THE 1977 PER JACOBSSON LECTURE

THE INTERNATIONAL MONETARY SYSTEM IN OPERATION

THE PER JACOBSSON FOUNDATION

Wilfried Guth
Sir Arthur Lewis

Sunday, September 25, 1977
The Atrium, International Monetary Fund
Washington, D.C., U.S.A.

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FOREWORD

The 1977 Per Jacobsson Lecture, the fourteenth in the series, took place on Sunday, September 25, 1977, in the Atrium of the International Monetary Fund Building, Washington, D.C., U.S.A. The Chairman of the Per Jacobsson Foundation, Mr. W. Randolph Burgess, presided over the proceedings during which Dr. Wilfried Guth and Sir Arthur Lewis spoke on the subject of "The International Monetary System in Operation." Included in this publication are the text of the statements of the speakers, answers to questions raised by the audience, and a brief biography of each of the speakers.

This series of lectures and publications is made possible by the generous contributions made by friends of Per Jacobsson, the late Managing Director of the International Monetary Fund, following his death in 1963, to establish a Foundation to promote informed international discussion of important current problems in the field of monetary affairs.

Per Jacobsson Lectures are published in English, French, and Spanish, and are made available, without charge, upon request to the Secretary of the Foundation. A full list of the titles in the series appears elsewhere in this booklet.

Inquiries may be addressed to the Secretary of the Per Jacobsson Foundation, International Monetary Fund Building, Washington, D.C. 20431, U.S.A.

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Opening Remarks

William B. Dale
Deputy Managing Director, International Monetary Fund

Ladies and gentlemen: I regret that I have to report to you that Mr. Witteveen is unavoidably detained by business--the meeting of the Development Committee, which takes place this afternoon. I express his regret and mine that he is not able to be here and to welcome you and the speakers and supporters of the Per Jacobsson Foundation.

I bid you all welcome to the headquarters of the Fund, and I hope that you will find enjoyment and provocation in the addresses that you will hear this afternoon.

* * * *

W. Randolph Burgess
Chairman, Per Jacobsson Foundation

Thank you, Bill. Will you please tender our appreciation to Mr. Witteveen for all that you and he and the Fund have done for our Foundation. The Fund works with us constantly. Mr. Witteveen, Bill Dale, and other officials of the Fund sat down with us when we were experiencing some financial problems. And now it has come to a point where we are an organization which has a balanced budget! People have their trouble, perhaps, in keeping the two organizations separate. But they are different animals, even though they are both devoted to the same general purpose.

Many people were saddened to hear about Mr. Witteveen's decision to leave the Fund. The news makes us appreciate the sagacity and the originality of this man and what he has done for us all. Thank heaven he still has a year to keep on making his unique contribution to the world of international monetary affairs.

Now let me turn for a moment to the Foundation. It seems almost incredible that the Foundation has been going on now for 14 years. We started with three of us working together with a secretary. Two of our stalwart officers have now retired from the Fund, although they keep right on working with the Foundation, without pay, and a new Secretary and a new Treasurer have been appointed from the Fund. We have a few more Directors to give the Board stability and breadth, and the number of adherents who believe in what we are trying to do has been growing steadily, as witness this meeting here.

We have had one really important change; we have a new President--Frank Southard. Frank has long been our guide, philosopher, and friend. He has given generously of his wide experience and deep knowledge in this field. I am delighted to have Frank Southard as our new President, and, in that capacity, I ask him to preside over the rest of the meeting.

* * * *

Frank A. Southard, Jr.
President, Per Jacobsson Foundation

Mr. Burgess, Sir Arthur Lewis, Dr. Wilfried Guth, and ladies and gentlemen: I have always felt that the best thing a presiding officer can do is to preside and not to make speeches.

We chose, necessarily almost a year ago, the subject of "The International Monetary System in Operation." It was a good subject then, and it is certainly a good subject today. And we were very fortunate in having two speakers agree to be here and to work diligently during the intervening time in preparing their statements: Dr. Wilfried Guth and Sir Arthur Lewis. One of them coming from the so-called industrial world will be emphasizing that aspect of this subject; and the other, Sir Arthur Lewis, not only coming from the less developed world, but having in much of his career concerned himself with the special problems of that world, will be speaking from that point of view.

I don't wish to take time to give biographical sketches of either of the speakers. You have in your hands this little brochure which gives the essential facts of their lives.

Now, without taking more time, I am very pleased to introduce the first speaker, Dr. Wilfried Guth, who is an old friend of mine and whom I am delighted to see here today.

I would remind you of the cards in your programs on which you may write the questions you would like to raise during the discussion period. There are ushers available to collect them and bring them up, so please don't forget that as you listen. Or, if you already have questions in mind, please jot them down. Dr. Wilfried Guth.

The Working of the International Monetary System

Wilfried Guth

Mr. Chairman, ladies, and gentlemen: I feel honored by having been asked, together with Sir Arthur Lewis, to deal with such an important subject in this Per Jacobsson lecture. The assignment has a special meaning for me in a double sense: First, I am proud to call myself a "Per Jacobsson pupil," having served under his inspired and inspiring leadership in the International Monetary Fund from 1959 to 1961 as an Executive Director for my country. And, second, it is a particular pleasure for me to perform here, side by side with Sir Arthur Lewis, with whom I thoroughly enjoyed cooperating in the Pearson Commission. However, to try to comply with this task, on the eve of the Annual Meetings of the IMF and the World Bank, carries a substantial risk, the risk of being corrected or refuted tomorrow by official statements on the same theme.

I would like to stress, therefore, at the outset, that I am speaking here entirely as a non-insider as far as the steering of our international monetary system is concerned. Obviously, this entails distinct disadvantages because I do not know the facts about day-to-day central bank cooperation and secret strategic arrangements in defense of our system. My own knowledge cannot be any more than that of an interested observer and an active market participant. It remains to be seen--and I must leave it to this distinguished audience--whether the non-insider's role has also some "compensatory" advantages, such as a greater freedom to speak about possible weaknesses of the system. In other words, the absence of the kind of risk usually incurred by finance ministers or central bank governors that their statements may have a substantial, and often undesired, effect on the market. At any rate, I wish to claim, right in the beginning, the right to "errors and omissions."

I. The World Economic and Monetary Environment--Recent Trends and Problems

International monetary events have been a source of unrest and concern and a subject of heated debate for many years. Several approaches have been tried to overcome the emerging difficulties. From the Smithsonian Agreement via Rambouillet to Manila there has been a learning process at the international level yielding new insights which had previously received little consideration.

Looking at developments during recent years one might say, in a nutshell, that we have had fewer and less serious currency crises than during the final phase of the Bretton Woods system, but that there has been no change, perhaps even a change for the worse, with regard to balance of payments problems. And there is probably, for the business community, a more constant feeling of exchange rate uncertainty and a fear of exchange losses. This constellation seems to be closely associated with the floating rate regime. But, of course, any attempt to analyze this relationship must take into account the far-reaching changes which have taken place in the underlying world economic and financial conditions since the early 1970s under the impact of global inflation, the oil price hike, and the ensuing world recession.

In overall terms, the world economic scene has been governed since the early 1970s by two basic forces running counter to each other. On the one hand, national economies have become increasingly integrated and interdependent at market levels, from "below" as it were, through strong expansion of international trade, direct investments, and credit transactions. This process is most clearly reflected in the rapid growth of the Euromarkets. Under these circumstances, the need for a reliable and effective monetary order would seem even greater than in the 1950s and 1960s during the Bretton Woods era.

On the other hand, national economic policies have become more divergent than in the past. There are growing differences not only in approaches and methods but--what is more important--in objectives and priorities. In many industrialized nations there has been a tendency toward more state intervention in the market process and an increasing public sector share in the national product. By the same token, economic protectionism has re-emerged under the double pressure of balance of payments problems and unemployment. While outright restrictions on the free flow of trade have fortunately not been applied on a major scale so far, appeals to commercial patriotism and attempts to pass on domestic structural problems to trading partners cannot be overlooked.

In the light of these latter tendencies it is difficult to maintain an effective international monetary order, based on sufficiently precise and generally applicable rules, and to work on improvements of the system. Indeed, there has been a marked shift in attitudes to reform since the years in which the Group of Twenty was working toward this goal. It is now generally recognized that blueprint solutions are not practicable. All hopes to the contrary were finally dashed by the oil price shock. The present situation demands a more pragmatic approach based, however, on the recognition of certain fundamental principles. Clearly, the danger today is one of too much pragmatism and permissiveness.

After this brief survey of the international monetary environment, I shall now try to sketch the basic principles of our present monetary order--if it can be called one--to describe its performance, and to take a closer look at the role of its main institutions. This should then lead to the final question of whether and how the system could be improved.

II. Basic Principles and Agreements of the Present System

Thus far, the conflicting world economic tendencies of recent years have been "accommodated" rather flexibly in the exchange rate and liquidity system which has emerged since the final breakdown of Bretton Woods in mid-1971. Historical landmarks in this accommodation process have been, as mentioned, the Smithsonian Agreement, Rambouillet, Jamaica, and Manila. The second amendment to the Articles of Agreement of the International Monetary Fund has partially legalized the far-reaching *de facto* changes over the years.

Today, we have an exchange rate system based on free options: The exclusive principle of fixed par values under Bretton Woods has been replaced by the member countries' freedom to choose their own exchange arrangements. Under the present "mixed" exchange rate system some currencies--the U.S. dollar, the pound sterling, the Swiss franc, etc.--are floating independently, some are floating jointly (as in the case of the European "snake"), others are pegged to the dollar, another individual currency, the SDR, or another basket of currencies, as in the case of many developing countries.

Instead of fixed rules (e.g., when to intervene, how to express parities), we now have norms of good conduct--each country ought to behave in such a way that it doesn't harm the other--the member countries' central obligation being to collaborate with the Fund and with each other "to assure orderly exchange arrangements and to promote a stable system of exchange rates." The Fund is "to exercise firm surveillance over the exchange rate policy of members." In the meantime, principles and procedures for the guidance of members and for the exercise of Fund surveillance were agreed by the Executive Directors and endorsed by the Interim Committee. But this document is kept in very broad terms and open to different interpretations. However, as a new element which should not be overlooked, the amended Article IV on exchange arrangements explicitly states that "a principal objective /of the system/ is the continuing development of the orderly underlying conditions that are necessary for financial and economic stability," and thus establishes economic stability (i.e., price stability)--not exchange rate stability--as a basic goal of international cooperation. Whether one can speak here of a "Copernican revolution" in the conception of exchange rate policy, as Otmar Emminger did, remains to be seen; it is at any rate extremely important that internal monetary stability has been given such a notable place in the new IMF arrangements.

In the international reserve system, contrary to what was expected--and hoped for by some--the U.S. dollar has played a more dominant role than ever since the oil price hike (though this is due less to the U.S. balance of payments position than to the surpluses of the Organization of Petroleum Exporting Countries (OPEC) and their investment). However, today the dollar enjoys by and large much more international confidence than some years ago. Besides this, the deutsche mark and, to a lesser extent, the yen have grown in importance as international transaction and reserve currencies. The SDR has assumed the role of official numeraire. However, it has not become a major reserve instrument as foreseen in the original reform concept. The problem of steering international liquidity has remained unresolved, and there is still a total lack of control in this field.

Gold has lost its function as common denominator. The provisions regarding the disposition of IMF gold represent a further step toward the phasing out of the precious metal from the system. But the use of gold in central bank transactions and reserve policies is left to the discretion of member countries (leaving aside here the temporary understanding between the Group of Ten countries). The question whether the new provisions amount to a demonetization or remonetization of gold thus remains open to debate. At any rate, as things stand today, there is no risk in predicting that gold will figure as an important element in the reserve system for a long time to come.

Joseph Gold characterizes the second amendment of the Fund's Articles as follows: "the new provisions dealing with exchange arrangements, gold, and special drawing rights do not establish firm prescriptions. Instead, they adopt the legal technique of giving the Fund authority to take decisions on these matters in the future."1/

To sum up, the second amendment provides for a maximum of flexibility in international monetary relations. There are no mechanisms, no rigid rules or automatic sanctions to ensure the stability of the system. The ways in which the national authorities fulfill their obligations are by and large left to their discretion and responsibility, though there is considerable scope for a strengthening of the central authority of the IMF.

In view of this state of affairs, some commentators simply refuse to call the present international arrangements a "monetary order" at all; they speak of a "nonsystem." I do not share this judgment because I have sufficient confidence in the basic will to cooperate in the framework of accepted obligations. But I do feel that there is room and, in fact, a need for improvement, for a strengthening of the stabilizing elements within the system.

Such a generalized statement is, of course, of little value; it needs specific elaboration. But before trying to speak more precisely on possible improvements of our monetary system, I have to fulfill an essential part of my assignment by analyzing its performance record up to now. What are the criteria for measuring the usefulness of a given monetary order? Certainly not the possible benefits for this or that country. We know, for instance, that the United States has been relieved by the new system of much of the burden it had to carry under Bretton Woods. The advantages or disadvantages for the developing countries will be commented on by my cospeaker.

But if this is not the right approach, it cannot simply be the amplitude and velocity of exchange rate movements either. As no monetary system is an aim in itself, we have to look at such broader purposes as the smooth functioning of world trade and investment and of international financial markets. Yet today, there is a yardstick of possibly even greater importance: How far does a world monetary order facilitate the return to greater monetary stability and to a better balance of payments equilibrium in all member countries? Or, to put it in the more technical language of the experts--not always comprehensible to the business community--how far does a given system facilitate the adjustment process?

1/ Joseph Gold, "Law and Change in International Monetary Relations," *The Record* (Association of the Bar of the City of New York, April 1976), p. 237.

I shall now examine these various points in some detail.

III. Performance of the System and the Role of Institutions

A. The Working of the System

1. *The floating regime*

In overall terms we can say that up to now the system of widespread floating has stood the test under extremely difficult conditions. Foreign exchange and financial markets have remained in working order and there has been no relapse into major exchange controls.

a. However, since the transition to floating, exchange rate developments, even after adjustment in the first round, have been less steady than expected by the advocates of flexible rates. A conspicuous feature in this context has been a marked tendency toward polarization between strong and weak currencies. Since the last exchange rate realignment under the Bretton Woods system at the end of 1971, the external values of the major currencies (measured against all other currencies) have changed as follows: the Swiss franc was revalued by around 50 per cent, the deutsche mark by roughly 35 per cent, and the yen by almost 15 per cent. The U.S. dollar, like the French franc (after devaluations and revaluations in the meantime), has today approximately the same parity vis-à-vis all other currencies as at the end of 1971. On the other hand, the British pound and the Italian lira each recorded devaluations of approximately 40 per cent.

More recently, an important new feature has emerged, namely, the relatively strong overall position of the U.S. dollar, the deutsche mark, the Swiss franc, and the yen, which have developed into a kind of "stability quadrangle" that has prevented all disturbances on the foreign exchange markets from escalating into a real world monetary crisis. These four key currencies form the core of a group of strong currencies (including, among others, the Netherlands guilder, the Belgian franc, and the Austrian schilling) whose interrelationships have been relatively stable over the medium term; or, more precisely, the sometimes considerable exchange rate movements between these currencies have proven to be by and large reversible, not one-way shifts. And such temporary movements of the four major trade and investment currencies against each other have not, up to now, impaired their stabilizing function, as their basic strength and the firm intention of governments to defend this position was not questioned.

The performance of the joint European float can be considered a qualified success only. Two major member countries of the European Community--the United Kingdom and Italy--have never been able to join the group, France had to withdraw twice, from early 1974 to mid-1975 and again since March 1976, and a month ago Sweden had to drop out as well. In the present "mini-snake," in which the currencies of the Federal Republic of Germany, the Benelux countries, Denmark, and Norway are linked by fixed central rates, we have seen three realignments during the last twelve months which were necessary in view of diverging inflation trends in these countries.

The snake experience suggests a more general conclusion: Over the longer term, differences in inflation rates (and largely parallel--balance of payments disequilibria) seem to be the main determining factor behind exchange rate movements. So far, however, the adjustment has proceeded not gradually and smoothly but rather in sudden "jumps," and in some cases corrections have been exaggerated. In the shorter term the development of interest rates has also been of significance--occasionally even a decisive factor--for the movements of exchange rates. But a clear relationship between changes in interest rate differentials and changes in exchange rates was only discernible under certain conditions (of "all other things being equal") and for limited periods.

In contrast to what postwar textbooks had claimed, competitive devaluations, believed by many to be the greatest danger of a floating regime, have not occurred. The emphasis has rather been on resisting the pressure to devalue in the light of likely adverse repercussions on internal inflation.

b. In their exchange rate policies national authorities have indeed been concerned to maintain "orderly market conditions" or, to use the other catch-phrase, "to avoid erratic exchange rate movements." It is interesting to note that central bank intervention in the market (frequently with borrowed foreign exchange) has been much more extensive under floating than under the fixed parity system in the 1950s and 1960s. Since spring 1973 interventions by the most important central banks have totaled around US$200 billion, a large part of which was spent in 1976.

All in all, there is broad consensus that central bank intervention has by and large been well handled, although there is certainly room for improvement. It seems questionable in particular whether the enormous foreign exchange outlays last year in support of the pound sterling and the Italian lira--carried out with borrowed money--were necessary, all the more so as they could not prevent the massive decline in the exchange rates of these currencies. Moreover, to the outside observer it seemed that at times the central banks were having some difficulties in agreeing on "lines of defense." Such agreement, however, is a precondition for effective intervention policies. If central banks, for whatever reasons, work at cross purposes, intervention becomes futile.

An impediment to an effective, coordinated intervention policy has in some cases been a "lack of ammunition." This is indeed a serious institutional obstacle (though a technically surmountable one) to a forceful intervention policy of the Federal Reserve. With this peculiarity in mind, the dollar has been very aptly described recently as a "reserve currency without reserves."

c. With regard to the effects of floating exchange rates on inflation, we can say today that the expectations of the advocates of flexible exchange rates have not been fulfilled. During the first two years after the transition to floating, inflation rates throughout the world continued to rise. While the oil price explosion contributed to this, other--domestic--factors played a fair part too. Although inflation rates have been reduced on average since then, they are more divergent today than ever before. Little success in the struggle against inflation has been achieved by the deficit countries whose currencies were devalued. Here the effects of rising import prices on domestic price levels were aggravated by incomes policies aimed at maintaining real wages, often by means of such compensatory mechanisms as wage indexation. On the other hand, however, floating has made it easier for the stability-minded countries to pursue consistent anti-inflation policies.

This is not by any means to say that floating would be an obstacle to a general policy of greater monetary stability. Basically, in my view, any exchange rate system, as an instrument, is neutral with respect to inflation. The underlying causes of inflation are to be sought not in the exchange rate system but in the national policies of individual countries. Nor, one should add today, are the underlying causes for the present sluggishness in the world economy to be found in the exchange rate system.

The hopes that flexible rates would increase the scope for national economic policy, particularly for the realization of different national priorities, have only been partially fulfilled. The gains, as just indicated, have been scored primarily by the countries already nearer to stability. On the other hand, the deficit countries have achieved nothing like the degree of freedom to realize their particular domestic priorities that had been expected in some quarters. "Quite contrary to the notion," so Henry Wallich has remarked, "that a floating exchange rate would allow greater freedom to stimulate domestically, unhampered by worries about any ensuing payments deficit, floating has narrowed these countries' scope for stimulative action."

d. On an overall view, the promotion and financing of world trade, contrary to many expectations, have not been adversely affected by floating exchange rates. Over the last few years, world trade has expanded more strongly than production, as under the Bretton Woods system. Trade restrictions have so far been kept within limits. However, for some members of the international trading community, the floating regime does have its disadvantages. The commodity producing countries, for example, are affected by falling dollar and pound rates; I am sure Sir Arthur Lewis will be expanding on this subject later on. In the hard currency countries, exporters who cannot invoice in their own currencies are also at a disadvantage. And there are also problems for medium and small-sized companies who don't have the full range of price-hedging possibilities at their fingertips.

e. The expansion and efficiency of international financial markets have not been impaired by floating. They have, on the contrary, seen an expansion beyond all expectations. But here again it was essential that at least one or two hard currencies were always available and that these main issue currencies remained relatively stable. Without this effective functioning of international financial markets, the system might well have come under extreme pressure, given the size of balance of payments deficits after the oil shock.

2. *International payments balances and liquidity*

a. In the field of payments balances, judgment on the merits or disadvantages of our world monetary system is most difficult and complex. The developments since 1973 have been characterized by a drastic increase in disequilibria, accompanied by rapid growth in the foreign indebtedness of many industrial and developing countries. The gross total of all current deficits (excluding official transfers) amounted to US$230 billion for the three years 1974 to 1976, compared with some US$60 billion for the preceding three-year period.

A substantial part of these disequilibria must, of course, be ascribed to the oil price hike, which means that they would have occurred under any system. The current account surplus of the OPEC countries, which has been increasingly concentrated on the four low-population Arabian Gulf states, totaled about US$140 billion for the period 1974-76. This was more than twelve times the figure for 1971-73, although distinctly less than had been expected immediately after the oil crisis.

Yet, as hitherto, balance of payments disequilibria also reflect the very different degrees of success achieved by the individual countries in their adjustment policies, i.e., mainly in their fight against inflation. Thus, over the past few years, a number of industrialized nations with comparatively low inflation rates (the Federal Republic of Germany, Switzerland, the Netherlands, and--with certain interruptions--Japan and the Unites States) have generated current account surpluses amounting to some US$60 billion for 1974-76, whereas the more inflation-prone countries in all parts of the world have run into considerable deficits.

Among the deficit countries, we can distinguish the following four groups:

(1) The big industrial nations--the United Kingdom, France, Italy, and Canada. In the period 1974-76 they recorded a total current deficit of US$38 billion, compared with a US$10 billion surplus for the previous three-year period. In 1977, an improvement is taking place in the position of these countries--particularly in the case of the United Kingdom and Italy, where domestic restrictive measures (plus the effect of North Sea oil exploitation in the case of the United Kingdom) are beginning to take effect.

(2) The small and medium-sized developed countries 2/ with a deficit of US$57 billion for 1974-76, whose overall account was more or less in balance in the early 1970s. No tangible improvement is in sight here in the near future in most of these countries, and this group is regarded increasingly as a new problem area.

(3) The non-oil developing countries (outside Europe) whose overall current account deficit trebled from 1971-73 to 1974-76 (from US$30 billion to US$90 billion) and whose total indebtedness has doubled over the last three years to US$160 billion. It is important to remember here that deficits and debt are concentrated on a very small number of countries. Nearly one half of the above-mentioned deficit was accounted for by only five highly indebted countries (Brazil, Mexico, Peru, Egypt, and South Korea).

2/ These include the Mediterranean countries (Greece, Portugal, Spain, and Turkey), the Scandinavian nations (Denmark, Finland, Norway, and Sweden), and a number of very different countries such as Australia, Austria, Iceland, Ireland, New Zealand, and South Africa.

(4) The state-trading nations of the East whose current deficit from 1974 to 1976 amounted to US$25 billion (US$9 billion in 1971-73). Here, as in group (1), the overall deficit will probably decline in the current year (from US$7 billion in 1976 to US$5 billion in 1977).

The United States represents a special case. Following the record surplus in 1975 (US$11.7 billion, including official transfers) and a more or less balanced current account in 1976, a deficit in the order of US$10-14 billion is expected in 1977, mainly in connection with the steep increase in oil imports and higher purchases from Japan.

Given the fact that these imbalances have occurred during a period of considerable exchange rate movements, one is inclined at first sight, at least on the basis of our experiences so far, to doubt the old textbook rule that revaluations or devaluations can correct balance of payments surpluses or deficits or, to put it differently, that floating makes big reserve movements unnecessary. But, in fact, this rule was never true. It was clear already under the Bretton Woods regime--and it had been particularly stressed by Per Jacobsson--that devaluations only work in the desired direction if they are underpinned by domestic deflationary measures. And, for reasons which were often more political than economic, that was precisely what did not happen in most cases. Thus, it became apparent that exchange rate changes alone can do no more than compensate different developments in national price and cost levels. In other words, they do not bring about a real change in the competitive situation. Beyond that, it has perhaps become more evident than hiterto that in a devaluing country, exporters' costs tend to be pushed up by higher import prices and compensatory wage increases, thereby reducing the competitive advantage on the price side. Therefore, in extreme cases, mere devaluation could worsen the balance of payments situation. There are clear consequences of all this for the adjustment policy concept, which will be discussed in the concluding section.

b. The pressure on deficit countries for internal adjustment measures was relatively moderate for quite a time, not least because the financing of deficits could be effected relatively smoothly. By far the largest part of the required funds was raised on the international financial markets, which reacted extremely flexibly to the massive changes in payments flows and financing needs following the rise in the oil price. The international banks with whom the OPEC countries deposited a large share of their surplus funds played a major part--and assumed a major share of the risks involved--in the recycling of petrodollars to the oil importing countries. In the years 1975-76 alone, new international bond issues and medium-term Eurocurrency credits totaled around US$115 billion. This amount corresponds to about three quarters of the overall requirements for the financing of current payment deficits during this period. Official balance of payments credits also increased strongly after 1973, but the share of conditional liquidity (i.e., recourse to the IMF's higher credit tranches) was low.

All in all, we may say that the difficult task of recycling the surpluses, in particular the oil surpluses, to the deficit countries has been successfully mastered in quantitative terms: a collapse of the world monetary system and thereby of world trade could be avoided. This was--and we should not forget this--more than many had dared to hope for at the time of the first big oil price hike. But neither should we close our eyes to the fact that a prolonged policy of accommodating balance of payments deficits through provision of generous unconditional finance via market channels has considerable shortcomings. There is general agreement at this juncture that the extent to which payments disequilibria have been financed so far by private institutions cannot be sustained indefinitely. In other words, the banks, due to their considerably enlarged engagement in this field, are becoming increasingly cautious in lending to certain deficit countries if no end to these deficits is in sight, while many deficit countries are recognizing more and more that in future official means must be used to a greater extent to cover their financial needs.

Due to the manner in which recycling has been effected, the tendency is today, even more than in the Bretton Woods period, towards the creation of too much rather than too little international liquidity. Within the last 4 1/2 years, world monetary reserves have increased by about the same amount as during the preceding 25 years, and today total roughly US$280 billion. At the same time, massive shifts have taken place in the distribution of official reserves. The OPEC countries, whose reserves have grown at an unprecedented rate, today hold more than a quarter of world monetary reserves, compared to 7 per cent at the end of 1972. Simultaneously, the industrial nations' share declined from about two thirds to one half, while the non-oil developing countries, in spite of their high current deficits during the last years, were able to strengthen their relative reserve position. Today they account for roughly one sixth of world monetary reserves.

The fact that countries with persistent deficits have been able to increase their reserves indicates that, in the present system, the creation of liquidity, i.e., official reserves, is largely demand-oriented--in striking contrast to the supply-determined reserve creation under the Bretton Woods system which was also foreseen in the various reform drafts. Thus, the conditions for the control of international liquidity have changed. In the final analysis, the growth of international reserves today depends largely on the creditworthiness of individual deficit countries in world financial markets.

B. The Institutional Framework

International monetary policy has never been a "one-man show," and any international monetary order will always rest on different pillars. This naturally applied to the Bretton Woods system too. In that system, however, the IMF played a rather central role. This is true not only with respect to the consultations prescribed under Articles VIII and XIV, governing the member countries' obligations to avoid restrictions and to achieve full convertibility in their current payments (which still apply today). It was also mainly the fact that the Fund had to authorize changes in par value in excess of 10 per cent which made it a decisive partner of national monetary authorities and the true center of the international system. The fall of the Bretton Woods system was therefore at first accompanied by a weakening of the Fund's importance. In the initial period after the introduction of floating, the impression could even be gained temporarily that the IMF's function in the policy field had shrunk to that of a passive observer. Today, this is no longer true, and I shall have more to say on this subject later on.

If we try to analyze the reasons for the revival of the Fund's role which is plainly evident to any observer, one of the most important ones seems to be the very fact that the floating system as described above did not prove to be the perfect market mechanism like Adam Smith's "invisible hand" that would have rendered a central supervisory body superfluous. Undoubtedly, a second reason was the appearance on the scene of the OPEC.

The IMF's lending activities have expanded strongly over the last few years. In fact, members' drawings on the Fund since the beginning of 1974 have totaled some US$20 billion, which is more than aggregate drawings up to the end of 1970. Of the recent heavy drawings, only a small portion--around one fifth--was under the Fund's credit tranches, this not only because of members' reluctance to accept economic policy conditions but also in view of the low volume of funds available under members' quotas in relation to the amounts required for deficit financing purposes. Instead, a major part of recent Fund lendings has been under its special facilities, mainly the--temporary--oil facility, where the Fund acted as a credit agent in the recycling of oil surpluses, and the compensatory facility, access to which was liberalized in 1975.

The increasing involvement of the Fund in the provision of financial support to developing countries--e.g., via the revised compensatory facility and the newly established Trust Fund--and the persistent further demands to this effect, have given rise to concern in some quarters that the Fund is in danger of being transformed into a development aid institution.

No doubt this danger is real and it should not be surprising that it exists. Given the inadequacy of official aid programs--in many countries they do not even reach one half of the agreed target of 0.7 per cent of gross national product--it seems rather natural that developing countries try to obtain more funds from other sources, such as the IMF, although this kind of borrowing does not correspond to their real needs as far as maturities are concerned.

I would like to say very clearly already at this point that in my opinion this tendency, understandable as it is, must nevertheless be resisted. Not only would it distort the function of the IMF and blur the sound "division of labor" between the Fund and the World Bank, it would also not be in the true interest of the developing countries themselves.

Returning to my descriptive remarks about the role of institutions in our present international monetary system, I now come to the central banks. It is almost unnecessary to say that they play a decisive role in today's international monetary relations. It must be added, however, that their degree of independence from treasuries or finance ministries is very different from country to country so that nowadays one has to define and distinguish very clearly their respective powers and responsibilities in international cooperation. Most central banks cooperate more or less closely in day-to-day operations on foreign exchange markets. As far as the major industrialized countries are concerned, their central banks are linked by an extensive swap network which has been strongly expanded since its inception in 1962. Special mention should be made here, by way of example, of the close cooperation between the Federal Reserve, the German Bundesbank, and the Swiss National Bank, which has become an established feature in the monetary scene. But it would be much too narrow a view to see the central banks only as the "engineers" of our international monetary machinery. With the limitations for some of them mentioned before, they form a very important body of thinkers and opinion-makers on all aspects of the system. They are, in other words, the true "counterparts" to the Fund and they shape the Fund's policies in the governing bodies. Thus, it is of paramount importance that the central banks cooperate as closely as possible with the Fund's Managing Director (and his staff) and that any divergencies of views are settled immediately upon their appearance.

The forum for central bank cooperation is the Bank for International Settlements (BIS) in Basle, where the central bankers of the Group of Ten countries and Switzerland meet regularly for confidential consultations. More and more, the BIS has become the meeting center for this distinguished club. Besides acting as an information clearing center, the BIS also plays an active part in the work of various committees of experts dealing with international monetary policy and coordination problems. Furthermore, the BIS has administered joint international monetary support actions such as the recent arrangements for sterling balances and has been associated with the implementation of the agreement on the sale of part of the IMF's gold holdings. All in all, one is inclined to say that the exact role of the BIS in international monetary relations is very difficult to define, but everybody knows what it is.

That the BIS and the IMF are linked by traditionally close personal ties, over and above their intensive working relationship, is eloquently demonstrated by the example of Per Jacobsson who, prior to becoming Managing Director of the IMF, had been economic adviser and head of the Monetary and Economic Department of the BIS.

Besides the IMF, the BIS, and the central banks, there are a number of groupings, organizations, and institutions that are also active in the field of international monetary policy and cooperation and thus influence the development of the system. Within the Organization for Economic Cooperation and Development (OECD), for instance, Working Party Three is engaged in discussions on and analyses of the member countries' economic and balance of payments situation and formulates policy recommendations.

In the European Community (EC), monetary cooperation is institutionalized in the Monetary Committee, the Committee of Central Bank Governors, the European Economic Cooperation Fund, and the various financial support mechanisms. In matters of reform of the international monetary system, the EC members endeavor--though not always successfully--to "speak with one voice."

Other groupings or institutions that should be mentioned in this context are the Group of Ten, as parties to the General Arrangements to Borrow, and the informal Group of Five (in the meantime extended to six members), in which the heads of government of the major industrial countries meet in ad hoc conferences, the most spectacular of which, in the monetary field, was the Rambouillet summit.

In the developing world, the Group of Twenty-Four may be cited as a body representing the interests of the developing countries in the field of international monetary relations. A few months ago, the Arab Monetary Fund was established to help Arab states with payments difficulties and to facilitate the flow of funds among Arab countries. More recently, the five central banks of the Association of South-East Asian Nations (ASEAN) have established a multicurrency swap facility intended to help members bridge temporary international liquidity problems.

Lastly, the formation of the creditor group for the new Witteveen facility [the Fund's supplementary financing facility] comprising seven OPEC and seven industrial countries should be mentioned here as a novel feature and a striking symptom of the changes in financial patterns in our system.

The group differs from others inasmuch as the common objective is not mutual assistance, and its setting up has therefore been received with mixed feelings on the part of deficit countries. Some observers feel that there is a potential danger here of polarization between debtor and creditor countries. On the other hand, the new grouping has the advantage that it unites, for the first time, a number of leading industrialized countries with strong currencies and the rich OPEC countries with their more recently acquired financial power, all of whom bear special responsibility for the effective functioning of the world monetary system.

To sum up, outside the IMF and apart from the central banks there are a number of institutions or groupings which--to a greater or lesser extent--participate in the management of the world monetary system. There is no "hierarchical" structure here, but all are working more or less towards the same goal--a harmonious development of the system. The IMF is represented as an observer or in a more active role in many of these bodies. But this enumeration raises, of course, the question of whether full cooperation between all these bodies is really assured and whether there is not an unnecessary amount of duplicated work.

IV. Can the International Monetary System Be Improved?

As I said before, the world's monetary policymakers were too much involved in actual pressing problems caused by hyperinflation, the oil price shock, and world recession to find the time for a resumption of the earlier reform talks. And it should not be called impertinent that some observers have considered this as very good luck. Nevertheless, we seem to have reached a point at which we can and should make a realistic and sober assessment of major world economic trends and prospects and the problems they imply over the medium term for effective management of the monetary system.

To my mind, there is a good likelihood that the twin problems of inflation and unemployment, coupled with severe balance of payments difficulties, will stay with us until well into the next decade. It therefore represents a real challenge for international monetary policy to support and coordinate national efforts towards improvement in these three areas.

Already over the past twelve or eighteen months the combined pressures of internal difficulties and external imbalances have led to increasing recourse to restrictive practices in the international trade and current payments fields (e.g., in the form of selective import restrictions, advance import deposit schemes, and export restraint agreements). In its recently published *Twenty-Eighth Annual Report on Exchange Restrictions*, the IMF notes, "By early 1977, it was apparent that there had been an interruption to the reduction of protectionism that had characterized the commercial policy of the industrial countries throughout the postwar period." In view of this disquieting development it is all the more important to strengthen the stabilizing elements in our international monetary system.

Has all this been satisfactorily settled at the various monetary conferences or can member countries and institutions further contribute towards achieving this aim? In my following remarks I shall look at this question in relation to the various sectors of international monetary policy.

A. Improvement of the Exchange Rate System

It is generally accepted and, I think, no matter for discussion here, that greater exchange rate stability cannot be achieved at the present stage via a change of the system itself, i.e., via the "introduction of a widespread system of exchange arrangements based on stable but adjustable par values" as mentioned in the second amendment to the Fund's Articles. In the face of prevailing inflation differences and balance of payments patterns as well as the existing huge volume of volatile funds in international markets, this is no realistic alternative today or in the foreseeable future.

This, of course, does not exclude the continuation and perhaps extension of limited fixed-rate arrangements in currency blocs or the formation of new ones. As regards Europe, I think that the present mini-snake, even in its newly reduced form, should be maintained, provided future realignments--unavoidable, no doubt, in view of members' still divergent price and payments trends--are effected as quickly and discreetly as on the last two occasions. For the smaller partner countries suffering from inflation and payments problems, the fixed exchange relations with their main trading partners have up to now provided a welcome support in the implementation of domestic stabilization policies. Last, but not least, endeavors to preserve the mini-snake would seem justified and desirable in the hope of a more extensive European currency association in the future, and in the light of its original conception as a nucleus of a European monetary union. This does not mean that the snake should be defended at any cost, particularly not if its preservation were to mean sacrificing the prime objective of stability. After the experience of the June-July period of this year, it should also be added that too great an upward pressure on the deutsche mark would tend to destroy the snake as the partner currencies could not follow this course.

Of much wider significance is the question how greater exchange rate stability can be achieved in the system as a whole. Although the business community and banks have generally learned to live with floating, they naturally have a strong interest in as secure a calculation basis as possible for their international transactions and thus in relatively stable exchange rates.

As we all know, greater *de facto* stability in the exchange system can, in the long run, only be attained by reducing discrepancies in underlying economic conditions, primarily in member countries' price, cost, and related external payments trends. This, however, is a task for economic and monetary policy. The relative success or failure of domestic stabilization policies will by and large determine the necessary corrections in exchange rates. The further ahead one looks, the more exchange rate stability thus falls within the scope of each country's general economic policy. The more short-run the perspective, the more it is the concern of central bank intervention policies designed to dampen excessive fluctuations in market rates.

The question then is, what objectives should--and can--be set for exchange rate policy proper? Would it be expedient and feasible, for example, as some observers think, to establish so-called "target zones," i.e., zones within which the exchange rates between two currencies should be kept, based on objective economic indicators? At first sight, this idea had some appeal and it also figured, *expressis verbis,* in the IMF guidelines for the management of floating exchange rates of June 1974. But I for one have strong doubts that there is such a thing as an objectively ascertainable "right" rate or zone at any given time. We may all have our own subjective ideas about what range for the U.S. dollar-deutsche mark rate or the dollar-yen rate would be appropriate; but we would all have the same difficulty in backing up these personal judgments with objective proof. Besides, to set a target zone would certainly not be something to be done once for all times; one would have to change it as the indicators change. All this, in my view, is neither practical nor desirable.

Apart from these problems, the setting up of such a system could well tend to increase destabilizing speculative transactions. But my main reservation is this: such target zones would be superfluous as long as the market moves within them anyway. But they could become very costly--in terms of interventions--if the market were to break out of their bounds. Would the central banks, in such a case, really be in a position to defend the target zones effectively and would they not be subjecting themselves to the same strictures as they had to bear under Bretton Woods?

Thus we may be more successful in the end by being less ambitious and more pragmatic in our efforts to stabilize the exchange system. I believe that we shouldn't try at this stage to go beyond the objectives agreed at Rambouillet and also included in the IMF guidelines of 1974 which I already quoted: to avoid or dampen erratic or excessive fluctuations, to maintain orderly market conditions, and not to intervene against basic market trends.

Of course, the difficulties continue with the question of how these objectives are to be defined in everyday practice. Arthur Burns, speaking before the House Banking Committee on the occasion of the recent dollar flurry, emphasized this problem. "No two of us agree," he said, "on a definition of what is a disorderly market." And he added: "When I see the dollar depreciating against currencies which are intrinsically weaker, I am compelled to ask whether the market is orderly." The same applies to excessive or erratic fluctuations: Where do the unjustified or undesired excesses begin?

But this problem should not be taken as an excuse for inaction. I think it would be wrong to claim that exchange rate movements can never be soundly assessed. There are certainly excessive fluctuations that can be recognized ad hoc (and treated) as such. They may be caused by individual large-scale exchange transactions during daily trading hours, by exaggerated reactions in the market to actual or expected changes in underlying conditions, or by cyclical differences between major trading nations.

In the latter case especially, larger exchange rate fluctuations may be averted by suitable interest rate policies and a corresponding "mix" in the partner countries' domestic stabilization measures. And national interest rate policies should indeed be deliberately used here to the greatest extent feasible within the given framework of money supply targets. Of course, such exchange rate oriented interest rate policies and central bank intervention must be harmonized.

As a general rule, intervention policies should try to smooth out movements around the market trend. Not to intervene against this trend, however, can certainly not mean that any market rate should be accepted. The emphasis must clearly be on the basic trend, which one could define as the trend indicated by underlying facts and figures. But I would expand this definition to include political and even psychological factors which will clearly have more than just a short-term influence on the market. Here, incidentally, is the main difference from the above-mentioned "objective indicators."

Quite recently we have all seen a very striking example of how political statements of intention can provoke sudden and massive swings in basic market sentiment and trends. And we have also seen that such swings can be reversed just as rapidly by the same method. But the damage in terms of market participants' increased uncertainty and the business community's fear of exchange rate losses is not so easily repaired.

Thus, particularly at the present time, where a lack of confidence is a major element in our domestic economic difficulties, it is important to remember that official international or bilateral debate on desirable or undesirable exchange rates and exchange rate policies--which may be perfectly legitimate and called for at times--is a matter for behind-the-scenes diplomacy.

I would suggest one main conclusion from all this: There can be no established rules for the management of floating which may be applied in each and every case. A skillful intervention policy is and remains an "art," which requires intimate knowledge not only of the techniques but also of the psychology of the market. It cannot, however, achieve miracles where domestic economic policies are failing or wavering. At any rate, for intervention policies to be successful the domestic policy intentions of the governments of both intervening parties must be made absolutely clear to the market and underpinned by credible action, while the underlying principles of intervention activities must remain secret.

There can be no doubt that responsibility for the management of floating lies with the central banks in their direct cooperation. What then is the role of the IMF, which according to the amended Article IV of the Fund Agreement has to survey members' exchange rate policies?

The Fund should certainly not interfere with day-to-day intervention policies but rather focus on members' exchange rate policies in clear cases of infringement against the rules of good conduct as laid down in Article IV.

Looking back, occasions for IMF intervention on such grounds seem to have been relatively rare. There have actually been no cases of competitive devaluations, if only because the potentially dangerous impact of such a policy on inflation was generally recognized. The deliberate holding down of an undervalued strong currency below its true market level has been suspected and criticized only in one or two instances. More frequent may have been situations where deficit countries tried to maintain overvalued rates which resulted in "protracted large-scale intervention in one direction." In these cases, however, the remedy would not have been devaluation alone but effective domestic stabilization programs, possibly in connection with IMF credit.

But I think it would be much too narrow a position if the Fund were to see its duty only in such an observation of proper exchange rate policies. In fact, the principles of Fund surveillance state that the Fund's appraisal of a member's exchange rate policies shall be based on an evaluation of its balance of payments position and on how far its policies are conducive to orderly underlying conditions. Thus, I consider it more important for the Fund to assess underlying monetary and economic policies in member countries and pay particular attention to the efforts being made to achieve adequate growth without endangering stability. It cannot be sufficiently stressed, in my view, that any negligence with respect to the inflation problem caused by too nervous a concern with unsatisfactory growth rates would lead all of us into a much more difficult situation in the not too distant future. In other words, the Fund's prime role lies in the field of adjustment policies. The provisions that future IMF consultations with members under Article IV "shall comprehend the regular consultations under Articles VIII and XIV" seems to support this view. And the Fund ought certainly not to be timid in fulfilling this task--a point to which I shall refer again later.

B. Coping with Balance of Payments Disequilibria: Adjustment and Financing

1. *Need for diversified strategies*

I already indicated that, in my view, balance of payments disequilibria and the connected problems of external indebtedness are the main areas of concern in our present world monetary system.

In assessing the problems in this field, two distinctions must be made:

(1) between oil price related surpluses and deficits and other imbalances; and

(2) between deficits of developing countries and those of industrial countries.

As it looks today, the oil surplus will be more persistent than we were led to believe during the world recession. Thus, for several years to come, the corresponding global oil deficit will have to be financed;

in other words, the problem of recycling petrodollars will stay with us for a longer period. At the same time, oil importing countries will have to increase--in many cases to actually still initiate--efforts to conserve energy and to develop new sources of supply so as to reduce their dependence on OPEC oil.

In contrast to the special structural payments disequilibria reflecting the massive change in terms of trade and in income flows imposed on the world economy by OPEC's oil price policy, the payments imbalances between industrial countries are a case for adjustment in the "classical" sense, as they result from discrepancies in internal and external stabilization policies. Orderly management of the international monetary system implies that such surpluses and deficits must be eliminated or at least greatly reduced in due course through appropriate domestic policies in accordance with members' accepted obligations.

Another traditional feature of the world payments pattern is the structural deficit of the less developed countries which depend on capital imports for their development and reasonable economic growth. Here, as in the case of unavoidable oil deficits, a viable financial system will have to ensure that the required external funds are obtainable in the amounts needed and with the appropriate maturities on a more permanent basis. To this end, constant efforts are required on the part of all developed countries, and the surplus countries in particular, to increase and improve their development aid. At the same time, many less developed countries (LDCs)--like other oil importing countries--will have to correct previous exaggerated growth targets, i.e., reduce inflated current deficits to sustainable levels, and to enhance their creditworthiness and repayment ability through appropriate adjustment policies.

To sum up--in order to achieve greater stability in the international payments field, the following policies must be adopted:

(1) effective energy policies on the part of oil importing countries;

(2) reduction of non-oil-induced external imbalances through stability-oriented domestic economic policies; and

(3) adequate financing of the remaining temporary and structural payments deficits.

To my mind, these targets for policy action of member states and institutions in our international system are more concrete and more helpful than the much-quoted, rather vague concept of "redistribution" or "more equitable distribution of the global oil deficit" which, I feel, might tend to divert attention from the real task. At least I can see a danger that, owing to this concern with redistributing deficits, the need to accelerate the pace of adjustment could be accorded less than its due priority. At any rate, a sensible combination of adjustment and financing will ultimately also lead to an acceptable distribution of deficits.

2. *Adjustment process reconsidered*

The principles of the adjustment process must be reconsidered in the light of slower growth and higher unemployment which unfortunately seem to be more than a temporary phenomenon. As mentioned earlier, experience has taught us that in the case of deficit countries sizable currency devaluations may hamper rather than help external adjustment due to the vicious circle of depreciation and inflation. So it would seem that exchange rate changes should be accorded a more limited role. Moreover, stabilization programs have to vary with the particular institutional, social, and political conditions in the individual deficit countries and take into account their longer-term balance of payments prospects as well. The great divergencies here from one country to another are apparent if we look at such countries as Norway, Italy, or Portugal. The tailoring of stabilization programs to each country's specific requirements must cover both the "mix" of monetary, fiscal, and incomes policies and the combination of adjustment and financing. In this concept, care must be taken not to subject countries in heavy deficit and with unstable internal conditions to excessive adjustment pressures which could trigger off disastrous changes in their sociopolitical structures. In this context it is important that private capital investment, already deficient everywhere, is not further discouraged by too restrictive policies. To prescribe adjustment policies which are too rigid under today's circumstances could, in other words, be as dangerous as the opposite course of renouncing internal adjustment.

Taking everything together, the best course of action for countries in serious external difficulties would be to devise stabilization programs for implementation over the medium term. They must be clear-cut and set realistic targets for each successive stage which are capable of winning the necessary trade union cooperation and of restoring confidence to the business community. And as they cannot eliminate the payments deficits at one stroke, they must be combined with a clear concept for external financing.

Furthermore, it is essential to ensure compatibility of the individual countries' different adjustment policies on an international level. This, in my opinion, is a prime coordination task for the IMF as the only international institution with the necessary overall insight. This position is based not only on its creditor relationship with deficit countries but also on its continuous contacts--in the framework of regular consultations--with the surplus countries among its members.

Under the prevailing circumstances it is understandable that hopes and demands for better adjustment of external payments imbalances are concentrating increasingly on the surplus countries. These countries bear a great responsibility indeed for the stability of the world monetary system. But there seems to be a tendency, at least in some quarters, to overestimate their possibilities to ease the burden on countries with persistent external deficits and high inflation rates, and sometimes one cannot avoid the feeling that even envy--always a bad adviser--is influencing some views. It is very important, however, at this stage, that misunderstandings here do not cause a rift between weak and strong trading nations as the problems of both can only be solved in voluntary cooperation.

I already mentioned the importance of the strong key currencies for the smooth functioning of international exchange and financial markets. It is therefore, in my opinion, a prime duty of the hard currency countries to maintain the strength of their currencies, which means that they must continue to be at least relatively successful in the fight against inflation. The question is then how this policy can be combined with other measures conducive to facilitating the adjustment process.

For one thing, the surplus countries should certainly try to reduce their current account surpluses and also be prepared to accept temporary deficits resulting from market developments. I doubt, however, whether it would be wise for them to deliberately aim at sizable deficits. Even though a major payments deterioration would not give rise to financing problems for these countries, it could undermine confidence in the stability and strength of their currencies.

For this very reason, i.e., largely on psychological grounds, I have found it difficult to consider the dramatic shift in the U.S. balance of payments as an international blessing. Another concrete danger attendant on the massive increase in the U.S. trade deficit are the mounting protectionist pressures (although the increase in the deficit is mainly due to higher oil imports, not so much to larger purchases of industrial goods). At any rate, it would be a great benefit, not just to the United States but to the world economy too, if an efficient energy program could be implemented without undue delay to cope with the main problem behind the drastic deterioration of the U.S. payments balance, i.e., the country's growing dependence on oil imports.

As far as the demands for more stimulative action in surplus countries are concerned, it has to be said that, although their current growth rates are disappointing for these countries themselves, their actual scope for inflation-free growth is limited, particularly in the short run. In the case of the Federal Republic of Germany, to cite my own country, the too modest growth is in fact largely due to structural problems which cannot be solved by more monetary expansion. Moreover, I think we can safely assume that under the political pressure of persistent unemployment, every democratic government will do all it can to achieve the maximum growth which is compatible with the maintenance of relative monetary stability, as borne out by the latest stimulative measures in the Federal Republic of Germany and Japan. Of course, governments, like human beings, can commit errors which then have to be corrected, but they are rather unlikely on the side of understimulation. And if there should be justified reason for outside advice, the IMF ought to be the one to give it. Advice to surplus countries from other countries to accelerate growth seems to me rather superfluous today, and I can see a real danger that the almost spellbound look at the three "locomotive" countries could create illusionary expectations and divert attention from other important tasks.

I am also rather skeptical with respect to recommendations to the surplus countries to deliberately raise the value of their currencies above the market rate, i.e., to an extent that more than compensate inflation differentials. For one thing, such artificial revaluations would infringe on the basic principles of the floating rate system as I see it. More important still, it is questionable whether such policies would in all cases actually help the deficit countries which, on the whole, are trying to avoid major devaluations because of their effect on domestic inflation.

To my mind, viewed realistically, the international obligations of the industrial surplus countries, i.e., the criteria against which they should be judged, lie in four areas:

(1) in a liberal trade policy, notwithstanding the painful economic restructuring it involves;

(2) in an exchange rate policy which does not artificially block the upward trend of their currencies in the market;

(3) in the creation of monetary and interest rate conditions which promote growth without endangering stability; and

(4) in responsible capital export policies, where necessary in the form of balance of payments assistance to deficit countries and a better fulfillment of international targets in development aid.

Taking everything together, the surplus countries must be prepared to fully accept the consequences of the deficit countries' adjustment policies. But it is the latter which--whether one likes it or not--must shoulder the heavier burden. For unless the deficit countries pursue forceful domestic stabilization policies, the surplus countries' adjustment contribution will only result in an even greater polarization of currencies, with the strong becoming stronger and the weak becoming weaker.

In other words, there is no easy way out. For any attempt to reduce imbalances by weakening the hard currencies would threaten the very existence of an already rather unstable post-Bretton Woods system. I am firmly convinced that Keynes' idea of a "national vice as an international virtue" cannot, under any circumstances, be applied to the stability policy of the major world trading nations. Instead, the true symmetry of the system is to be seen in the clear obligation on the part of both deficit and surplus countries to fight inflation and achieve stable growth in their domestic economies.

3. *Improving international financing structures*

The strong expansion of international financing requirements connected with the greatly increased payments imbalances of the last few years has been more or less smoothly accommodated, thanks mainly to the private banking system assuming the role of intermediary. Or, to put it the other way round, the IMF plus bilateral official assistance would have had to shoulder an impossible task if the large commercial banks of the Western world had not entered the field of balance of payments credits in open or disguised form.

Yet, recently there have been growing doubts as to whether the financing patterns which have evolved in this process can be sustained. Indeed, at this juncture, two questions must be raised regarding the present financing system and its adequacy for the future:

(1) Is it conducive to the stability of the monetary system as a whole, i.e., to the "right" combination of adjustment and financing?

(2) Will it be able to provide the funds needed to finance unavoidable new current deficits and at the same time ensure orderly refinancing of the outstanding external debt, a large part of which is due for repayment in the years ahead?

On both counts the answer is at best a "qualified yes," i.e., there is a clear need for improvement.

For one thing, the banks as today's main international creditors are unable to bring about by themselves a better balance between external adjustment and financing; they are in no position to impose effective economic policy conditions on borrower countries with unsustainable current deficits. On the contrary, there have been well-known cases where deficit countries have taken recourse to bank credits in order to avoid IMF-imposed stability programs. Furthermore--and this concerns the second question--the banks are coming up increasingly against their self-imposed country limits and are therefore unlikely to maintain the recent rate of expansion in their international lending for balance of payments purposes (although it has to be added that these limits have not been too rigid in recent years). In parallel to this, a number of highly indebted major deficit countries are reaching the limits of their market creditworthiness.

All these factors point to the need for a larger share of official funds in the future financing of payments deficits. (In the past three years, the assistance provided by governments and international institutions only covered 20-25 per cent of overall deficits, while the remainder was financed by the markets.) A sizable increase of public credits and aid flows is needed above all to cope with the external payments and debt problems of many non-oil developing nations. This applies not only to the poorest LDCs, which have always been exclusively dependent on concessional aid, but also to more advanced countries which have access to the markets but whose foreign debt structure has become vulnerable and unsustainable in the longer run due to the large share of bank credits with relatively short maturities and high interest costs.

Despite the precarious state of domestic public sector finance in most countries, the governments of the industrialized world must make every effort to step up their development aid. Progress here is imperative in my opinion if we want to ensure the longer-term viability of our financial system and also avoid serious friction in the North-South dialogue. International monetary experts and policymakers must therefore not take the narrow view of regarding the question of development aid as belonging "to another department" outside of their concern. Parallel with the increase in bilateral aid flows, the lending capacities of multilateral development institutions should be expanded through an enlargement of their capital base by member governments. Through increased borrowings of those institutions in the markets, it should also be possible to channel additional OPEC funds to the developing countries for the restructuring of their economies necessitated by the multiplication of the oil price.

Apart from and in addition to these improvements required in the financing of LDCs' structural deficits, the flow of conditional funds must be increased and the IMF's lending activities in particular must be stepped up in view of the widespread adjustment needs in both industrialized and developing countries.

For the time being, the recent agreement on the new IMF loan fund, the so-called Witteveen facility, provides the necessary scope for meeting the need for more Fund credit and more extensive Fund influence on members' economic policies. This supplementary arrangement takes into account that the problem in our official financial system lies in the distribution of international liquidity rather than in its overall volume. As a genuine recycling mechanism, the new facility is much more important than a general increase in quotas--planned anyway--which only yields a limited amount of convertible currencies for Fund lending purposes. Gratifying above all is the success in securing the participation of the OPEC countries on a roughly 50:50 basis.

In the implementation of the Witteveen facility, it is important that the agreed conditionality (parallel to that of the IMF credit tranches) is strictly observed. Furthermore, it is to be hoped that countries with persistently high deficits, which have so far shied away from the Fund's "strings" and relied on private credit sources only, will make use of this facility. This would seem possible in view of the amounts and range of maturities available to potential borrower countries under the new loan fund compared with their present drawing facilities.

While the payments position of the United Kingdom and Italy is improving, the deficits of many other countries will probably remain high in the coming years. Therefore, the newly agreed US$10 billion credit line to the Fund ought not to be considered a "one-time" stop-gap measure by the participating surplus countries--and, hopefully, other potential creditor countries--but should become part of the system, like the General Arrangements to Borrow, and if necessary, further contributions should be made to the facility, as envisaged.

In this context I would also like to add a cautious word on the question of whether or not to set up the OECD's US$25 billion Financial Support Fund. I am in favor of such a move provided the approval of the U.S. Congress can be secured. Very rightly, in my opinion, this facility has been conceived as a "safety net" which hopefully would never have to be used. But its mere existence might provide an added degree of reassurance.

4. *Cooperation between official institutions and commercial banks*

Despite the expected slower growth in commercial banks' foreign lending, private markets will continue to provide a large share of the funds needed to meet total international financing requirements. But it is increasingly recognized by both authorities and banks that a better coordination of private and official lending is desirable. One area in which such efforts have been made and some progress already been achieved during the last few years is the complementary financing of projects in LDCs by international development institutions, i.e., the World Bank and the Inter-American Development Bank, and private commercial banks. Such cofinancing of projects brings clear advantages to all three parties involved and should therefore, in my opinion, be more actively pursued by the institutions concerned. But there can be no doubt that it will not grow into dimensions of real significance for the working of the world monetary system.

It is, therefore, on the possibilities of closer cooperation between the IMF and commercial banks that attention must be primarily focused in this context. The purpose of such cooperation is very clear: From the Fund's--but not only the Fund's--point of view it seems desirable that countries with unsustainable current payments deficits should no longer be able to avoid necessary policy adjustments, stringently connected with the use of the Fund's higher credit tranches, by continued recourse to bank credits. On the other hand, the banks would like to operate more under the protection of the Fund's "umbrella" in all those countries whose indebtedness has reached critical proportions. They would also be grateful for the help of the IMF in their assessment of country risks.

In this connection the idea of joint financing or parallel financing by the banks and the IMF has been much discussed recently. In fact, in recent years there have been several occasions on which international bank credits have been associated with IMF lending or even linked to IMF conditions, as in the case of Argentina (in connection with the rescheduling of the country's commercial debt).

Nevertheless, in my opinion, joint or parallel financing by banks and the IMF is easier said than done. The Fund can neither compel deficit countries to draw on its facilities nor exercise any control over the commercial banks' lending policies. In the end, the only possibility is voluntary cooperation, based on enlightened self-interest, between all parties concerned.

As far as the modus of linking commercial bank credits with Fund assistance is concerned, it is largely agreed that this cannot be regulated by rigid rules or procedures but must be handled pragmatically on a case-by-case basis. And the preconditions for arriving at some sort of joint concept of financing are, of course, much better in the weaker countries. Or, to put it differently, it is where the banks are becoming afraid to lend more to a given country that the Fund's appearance on the scene might change the picture.

Ultimately, implementation of the Fund's stabilization concept will always have to be based on its agreements with the debtor country. By the same token, effective Fund control of additional private lending to a given deficit country is only possible via the debtor and not via the commercial banks. Some sort of negative clause--there have been examples--has then to be agreed in respect of the debtor's further borrowing from private sources. The brake is thus applied on the demand side and not on free market supply.

In a realistic assessment of the scope for cooperation between the IMF and the banks, it must be recognized that each side has different tasks and responsibilities and neither one can relieve the other of its risks and obligations. And each one also wants to preserve its freedom of judgment and action. While some progress seems possible in the field of Fund information to banks on borrowers' economic prospects and policies, the IMF's role as confidential adviser to its members must not be endangered. For this reason the idea of an IMF certificate of good credit standing, in my view, cannot materialize and, even with more extensive information on prospective debtors, the credit decisions of commercial banks will still remain the outcome of a highly complex and subjective process of assessment in which such factors as competition, corporate strategy, and liquidity play a part.

I do not want to see these remarks interpreted as being destructive of the many hopes which have been ventured in this respect over the last half year or so. On the contrary, I find it highly desirable that the commercial banks take a more distinct interest in the Fund's lending activities and vice versa. As the commercial banks' foreign lending, mainly through the Euromarkets, has become--quite unexpectedly, I am sure, for many of us--a crucial element in balance of payments financing in our system, it automatically belongs to the complex "mix" of adjustment and financing in deficit countries to which I referred earlier and which is one of the main tasks of the Fund to survey. And once deficit countries recognize that it is in their best interest to see the efforts and possibilities of IMF and commercial banks combined, fears of the Fund with respect to secrecy will lose in importance.

Against this overall background, I would also be in favor of the efforts that are under way at the national level to improve official information on banks' international lending and coordination of these efforts within the framework of the BIS.

C. The Role of the IMF and Other Institutions

I already mentioned that under the present system of "controlled flexibility" the Fund's role and tasks are quite different in scope and nature from those under the Bretton Woods system (and subsequent reform drafts) in which international monetary relations were regulated by fixed rules and mechanisms based on objective indicators. For the IMF to effectively carry out its fundamental tasks "to oversee the international monetary system in order to ensure its effective operation," its activities must cover a wider field today and its authority must be enhanced.

Greater IMF discipline can, as in the past, be brought to bear in the creditor-debtor relationship between the Fund and member states, and it is therefore essential that sufficient funds for conditional lending are always available. Another possibly more important case for greater Fund influence on member countries' policies is its new task foreseen in the amended Article IV, Section 3 under the somewhat misleading heading "Surveillance over exchange arrangements." In reality, as I said earlier, what is to be surveyed by the Fund is members' fulfillment of their obligations in general. And these obligations which are detailed in Section 1 of Article IV cover economic policy in the broader sense of the word.

All in all, I think that the new Amendments have strengthened the Fund's legal position. But the IMF is no exception to the basic rule that institutions are as strong or as weak as their members want them to be. Thus, national member governments must be prepared to accept greater IMF authority with all its implications, not just pay lip service to the idea and do the opposite when put to the test.

This will be easier in all those cases where the Fund is urgently needed as lender. It will be more difficult where the IMF exercises its new role of exchange rate surveillance in the broader sense. In this area, one can only hope that the members are prepared to engage in genuine cooperation based on the insight that the system as a whole will only function if all countries respect the "rules of the game," and that the proper working of the overall system is in the interest of each individual member.

Under the specific conditions of our present system, the Fund's role is not and should not be that of a world policeman as it cannot and should not replace national sovereignty, which means responsibility for sound policies. The Fund should rather be seen as world chief adviser or consultant, equipped with sufficient resources to bridge difficult adjustment periods which tend to be longer than hitherto.

It can effectively exercise this function:

(1) on the strength of its vast knowledge of member countries' economic conditions and policies and the superior quality of its staff;

(2) as a truly supranational institution observing strict neutrality towards all members (there must be no bias in favor of or against any group of countries, be it developing nations or surplus countries for instance);

(3) on the basis of its financial power; and

(4) on the basis of the unrestricted moral and material support of its members who must be aware that whoever evades or undercuts Fund authority damages the system as a whole.

By virtue of such authority, the IMF certainly has the possibility of influencing deficit and surplus countries as well; its opinion cannot be ignored.

Of course, the actual influence of the Fund will depend on what it makes of the opportunities offered by the amended Articles. It must, for its part, meet the challenges and demonstrate effective leadership. It must never retreat to an ivory tower but "join the battle," quite independent of whether the policies of small countries or the most powerful countries have to be looked at. The Fund should not only react, but act with an eye to the future. In other words, it should not go into action when the house is burning but at the very first sign of smoke. The earlier the Fund's influence is brought to bear, the sooner it can be hoped to take effect. At the same time, this should provide the best safeguard against any possible tendencies to develop international monetary policy in exclusive groups outside the IMF.

Provided the IMF can maintain its role as a strong central pillar with natural authority, the present multipolar system will not do any harm as long as all parties cooperate. However, as far as this is not yet the case--and here, I have not sufficient inside knowledge--the activities of the various groupings and institutions should be coordinated and a clear "division of labor" should be agreed upon on the basis of common principles. (Parkinson could also apply to international organizations!) The role of the Group of Ten, the BIS, the OECD, and the EC is a subsidiary one as far as the international monetary order is concerned, while the task of overall coordination clearly rests with the IMF. The BIS, though, could perhaps take on certain tasks which the IMF cannot assume due to one or the other reason.

Basically, if we look at the representatives of member countries in the various institutions, international monetary affairs are practically always handled by central bankers, finance ministers, or their delegates, and the IMF. It is their cooperation that counts!

D. International Reserve Policy and Liquidity Control: No Case for Reform in the Near Term

Much as I want to see the IMF in a strong position with necessary powers, I am very skeptical about the idea of turning the Fund into a world central bank. The project of creating a "central bank of central banks," responsible for the control of international liquidity and acting as lender of last resort, has been persistently advocated by some observers as the only reliable way to ensure world monetary stability. But, quite apart from my antipathy towards any attempt to solve problems by creating new institutions, and especially superinstitutions, I simply cannot, for political reasons, imagine such a development, not even in the more distant future. The example of the EC clearly shows how difficult it is to achieve the necessary harmonization of national monetary policies--even where the partner countries have declared their political will to do this.

Apart from the overambitious project of a world central bank, other methods of controlling international liquidity have, of course, been discussed and explored by experts inside and outside the Fund.

But here too I must admit to having strong doubts as to the possibilities of achieving tangible progress within the near future. This applies, for one thing, to the objective of making the SDR the principal reserve asset which would be tantamount to changing the present demand-oriented system of reserve creation to a supply-determined one. As things stand today, major new SDR allocations that would significantly increase the share of SDRs in overall reserves are out of the question. On the other hand, the idea of establishing a substitution account in the Fund through which SDRs could be substituted for member countries' gold holdings or reserve currency assets hardly seems practicable in view of the actual preference of national monetary authorities. By the same token, a change to some form of asset settlement seems to me unlikely in the near term.

Lastly, I also doubt whether the global amount of international reserves can be effectively managed by the introduction of a prescribed minimum proportion of SDRs in IMF member countries' official reserves as ventured by Mr. Witteveen about two years ago in a speech in Frankfurt.

All in all, we shall have to accept, I believe, that liquidity control is not possible, for the time being, by changes in the reserve system. Equally, I see no chance of effectively harnessing the huge volume of private international liquidity through the introduction of restrictions, i.e., minimum reserve requirements or other devices, in the Euro-currency market. An added problem is the fact that under a floating rate system it is difficult to quantify the "appropriate" global reserve level.

But for all these objections, I would like to stress that for me--in contrast to some observers--the development of international liquidity is not a matter for "benign neglect" in our present monetary system. On the contrary, the avoidance of excessive liquidity growth is and will remain an important objective within the overall efforts to stabilize international monetary relations. But the only way this objective can be achieved is through the quality of national economic policies and of international cooperation and not by regulatory mechanisms.

V. Conclusions

Responsible national economic policies and effective international cooperation are, in a nutshell, also the key conditions in the answer I have tried to give to the general question assigned to me in this lecture: Is the present monetary system workable?

To sum up, yes, this system is workable. It needs no fundamental corrections: improvements can only be achieved in the way in which existing instruments are utilized. In my view the basic aims of liberal trade flows, stable economic growth, and a more equitable distribution of world income can be realized, if the following policies are adopted:

- All member countries--both deficit and surplus countries--while striving for more satisfactory growth must continue their fight against domestic inflation, i.e., the international differential must be reduced through a downward adjustment of price trends.

- In view of persistently slow economic growth and high unemployment, an appropriate "mix" of balance of payments adjustment and deficit financing is needed, and adequate official funds must be available for this purpose. Policies in both fields must be tailored to the individual countries' specific needs and based on clearly defined medium-term concepts.

- In the financing of balance of payments deficits, coordination of private and official lending, especially IMF lending, must be improved and the share of conditional credits increased where deficits are due to insufficient internal adjustment and stabilization policies. In the case of developing countries' structural deficits, official aid flows will have to be stepped up.

- Based on its financial power and the unrestricted moral and material support of its members, the IMF must assume a strong and active role as chief world coordinator and counsellor in order to ensure that the flexibility provided by the present system will be used to the full advantage of all member countries. And, particularly at critical moments, which are bound to occur from time to time, the Fund's authority must be apparent not only to public officials but also to the market to demonstrate that there is a monetary order.

In concluding I would like, however, to stress once more that whether we will succeed in strengthening the world monetary system along these lines will ultimately depend on the voluntary cooperation of all member countries towards this goal. In this venture the responsible authorities of surplus countries and deficit countries, of oil exporting and oil importing countries, of developed and developing nations alike must at all times clearly demonstrate their willingness to uphold and defend the commonly agreed principles through credible action. Only then will it be possible to restore the confidence of the international business community and to win the understanding and support of the national economic, social, and political groups which is indispensable in the parallel efforts towards more vigorous and persistent growth and greater stability on the domestic and the international front.

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MR. SOUTHARD: Thank you, Dr. Guth. I believe Dr. Guth managed to cut his full text almost in half and I am sure that all of you will want to read the whole text. I have read it and I assure you that it is carefully and cogently put together.

The remaining speaker is Sir Arthur Lewis. Again, I will not read his biography except to repeat that he has for much of his professional life concerned himself with the problems of development and of the developing world, and he will talk about that aspect of this subject. Sir Arthur Lewis.

The Less Developed Countries and Stable Exchange Rates

Sir Arthur Lewis

Mr. Chairman, ladies, and gentlemen: It is an honor to be asked to give a Per Jacobsson lecture, and it is a special privilege and pleasure to be asked to share it with Wilfried Guth, who is an old colleague. At the same time, I was somewhat frightened by the invitation because I wasn't sure what I would be able to talk to you about. I am, alas, not a banker, and I have no day-to-day connections with the international monetary system. So what I have done is what most aging economists do: I have taken refuge in talking about history.

It is now the conventional wisdom that the currencies of the developed countries should float, but the currencies of the less developed countries (LDCs) should not; that is to say that each LDC should choose a more developed country (MDC) as a partner--or the SDR--and tie itself in a fixed relationship. It is quite an advance in our thinking to recognize that in the international monetary sphere the LDCs may require different treatment from the MDCs. Members of the Group of Ten used to assume, rather in the spirit of General Motors, that whatever solution was best for them would also be best for all, and were surprised when the LDCs insisted on having the wider Group of Twenty. The purpose of my paper is to explore aspects of the special problems of LDCs.

One has to begin by confirming the General Motors proposition, up to a point. LDCs require two things of MDC currencies, and neither of these is fixity in relationship to each other. The first requirement is that they be freely convertible into each other, so that what LDCs earn in one market they can spend in another. And the second requirement is a regime within which MDCs feel comfortable, in the sense that they have no urge to restrict their imports from the rest of the world. In this limited sense, any regime that is good for the MDCs is also good for the LDCs. Any individual LDC that wishes to keep its currency relatively stable in terms of floating MDCs can tie itself to the SDR and can hold its reserves in an appropriate basket of currencies. It will suffer inconveniences from other countries' fluctuations, but these are a minor nuisance compared with a possible breakdown of world trade occasioned by MDC currencies operating within an inappropriate regime.

However, my main concern is with what LDCs should do, and not with what MDCs should do.

It is quite clear why the experts advise the LDCs that they should be stable even though the others float. Note four powerful reasons.

In the first place there are forward markets for MDC currencies but not for LDC currencies. This is a particular nuisance for LDCs trading with each other and is one of the obstacles to regional integration and, more generally, to the expansion of inter-LDC trade. (It applies also to LDC trade with MDCs, but the behavior of other LDC currencies is perhaps somewhat less predictable.)

Secondly, fear of devaluation inhibits investment--not portfolio investment denominated in external currencies, but direct investment, whether of foreign or of domestic capital, since there is no certainty that capital values will rise by as much as the currency depreciates.

Thirdly, frequent changes in the value of an LDC currency add to the uncertainty of holding it and increase its instability. If the government is known to be ready to let the currency depreciate whenever it runs into balance of payments problems, nobody is willing to hold it, since the prospect of depreciation is always on people's minds. The onset of every minor difficulty then leads to a rush to sell and an exhaustion of the country's foreign exchange reserves.

Fourthly, the instruments of monetary control are perhaps more fragile in LDCs than in MDCs. When an LDC devalues, forces are set in motion that it may not so easily control. Our theories of these matters were framed in the eighteenth century, when food was a small proportion of imports, and when trade unions had not yet acquired the power to keep real wages rising in all situations. An economy with weak control over its internal prices is likely to find itself on a treadmill, where devaluation raises domestic money incomes and prices, so setting off further devaluation, *ad infinitum*. Firm control over the level of money incomes is a precondition for successful floating.

For such reasons it is easy to understand why the representatives of LDCs at IMF meetings have always expressed their preference for stability of currencies, and also why LDC central banks have shown so much reluctance to devalue over the past thirty years, even in situations where there was clearly no other viable alternative.

I shall proceed from the assumption that an LDC desires to keep its foreign exchange value constant in terms of SDRs, and that it is pursuing reasonably orthodox fiscal and monetary policies, which need not be defined for this purpose. I have also to assume that the rate chosen *ab initio* is the right rate, which again need not be defined for this purpose, but which I nevertheless will define, in order to spice the discussion, not as the rate which balances imports and exports, since any rate can do that via employment and income effects, but as the exchange rate which produces the rate of growth of exports appropriate to the targeted rate of growth of output; say, the exchange rate that is required for exports to grow by 6 per cent a year.

My question is then what external conditions must be met if the country is to be able to maintain exchange stability. Our literature focuses rather on what the country's internal policies should be. And if exchange stability cannot be retained we tend to assume automatically that this is the fault of the LDC's government. I, on the other hand, assume a well-behaved government--which you may define in any way you wish--and am in effect asking what cooperation it is entitled to expect from an international monetary system in its effort to hold exchange rates steady.

My paper originates in a suggestion that I should approach this question historically: What in fact have been the main problems menacing exchange stability in the less developed countries, other than those arising from their own disregard of orthodox financial canons; and how can an international monetary system help to reduce such stresses?

For this we do not need to go back beyond the 1870s, the decade in which Western Europe and the United States adopted the gold standard. At that time most of the countries of Latin America, Eastern Europe, and Asia were on silver. In the 1870s the price of silver started to fall, and it halved over the next twenty years, taking their exchange values with it. What were the silver countries to do? After long hesitation the majority moved to gold (or a gold exchange standard) and had accomplished this by 1900. From 1900 to 1929 the consensus of economists was that all countries, whether more or less developed, should maintain fixed exchange rates. However, from 1930 to 1965 it was increasingly felt that primary producing countries (even rich Australia) had special problems. Our current consensus that the developed should float while the less developed peg is the exact opposite of what had nearly become the consensus only a dozen years ago.

The debate between gold and silver in the 1880s and 1890s raised all the problems, though the context in which it was then set--the merits and demerits of bimetallism--obscures the matters of interest to us. The challenges to exchange stability which surfaced in the 1880s and 1890s can be grouped, with some overlap, under three heads:

- Long-run price movements
- The trade cycle
- The debt problem.

These challenges all arose again in the 1930s and, with some modification, in the 1950s and 1960s.

The World Price Level

A long period of falling commodity prices affects the LDCs' capacity to maintain fixed exchange rates in three ways:

(1) it tends to be deflationary, and so to discourage exports;

(2) it raises the real burden of debt; and

(3) it tends to be associated with adverse terms of trade for agricultural commodities.

We have had three of these long secular declines over the past hundred years. First, from 1873 to 1895; the British index of wholesale prices fell 36 per cent from 1871-75 to 1891-95. Then in the 1920s and the 1930s, the price index of tropical agricultural exports fell by 43 per cent between the two peak dates of 1925 and 1937. And thirdly in the 1950s and the 1960s. In the developed world we tend to think of the whole period since 1945 as one of inflation, but in fact tropical agricultural prices fell 20 per cent between the first half of the 1950s and the second half of the 1960s.

Those developing countries that remained on silver in the 1880s and 1890s escaped the first consequence of the secular decline of prices (deflation), but not the second and third consequences (the debt burden and the adverse terms of trade).

Prices were falling in the countries on gold, but rising in the countries on silver. The argument that the countries on gold were repressed depends on what happened to relative prices; they were deflated if export prices fell by more than domestic prices and wages. On the other side, the countries on silver were stimulated if the prices of export crops rose faster than food prices, encouraging the small farmers to switch; or if plantation wages failed to keep up with export prices. The planters of Ceylon, which was on silver, seem to have been unanimous that the price of tea in silver was rising faster than wages, and that continual depreciation therefore stimulated production for export. Indian data bear this out. Between 1880-84 and 1890-94 Indian agricultural wages rose by 2 per cent, while wholesale prices rose by 21 per cent;[1/] over the same period the export price of tropical agricultural commodities, excluding freights, fell in gold by 15 per cent.

The Indian literature of the day was not much concerned with the effects of inflation or deflation on output. Majority opinion was strongly in favor of switching to gold, because the rupee burden of India's fixed commitments in sterling was magnified as silver depreciated. Here it is important to distinguish the two influences at work. Since prices were falling in gold, the real burden of fixed commitments, such as debt charges, increased whether the rupee depreciated or not. The further burden imposed by rupee depreciation was an internal shift within the country, of the kind which economists love to ignore as "mere transfers," but which statesmen cannot neglect. The depreciation of the rupee, with its accompanying rise of internal prices, did not affect all classes equally. Specifically, the incomes of civil servants lagged, because the Government found it hard to keep raising taxes every year. And since India was ruled by civil servants, the authoritative view was that India should switch to gold. The possibility that continual depreciation had the merit of counteracting any deflationary tendencies inherent in what we now call the Kondratiev downswing finds little mention in the Indian literature of the day.

It is hard to know whether the depreciation of the silver currencies stimulated development, but there is no doubt that the continual fall of prices in gold aggravated the debt burdens of the LDCs of the day, contributing to the massive defaults on debt obligations of the 1870s and 1890s; just as an earlier long Kondratiev downswing contributed to the massive defaults of the 1820s and the 1840s, and a later one to the

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1/ Calculated from M. Mukherjee, *National Income of India* (Statistical Publishing Society, Calcutta, 1969), pp. 91 and 94.

defaults of the 1930s. The troubles of Argentina and Australia in 1890 did not even wait for a recession; seventeen years which took a third off the price of wool made the accumulated debt intolerable.

I shall return to debt in a moment. The third menace of a falling price level is that it is associated with adverse terms of trade for agriculture. Thus the terms of trade moved against the agricultural countries in the 1880s and 1890s, in the 1930s, and again in the 1950s and 1960s. In the first two periods both industrial and agricultural prices fell, whereas in the 1950s and 1960s industrial prices rose while agricultural prices fell; this is why these last two decades seem inflationary in the developed but deflationary in the less developed countries.

The mechanism which causes these long Kondratiev swings in world agricultural prices is controversial. The Victorians thought that it was changes in gold supply; Schumpeter that it was changes in the level of investment in major industrial innovations; others, including myself, that it is primarily changes in the relative growth rates of world demand and supply of foodstuffs. Whatever the cause may be, the effect seems to be that the terms of trade move in the same direction as agricultural prices.

In sum, long periods of falling prices put pressure on the exchange rates of agricultural countries, whether by discouraging production for export, by increasing the real burden of debt, or by moving the terms of trade adversely. It is therefore easy to understand the appeal to these countries of proposals for commodity price stabilization, whether through a commodity reserve currency, or through international buffer stocks. Such measures would not guarantee the terms of trade (might indeed work adversely in inflationary times), but would at least evade the other two burdens (the discouragement of exports and the aggravation of debt). They belong in the same category as the domestic agricultural programs by which the governments of developed countries have now set minimum levels to the prices received by their own farmers; and they would make the same kind of contribution to the stability of the world economy, by maintaining purchasing power at times of general cyclical recession and stimulating developed country exports too. It is in the joint interest of both developed and developing countries that the prevention of secular decline of commodity prices in world trade be a declared objective of an international monetary system, ranking equally with the maintenance of full employment in the minds of the system's governors.

The Trade Cycle

Quite apart from the question whether to peg to gold or to silver, if one were to peg, the question whether to peg to anything or to float was already at issue before the first world war. An ordinary Kitchin or even a Juglar recession might be taken in one's stride, but Kuznets' great depressions, both deep and prolonged, put an intolerable burden on foreign exchange. The relevant dates in world trade are 1873-76, 1891-95 and after the war, 1929-33.

These depressions created both an exchange problem and also an output problem. The output problem originated in the fact that as exports declined, domestic income would decline by more than the original fall in foreign exchange. This could be mitigated by depreciating the currency to the extent of the fall in export prices, since this would keep constant the domestic money incomes of those producing for export. The case of the United States is particularly interesting. The United States was caught in a foreign exchange jam in the first half of the 1890s, partly because the prices of its agricultural exports fell, and partly because the British had cut their lending. It held on to the gold standard through six difficult years. But the considered judgment of Milton Friedman is:

> It should perhaps be noted explicitly that we do not intend to suggest that the alternative involving abandonment of the gold standard was economically undesirable. On the contrary, our own view is that it might well have been highly preferable to the generally depressed conditions of the 1890's. We rule it out only because, as it turned out, it was politically unacceptable.[2]

The check to output could of course be mitigated through internal stabilization schemes for keeping domestic money income constant irrespective of changes in international prices. This is more difficult for the developing than for the developed countries. Fluctuations in the developed originate mainly in domestic investment, which is presumably susceptible to control by domestic monetary and fiscal policies. Whereas fluctuations in the developing originate mainly in exports, which the government cannot control, and can only adjust itself to. The timing is also difficult, because the industrial countries have their balance of payments difficulties in the boom, while the developing have theirs during the slump. Measures to revive the economy in the slump are constrained by shortage of foreign exchange in the agricultural but not in the industrial countries. Nevertheless, in theory, internal stability could always be achieved by such internal measures as maintaining buffer stocks or varying export taxes inversely with prices. But to stabilize income would be to stabilize imports (or even to increase them as their prices fell), and this would not be feasible unless one had large reserves of foreign exchange. In this sense the output problem resolves into the exchange problem.

In theory the less developed countries could ride the trade cycle simply by holding large enough foreign exchange reserves, but the problem is more difficult for them than it is for the developed, for three reasons.

First, the recession dries up not just the earnings on current account, but also the long-term capital inflows. International investment was particularly vulnerable to the Kuznets great depressions. Borrowers could not meet their commitments, and a string of defaults was inevitable, or as we would now call them "requests for rescheduling of debt." We tend to be shocked by such requests, but they are an old and intrinsic part of international investment. There were heavy defaults in the 1820s, the 1840s, the 1870s, the 1890s, the 1930s, the 1950s, and we are now

2/ Milton Friedman and Anna Jacobson Schwartz, *A Monetary History of the United States, 1875-1960* (Princeton University Press, Princeton, N.J., 1963), p. 111.

holding our breath for the heavy defaults of the end of the 1970s. The European capital market took such defaults in its stride. It knew that the borrowers would have to come back for more money, and could then be made to recognize outstanding obligations before becoming eligible for new borrowing. But the United States lost its temper when caught in the defaults of the 1930s, and with its "blue sky" laws effectively closed its long-term capital market to foreign governments, with unfortunate consequences for our day, which we shall come to in a moment. All the same, although the defaults had no long-term effect on European lending in the nineteenth century, the immediate short-term effect was a cyclical drying up of foreign investment, coinciding with the reduction in current earnings. Paradoxically, we have done better at the cyclical level since 1950, because the bilateral and multilateral lending agencies, unlike the private lenders, have maintained their lending without cyclical fluctuations.

The second element distinguishing the developing countries is that they cannot use short-term capital inflows and outflows, responding to changes in their discount rates, to meet temporary shortages of foreign exchange. On the contrary, an LDC which raises its discount rates is signaling a crisis which is more likely to drive money out than to bring money in. It is true that some of the developed countries have now become more like underdeveloped countries in this respect; but the central banks of the industrial countries help each other out in time of trouble--a tradition which goes back to Bank of England reliance on the French and German central banks in 1890 and 1907.

Thirdly, taking these elements into account, the magnitude of the foreign exchange reserves that an LDC would have to carry in order to ride out a Kuznets cycle would simply be beyond its means. It is not unusual for the price of one's principal commodity export to fall by one third, producing over the course of, say, four below-average years a deficit of 50 per cent of one year's exports. One must also anticipate some decline in private foreign lending or investment during the slump. So, if committed to stabilizing domestic money income through the cycle, the government would have to approach the slump with reserves equal to at least 75 per cent of a year's exports. This would be very expensive, since a debtor country which keeps large foreign reserves is in the position of a man borrowing money at 6 per cent to put it in the bank at 3 per cent.

In the 1890s most of the currencies of the agricultural countries were already tied to one or other of the precious metals, gold or silver. Those on gold, such as Australia and New Zealand, took a terrible beating, as agricultural prices dropped to previously unimagined levels. Those on silver were partly shielded by the sharp decline in the price of that commodity. India chose the year 1893 to abandon silver, fortunately for it only a couple of years before prices in gold reached their lowest levels and started their upward climb. There were very few countries on a floating paper standard in the 1890s; such behavior was held in the deepest contempt by the monetary experts of the day. The two most important were Argentina and Brazil. Their floating was a calculated policy. It paid the agricultural classes to let the peso fall as prices fell in gold. This kept up their incomes in pesos, and by preventing the urban community from enjoying the lower gold prices of imports, also moved the terms of trade in favor of the agricultural classes.3/ When prices began moving upwards again, Argentina joined the gold standard, for the same reasons in reverse.

Australia and New Zealand were caught in the 1890s, but not in the 1930s. When this depression arrived, Argentina was the first country to leave the gold standard, Australia the second, and New Zealand not far behind. British and French colonies on gold again took a beating. International investment collapsed altogether, and by 1933 most of the leading countries in the world had abandoned the gold exchange system.

By 1939 it was clear to all that the foundation of any new international monetary system must be a lender of last resort, and this was built into the International Monetary Fund. Unfortunately, the magnitude of the LDCs' problem was not then, and still is not now fully comprehended. I earlier hazarded that fully to ride a Kuznets depression would require access to reserves equivalent to 75 per cent of a year's exports. Oil importing country exports last year amounted to US$118 billion. If the LDCs keep three months' reserves on their own, they need stand-by facilities of, say, US$60 billion over four years. Now the original quotas of the oil importing LDCs amounted to less than US$7 billion, carrying a right to borrow of only US$13 billion. These quotas are about to be increased, and one must also add SDRs, the IMF buffer stock scheme, and funds available under the export compensation schemes, both of the IMF and of the European Community.

The net potential stand-by need from the IMF will not be clear until some decision is reached on the international buffer stock proposals which, if successful, would considerably reduce the need for individual country reserves. But it is quite clear that the IMF has not helped significantly to reduce the required reserves of the LDCs, and that while adequately provided for a small slump, it could not now cope with a large one. It is also clear that if LDC trade is to grow by 6 per cent a year, doubling every dozen years, the IMF armory of quotas, SDRs, and compensation schemes should be doubled at least as often or sooner (to allow for rising prices).

Long-Term Finance

The developing countries have to invest more than they can save, and must therefore borrow. If they cannot borrow long, they will either borrow short or inflate. Either of these leads to a shortage of foreign exchange, and therefore menaces exchange stability.4/

It is not because they are poor that LDCs have to borrow. In the last quarter of the nineteenth century the biggest borrowers, the United States, Canada, Australia, and Argentina, were richer than the principal lenders, the United Kingdom, France, and the Federal Republic of Germany.

3/ The Argentinian strategy is analyzed in A.G. Ford, *The Gold Standard--1880-1914, Britain and Argentina* (Oxford University Press, Oxford, 1962).

4/ This section overlaps with the corresponding section of my forthcoming book, *The Evolution of the International Economic Order* (Princeton University Press, Princeton, N.J., 1978).

They borrowed not because they were poor, but because they were urbanizing rapidly. In the lending countries the urban population was growing by less than 3 per cent per annum (France 1.0, the United Kingdom 1.8, and the Federal Republic of Germany 2.5), while in the rich borrowers the urban population was growing by more than 3 per cent (Australia 3.5, the United States 3.7, Canada 3.9, and Argentina 5.3). Nowadays, population is growing more than twice as fast in LDCs as it ever grew in Europe, and urbanization is also twice as fast. And there is also a drive, sparked by recent independence, to build roads, schools, health facilities, and water supplies in rural areas. So the pressure on LDC governments for large capital budgets is inescapable.

Seen through the historian's eye, dependence on borrowing has created two problems for developing countries. One is its liability to wide fluctuations, which we have already considered, and the other is the speed with which the debt charges build up, to which I now turn.

Domar has given us the formula for the ratio of debt charges to new annual lending.[5/] It rises asymptotically to a limit

$$\frac{D}{F}L = \frac{a + i}{a + g}$$

where a is the annual repayment ratio (on the diminishing balance principle), i is the rate of interest, and g is the rate of growth of annual lending. Thus, if the rate of interest if 5 per cent, and annual lending grows by 5 per cent, the debt charge will mount until it exactly equals the annual lending. If lending is to contribute net resources to the borrower, it must grow faster than the rate of interest.

In the British case in the last quarter of the nineteenth century, lending grew less rapidly than the rate of interest. So from 1890 onwards, new lending was less than the sum of repayments, interest, and dividends. The average difference in favor of the United Kingdom was £42 million a year, from 1890 to 1907. Only in the final prewar spurt between 1908 and 1913 did average lending exceed the average inflow, and then only by an average of £3 million a year.

In consequence, the debt situation in 1913 was incredible. For comparison let us look at the situation of developing countries in 1972, just before the explosion of oil prices affects the situation. Outstanding debt of developing countries was than 1.8 times annual exports. (Government debt was US$85 billion, private investment US$53 billion, and trade US$75 billion.) This ratio of 1.8 was already thought to be very high; people were worrying about it, and calling for debt cancellation. By comparison, ratios of debt to exports (not debt charges but outstanding debt) were enormous in 1913. The lowest ratios, those for India, Japan, and China, were around 2 1/4. Australia's ratio was 4.8, Latin America's 5.2, and Canada's 8.6. (Canada tops this list, since its annual borrowing had been averaging 7 per cent of national income.)

How does one meet debt charges on obligations which are 8.6 times exports? If the debt charges were 10 per cent of the debt, they would absorb 86 per cent of exports. Argentina's debt charges in 1890 were

5/ E.D. Domar, "Foreign Investment and the Balance of Payments," *American Economic Review*, December 1950.

indeed 60 per cent of its exports. Still, after the troubles of the first half of the 1890s, the borrowers met their obligations during the next twenty years preceding the outbreak of the first world war, without much difficulty.

They managed for three reasons. First, prices moved upwards after 1895, eroding the burden of debt. As we have seen, prices for LDCs moved downward in the 1950s and 1960s, increasing the burden of debt. But the turnaround of the prices of tropical exports has been so marked since 1969, and more so since 1974, that in spite of the huge borrowings of the last three years, the oil importing LDCs had at the end of 1976 a ratio of public debt to exports which was still less than two to one.

The second reason why a high debt ratio was manageable in the early part of this century is that the borrowers' exports were rising 50 to 100 per cent faster than their national incomes, in contrast with the 1950s and 1960s, when national income and the purchasing power of LDC exports rose at the same rate (about 5 per cent a year). Various factors have closed the gap. For one, LDC growth was spurred in the nineteenth century only by exports, whereas since the second world war it has responded also to domestic demand (services and import substitution). For another, the developed countries have built formidable obstacles to LDC trade, whether in agricultural products or in manufactures. Estimates of how much more the LDCs could export without such obstacles start from US$10 billion a year upwards.

The ability of LDC governments to meet their debt obligations depends on how rapidly their trade is growing. It is not enough that an economy be buoyant, and that its government be able to raise the money through domestic taxation; the proceeds must also be convertible into foreign exchange. This two-gap problem did not surface in the nineteenth century because in the developing countries of the day exports were growing much faster than national income. Imports therefore lagged, and there was no pressure on foreign exchange. The situation is reversed when the growth rate of exports drags behind that of income. Some LDCs are much better placed than others for rapid growth of exports; LDCs are far from being all alike. It is true that any individual country can speed up its exports and decelerate its imports by adopting appropriate policies; but even so, the fallacy of composition reminds us that the capacity of all LDCs taken together to increase their exports is much smaller, since what they do at each other's expense cancels out. Exports of the group as a whole depend to a large extent on the willingness of the developed countries to buy more from them. LDCs will not be able to maintain a 6 per cent growth target and meet all their debt obligations unless the developed countries now make more space for them in world trade, by dismantling some of the barriers to LDC exports.

The third reason why a high ratio of foreign obligations was more manageable before 1913 is that it really was less of a burden. In the first place, the ratio of equities to bonded debt was larger. Private investors built a lot of infrastructure (railways, etc.), as well as the factories, plantations, and mines, so the profits to be transferred fluctuated *pari passu* with foreign exchange earnings.

In the second place, the ratio of short-term to long-term debt was negligible, and it was the heavy charges on short-term debt that started forcing LDCs into bankruptcy already in the 1950s and 1960s although the ratio of outstanding debt to exports was still small. In 1913 the United Kingdom's outstanding short-term loans were only about £300 million, in contrast with long-term lending of nearly £4,000 million. But the developing countries have been shut out of the long-term capital markets of the United Kingdom, France, and the United States by the foreign exchange restrictions of the first two and by the "blue sky" laws of the third. This exclusion of LDC governments from private portfolio borrowing is a major change in the international economic order, with major adverse consequences. Government-to-government lending is a partial but insufficient substitute. So LDC governments have been driven into short-term borrowing; through suppliers' credits in the 1950s and the 1960s, and Eurocurrency loans in the first half of the 1970s. Already at the end of 1972 about 30 per cent of LDC obligations were short term, and the oil crisis is pushing this figure higher and higher.[6/] A curtailment of short-term borrowing, with corresponding expansion of access to long-term lending, is the biggest financial requirement of LDCs.

The third reason why foreign obligations were easier to manage before 1913 is that debt could be rolled over. In 1913 a government could borrow in Europe for unspecified purposes, or even specifically to pay off old debt or the interest thereon, whereas nowadays the World Bank and the bilateral government agencies insist on tying new loans to new projects. The only good thing one can say of today's large debt to European and American bankers is that it can be rolled over, thus increasing the flexibility of debt management. But it would be better still for LDC governments to regain access to long-term capital markets, with some capacity to borrow for roll-over purposes. This would at least diminish the frequent unpleasantness of asking the Paris Club to reschedule short-term obligations.

In sum, LDCs have a continuing need for long-term finance for capital development, in the absence of which they will be driven either to more short-term finance, or to inflation, at the expense of exchange stability. What is wrong in the current situation is not that debt ratios are high--they are low by historical standards. What is wrong is the structure of the debt: too short and too much tied to projects. What we need is an adequate flow of long-term finance, of various kinds, through all conceivable channels, including a long-term capital market reopened to good borrowers, supplemented by the multilateral and bilateral government agencies and by private foreign investment, on terms ranging from market rates to grants to the poorest countries. This has been agreed by governments ever since the beginning of the 1960s. Members of the Organization for Economic Cooperation and Development are pledged to an annual net flow of not less than 1 per cent of their national incomes and have further agreed that the average rate of interest on the government-to-government part of this flow should not exceed 3 per cent. If the developed countries actually honored these commitments, which are not particularly burdensome, the flow of long-term finance on reasonable terms would be adequate; we could reduce the

6/ I need not pursue here the implications of the oil crisis. It is clear that what the oil importing LDCs need for this is a special medium-term (say, 15-year) security, producing about US$10 billion a year (the amount by which their oil bills were increased) and tapering off over 10 to 15 years. Short-term finance will probably have to be rescheduled in numerous cases.

short-term borrowing and would not have to bother about the burden of debt. The problem, then, is how to get the developed countries to keep their commitments, but this is outside my present terms of reference (apart from the fact that I do not know the answer).

Conclusion

Putting together the various sections of this paper, the answer of the historical record is that the exchange stability of developing countries is menaced by secular decline in world prices (which depresses the economy, increases the debt burden, and worsens the terms of trade); by cyclical fluctuations (which call for larger foreign reserves than can be afforded); by an excessive offer of short-term relative to long-term finance; and by developed country barriers which retard the growth rate of LDC exports. Since all these forces were in operation in the 1950s and 1960s, it is not surprising that there was a record number of devaluations and defaults, though of course a substantial number of these also resulted from human error.

If this list seems to take us beyond the confines that are normally considered to be appropriate for an international monetary institution, this itself underlines the difference between developed and developing countries in this sphere. International monetary problems derive from the entire network of international economic relations and cannot be solved within the walls of any single institution. In fact, the developed countries, with stronger economies, less dependence on international inflows, and easy fraternal relations between central bankers, could get along fairly well without an international monetary institution; and having one, could manage quite well if its function was confined to discussing changes in exchange rates. To the LDCs, on the other hand, an institution which did not look beyond exchange rates to the wider context which determines international monetary flows could be a menace rather than a help. Given the difference in their immediate interests, the instinct of the developed countries will be to narrow the discussion, while the instinct of the developing will be to widen it. In the long run, our salvation lies in the General Motors proposition: What is good for the developing countries is also good for the developed.

* * * *

MR. SOUTHARD: Thank you, Sir Arthur.

Questions and Answers

Following the formal presentations, Dr. Wilfried Guth and Sir Arthur Lewis answered written questions from the audience.

DR. GUTH: The first question: *Would your reasons for opposing "target zones" for exchange rates also imply that there should be no snake?*

I left out the snake in my oral presentation. I have dealt with it in the written version. I think the snake is a separate issue. The very fact that I have already referred to, namely, that we have no chance whatsoever in the foreseeable future--and probably that's a rather long foreseeable future--of returning to fixed exchange rates in our international monetary system, demonstrates that the snake experiment is a separate issue. And, as far as the snake experiment is concerned, we have all seen that there have to be rather frequent changes; and, at times, when there was the illusion that fixed exchange rates within the snake could be defended by heavy intervention policies, the attempts to defend the exchange rate arrangements caused disagreement among the central banks concerned. Therefore, the only way the snake can survive is by adoption of the method which has recently been so efficiently put into effect (although with a smaller and smaller physical size of the snake), i.e., to react quickly and to change parities once one sees that the "target zones" are not realistic.

So there is for me really no comparison between the two questions. I would, for other reasons, favor the continuation of the European mini-snake as long as the participants think it is useful. And, to put it quite frankly, I would even go a step further and say--as long as the small participants consider it useful to be in the snake. And still, for perhaps emotional reasons, I would not like to give up the idea of a stronger European harmonization of economic and other policies which would then make the snake arrangement easier to handle. But that's hope; it's not more than hope at the moment.

Now the second question: *The steps to be taken to relieve the private banking system of the burden of assuring too great a share of the financing of LDCs are a step in the right direction, but not sufficient to prevent a blocking of the international monetary system if there was a major solvency accident if one remembers that one third of the debt is owed to banks whose lenders of last resort are not U.S. lenders. This aspect, which would have the IMF act as a lender of last resort, is never discussed. Why?*

That is an interesting question. What Arthur Lewis said seems to me to be the right answer. That is, if we should have to ride out a major slump in the world economy and cope with deficits of the developing countries, then the combination of commercial bank lending--which would then probably be very cautious--and IMF transactions would not be sufficient, as he has clearly said. Therefore, the lender of last resort must be equipped with greater means, as I have said before. In my written version I have even included a reference to the so-called Kissinger fund as a safety net if that should happen, i.e., if we should come into a real world crisis requiring a tremendous volume of funds. If I read the question correctly, my answer would be that the commercial banks, as long as there is no case of a major default, will be able to carry quite a bit of the burden, improving coordination and cooperation with the IMF. As I said, of course, the real danger would occur if one of the debtor countries runs into real default. Then the IMF and other international institutions would have to intervene in time to prevent this becoming a chain reaction.

Based on your experience as a private banker, how real are the fears of foreign exchange losses in the international banking system at present?

Well, the answer is very simple. A bank normally shouldn't incur foreign exchange losses if it handles its foreign operations prudently. And, therefore, I think it is not so much on the side of banks as on the side of business that there is a fear of exchange loss. Looking at the companies with which I am familiar, what they fear is a decline--a sudden as well as a gradual decline--in the exchange rates of those countries where they have their subsidiary companies, where their total earnings from foreign operations could come down to zero if they have to be corrected for exchange rate changes. But there is no remedy for this. As we have seen, the revaluation of the strong currencies--of the deutsche mark, of the yen--has been unavoidable, and this is a price that has to be paid for keeping the system in equilibrium. The other kind of exchange loss that could occur is the one to which I have just referred--the exchange loss through a moratorium or an inability of the indebted country to repay. But here I would repeat what I have said--I rely, as Sir Arthur has so clearly said, on the historically proven possibility of the system to revolve, to renew, and to give new credits to repay old ones. This might not be reassuring to a very conservative mind, but it is the only way to get over the problem. And, therefore, I wouldn't be too much afraid of banks incurring foreign exchange losses as long as the system functions in the way I have tried to describe.

I have one more question, probably the one you have been expecting: *In view of the fact that Germany's growth rate is falling more and more behind the official growth targets, is it justified to say that advice to her to accelerate growth is superfluous?*

Well, I tried to explain that. First, the fact that the growth rate is falling behind targets is very much regretted by the Government itself, and it doesn't make the position of the Government easier. Second, I tried to make it clear that that advice, in the true sense of advice, ought to come from the IMF--and behind the scenes--and not from other countries. I have felt over the recent period that advice--so-called advice or admonition--from one country to another only creates irritation on both sides. Those who give the advice get excited if it is rejected, and those who receive the advice feel that they should not be lectured by someone else. And this is true in both directions. The surplus countries shouldn't lecture either; they have done it sometimes but they shouldn't.

Finally, there is a difference between advice to grow faster and advice what to do. The advice to grow faster is really--and on this I am fully convinced--superfluous and not helpful. I have seen that in some discussions it has been said that the German Government failed to be fast enough in turning around the orientation of its fiscal policies. That was good advice, but it also came at the same moment when the German Government itself had discovered that it was too late. And why was it too late? Because it did not estimate correctly the rate of growth. There was an error in estimating the rate of growth, and the error was committed by everybody. And the same error was committed in predicting long-term interest rates. Nobody thought in Germany that we would end up at 6 per cent a year ago, nobody thought of it. Just as I said I claimed the right to errors and omissions at the beginning of my lecture, so governments have the right to claim errors and omissions too. But, still, as far as the Fund is concerned--and as I just said to Sir Arthur--the only point of disagreement, the only little point of disagreement with what he has said (otherwise, we find ourselves in full accord) is when he said a strong central organization for the international monetary scene, with broad scope, is necessary only for the LDCs, whereas the developed countries, with their central bankers being so friendly with each other, could very well do without it. There I disagree. I think it has been very clearly proven that we need (in order not to have this country-to-country admonishing) a central authority which has really the possibility and the means of advising countries what to do. In other words, if the Fund four months ago had told the German Government (and I don't know whether Mr. Witteveen did so) "You might have to change your fiscal orientation more rapidly," it probably would have been helpful.

What I am saying is not meant to imply a rejection of all advice. It is just a rejection of the slogan "Please grow faster," because such a slogan only underestimates the difficulties of growing faster. It is not like opening a water valve and saying that if we pump so much into the economy then we will grow faster. It is not easy in the short run to attain faster growth. And therefore, as I have said on another occasion, to advise surplus countries to grow faster reminds me of the old saying in Russia, when hotel rooms were short, "Sleep faster, comrade."

* * * *

SIR ARTHUR LEWIS: This question reads: *Your remarks imply but do not seem to recognize another crucial difference between 1913 and the present: the balance between consumption and savings in the LDCs and the smaller share in rising national income, which is now available for debt service. What is the remedy for this?*

One must, I think, distinguish between "investment" and "saving." As far as investment is concerned, the proportion of national income that is being invested in less developed countries is not any higher now than the proportion being invested in Canada, or Australia, or any of the other borrowing countries--big borrowing countries--in 1913. The net or gross investment in the LDCs is not all that particularly high. Regarding saving, the question is more to the point. The share of saving in national income has been rising quite steadily over the last 25 years in the developing countries--net saving is probably now of the order of about 10 per cent of the national income (which is not very different from British net saving in the first decade of the nineteenth century). The rate is, admittedly, too small, but it is certainly going up all the time. And LDCs differ very widely in the quality of their performance on this. But if you just take the overall average of LDCs, their record for the increase in the share of saving over the last 25 years is not at all bad.

Concluding Remarks

Frank A. Southard, Jr.
President, Per Jacobsson Foundation

Both speakers, I think very properly, have emphasized the need for central organization in this system--or nonsystem--in which we are living. Those of us who have lived with the Fund over a long period of time and have watched its evolution, of course know that its main task has been to carry out the process of surveillance of the system (which, as Dr. Guth has said in his full text, is emphasized in the new Articles of Agreement that are now being ratified by member countries). So what we must hope for is that the central organization and its related institutions (as Dr. Guth has laid them out) will find a way in which there can be discipline, in which there can be guidance, and of course, as both speakers have said, in which there can be a provision for the kind of resources that are going to be needed as we look ahead in an unbalanced world.

I thank you all for coming. It has been a pleasure to see this good attendance. In due course these two fine papers, together with the questions and answers, will be printed, and you will be able to get copies of them in one or another of the three languages.

And finally, I express our appreciation to Dr. Guth and to Sir Arthur Lewis for taking the time and the care to prepare their statements. We will now adjourn. There will be an opportunity for private talk and a small reception. We hope to see you again the next time. Thank you very much.

Biographies

Dr. Wilfried Guth has been a Member of Board of Management of the Deutsche Bank, A.G. in Frankfurt, since 1968. He was educated at the Universities of Bonn, Heidelberg, and Geneva, and at the London School of Economics.

Dr. Guth began his career in the Deutsche Bundesbank (Research Department) in 1953 and served there in various capacities until 1959 when he was appointed Executive Director for the Federal Republic of Germany in the International Monetary Fund. He returned to Germany in 1962 as a Member of the Board of Managers of the Reconstruction Loan Corporation, the principal German lending institution for development aid, where he remained until 1968.

Dr. Guth's publications include *Capital Exports to Less Developed Countries* (1957). He was also the German member of the Commission on International Development (Pearson Commission) which presented its Report *Partners in Development* in 1969.

Sir Arthur Lewis has been Professor of Political Economy, Princeton University, since 1963. He was educated at the London School of Economics where he served as Lecturer from 1938 to 1948. Afterward he became Professor of Political Economy, University of Manchester, a post which he held for ten years.

From 1959 to 1963 he served first as Principal and then Vice Chancellor, University of the West Indies. He was also President of the Caribbean Development Bank from 1970 to 1973.

Sir Arthur Lewis gave the Janeway Lecture on "The Evolution of the International Economic Order" at the Woodrow Wilson School of Public and International Affairs in March 1977. His publications include *Economic Survey, 1918-1939* (1949), *The Theory of Economic Growth* (1955), and *Development Planning* (1966), as well as various articles in technical, economic, and law journals.

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