number of weaknesses and of most concern is the volatility experienced in exchange rate movements. The Deputies consider that this can be best addressed by improving the functioning of the existing system by the implementation of a more stable and consistent approach to domestic economic policy among the major industrial countries. An improvement in the effectiveness of surveillance, with a key role being played by the IMF, is seen as being a mechanism by which more consistency in policy may be achieved. A return to a system of fixed exchange rates is not thought to be the solution to the difficulties that have emerged.