THE 1983 PER JACOBSSON LECTURE

Developing a New International Monetary System: A Long-Term View

H. Johannes Witteveen

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FOREWORD

The 1983 Per Jacobsson Lecture, entitled "Developing a New International Monetary System: A Long-Term View," was delivered by H. Johannes Witteveen, at the Dorothy Betts Marvin Theatre of the George Washington University in Washington, D.C., on Sunday, September 25, 1983. Mr. Witteveen, former Managing Director of the International Monetary Fund, is Chairman of the Consultative Group on International Economic and Monetary Affairs (Group of Thirty). William McChesney Martin, Chairman of the Per Jacobsson Foundation, presided over the meeting, the proceedings of which are presented in this publication.

The Per Jacobsson lectures, which are held annually, are sponsored by the Per Jacobsson Foundation. The Foundation was established in 1964 in honor of Per Jacobsson, the third Managing Director of the International Monetary Fund, to promote informed international discussion of current problems in the field of monetary affairs.

The lectures are published in English, French, and Spanish and are distributed by the Foundation free of charge. Through the courtesy of other institutions, other language versions are also issued from time to time. Further information may be obtained from the Secretary of the Foundation.

CONTENTS

Opening Remarks

William McChesney Martin

It is a great privilege for me to call this twentieth annual lecture meeting of the Per Jacobsson Foundation to order. These lecture meetings are memorable occasions for us because not only do we benefit from them intellectually but they also give us the opportunity of meeting old friends and colleagues.

Let me begin by saying a few words about the Foundation. I am glad to be able to report that the Foundation is in sound financial condition and that it is carrying on its activities in a satisfactory manner. In this context, I would like to recall the contributions of our Founding Chairman, Randolph Burgess, who probably helped more than any other individual to organize the Foundation and to further its causes. He was assisted by two extremely able Honorary Chairmen—Marcus Wallenberg and Eugene Black. We were saddened by the death of Marcus Wallenberg last year; we shall greatly miss his wise counsel and guidance. Eugene Black is unable to be with us this year, but he sends his warm regards to all of you.

I would like to welcome to the Foundation two new Directors, both of whom are very well known—Peter Wallenberg and Sir Jeremy Morse. Marcus Wallenberg was a good friend and a strong supporter of the Foundation, and we felt that it would be fitting to continue the tradition of having a Wallenberg on the Board. We are glad, therefore, that we were able to persuade Peter Wallenberg to join us. We are equally fortunate that Sir Jeremy Morse has also agreed to be on our Board. So the Board has been strengthened, and we look forward to working with our new members.

We acknowledge with gratitude the help that we have always received and continue to receive from the International Monetary Fund. The Fund assists us in a number of ways, besides providing us with the staff to work with. The President of the Foundation is Frank Southard, who is sitting on my left. Frank Southard has had a most distinguished career in the field of international economic affairs. He was the Deputy Managing Director of the Fund under Per Jacobsson for six months, until Per Jacobsson died in 1963, and continued in that position under Pierre-Paul Schweitzer. Over the years, his efforts on behalf of the Foundation have been unstinting and invaluable.

As you will see from the program, we have set aside some time for questions and answers following the lecture, and I have asked Frank Southard to take over the proceedings at that time. If you have any questions that you would like to ask the speaker, please write them on the card at the back of the program. The cards will be collected and given to Mr. Southard who will present them to Mr. Witteveen.

We have had many eminent speakers at our meetings—Governor Bouey's timely and thought-provoking address last year will be long remembered—and in continuing that tradition we are honored to have H. Johannes Witteveen to speak to us today. Johannes Witteveen preceded Jacques de Larosière as the Managing Director of the Fund. He has also served as First Deputy Prime Minister and Minister of Finance of the Netherlands and is at present the Chairman of the Group of Thirty. His outstanding career has encompassed the academic world, government, banking, and international affairs. He is in a unique position to guide us at this present critical juncture of international economic events.

Let me end on a somewhat facetious note. As some of you may know, I have been suffering from arthritis, and I find that doctors don't know too much about it. I asked the last doctor I went to what he thought of my condition. "Well," he said, "you gave me some literature on the international monetary system and I think that you are in just about the same condition!" As you know, there are as many views on arthritis as there are on the international monetary system, but I personally was encouraged!

May I now present to you, H. Johannes Witteveen.

H. Johannes Witteveen

Mr. Chairman, thank you very much for your kind introduction. After your last remarks, I scarcely dare read the first sentence because it says that our monetary system is in a rather frightening state! So, I would like to take it back but it is written down here and cannot be changed!

Developing a New International Monetary System: A Long-Term View

H. Johannes Witteveen

Our monetary system is in a rather frightening state. When the Chairman of the Per Jacobsson Foundation, William McChesney Martin, in his invitation to give the Per Jacobsson Lecture, wrote: "we depend on people like you to give us some orderly direction," I experienced a mixture of feelings. In the first place, I felt, of course, pleased and honored to be given this unique opportunity to present some thoughts to the international financial community. But I also saw it as a great challenge to give "orderly direction" at a time when we are beset by so many confusing problems. And I hesitated because we are confronted with a dilemma. On the one hand, the international monetary system is clearly in very unsatisfactory shape, so that a cooperative reform effort is urgently needed. On the other hand, however, the willingness or ability of governments to cooperate internationally seems minimal except in an immediate crisis situation. All proposals for reform therefore run the risk of being quickly discarded as unrealistic.

What is the reason for this weakness in international monetary cooperation in a period when a more and more integrated world economic and financial system so clearly needs it? A basic explanation is certainly that decision making on international affairs is still centered in national governments clinging to a concept of sovereignty that in reality is made largely illusionary by the manifold interdependence between national economies. But I believe that an important role is also played by a lack of insight, leading to very different views of the way in which our economies and our monetary system really function and of the fundamental causes of our difficulties. We seem to be quite far, therefore, from any consensus on an effective and acceptable approach to reform. This is clear for the two major problems we face. With respect to exchange rates, we seem to understand the reasons for their dangerous instability only very partially. The recent dramatic rise of the dollar, confounding a large majority of economic forecasters, has shown this clearly. And, in any case, the monetary authorities seem powerless to counter or manage the massive capital flows that have come to dominate foreign exchange markets.

With respect to the banking situation, we are now faced, after long and only partially resolved debates on the meaning and determination of Euromarket growth, with the urgent problem of how to take effective action on the debt issue without opening the way for a new burst of overlending in the future. How to stimulate bank lending now, while establishing discipline for the future? This is the problem for which no solution has as yet been found.

With such questions still unsolved we are certainly not ready for a major conference to design or agree on a new international monetary system. We need further study to gain a clear understanding, which will then enable us to move step by step, initiating reform where the needs are most pressing. In this way, we will gradually have to develop a new monetary system.

In accepting the Chairman's invitation, I will try to bring together some insights and ideas that are beginning to emerge and that could be building blocks for an improved system. I hope that this could begin to give some direction to our work in coming years.

In setting out these thoughts, I will draw heavily on the work of the Group of Thirty, which aims specifically to contribute to a better understanding of international monetary mechanisms and of the international aspects and consequences of national policies. I will not be able, however, to report a consensus in the Group on many aspects of what we should aim for in the longer term. The work of our study group on this subject is still at an early stage.

Recent Evolution of the International Monetary System

Let me begin by summarizing some of the most characteristic features of the development of the international monetary system over the last 10 to 20 years.

(1) The rapid growth of international lending by commercial banks through Euromarkets and other offshore markets has created a very perfect international capital market, largely outside the regulatory controls of any monetary authority or international institution. Strong

competition in this market between a growing number of banks has led to a very fast expansion of international liquidity and to an enormous increase in short-term and medium-term debt of many developing and Eastern European countries, mainly on a rollover basis. Thus, the world's commercial banking system has been internationalized to a large extent. In the resulting environment, capital movements have begun to play a growing and often a dominant role in international payments and in the determination of exchange rates.

The role of governments in this financial system has weakened and could be described by saying that governments now participate as partners with commercial banks in a market-based monetary system. As a corollary of this, the monetary system has evolved into a multiple reserve currency system. Many central banks, acting like private investors, are shifting their reserves between the main reserve currencies according to relative interest rates and their expectations of exchange rate developments.[1]

Among official international institutions, the International Monetary Fund has played a role of growing importance through the essential conditionality of its stand-by arrangements. But the Fund's size has seriously lagged behind the growth of international trade and even more behind the rapid increase of international capital movements. Aggregate Fund quotas have fallen from 16 percent of world trade, when the Fund was created in Bretton Woods, to 4 percent recently. This was a consequence of the restrictive position taken from the beginning by the U.S. Administration and later also by other governments of creditor countries who wanted to limit their commitments, fearing inflationary effects of increases in the Fund's resources. In fact, the whole complicated structure of this world monetary institution as a "fund," consisting of limited amounts of gold and of its members' currencies, was a result of this restrictive attitude. Similar attitudes precluded the Fund's new international reserve asset, the SDR—although it was meant to become "the principal reserve asset in the international monetary system"—from gaining a role of real importance. This completes the picture of a monetary system where official liquidity—and thus, official influence—has gradually been overwhelmed by gigantic masses of quickly

[1]See Group of Thirty, *How Central Banks Manage Their Reserves* (New York, 1982), and *Reserve Currencies in Transition* (New York, 1982).

movable private international liquidity. The consequence of this has, of course, been quite contrary to what our cautious finance officials of creditor countries intended! Instead of having to cover their balance of payments deficits by drawing on the Fund under strict conditionality, most countries have recently been able to borrow enormous amounts without any policy conditions from eagerly competing banks.

(2) In this system, floating of exchange rates among the main currencies became inevitable. Many economists considered this as a desirable arrangement. Governments which favored floating were influenced by this and were guided by economic theories, suggesting that floating exchange rates would give them independence for their national fiscal and monetary policies. At the same time, the growing influence of monetarism led to monetary policies focusing more and more stringently and exclusively on national targets for the increase in the money supply. The expectation, however, that a stable increase in the money supply would lead to stable exchange rates proved completely illusionary notwithstanding the fact that inflation rates have been converging. On the contrary, we have experienced a serious volatility and instability of floating exchange rates. This instability has sometimes been increased by a tendency of central banks in a multicurrency system to shift reserves from "weak" into "strong" currencies.[2]

Stabilizing International Credit Markets: The Present Need for Stimulation

What can be done now and in coming years to develop a more satisfactory international monetary system? Let us first look at the problem of international lending through Euromarkets and offshore markets. Here, we have seen a highly destabilizing development. For many years, these markets have been growing very fast, by 25 percent to 30 percent annually, until in 1980 a level of net new lending by banks in the reporting area of the Bank for International Settlements was reached of $160 billion. About one third of this was

[2]Peter B. Kenen, in his paper for the conference on international money, credit, and the SDR, mentions research by Bergsten and Williamson showing that reserve shifts by central banks have indeed, in general, been destabilizing. Peter B. Kenen, "Use of the SDR to Supplement or Substitute for Other Means of Finance," in *International Money and Credit: The Policy Roles*, ed. by George M. von Furstenberg (Washington: International Monetary Fund, 1983), pp. 327–60.

directed to non-oil developing countries. In 1981 these amounts stabilized; but in 1982 they were almost cut in half to a total amount of net lending of $95 billion, which included $25 billion for non-oil developing countries. In the first half of 1983, the flow of net new lending to sovereign borrowers in non-oil developing countries—apart from more or less forced lending to Brazil and Mexico—showed a further substantial reduction.[3] This instability in financial flows, which have become so important for the growth of the world economy, indicates that there is a need for an official international instrument that could be used to influence them. Restraint or stimulation seems to be alternatively needed to bring about a more stable development of the international economy.

The need for restraint has been repeatedly discussed during the period of rapid growth that is now behind us. However, serious differences of view and, to some extent, also conflicting interests have prevented any action being taken. There has even been a move in a contrary direction by the establishment in New York of an international banking facility where U.S. banks have similar regulatory advantages as their competitors in offshore centers.

In the debate about the possible inflationary consequences of the rapid growth in international bank lending, the main counterargument has been that central banks should always be able to protect their own economies against such undesirable effects by keeping their money supply limited or, especially in the case of the United States, to compensate for the strong growth of Eurodollar liquidity by a slower internal money growth. But there are two weaknesses in this argument.

(1) In the first place, competition in Euromarkets has made it so easy for governments with market access to finance their balance of payments deficits by borrowing at very low spreads that many of them certainly have been tempted to set overambitious development plans or to postpone needed adjustments. This tendency was further encouraged, because U.S. interest rates, which also determined international interest rate levels, were low or even negative in real terms for many years. Thus, countries often approached the Fund only when their creditworthiness had deteriorated seriously and

[3]See Richard Williams, Peter Keller, John Lipsky, and Donald Mathieson, *International Capital Markets: Developments and Prospects, 1983*, International Monetary Fund, Occasional Paper No. 23 (Washington, July 1983).

when disequilibrium had progressed so far that the needed adjustments were extremely difficult and painful.

(2) On the other hand, it could be stated from the viewpoint of the United States that to offset Eurodollar growth by a slower growth in U.S. money supply would imply a monetary policy that would be more restrictive than would be desirable from the U.S. domestic point of view. In that sense, it would put an unfair burden on the United States. In 1978–79, the United States therefore proposed to central banks of countries of the Group of Ten[4] that a cooperative system of restraint on Euromarkets be established by setting reserve requirements on Euro-liabilities, so that the favored treatment of these liabilities in comparison with domestic deposits in the United States would be eliminated. This proposal met strong opposition, largely because the instrument of reserve requirements did not fit into the techniques of monetary control of some other central banks. This problem was discussed in the Group of Thirty, where a certain consensus was reached on an approach in which central banks would agree on a range of growth for international lending that would be acceptable, while using their own instruments of control to achieve this. In Basle, however, central banks did not move beyond some strengthening of prudential controls. And with the second oil price rise in 1979–80, the need for renewed recycling of dollars held by members of the Organization of Petroleum Exporting Countries made restraint on international bank lending seem inappropriate. But the further explosive growth of this lending which followed has now saddled the world with a debt problem that fundamentally threatens the international financial system and demonstrates with complete clarity the dangerous results of the rapid growth of international bank lending in the past.

The urgency of this debt problem is closely related to the drastic slowdown in the flow of net new credit, especially to non-oil developing countries, which we are experiencing now. This slowdown is, of course, brought about by the difficulties that many developing countries experience in servicing their debts to the banking system. In the present world economic situation, the strong increase in real interest rates and the recession and slow recovery in industrial countries have increased debt burdens and made it much

[4]Industrial countries that participate in the Fund's General Arrangements to Borrow (GAB).

more difficult for developing countries to meet their obligations. But, in turn, this slowdown in new credit aggravates and extends the difficulties in a vicious, cumulative deflationary process. For this reason, the Fund and central banks of the main industrial countries found it necessary, in many cases where debts had to be rescheduled and adjustment programs to be negotiated, to put strong pressure on commercial banks to provide certain amounts of net new credit.

The need to exert this pressure puts central banks in a very ambiguous position. As supervisors they have to urge caution and to prescribe new or increased provisions on loans to rescheduling debtor countries. But their responsibility for the world monetary system induces them, on the other hand, to press commercial banks to increase the very exposure that they criticize and may even punish in their supervisory role. This difficulty is compounded by critical reactions in public opinion—reflected especially in the U.S. Congress—which push and force supervisory authorities to strengthen their prudential restraint. It therefore seems clear that central banks will experience growing difficulties in repeating and continuing this contradictory behavior.

On the other side, commercial banks may be less and less inclined to follow such essentially conflicting official exhortations. Nevertheless, a resumption of a reasonable flow of bank credit is essential for world economic recovery—or even for preventing a disastrous debt crisis when in some developing countries social pressures, caused by tough adjustment measures, would become unmanageable. Recently, many radical solutions to solve the debt problem have therefore been proposed, aiming at some form of takeover and consolidation at a discount of problem loans of commercial banks. It is difficult to see, however, how any international institution could be enabled by governments to take over the gigantic amounts of bank loans involved. It is also doubtful whether such an approach tackles the problem from the right side. The existing debt is being rescheduled and thus, in fact, consolidated for the time being. The difficulty arises because banks are less willing to provide new loans. Here, these proposals to consolidate old loans raise a dilemma. A takeover on relatively attractive terms would absolve banks too easily from their responsibility, so that they would be tempted to expand their international lending again too rapidly and in some cases imprudently in the future. On the other hand, stiffer terms, including significant discounts, would discourage new lending by the banking system, so that the crucial problem of restoring the needed international credit flow would not be resolved.

It seems to me that this is the strategic point where an improvement in the international monetary system could be initiated. What is needed is a reasonable measure that will restore the willingness of banks to provide on a voluntary basis the new financing that the Fund considers necessary for the success of agreed adjustment programs. This need would be met exactly by the creation of an insurance facility for these loans against political risks, comparable to what national export credit insurance agencies do in their field. Lord Lever has recently proposed[5] that export credit agencies should therefore set up a central agency that would act on the advice of the Fund to fulfill this function.[6] It would seem much more efficient, however, if the Fund itself could be enabled to set up such an insurance facility. This insurance would only be given as long as the debtor country met the agreed performance clauses. The percentage to be insured and the premium that banks should pay for this protection would be adjustable according to the needs of the situation; some part of the risk—probably at least 25 percent—should in all cases remain with the banks, however.

As the amount of the insured credit grew, the Fund's resources would, of course, have to expand in parallel, possibly in the form of guarantees by participating governments. But the risk would in all probability be quite limited. The establishment of this facility would by itself have a major positive effect in resolving the debt crisis; and debtor countries would certainly do their utmost to meet their obligations with respect to these Fund-insured loans, as failure to do this would close off completely financial assistance and access to financial markets.

The decisive advantage to the system of such a new function for the Fund would be that the task of assuring a sufficient flow of international credit would be vested in the international institution that by its world economic responsibility and experience is uniquely qualified for it. Central banks could then focus unambiguously on their national supervisory tasks.

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[5]See "The International Debt Threat: A Concerted Way Out," *The Economist* (London), Vol. 288 (July 9, 1983), pp. 14–16.

[6]The Export-Import Bank of the United States is apparently already trying to set up a somewhat similar arrangement for Brazil and Mexico.

It is clear, however, that such a new function for the Fund should be connected with an effective international mechanism to restrain credit flows when they tended to grow too fast. Ideally, the instruments for stimulation and for restraint should go together. The necessary political support for an insurance facility in the Fund will certainly not be obtainable if no satisfactory assurance can be given that overlending will be avoided in the future. How can this be done?

Stabilizing International Credit Markets: The Need for Future Restraint

As we have seen, it is possible to envisage a cooperative effort of central banks to restrain the international lending of commercial banks in their jurisdiction. Such a cooperation should be developed in the context of the Fund because it vitally affects many countries—in fact, the whole world economy. This could also help to bring small actual or potential offshore centers into this cooperative system. This is needed if the restraint is to function effectively and fairly.

A cooperative system to control international bank lending must address itself to two main weaknesses. On the one hand, the funding of international loans in the Eurocurrency markets has been easier and cheaper than in the main national money markets, because no reserve requirements have been imposed on them. On the other hand, solvency requirements—prescribing maximum ratios between different categories of assets and capital—which have been the main instrument of control in some European countries, were in many cases not applied on a consolidated balance sheet, while sovereign loans were, in most cases, left out altogether. Their solvency ratio was zero.

These weaknesses have to be eliminated. With respect to the asset side of the balance sheet, solvency requirements should be gradually applied also to sovereign loans. in a few risk categories. They should be calculated on the basis of a consolidated balance sheet. This would also help to bring offshore centers under these controls, as most banking offices there would be related to banks in Group of Ten countries. The percentage of these solvency ratios could be made variable between certain limits. In that way, they could serve monetary control purposes besides their prudential significance. They could then be used to keep the growth in international lending between internationally agreed limits.

On the liability side of the balance sheet, we would need reserve requirements on Eurodeposits. This could be seen as a liquidity measure, but their function would be also to eliminate or reduce the regulatory advantage that has been behind the rapid growth of Euromarkets in the past. They could help to stop leakages. These reserve requirements should also be variable so that they could help to stabilize the flow of international credit.

These two approaches to the management of international credit markets could then supplement and strengthen each other.

There may be certain advantages in bringing such a reserve requirement on these typically international liquidities, which are not clearly related to any national economy, under the international control of the Fund. The growth of international credit and liquidity could then be guided by the need for balanced growth of the world economic and financial system, leaving individual central banks free to follow their own national monetary policies. The definition of the liabilities to be brought under a Fund reserve requirement should, of course, be carefully worked out, so that it would fit together with the definitions of central banks determining which categories of deposits are covered effectively by their national regulatory instruments.

These controls would be macroeconomic in character. They need not interfere with the day-to-day functioning of these very efficient markets. Their aim would be to prevent new derailments. I feel that this is a key condition for maintaining microeconomic freedom in international credit markets.

While it is easy to point out this desirable direction for the international monetary system, it is also easy to see the undoubted difficulties of achieving the necessary improvements through international negotiations. A special difficulty, which has often been stressed, is to bring the smaller offshore centers within this scheme, as it would imply a certain limitation of their freedom to attract banking services by a minimum of regulatory and fiscal control. This advantage for these centers should not be exaggerated, however. The introduction of international reserve requirements would not by itself weaken their competitive position, because Eurocurrency liabilities are not subject to reserve requirements at the moment. It would probably make it easier to bring offshore centers into the system if the introduction of the two instruments to restrain and to stimulate international lending could be tied together.

Offering the insurance facility could be an inducement for all countries, especially also for offshore banking centers, to cooperate. The insurance facility should then only be made available to banks in a country and for debts of a country where the regulators would apply appropriate solvency ratios on a consolidated basis and would establish the Fund's reserve requirement on Eurocurrency liabilities. This would create a certain balance. Against the loss of part of their freedom not to regulate, countries would gain the protection of the insurance facility for their banks.

There is a timing dilemma here, however. The establishment of cooperative central bank restraint on the growth of international credit and of a Fund reserve requirement will be a difficult and time-consuming undertaking. This restraint is not needed in the short term. What is urgently needed now is the insurance facility. If, under the pressure of continuing debt problems, a sufficient political will to move in this direction were to develop, this dilemma could perhaps be resolved by starting the insurance facility on the basis of commitments in principle by participating central banks, to cooperate in an effective international mechanism to restrain international credit flows. If, after a certain period of negotiation and preparation, certain central banks nevertheless refused to participate in this system, their commercial banks could be excluded from further use of the insurance facility.

Further Development of the Fund

Urgent Needs

To enable the Fund to fulfill its financing tasks, which are so crucial in the present critical stage of the world economic and financial system, the most urgent need is, of course, the early ratification of the quota increases and augmentation of the GAB. Delay—or even rejection by the U.S. Congress—would expose the system to incredible risks. The result could be a real debt crisis, which would abort the world economic recovery and would cause enormous economic damage to both developed and developing countries.

But it is necessary to make the point that, even with the quota increase, the size of the Fund would remain far too small; and in coming years it would shrink again in comparison to world trade. A further increase in the Fund's resources would be a logical and necessary complement to an evolution in the direction of more controlled and better-balanced growth of international credit markets. If, in such a better-managed financial system, balance of payments equilibrium could not be so easily financed anymore through private credit markets, more official financing would have to be available; and if we want better and speedier adjustment, this financing should come from the Fund under appropriate policy conditions. The difficulties in which we find ourselves now have certainly been aggravated because the amount of financial assistance that the large borrowing countries could obtain from the Fund had become almost irrelevant in the total flow of their borrowing. The decision of a few years ago to multiply the percentage of quota that countries could draw on the Fund implicitly recognizes this difficulty; but it provides only a very temporary solution.

A second short-term aspect is the need to enlarge the official reserves of central banks. In a world where political and economic uncertainties have increased and where central banks—as we will see—may again have to play a larger role in stabilizing exchange rates, the size of international reserves should at least grow in parallel to world trade and financial flows. In recent years, this has not been the case. There is a strong argument, therefore, for a new allocation of SDRs.

Longer-Term Development

Let me now assume that the new international instruments and responsibilities, which I have suggested, are accepted and that they are entrusted to the Fund. This would, of course, mean an important increase in the influence of the Fund in the international financial system. This may frighten some national authorities and politicians, who often tend rather jealously to resist greater power for supranational institutions. But the attempt to keep to national sovereignty in the international monetary field results in impotence, leaving the international community without any means to control the enormous flow of international credit that is so crucial for world economic growth. Entrusting the Fund with certain urgently needed international monetary functions would merely fill a dangerous vacuum.

What further development could we then aim for in the longer term? I would hope that the role of the SDR could gradually be simplified, strengthened, and expanded by a series of moves that build logically on each other.

(1) To simplify the structure of the Fund and make it better understood, it could be based fully on the SDR, as Jacques J. Polak had set it out in 1979.[7] This would eliminate the complicated division into two Departments—the General Department and the SDR Department. The currencies in the General Department would be replaced by SDRs, and the quota limits on the Fund's resources would be replaced by acceptance limits for SDRs. This restructuring of the Fund would require an amendment of its Articles of Agreement.

(2) The role of the SDR could and should also be strengthened materially, so that the agreed aim of making it "the principal reserve asset in the international monetary system" could be brought closer. The major need here would be to give the official SDR market liquidity by allowing private institutions to hold them and trade in them. The SDR should become freely transferable. This would, of course, imply that the SDR interest rate has to be market determined; but with its interest rate already determined as a weighted average of interest rates of its five component currencies this need not pose serious problems. This move would make the SDR a more real, less abstract asset in the financial system. It would make it much more attractive as a reserve asset for central banks; and it would make intervention in SDRs possible. As Henry Wallich argued a few years ago, this would in itself "constitute a significant improvement in the international monetary system. It would limit the undesirable effects arising from the use of national currencies."[8] To achieve the transferability of SDRs, it may be necessary, as Peter Kenen has shown, to create a clearinghouse between private and official SDRs that would link them together. Otherwise, difficulties over the acceptance limits of central banks for SDRs might result.[9]

(3) The acceptance limits—replacing the present quota limitations—should be increased so that the financial basis of the Fund would be brought closer to its original proportion of world trade. If the SDR were to be freely usable in financial markets, higher acceptance limits

[7] J.J. Polak, *Thoughts on an International Monetary Fund Based Fully on the SDR*, IMF Pamphlet Series, No. 28 (Washington: International Monetary Fund, 1979).

[8] Henry C. Wallich, "The World Monetary System After Postponement of the Substitution Account," remarks to the HWWA-Institut für Wirtschaftsforschung (Hamburg), June 12, 1980.

[9] See Peter B. Kenen, "Use of the SDR to Supplement or Substitute for Other Means of Finance," in *International Money and Credit: The Policy Roles*, ed. by George M. von Furstenberg (Washington: International Monetary Fund, 1983), pp. 327–60.

would be less burdensome to central banks. In fact, as the SDR became a generally acceptable financial asset, many central banks might be ready to accept SDRs even beyond agreed acceptance obligations. Ultimately, the designation mechanism with its acceptance limits might disappear. The scale of the Fund's operations would then simply be decided by the Executive Board or by the Interim Committee.

(4) As the SDR would develop along these lines, becoming an attractive and generally usable international money, it would make sense to create an opportunity for central banks to consolidate their holdings of reserve currencies into SDRs. At this stage of international monetary development, a substitution account could succeed. Substitution on a sufficiently large scale would have two advantages. In the first place, this would eliminate or gradually reduce the additional destabilizing element of currency shifts in central bank reserves. But it would also, as Peter Kenen has argued, give the Fund a much greater scope for stabilizing the growth of international reserves by allocating or canceling SDRs. The Fund would acquire significant symmetrical influence over the supply of reserves (see footnote 9).

(5) Once the SDR would have developed sufficiently in this direction, it would be logical to have commercial banks meet their reserve requirements with the Fund by depositing official SDRs. This would open up further possibilities for the Fund to influence world financial markets by open market operations in SDRs.

Stabilizing Exchange Rates

Having in this way looked rather far into some possible and desirable future developments of the Fund's functions, we now have to return to the other unsatisfactory aspect of our international monetary system, namely, the instability of floating exchange rates.

If international control could bring about a reasonable stabilization of the growth of international credit and liquidity, as I have suggested, this could also have some stabilizing effects on exchange rates. Some connection between the rate of growth in international liquidity and anticipatory movements in and out of certain currencies seems plausible. In addition, variations in this rate of growth—which mostly consist of dollar liquidity—could be a factor pushing the dollar rate up or down. Rapid growth in available dollar liquidity could strengthen an inclination to diversify out of dollars into other currencies and vice versa. Thus, the fact that central banks' dollar reserves have shown practically no increase since 1980, while Eurocurrency lending has slowed down since 1981, could be an element in the strengthening of the dollar during the recent period.

But it is clear that this would be only one element in the complex causes behind exchange rate instability. Fundamental explanatory factors can be found both in the mechanisms of current account and of capital account equilibrium. Instability in the current account adjustment process arises, as is now rather widely recognized, for a number of reasons:

(1) Time lags in the adjustment of the import and export volumes can cause a cyclical movement of the exchange rate, comparable to fluctuations in some commodity markets where supply reacts with a time lag to price changes (for example, the so-called pig cycle).

(2) The short-term effect on the terms of trade, where import costs adjust more quickly than export prices, also has been a disequilibrating aspect in the short term (the so-called J-curve effect).

(3) Such an effect will also result if the adjustment in trade volumes is allowed to influence income levels.

The effects of exchange rate changes on the capital account are very dependent on expectations so that many psychological factors are involved. In this case, the equilibrium will be determined and brought about by a relationship between interest rates on claims denominated in different currencies that—at the margin—would balance the expected change in the exchange rate. McKinnon [10] has shown, however, that when central banks keep the increase in the money supply constant, a change in expectations leading to a shift in currency preferences could set off a destabilizing movement. The capital movement that results from this shift in preferences would have to bring the interest rate in the more attractive country to a lower level in order to re-establish equilibrium. But McKinnon has made it clear that this capital movement implies direct or indirect currency substitution. Foreign investors will collectively attempt to increase their holdings of liquid or of more long-term claims. In the last case,

[10] Ronald I. McKinnon, "Why Floating Exchange Rates Fail" (mimeographed, Working Papers in Economics No. E-83-12, Stanford, California: Stanford University, July 1983), and "Dollar Overvaluation Against the Yen and Mark in 1983: How to Coordinate Central Bank Policies" (mimeographed, Stanford, California: Stanford University, October 1983).

there will be an incipient tendency for longer-term interest rates to be pushed down. But then an unchanged liquidity preference of domestic investors would induce a shift by them to more liquid claims. The demand for money would therefore increase in both cases. If the central banks then refuse to accommodate this increase in the demand for money, interest rates will not fall and the exchange rate will continue to rise. This process will continue until expectations that the currency has to fall begin to compensate the continuing interest rate advantage of investments in the capital-importing country.

A mechanism like this seems indeed to have been functioning with respect to the dollar. The common explanation that it is the large U.S. budget deficit that keeps interest rates and the dollar high is insufficient. The fact that the rise of the dollar has continued so long shows that more capital is moving into the United States than is necessary to finance the gap between saving and investment, reflecting itself in the current account. There is clearly an increased preference for dollars, creating a capital flow that exceeds financing needs; that interest rates have not been coming down nevertheless can be explained because the Federal Reserve has refused to expand the money supply in response to the increased demand for it.

I need not take much time here to demonstrate that this instability of exchange rates between the main currencies is economically harmful. The exchange rate is the strategic price for all international transactions. Its economically meaningless fluctuations give erroneous direction to investment decisions and interfere seriously in the process of international resource allocation. They cause increased uncertainty, which reduces investment and growth, and they lead to strong protectionist pressures, which seriously endanger our open international trading system.

All this and the resulting desirability of creating a more stable exchange rate regime is now rather widely recognized. But how is this to be achieved?

Attempts by central banks to manage exchange rates by intervention have had little success and seem to have left the monetary authorities in a rather helpless position in face of overwhelming market movements.

It seems to me, nevertheless, that a coordinated strategy for stabilizing exchange rates can be developed on the basis of the analysis of the causes of instability which I have just indicated briefly.

In developing such a strategy, it would be necessary to distinguish between disturbances on the current account and on the capital account of the balance of payments. A disturbance on the current account should temporarily be financed in substantial part. This is desirable in order to prevent the exchange rate from moving too far during the initial period when the adjustment of trade volumes has not yet made itself felt. Official borrowing or lending can be used during this period; as Henry Wallich has suggested (see footnote 8), this could be combined with a correct functioning of market forces if the foreign exchange acquired by borrowing (or needed for lending) is fed regularly into the market. Alternatively, intervention on a sufficient scale of the "leaning against the wind" type could be used. If governments wish to screen their economies from the inflationary or deflationary effects of such an exchange rate disturbance, this intervention (or official financing) should be sterilized.

If the balance of payments disturbance originates in the capital account, however, the strategy should be different. Here, some adjustment in interest rates is necessary to restore equilibrium. To make this possible, the currency substitution that results from a disturbing capital flow has to be accommodated by monetary policy. This implies an increase in the money supply to meet the additional demand for money in the country receiving capital inflows—and vice versa in the capital-exporting country. In other words, what is needed here is coordinated unsterilized intervention: increases of the money supply in one country and decreases in the other, so that the shift in currency preferences is met, while the combined money supply of the countries involved remains within its target range.

This conclusion is a more specifically argued case of a more general conclusion of the Group of Thirty in its policy statement on *The Problem of Exchange Rates,* which stated that it would be sensible to introduce an element of flexibility in monetary targeting to enable countries to "operate at the upper or lower end of their target range depending, among other things, on what is happening to the exchange rate." [11]

A strategy along these lines could be strengthened and be given an international underpinning if governments with floating currencies would agree with the Fund on a target zone for their currencies.

[11] Group of Thirty, *The Problem of Exchange Rates: A Policy Statement* (New York, 1982), p. 6.

As was suggested in the "Guidelines for the Management of Floating Exchange Rates" that the Executive Directors of the Fund recommended to Fund members in June 1974, such target zones could from time to time be adjusted to changing circumstances.[12] Within it, central bank intervention should be of the "leaning against the wind" character. If exchange rates were to move outside this range, the guidelines would allow more aggressive intervention to bring them back within it.

In light of our present experience and of our analysis, this would, in general, not be sufficiently effective. Instead, a move of an exchange rate to the limits of the target range should trigger consultations about financing and adjustment if the deviation of the exchange rate has its origin in the current account, and about an adaptation of monetary policy in the case of capital account disequilibria. A logical form of this last adaptation would be substantial nonsterilized intervention.

Conclusion

We can conclude from these sometimes technical considerations that there are certainly promising approaches to overcoming the paradoxical difficulties which have confused us and have prevented effective action to improve the international monetary system. It is possible to stimulate bank lending now while building a system that can prevent a repetition of lending excesses in the future; and it would be possible to obtain greater stability of exchange rates by a coordinated strategy agreed with the Fund.

In general terms, the direction in which we have to move in coming years could be characterized as a move to a better balance between private markets and official international influence. Just as in national economies an effective monetary policy is a key condition for their satisfactory functioning, in the same way we need a minimum of international monetary management to create a climate in which our more and more integrated market-based international economy can continue to develop with satisfactory results for world economic welfare. We will only be able to maintain freedom for our greatly increased private financial flows if the power, the means, and the

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[12]International Monetary Fund, *Annual Report of the Executive Directors for the Fiscal Year Ended April 30, 1974* (Washington, 1974), pp. 112–16.

scope of our official monetary institutions—central banks and the Fund—are augmented in an adequate proportion to these private flows and are used in a cooperative manner to influence their size and to exercise a countervailing power where needed.

Before we can hope for success in a second Bretton Woods conference, these issues will have to be explored and discussed carefully between governments and the Fund so that the essential elements of a new consensus can be worked out. The critical juncture in which the world economy finds itself gives great urgency to this task; this is essential for the preservation of an open, free, and growing world economy.

* * *

MR. MARTIN: On behalf of the Per Jacobsson Foundation and on behalf of all those who are here today, I would like to express our heartfelt thanks to our speaker for his encouraging, constructive, and helpful remarks in this difficult field. Thank you very much.

Questions and Answers

Following the formal presentation, Mr. Witteveen answered written questions from the audience.

MR. WITTEVEEN: The first question reads: *Your insurance facility assumes that the problem of past debts is solved so that the facility merely has to cover new money needs. But should we assume that new money needs will be so large that their commercial funding is not possible? Hopefully, without new oil shocks, the developing countries' payments gap should be financeable on its own merits.*

One can always say what should be, but, as I understand it, there is a lot of net new financing needed for many developing countries. And, at the moment, the inclination of many commercial banks to provide it is very limited.

I think the problem of past debts is very closely related to this need for new financing. In many developing countries, it is largely a liquidity problem. These countries have been accustomed to regular amounts of net new bank loans; besides, for developing countries, it is normal—not abnormal to have a current account deficit. Therefore, if loans are suddenly cut off, a debt problem arises. So, I think that if these flows can continue, the problem of old debt will be much easier to solve; I'm afraid, however, that without appropriate measures these deficits will not be so easily financeable.

What effect does the deficit in the budget of the United States have on the present unsettled international monetary situation? Would elimination of this deficit obviate the need for structural international monetary reform?

I certainly think that the large U.S. budget deficit is one of the causes of the present situation because it has kept interest rates and the value of the dollar high and, therefore, has made the debt problem for developing countries—for debtor countries in general—more serious. But I don't think it is the only cause.

The present situation has arisen because of much more deep-seated difficulties. Besides, even if that budget problem were to be resolved suddenly, we would still need to improve the system.

You have outlined a number of technical solutions which with good international management can make our monetary system more stable. How can we achieve the political consensus among a series of national, not internationally minded governments to allow these solutions to be achieved?

That of course is the question that we and the governments have to face. But the first step is to make clear what needs to be done. That is the task for observers and for people who think about the system. The more urgent the need becomes and the clearer the difficulties and the dangers become, the more we can expect the governments to do what is required. That is certainly the task and the responsibility of governments.

Which agency would insure the banks against economic risk?

Banks certainly could not and should not be insured against all economic risks. They are enterprises, and they have to bear some risks. Banks are willing to bear risks, but not extraordinary risks, and they should have protection in cases where the system needs credits that they otherwise would not be inclined to give.

A lot of control would be brought about automatically if the SDR were to become the principal reserve asset. However, in order to make it marketable, a buyer of last resort is needed. Why can't the Fund change its Articles to become, perhaps together with the Bank for International Settlements, a buyer of last resort?

This is indeed one aspect of the development of the system in the longer term to which I have addressed myself and which could be worked out in somewhat greater detail. Of course, at the moment the buyers of last resort are the central banks—by the acceptance limits. They have to accept SDRs up to the acceptance limits, and to develop the SDR further, as I have indicated, one would also have to increase these acceptance limits.

If the U.S. Congress will not approve the quota increase and the general and special increases fail to become effective, would you favor borrowing by the Fund in the market from the public? And, if so, what should be the limits of such borrowings?

I would certainly be in favor of Fund borrowing in the market. The Group of Thirty argued quite some time ago in a paper that market borrowing by the Fund might be necessary and might be a good solution, even if only to bridge a temporary difficulty, a temporary shortage of funds that now indeed seems to be with us. I would still favor it very much. But, of course, such action requires the approval of governments.

The implementation of creative solutions to the system's problems requires time. In the meantime, what is to be done in the short run if default by a large borrower country causes a confidence crisis?

The first step will be to avoid such a crisis, and my suggestion, which I think is important for the short term, is to create an insurance facility for the new lending by commercial banks that the Fund considers necessary in the context of agreed adjustment programs.

Would you agree that some of the lending bankers have acted in an absolutely irresponsible manner? What reason should there be to believe that they will behave better in the future?

I would like to say something about that. It is easy now to accuse the banks of irresponsible action because of the debt problems of so many countries. But we need not go back very far to see that a few years ago when such lending was taking place almost everybody considered it to be a marvelous solution. Governments were very happy that the OPEC surplus was being recycled to developing countries as well as to other countries by the commercial banking system.

In 1974 when we were discussing the oil facility that I was proposing in the Fund, quite a number of governments argued that it was perhaps not necessary because the markets would cope with the surplus funds. We established an oil facility, and it was very useful for many countries, but, nevertheless, the major flows were indeed cycled through the market and through the banking system.

So, it is always easier to criticize after the fact than at the time when decisions are taken. And we also have to remember that perhaps it was not so clear at that time that a world economy characterized by strong growth and low real interest rates would suddenly change to very high real interest rates and recession followed by a still very slow recovery. Those developments were different from what most people expected.

To answer the second part of the question, in the first place, one learns from experience, and, in the second place, it is exactly for that reason that I proposed some cooperative system for restraining commercial bank lending if it again would rise too fast.

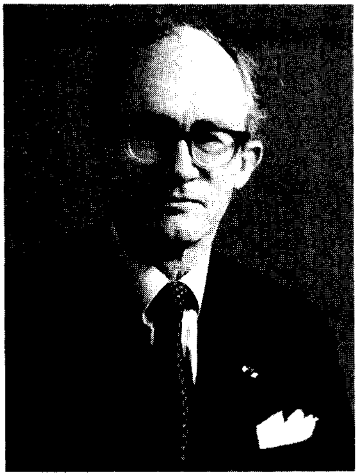
* * *

MR. SOUTHARD: I regret that we have used up all the time we had allotted for questions and answers in view of everyone's busy schedule and the need to allow some time for the reception being given by Mr. de Larosière, which is just about to begin and to which you are all invited.

I am sorry that there are a few other questions that we would have liked to have been able to answer. Clearly, Dr. Witteveen's talk, like Gerald Bouey's a year ago, requires a lot of study. We will publish the lecture soon, and all of you will be able to obtain it. If you are not on the mailing list of the Per Jacobsson Foundation and would like to receive a copy of the lecture, please send your name and address to the Per Jacobsson Foundation at the International Monetary Fund and we will see to it that you get a copy.

Thank you very much. This meeting of the Per Jacobsson Foundation is now adjourned.

Biography



H. Johannes Witteveen was born in 1921 in Zeist, the Netherlands. Following studies at the Netherlands School of Economics in Rotterdam, he accepted appointment in 1948 as Professor of Business Cycles and Economics at that institution.

During the years 1958–73, he served variously as a Member of Parliament in the First and Second Chambers and as Minister of Finance and First Deputy Prime Minister.

In 1973, he was appointed as the Managing Director of the International Monetary Fund, where he served until 1978.

Since 1978, Mr. Witteveen has held posts and directorships with a number of industrial and banking corporations, and he is at present the Chairman of the Consultative Group on International Economic and Monetary Affairs (Group of Thirty).

Mr. Witteveen is Commander in the Order of Orange-Nassau and in the Order of the Netherlands Lion.

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