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THE INTERNATIONAL MONETARY SYSTEM: SHOULD IT BE REFORMED?

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ABSTRACT

This paper addresses the question of reform of the international monetary system. It starts by identifying the sources of disenchantment with the performance of the present regime of floating exchange rates and by outlining the reasons for the lack of convergence of views about the characteristics of the desired system. A central theme in the discussion is that a reform of the monetary system without a fundamental change in macroeconomic policies may be harmful. The analysis proceeds by examining the broader issues and principles relevant for an evaluation of reform. The key questions are: what should be reformed, what are the costs of reform and when should the reform occur. In this context special attention is given to the "target-zones" proposal for exchange rate management. The paper concludes with the observation that a reform of the system should not be viewed as an instrument for crisis management dominated by short-term considerations, but rather should be guided by long-term perspective. It is argued that if the root cause of the current economic difficulties is fiscal imbalances in the world economy, then a drastic reform of the international monetary system (if one is needed) might better wait until nations restore a more sustainable course of fiscal management.

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A casual glance through the proceedings of past annual meetings of the American Economic Association reveals that in almost every year during the past twenty years presidents of the AEA have devoted at least one session to an examination of issues concerning the international monetary system. Prominent on the agenda has been the question of reform. How should the international monetary system be reformed so as to function more effectively? The premise underlying this question is that the international monetary system has failed and that it must be reformed by an institutional change. In what follows I present some skeptical notes on both the verdict on the failure of the system and on some proposals for reform, especially the target-zones proposal.

To set the stage it is worth noting that one of the main sources of disenchantments with the present monetary system has been the unpredictability of exchange rates. There has been nothing more confusing than reading through the ex-post journalistic explanations offered for the day-to-day changes in the U.S. dollar. For example, over the past few years we were told that "The dollar <u>fell</u> because the money supply grew faster than expected -- thereby generating inflationary expectations," but on another occasion we were told that "The dollar <u>rose</u> because the money supply grew faster than expected-thereby generating expectations that the Fed is likely to tighten up and raise interest rates." On another date we were told that "The dollar <u>fell</u> since the budget deficit exceeded previous forecasts -- thereby generating inflationary expectations on the belief that the Fed will have to monetize the deficit," but, on another occasion we were told that "The dollar <u>rose</u> since the budget deficit exceeded previous forecasts -- thereby generating expectations that government borrowing - needs will drive up interest rates since the Fed is be unlikely to give up its firm stance." On yet another day we were told that "The dollar <u>fell</u> since oil prices fell -- thereby hurting Mexico and other debt-ridden oil-producing countries whose bad fortune may bring about the collapse of important U.S. banks," but, on another occasion we were told that "The dollar rose since oil prices fell -- thereby helping the debt-ridden oil-consuming countries whose improved fortune will help the vulnerable position of important U.S. banks." More recently the dollar changed again, and this time the explanation was a bit more sophisticated "The dollar changed because the extent of the revision of the estimated GNP growth rate was smaller than the expected revision of previous forecasts of these estimates." One cannot but sympathize with the difficulties shared by newspaper reporters and financial analysts who feel obligated to come up with daily explanations for daily fluctuations of exchange rates, and one can only imagine the deep frustration that yielded the recent headline in the International Herald Tribune according to which "The dollar rose on no news."

The dismal performance of short-term forecasting does not reflect a lack of effort. Rather, it is an intrinsic characteristic of efficient asset markets. Difficulties in forecasting short-term indices of stock markets (like the Dow-Jones index) do not call however, for a reform of the way stock markets operate. For similar reasons one should not assess the performance of the international monetary system on the basis of short-term forecastability of exchange rates. This does not imply of course that the present monetary system is without faults or that it should not be reformed. It implies, however, that if a reform is warranted then it better be justified on different grounds.

A second noteworthy observation is that over the years both academics and policy makers have made numerous proposals for reform while, at the same time, the monetary system itself has been in a constant state of change. It evolved from the gold standard to paper money, from the Bretton Woods system to managed float. We also had the Gold Commission but stayed with floating rates and now attention is focused on target zones, with soft or hard margins.

In spite of the ongoing debate there seems to be little convergence of views about the characteristics of the desired system. This lack of convergence in my view does not reflect lack of effort. Rather, it reflects more fundamental factors that are unlikely to vanish over time. Several are noteworthy. First, participants in the debate have not shared the presumption concerning the relevant alternative to the system they promote. Thus, extreme promoters of fixed rates believe that the relevant choice is between a "good fix" and a "bad flex"; on the other hand, extreme promoters of flexible rates believe that the relevant choice is between a "bad fix" and a "good flex." As is obvious, if these are the alternative choices the outcomes are self-evident, for who would not prefer a "good fix" over a "bad flex?" And, by the same token, who would not prefer a "good flex" over a "bad fix?" In reality, however, the choices are much more complex and much less trivial since they may involve comparisons between a "good fix" and a "good flex" or, even more frequently, between a "bad fix" and a "bad flex." When these are the choices, one may expect lack of unanimity. Reasonable people may also differ in their assessments of which "good" system is more likely to gravitate toward its "bad" counterpart. Furthermore, the likelihood that a given "good" system would deteriorate and be transformed into its "bad" counterpart depends on the circumstances and, therefore, it is likely that some countries would be wise to choose greater fixity of rates while other countries would be equally wise to choose greater flexibility.

Second, there are different concepts of the "equilibrium" exchange rate and not all participants in the debate share the same concept. A trivial definition would identify the equilibrium rate as the one that is generated by the free operation of the market place. A more subtle definition emphasizes the <u>sustainability</u> of policies as the criterion for equilibrium. Accordingly, if for example, the current exchange rate reflects unsustainable budget deficits, then this rate is not viewed as an equilibrium rate even though it reflects equality between demand and supply in the market place. An even more subjective view emphasizes the <u>consequences</u> of the exchange rate as the ultimate criterion. Accordingly, if the exchange rate yields undesirable results in terms of growth, export, resource allocation, unemployment and the like, then this rate is not viewed as an equilibrium rate even though it emerges from the market place and reflects sustainable policies.

Third, different countries face different shocks. On purely theoretical grounds it is clear that the appropriate exchange-rate regime depends on the nature and origin of shocks. Are the shocks real or monetary? Are they induced by the private sector or by the public sector is their origin domestic or foreign? Are they permanent or transitory? The list of questions is long and circumstances vary across countries and over time.

Fourth, the cost of mistaken policies and the ability to correct errors differ across countries. They depend on the exchange-rate regime and on the structural characteristics of the economy. Countries differ from each other in the flexibility of their economic system (e.g., the degree of wage indexation, labor mobility, external and internal debt position) as well as in the flexibility of the policy making process (e.g. the speed by which fiscal and monetary policies can be assessed and modified).

Fifth, countries differ from each other according to the various criteria governing the choice of optimal currency areas. These criteria include the degree of openness of the economy, the size of the economy, the degree of commodity diversification, the degree of inflation rates among prospective members, the degree of capital mobility, the degree of other prevailing forms of integration (like custom unions), the degree of similarities of tax structures and other fiscal characteristics, and the degree of similarities of external and domestic monetary and real shocks.

Sixth, views differ about the functions of exchange rates in general and of market mechanisms in particular. On the one hand there are those who believe that exchange rates are just a nuisance, especially if they move, and anything that moves had better be stopped (one only wonders whether proponents of this view would also like to see greater fixity of stock market indices?). There are also those who, in spite of the meager evidence, advocate the bubble theory according to which exchange rates have "life of their own" unrelated to "fundamentals." On the other hand there are those who view exchange rates as an important gauge which provides valuable information about current as well as prospective policies. According to this view manipulating the exchange rate by intervention and blaming the volatility, unpredictability and misalignment on the monetary system makes as much sense as blaming the messenger for conveying bad news.

Finally, there are also different views about the advisability and effectiveness of foreign-exchange intervention. In spite of growing evidence that the effectiveness of sterilized intervention in exchange-rate management is very limited (at least as it operates through the portfolio-balance mechanism), there are those who are still ready to rely on such intervention. In principle, sterilized intervention can be effective by signalling to the market the intent of policy makers. Since the credibility, and thereby the effectiveness, of such signals, depend on the track record of past policies, circumstances differ across countries.

The foregoing arguments explain why views about the need for, and the desired characteristics of a reform are likely to differ across countries and are not likely to converge with the passage of time.

Has the system failed? It is clear that during the past decade foreign exchange markets have gone through great difficulties. In addition to the volatility and the unpredictability of exchange rates, there is the perception that real exchange rates have been misaligned, and that this misalignment has been costly in terms of resource allocation and general economic performance. The relevant question is whether these faults reflect deficiencies of the international monetary system or of macroeconomic policies? I believe that faulty policies, especially the lack of synchronization of fiscal policies in the U.S., West Germany and Japan, are at the root-cause of the misalignments. Reforming the monetary system without reforming the policies will not do any good and may in fact do harm by diverting attention from the root-cause of the problem to the monetary system.

There is also the view that the system has failed since it did not yield current-account balance among the major trading partners. Taken by itself, however, this should be viewed as one of the achievements of the monetary system. The ability to rely on international capital markets to smooth out consumption in spite of real shocks should not be viewed as a failure.

We may also wish to ask whether the United States could have carried out its highly successful disinflation policy of the early 1980s while committed to fixed exchange rates? I believe not! The key point that needs emphasis is that the volatility and the misalignment of exchange rates may not be the source of the difficulties but rather a manifestation of the prevailing package of macroeconomic policies. Fixing or manipulating the rates without introducing a significant change into the conduct of policies may not improve matters at all. It may amount to breaking the thermometer of a patient suffering from high fever instead of providing him with proper medication. The absence of the thermometer will only confuse matters and will reduce the information essential for policymaking. If volatile events and macropolicies are not allowed to be reflected in the foreign exchange market, they are likely to be transferred to, and reflected in, other markets (such as labor markets) where they cannot be dealt with in as efficient a manner.

The preceding argument ignores, however, one of the important characteristics of the gold-dollar system - the imposition of discipline. Accordingly, it could be argued that the obligation to peg the rate or to follow a predetermined intervention rule would alter fundamentally the conduct of policy by introducing discipline. This view, however, is questionable for two reasons. First, it could equally be argued that by being highly visible flexible exchange rates also impose discipline since current and (expected) future policies are immediately made transparent to both private and public sectors at home and abroad. Indeed, the G-5 Plaza agreement of September 1985 may be viewed as a manifestation of the disciplinary capabilities of flexible exchange rates. Furthermore, it may be argued that national governments are unlikely to adjust the conduct of domestic policies so as to be disciplined by the exchange rate regime. Rather, it is more reasonable to assume that the exchange rate regime is likely to adjust to whatever discipline national governments choose to have. It may be noted in passing that this is indeed one of the more potent arguments against the restoration of the gold standard. If governments were willing to follow policies consistent with the maintenance of a gold standard, then the gold standard itself would not be necessary; if, however, governments were not willing to follow such policies, then the introduction of the gold standard per se would not restore stability since, before long, the standard would have to be abandoned.

Webster's dictionary defines reform as an improvement and a removal of faults. How can anyone be against reform? The key questions, however, are <u>what</u> should be reformed, what are the <u>costs</u> of the reform and <u>when</u> should such reform be adopted. A prerequisite for target zones is that there be agreement on the approximate value of the equilibrium exchange rate, on the boundaries of the zones, and on the actions that must take place once the boundaries are reached. At the present such agreement is absent. Even if there is agreement on the "equilibrium" exchange rates one needs to specify in detail what happens if the boundaries are exceeded? It is not enough to say "push them back." We must decide which country should bear the burden of adjustment and which policy will effect that move -- monetary, fiscal, government spending, tax? Once this is recognized it becomes clear that the key difficulties may not lie in the formal structure of the present international monetary system but rather in the overall mix of macroeconomic policies.

Supporters of target zones say that it is just a matter of tactics whether one examines the system by looking through the exchange rate lens or through the global lens and that they prefer to focus on the exchange rate lens. I disagree. I believe that the difference between the two lenses is fundamental. It is not a matter of tactics, but is the difference between having a general framework and having a particular framework. It is the difference between patching up a hole here and forgetting that the dam is going to collapse there versus having a consistent set of policies. In principle the adoption of target zones could be acceptable if they encompassed the <u>entire</u> array of macroeconomic policies, including in particular fiscal policies. At present the diverging international positions of fiscal policies suggest that it is entirely unlikely that international agreement on such a sweeping reform is feasible. Most of the burden, therefore, is likely to fall on the instruments of monetary policy. As long as fiscal policies are misaligned, a "successful" targeting of the exchange rate by using monetary policies may exacerbate the departures from the optimal mix of fiscal and monetary policies and may be very costly in terms of the overall economic system.

An argument favoring target zones is that the very process of negotiations is likely to enhance the degree of international policy coordination. It must be noted, however, that successful coordination efforts have also occurred during the past decade (e.g., the U.S. dollar support package of November 1978, the Bonn economic summit of 1978 and most recently the G-5 agreement of September 1985). Further, it might be argued that coordination should not be complete, because the perception of independent monetary policy may be necessary for sustaining confidence that monetary policy will not be inflationary in the long run. In addition, there is the danger that the processs of negotiating target zones could produce dangerous frictions among the negotiating parties and could lead ultimately to a reduced level of coordination in this and other areas.

Every system must have a safety valve which allows some flexibility and prevents a crisis and collapse with every conflict. With misaligned fiscal policies and with monetary policies geared towards exchange-rate targeting, national governments may be forced to exercise their sovereignty by resorting to protectionistic trade policies -- to an even greater extent than has been the case under the present system of floating rates with independent monetary policy. The growing frustration with the efforts to reduce the U.S. fiscal deficit by conventional measures have brought about new desperate arguments for the adoption of protectionist measures like import surcharges. The danger with such recommendations is that they might receive the political support of two otherwise unrelated groups. They are likely to gain the support of the traditional advocates of protectionism who claim to defend local industry and workers from what they believe is foreign unfair competition. But, more dangerously, they may gain the support of those whose exclusive concern with the budget deficit leads them to support almost any policy that raises fiscal revenue. Import surcharges, once in place (even those surcharges that are adopted as "temporary measures") are hard to remove since, as George Stigler once remarked "a sustained policy that has real effects has many good friends." At the present there are very few measures whose long-term costs to the interdependent world economy may be as high as protectionist measures. Taxes on trade will hurt exports, and will restore inward looking economic isolationism instead of outward looking economic coordination. Protectionist measures will transmit the wrong signals to those developing countries that are still attempting to resist domestically popular pressures to default on their debt, and, further, they may ignite a trade war. This argument should be considered against the claim that by preventing misalignments of exchange rates target zones reduce the protectionist pressures. With misaligned fiscal policies the net effect of target zones for exchange rates, implemented through monetary policy, are not clear cut.

The key point made by proponents of target zones is that such a system encompasses the <u>best</u> of both worlds -- it posses the flexibility of the flexible exchange-rate regime as well as the stability of the fixed exchange-rate regime. The same logic could be used, however, to argue that this hybrid system encompasses the <u>worst</u> of both worlds -- it possess the instability of flexible rates and the unsustainability of fixed rates. For in contrast with fixed parities, the target zones are moving. As they move, how do we escape from the inherent difficulty of having the private sector speculate against governments? In the absence of an anchor what ensures credibility? How exactly are conflicts resolved? What ensures that the moving target zones do not increase turbulence in the foreign exchange market rather than reduce it?

A central feature of any operational monetary system must be a formal resolution of the so-called n-1 problem. We have n currencies and only n-1 independent exchange rates. We thus have one degree of freedom and its disposal must be explicitly specified. It takes two to tango and it takes one for intervention. The original Bretton Woods system allocated the degree of freedom to the United States which obliged itself to peg the price of gold at $35 an ounce; the other n-1 countries then committed themselves to peg their currencies to the U.S. dollar. A design of the international monetary system is not complete unless it provides an explicit resolution to this n-1 problem. Therefore, it is essential to ask how the various proposals, including those for target zones, deal with the extra degree of freedom.

As a general rule, a reform of the system should not viewed as an instrument for crisis management. The considerations appropriate for crisis management focus on <u>short-term</u> effectiveness. In contrast the considerations appropriate for designing the optimal monetary system should be governed by a <u>long-term</u> perspective. The two need not coincide and it is sensible to separate them. In the present context the short-term crisis concerns the fiscal imbalances in the world economy rather than the monetary system. To be sure, the existing international monetary system is not perfect and it might benefit from a face lift or even from a more drastic reform. But such a reform should better wait until nations restore a more sustainable course of fiscal management.

A reform of the international monetary system should be viewed as a constitutional change that should not be taken lightly. The success of a new monetary arrangement depends on the adoption of a consistent set of policy tools and on a reasonable understanding of the implications of each course of action. In these matters the cost of delaying the adoption of a new international monetary arrangement until its full implications are understood is likely to be small relative to the cost of a premature implementation. The various proposals for reform of the present international monetary system have many attractions. But since they are novel, prudence is clearly called for. More discussions and critical evaluations can be highly desirable. In view of this it may be a good place to conclude with a quote from John Maynard Keynes' remarks in his closing speech at the original Bretton Woods Conference held over 40 years ago. Speaking on the desirability of critical evaluations of the proposed system Keynes said: "I am greatly encouraged, I confess, by the critical, sceptical and even carping spirit in which our proceedings have been watched and welcomed in the outside world. How much better that our projects should <u>begin</u> in disillusion than that they should <u>end</u> in it!"