

# THE FUNCTIONING OF THE INTERNATIONAL MONETARY SYSTEM

*In a comprehensive report, the Group of 24 (this term is explained below) has presented the developing countries' views on the international monetary system. The report concludes that greater exchange rate stability could be achieved by more closely co-ordinating the national economic policies of the major industrial countries. In addition, the Group of 24 recommends an immediate allocation of Special Drawing Rights and steps to ensure that developing countries are able to borrow adequate amounts from the International Monetary Fund.*

## Introduction

During 1985, two reports were published on the functioning of the international monetary system. The first was prepared by representatives of the Group of Ten (G10) major industrial countries and was summarised in an article in the September 1985 *Bulletin*. An alternative viewpoint on the same issues is presented in the second report which was published in August 1985 by the Intergovernmental Group of 24 on International Monetary Affairs (the G24). The G24 is a group of developing countries (independent of the Group of 10) with a balanced representation from Africa, Asia, Latin America and the Caribbean. As a group, the nations represented in the G24 aim to ensure that the interests of developing countries are taken into account in discussions on the international monetary system.

The group's latest report is a continuation of work by the G24 on the international monetary system which had earlier resulted in the publication in September 1984 of a 'Revised Program of Action Towards Reform of the International Monetary and Financial System'. That programme provided a clear statement of the views of the developing countries on reform of the international monetary system. The latest report is based on the findings of a working group set up by the G24 in May 1985 to examine the issues under consideration by the G10. Although covering much of the same ground as the G10 report, the G24 report arrives at rather different conclusions. These are summarised below under the same headings as used by the G24 in presenting its findings.

## The Functioning of the Present Exchange Rate System

The G24 report argues that the present floating exchange rate system has not performed as well as was expected. Particular concern is expressed about short-term volatility in exchange rates and about the persistent

deviations of rates from their equilibrium levels. Short-term volatility in rates is thought to have resulted in considerable uncertainty about future exchange rates and this has discouraged international trade and investment by adding to financial risks. This problem is seen as being of major importance for developing countries which lack sophisticated financial markets, especially facilities for arranging forward cover. In addition, the uncertainty has meant that developing countries have had to hold greater foreign exchange reserves. Considerable deviations in exchange rates from equilibrium levels are also seen as having been a major problem for developing countries because they have resulted in an inappropriate use of resources and have added to pressures for increased protection.

The G24 considers that the main reason that exchange rates have exhibited these deviations has been a failure on the part of industrial countries to consider fully the international impact of their domestic economic policies before implementing those policies. Thus there is seen to be a need for greater discipline and co-ordination in the selection of policies and for exchange rate stability to be an important objective of policy in those major industrial countries whose exchange rates are of prime importance within the international economy. The adoption of target zones for the exchange rates of major currencies is seen as another way of possibly achieving greater exchange rate stability and the G24 suggests that the idea should be studied further. Direct intervention in the foreign exchange market is seen to have a role as a complementary measure to other policies.

## Surveillance

The G24 believes that greater co-ordination in economic policy would allow the achievement of a better economic performance in each country than could be achieved if those countries were to pursue independent policy lines. The Group sees a key role for

International Monetary Fund (IMF) surveillance of policies in obtaining this greater consistency. However, it notes that in the past there has been an asymmetry in surveillance. The ability of the IMF to influence policies in developing countries has been much greater than its influence over the major industrial countries who have adequate access to external financing and do not require IMF supported adjustment programmes. To overcome this problem the G24 recommends that the IMF should monitor developments in industrial countries more closely. It is also suggested that surveillance would be more effective if it was focused on international policy interactions and economic linkages rather than being confined narrowly to surveillance of exchange rates.

Some improvements in the mechanics of the surveillance process are seen as being necessary and it is suggested that a two stage process should be developed. The first stage would involve multilateral discussions among IMF members to agree on a set of objectives and a set of policies to achieve collectively those objectives. The second stage would involve comparing actual outcomes with the recommended targets and a discussion of appropriate measures to be taken should the two differ. It is thought this second stage could be undertaken on a bilateral basis within the framework of the IMF's regular Article IV consultations with members.

### **Management of International Liquidity and the SDR**

In the early 1970s when floating exchange rate systems became more widespread it was expected that there would be a fall in the demand for foreign exchange reserves. The G24 report notes that this fall has not occurred. Large movements in exchange rates and the resulting uncertainty along with significant exogenous shocks, a trend towards increased protection, and the desire to demonstrate creditworthiness have meant that countries have found it necessary to continue to hold substantial reserves.

Over the floating rate period, the supply of foreign currency reserves has mainly originated from lending by private banks. The G24 considers that leaving the provision of reserves to the market in this way has not been satisfactory because it has resulted in an inadequate and unevenly distributed supply of reserves. Of particular concern to the G24 is the fact that many developing countries have not had access to borrowed reserves and have had to rely on trade surpluses to service their external debt and to build up their reserve levels. Furthermore, success in adjustment programmes has not restored creditworthiness to developing countries, many of which still have difficulties in obtaining reserves.

The G24 concludes that this problem cannot be solved by improvements to the operation of private capital markets. A better solution would be for the IMF to allocate additional Special Drawing Rights (SDRs). It is recommended that a sizable allocation be made immediately to provide reserves for debtor countries without access to credit. In addition, it is recommended that SDRs should be allocated regularly to enable the SDR to develop into the principal reserve asset in the international monetary system, a goal which is stated in the IMF's Articles of Agreement.

### **Role of the IMF**

The G24 expresses concern that, although the IMF plays a central role in the international monetary system, it has in the past not adequately met the needs of developing countries. As well as improving its surveillance of industrial countries and allocating additional SDRs, the Fund could assist developing countries by liberalising its balance of payments financing facilities and applying its adjustment programmes more flexibly.

Factors outside the control of a country such as a cyclical downturn in demand in other countries or high interest rates in international capital markets can result in a transitory balance of payments deficit. Such a deficit will require financing and it is recommended that countries should have access to sufficient resources to cover the shortfall and that there should be a minimum of conditionality associated with such lending. When an external imbalance is more persistent, appropriate adjustment policies will be needed. The G24 criticises the IMF for placing too much emphasis on demand deflation in its adjustment programmes. Instead it would be more appropriate to aim to restore sustainable growth in output. Demand deflation should only be required if the current account deficit stemmed from excess domestic demand but the G24 considers that the main cause of a persistent deficit is usually of a structural nature which leads to an inappropriate use of a country's resources. Adjustment to such problems will take time and will require access to finance over a period of several years.

A further problem highlighted by the G24 is the inadequacy of IMF quotas. In recent years developing countries making use of Fund facilities have borne the extra cost involved in the IMF needing to borrow to supplement the resources provided by quotas. The G24 recommends that quotas be increased and that their total size be linked to some measure of the size of the world economy. Similarly the G24 recommends an increase in the general capital of the World Bank to allow the Bank to maintain its development assistance to low income countries.

To ensure a greater consideration of the views of the developing countries at both the IMF and World Bank the G24 would like to see the voting share of such countries increased. It recommends that 50 percent of the votes at both institutions be allocated to developing countries.

### **The Debt Problem and Transfer of Resources**

A solution to the debt problem is seen as requiring a co-ordinated response by debtor countries, industrial countries, private banks and international financial institutions to ensure that the debt burden is within the ability of countries to pay. The specific recommendations made by the G24 on this question include a reduction in protection in industrial countries to improve access for developing country exports, and policies to discourage capital outflows from developing countries with capital flight problems.

The G24 also notes that the problems of heavily indebted countries stem, to a large extent, from a lack of development finance. To help overcome this problem the G24 suggests that industrial countries should

attempt to increase their official development assistance to developing countries. In addition, the report recommends that the resources available to the International Development Association (the World Bank's 'soft loan' arm) should be increased substantially.

### Summary

In preparing its report the G24 has presented the views of the developing countries on the international monetary system. The report discusses the same issues as those covered by the earlier G10 report but its developing country focus yields significantly different conclusions. The G24 suggests that to improve the prospects for continued growth and development in developing countries it will be necessary to achieve greater exchange rate stability by more closely coordinating the national economic policies of the major

industrial countries; improve surveillance of major industrial countries to ensure their policies will benefit the international economy as a whole; allocate additional SDRs to provide the reserves needed by many developing countries without access to private capital markets; and ensure that debtor countries can borrow adequate amounts easily from the IMF.

Both the G10 and G24 reports were considered by the IMF Interim Committee, at its meeting in Seoul, South Korea in October 1985. Because of the importance of the issues discussed in the reports the G24 would like to see them considered by a representative committee of Ministers from industrial and developing countries. However, in the first instance, the reports were referred to the IMF Executive Board with the intention of allowing the IMF's Executive Directors to narrow and refine the issues, and to identify those proposals requiring further consideration by the Interim Committee at its next meeting in April 1986.